Create Your Own Hedge Fund

Increase Profits and Reduce Risk with ETFs and Options

MARK D. WOLFINGER

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This book is dedicated in loving memory to my parents, Betty and Khiva Wolfinger. They would have loved to see their son become an author.

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Preface

Everyone wants to make money in the stock market, and each individual has reasons for owning stocks. Whatever your motivation—saving for retirement, saving to provide a college education for your children or a home for your family, even trying to earn more money so you can enjoy the good life—making money via investing is the goal of millions of people all over the world.

Although everyone agrees that making money is the goal, not everyone agrees on the best way to accomplish that goal. This book introduces you to a twenty-first-century style of investing that combines the best aspects of two important investment tools: exchange traded funds (ETFs) and stock options. You will learn to hedge, or reduce the risk of owning stock.

Most investors who make their own investment decisions overestimate their results and, if asked, would say their methods produce market-beating results year after year. They are not exactly failing to tell the truth, because most *believe* they can (and should) consistently outperform the market. And if they didn't do especially well this past year or two, well, that's okay, for they *know* their performance during the next few years will more than compensate for any recent underperformance.

The truth is that individual investors, on average, consistently underperform the market. That's sad because many people love making those investment decisions and being actively involved with trading. If you currently make all your own investment decisions, this book shows you an alternative method for handling your investments—a method that reduces overall risk at the same time it increases your chances of beating the market. And for those who enjoy being active traders, this methodology is fun. There are decisions and trades to make every month, although you can modify the method to trade less frequently (every three or even every six months), if that's your preference.

A great many investors have neither the time nor the inclination to make their own investment decisions. They feel more comfortable depending on others, and there are many professional money managers eager to take their money and make those investment decisions. These investors, who ordinarily do meticulous research before spending money on a vacation, a car, or even a home computer, and who seek every opportunity to determine which product provides the best performance or which received the best reviews from consumers, often invest money based on information gleaned from advertisements that gloat over recent good performance. They place their future financial security entirely into the hands of people they haven't bothered to research thoroughly—specifically, mutual fund managers. The fund managers who do achieve above-average results advertise those results to a public eager to invest. Unfortunately, evidence shows that recent track records bear little resemblance to future results. It's impossible to predict in advance who the successful fund managers will be this (or any) year. But, no matter, there are millions of investors eager to throw billions of dollars at those fund managers. The question is: Do those managers perform any better than individual investors? Are they able to outperform the market year after year? We'll take at look at the evidence, but the short answer is no. They perform no better than individual investors, yet they are not bashful about charging fees to manage investor money.

The recent scandals involving after-hours trading and allowing favored customers to buy and sell shares without incurring fees that individual investors would have to pay make it even more unlikely that mutual fund managers can provide individual investors with the service they deserve. Fortunately, there are viable alternatives, and you don't have to accept those poor results any longer.

There are several ways a public investor can earn better returns than are available by entrusting hard-earned savings to professional mutual fund managers. One simple way is to invest in index funds. At least these funds make no attempt to beat the market; they are content to match the performance of the averages. With fewer commissions and no research, this management style results in significantly lower annual expenses for the fund, and the savings are passed on to the investor. Average performance is better than underperformance, and paying smaller fees is better than higher fees.

But indexing, by itself, is not the final answer. There is more an investor can do to enhance investment returns. This book shows how to accomplish that goal.

You will learn to choose an investment advisor who is entirely trustworthy and capable of handling all your investment decisions. That advisor follows the teachings of modern portfolio theory (MPT). That advisor builds a well-diversified portfolio of stock market investments and manages those investments without charging a fee. That advisor uses methods that increase the probability of beating the market averages and does so with a reduced chance of incurring losses. That's right: Enhanced earnings and reduced risk. So where do you find such an advisor? That's easy: Look in the mirror. You can make your own investment decisions. You can be your own fund manager.

There is no magic formula involved, nor some high-risk hocus-pocus. There are no promises of getting rich in a hurry. The success of this investment methodology is based on the steady growth of capital that comes from doing well on a consistent basis. It is based on combining two readily available investment tools into one cohesive strategy. Exchange traded funds, the modern version of the traditional mutual fund, and stock options are the tools used to manage your investment portfolio.

You'll learn why ETFs are a more efficient investment vehicle than traditional mutual funds for most individual investors. They have tax advantages, charge lower fees, and essentially match the performance of the market averages. No more paying fees for underperformance!

Options are a misunderstood investment tool. Options were designed to reduce investment risk, but too many investment advisors tell their customers that options are dangerous and should be used only by speculators. We'll clear up that misconception, and you'll learn to use options to both reduce risk and enhance profits.

By combining these two tools into one investment methodology, you essentially create and run your own hedge fund. And the best part is that it's not complicated. You can readily learn to manage your investments yourself, but if you are a busy professional who believes there is not enough time to intelligently make your own investment decisions, you can turn the whole process over to a broker or financial planner you trust to follow your instructions.

Many investors reaped rich rewards during the strong stock market of the late 1990s, but a large percentage of those investors gave back all those profits (and then some) during the ensuing bear market at the beginning of the new millennium. Many are searching for the elusive holy grail of investing, namely finding a way to consistently outperform the market averages with limited risk. This book shows those investors such a path to financial security. Investors are no longer forced to rely on mutual fund managers because they don't feel there is any alternative. The methods taught here require some effort, but the rewards are worth it.

Investing is not a game. It's a project that must be taken seriously, as your future financial independence is at stake. It requires an understanding of the risks and rewards of investing. Successful individual investors who make their own decisions devote a great deal of time and effort to avoid making bad decisions. Some spend countless hours poring over annual reports and 10-k filings in an effort to find companies that have the potential to earn great profits in the future (fundamental analysis). Others spend time with charts and graphs, attempting to use price and volume data to predict future stock prices (technical analysis). If you follow the methods taught here, you can be spared those hours of research. Individuals, on average, are not able to find those great companies, and unless you have a proven track record of consistently outperforming the stock market averages, it's less risky to own a diversified portfolio, such as those represented by ETFs. Those investments can be hedged with options, reducing risk even further.

The methodology taught in this book does not guarantee profits. But it does present an investing strategy that increases your chances of being a successful investor. It increases the odds that your portfolio outperforms the market averages on a consistent basis, *and* it reduces your overall investment risk. Those are not just idle claims, and statistical evidence is included to support those claims. The path to investment success discussed in this book uses neither fundamental nor technical analysis. The recommended strategy is one that you, an individual investor, can readily adopt for yourself.

That investment method involves:

- *Asset allocation:* Determine the portion of your assets to be invested in the stock market and in other asset classes, such as bonds, cash equivalents, real estate, collectibles, and so forth. The methods discussed here are limited to working with the funds allocated to investing in the stock markets of the world.
- *Diversification:* Using the teachings of modern portfolio theory, you build a portfolio of stock market investments. Building an appropriate, diversified portfolio (diversification reduces risk) is much easier to accomplish than you might believe. You'll learn to use the modern version of the traditional mutual fund, the exchange traded fund, as the backbone of your portfolio.
- *Stock options:* We'll explode the myth that options are dangerous. This versatile investment tool can be used conservatively and intelligently to enhance the performance of your stock market portfolio. You'll learn to adopt an easy-to-understand options strategy that both enhances performance and reduces risk even further.

The journey begins with a brief discussion of MPT—what it is, why it's relevant to you, and how you can use its teachings to compile a portfolio that provides two substantial benefits: reduced risk *and* a better return on your investment. We'll take a look at the record and examine how well individual investors and professional mutual fund managers have fared in their attempts to outperform the market. Then we'll move on to discuss how you can use modern mutual funds—but not traditional mutual funds—to achieve the goals of MPT. You'll learn why ETFs, or the twenty-first-century version of the traditional mutual fund, are superior to traditional funds and how you can use them to achieve your investment goals. Finally, you'll learn about the versatile investment tool: the stock option. After a primer for those unfamiliar with stock options, you'll see how to adopt either (or a combination) of two conservative options strategies to help you enhance your stock market success. We'll take time out to examine the historical evidence proving that these option strategies really do enhance investment profits and simultaneously reduce risk.

Have you heard that options are dangerous and only for speculators? Options are not dangerous, and, in fact, you'll learn to use them to reduce risk. You'll see how to combine the best qualities of stock options with the benefits of investing in ETFs to achieve a portfolio with the potential to outperform portfolios managed by professional money managers—and you won't have to pay professional money managers to achieve those results. Not only that, but your investment portfolio will be less volatile, reducing your stress level. You can expect to earn substantial profits when the market rallies, you'll love your profits when the markets are stagnant, and you'll lose less (and may even show a profit) when the markets decline.

You can easily learn to manage your own portfolio better and more efficiently than professional money managers. Instead of paying someone else to provide for your future financial security, you get to own and operate your own mutual fund—really a hedge fund.

If you are tired of paying excessive fees to others to (mis-)manage your money, it's time to make your own decisions. If you accept the fact (many do not) that it's difficult to beat the market averages, here's a method that greatly increases your chances to do so. If you love trading and want to be involved with the decision-making process, then this methodology is custom made for you. And if you are a financial planner, here's a method you can use to enhance the profits of your clients.

Those who currently invest in index funds understand the folly of attempting to beat the market by buying individual stocks or mutual funds. They can do even better by adopting the strategies taught in this book.

Each of you may even come to cherish the time you spend working on your investments.

Get ready to update your investment methodology.

Create Your Own Hedge Fund

PART I

Outperforming the Market

CHAPTER 1

Modern Portfolio Theory

People invest money in the stock market with one primary goal in mind: to earn a satisfactory return on that investment. Some consider investing to be a full-time occupation with the goal of earning enough to provide for their day-to-day living expenses on a continuing basis. Some will be retiring soon and must plan to begin using their investment nest egg to meet expenses. Others have a much longer time horizon and are planning 30 or 40 years into the future.

With such a variety of time frames and purposes, there is no single investment strategy that suits all investors. There is no single "best" portfolio of investments to own.

INDIVIDUAL INVESTORS

Many individual investors decide for themselves which specific stocks to own. Whether the buying decision is based on sound research into the fundamentals, including a thorough reading of the various financial reports issued by the company, or whether price history charts are studied in an effort to perform a thorough technical analysis, or whether an investment decision is based on a tip received from a stockbroker, bartender, chat room, or a talking head on CNBC or *Wall Street Week*, investors seldom consider their entire portfolio when making a new purchase. The buying decision is often based on investors' belief (hope) that some information has been uncovered—information not yet known to other investors—that will soon make the price of the newly purchased stock soar.

Some investors make investment decisions alone, shunning the advice of others. Some rely on the camaraderie of an investment club. Some listen to the advice of professionals before making the final decisions themselves. Some blindly follow the advice of a stock market advisory newsletter while others do everything their stockbrokers suggest. Regardless of the source of an investment idea, most individual investors never think twice about whether the new investment is suitable or whether it helps them achieve their overall investment goals. In fact, many have no overall objectives in mind and simply make new purchases to produce a portfolio based on chaos. Some investors are happy with their results, while others are not. Modern portfolio theory (MPT) teaches us that this is a poor way to invest. With so many investors accumulating stocks and building a portfolio in this haphazard manner, it's important to know: Are individual investors generally successful? The answer to this question is postponed until Chapter 2.

Investing in Mutual Funds

Many millions of other investors don't want to take the time or make the effort to choose their own stocks. Instead, they rely on financial professionals to make investment decisions for them. Some of these investors follow the advice of a guru who sells stock market advice for a fee (e.g., newsletters and advisory services), while others accept the investment advice of financial planners or stockbrokers. But the vast majority of these investors buy shares of mutual funds.

Mutual funds serve a great purpose. They allow investors to quickly own a diversified portfolio of stocks without being required to buy shares in each of the individual companies. This is especially important for small investors who lack the funds to own a properly diversified portfolio of stocks. It has been known for a long time that proper diversification is a strategy that reduces the risk of investing in the stock market. It's one of the cornerstones of MPT.

Having decided to buy shares of mutual funds, investors must rely on the ability of fund managers to make intelligent investment decisions and earn a good return on investor capital. Some investors make a careful study of mutual funds before selecting which to buy. They study how well mutual funds have performed in the past; they check out Morningstar's[1] rating on the funds, or they accept the advice of a stockbroker.[2] Some investors go further and choose funds that invest in the type of stocks they want to own. For example, some funds only buy stocks of large companies; others specialize by investing in smaller, growing companies. Some funds buy stocks for income (dividends); others buy stock for long-term growth. Some funds specialize in the companies in one specific industry (sector funds); others are more diversified. Some buy stocks in American companies; others invest in businesses from around the world. There are many mutual funds in existence, each with its own investment strategy, and the public investor can choose any of them.

Some who buy shares of mutual funds invest their money, close their eyes, and, placing their trust in the fund's managers, hope for the best. Others take the opposite approach and constantly monitor the performance of their funds and hop from one fund to another, chasing those with the best recent performance.

Most of those who invest in mutual funds would be better served if they had an understanding of how to construct a safer and better-performing investment portfolio on their own. Our goal is to show you, the individual investor, how to do just that.

Some investors are sophisticated enough to know how to avoid paying a sales commission (load) when buying funds; others pay that load, not knowing there is any alternative. The bottom line for the vast majority of mutual fund investors is that once the decision to buy a fund is made, no further thought goes into the process. They leave it to the fund management team to produce superior returns on their money. Over the years, most investors have been satisfied with this methodology, especially since the trend of the American stock market has been bullish over the long term.[3] With so many Americans relying on mutual funds to meet their investment objectives, two important questions must be considered: Are mutual fund investors generally successful? Are they well served by the managers of those funds? Let's postpone a discussion of the answer until Chapter 5.

MODERN PORTFOLIO THEORY

Investors seldom, if ever, consider their entire portfolio as anything but a collection of individual investments, regardless of whether those investments are individual stocks, mutual funds, or any of numerous other assets, such as bank certificates of deposit, bonds, or coin collections. Few consider whether adding a new investment to a portfolio affects the overall risk parameters of the portfolio, or whether it helps to diversify their holdings. Usually asset allocation is totally ignored. This is not a good thing.

There exists a large body of knowledge that has collectively become known as modern portfolio theory. MPT tells us that investors can successfully (and easily) use a scientific approach to compile an investment portfolio. It's worthwhile to make a brief study of this collection of knowledge because it contains ideas you can easily adopt to make your own investing more efficient and more profitable. One of the great benefits of

MPT is that it shows how to increase the expected profits *and* lower overall risk at the same time

MPT is concerned with the methods used to compile an investment portfolio and with the performance of that portfolio. Investors can easily earn the risk-free rate of return by purchasing U.S. Treasury bills.[4] But to earn more, investors must accept the fact that a certain amount of risk must be accepted. It's generally understood in the investment world that the greater the risk of an investment, the greater the potential reward. This must be true, or else no one would ever knowingly accept greater risk. It's important to point out that the term "risk" is usually considered to represent the chances of losing money from an investment. According to MPT, risk is much more than that; it's also a measure of how much the return on an investment varies from the expected return. Thus, risk is a measure of the uncertainly of the future.

The work of Harry M. Markowitz changed the way investment managers think, when he demonstrated that including certain classes of assets in a portfolio influenced not only the profit potential of that portfolio, but also its volatility, or the rate at which the value of a portfolio fluctuates.[5] The major conclusion of MPT that concerns our discussion is how to construct an investment portfolio that aims for higher profits with reduced risk.

Markowitz did the original work in this field, and others have made significant contributions.[6] Among those are Professors Sharpe, Cootner and Fama.[7] A good discussion of MPT can be found in the text authored by Rudd and Clasing.[8] The theory is not some obscure topic of interest only to academics, but is widely used in today's investment universe. Markowitz and Sharpe shared the Nobel Prize in economics in 1990 for their contributions to this field.[9]

The early development of MPT relied heavily on statistics, and the pioneering work is highly technical. Nevertheless, the basics of MPT can be explained in simple terms (the more complex math remains available for those readers interested in such details[10]). The discussion here is limited to explaining what MPT is, why it's important for today's investor to understand its basic teachings, and how you can easily build a portfolio based on its precepts.

Here is a simple summary of how MPT describes the thought process behind investing:

> *An investment is made in a security, or portfolio of securities, in anticipation of receiving a monetary reward. The expected reward is the average reward that results from holding the specific investment(s). Some years the return on the investment exceeds the expected return, and some years the return on the investment is less.*