Hedging: Managing potential outcomes in the market

You may have heard the phrase "hedging my bets" at some point in your life. People say this when they want one outcome, but are preparing a back up plan just in case. Hedging against negative events is common practice in investing as well.

While investments are typically made to take advantage of a positive situation, hedges are different. Investment managers, individual investors and corporations typically use a hedge in seeking to prevent or offset potential risks to their portfolios, such as inflation or a large drop in the market.

Simply put, investors use hedging to attempt to balance the risks of their portfolio.

What would an investor hedge against?
There are several types of risks that investors may hedge against, including inflation, currency, foreign exchange, market, price and political risk.

Hedging can be used as a way to guard against negative outcomes in the market.

What does a price hedge look like?

The decision

Concerned about the price of oil, a trucking company signs a contract to buy fuel for its fleet at today's prices rather than waiting until the summer season, when oil prices are typically higher.

The hedge

The decision to lock in today's price is a hedge against rising fuel prices. By locking in today's price for it's future fuel supply, this hedge helps the company keep costs down if the price of oil increases as expected.

The cost

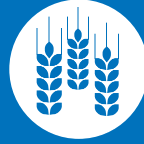
This decision also carries a potential cost, since the company could lose money if the price of oil falls instead of rising as expected.

For illustrative purposes only

What does a hedge against inflation look like?

The decision

Concerned that inflation may be on the rise, an investor calls his financial professional to discuss options to guard himself against the negative effects of inflation on his portfolio.



The hedge

In order to manage the risk of inflation, the financial professional suggests adding commodities to the investor's portfolio. Commodities have historically performed well in inflationary market environments, although past performance is no guarantee of future results.

The cost

The decision also carries a potential cost if there is no inflation. Commodities may not perform as expected and the investor's portfolio may lag the overall market.

For illustrative purposes only. Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Talk to your financial professional

While portfolio hedging is designed to curtail potential losses, it does, however, come at a price, since hedging may also limit potential profits. Investors should weigh the costs of the hedge against its benefits. For instance, if you're a long-term investor, is it worth the potential cost to hedge against a short-term risk?

No matter if your goal is to hedge against the risks of inflation or understand the basics of hedging, your financial professional can answer questions you may have about the best way to build your portfolio to meet your future needs.

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