Hedging Strategies In This World of QE

Investment Ideas for Short-term Hedging

We live in a unique time! Years of quantitative easing (QE) have created many distortions in the financial markets, such as the US$ 13 Trillion in negative yielding bonds. Negative yields are not a natural phenomenon in Finance. Instead, they are the result of a huge experiment by central bankers who have limited world experience, poor judgement, and a lack of common sense, albeit plenty of academic credential. The fact is that it is human nature to want things now rather than later. This is why interest rates (the price of money), should be positive. Negative interest rates turn that concept on its head. As Jim Grant, founder of *Grant's Interest Rate Observer*, explained: "We've seen low rates beget lower interest rates, and radical policy making beget more radical policy making, because it doesn't work."

Since Brexit, many clients have inquired about HEDGING. As a result, the topic of hedging portfolios was initially brought up in our Investment Committee. This unique world of QE has created a curious situation for hedging assets. An intellectual discussion on what makes a good hedge in today's world turned into an actionable list of investment ideas for short-term hedging, which we distinguish from our long-term intrinsic value driven portfolios. Long-term "intrinsic value" driven assets are those that protect against permanent capital loss and focus on generating positive real rates of return over a period of 5 years or more. We will discuss these long-term assets in our next Thinking Man piece.

The short-term hedges we identified include a list of assets that go up in price when there is a big "risk off" trade or a flight to quality. It is important to point out is that while these assets may prove to be successful hedges in the short-term, they do not generally offer longer term intrinsic value.

Short-term "Protector Portfolio": *investment ideas for minimizing short-term losses during uncertain and volatile periods of time*

➢ Government Bonds (TLT)

Government debt from the US, Japan, and Germany is often considered the ultimate safe haven by investors. In times of global turmoil, uncertainty, and market volatility, investors flock to assets backed by these developed governments, who they believe have little to no risk of default. Long duration government debt also tends to perform well during periods of weak growth, low inflation and accommodative monetary policy – all characteristics of the world we've been living in for the last few years, and will likely continue to live in. Among developed markets, US Treasury bond yields are most attractive and are likely to

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In this piece, we set forth several short-term hedging assets as investment ideas for minimizing short-term losses during uncertain and volatile periods of time. Such assets include government bonds, gold, safe haven currencies, gun manufacturer stocks, utility stocks, VXX, and SPX puts. While the assets in this "protector portfolio" make good short term hedges, they do not create value over the long term. In our next piece, we'll focus on our long term "intrinsic value" driven portfolios.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

ideas@bigsurpartners.com remain attractive in the foreseeable future. A potential investment vehicle to use for long duration treasury exposure is TLT.

- Gold (GLD)

Gold is often viewed as a hedge against certain extreme outcomes, simultaneously offering protection against unexpected inflation, currency debasement, financial system failures or crises, and geopolitical unrest. Demand for gold increases when there are "fear factors" in the market, therefore we like gold as a short-term, event related hedge. When economic or political uncertainty hits the markets, gold tends to rally, as we saw during the August market correction in 2015, then in January when the markets saw extreme volatility, and again, right after Brexit. In the longer term, we see gold as an inflation hedge, and not a dollar hedge. The dollar will be strong in this world; it has positive interest rates, even strong real rates against negative nominal rates. And in today's world, we don't have inflation. While we can buy gold for a short-term hedge, (using a low cost ETF like GLD), for the longer term, it isn't clear that there is any intrinsic value as gold provides neither yield nor cash flows.

- VIX (VXX)

VIX is the CBOE Volatility Index which shows the market's expectation of 30-day volatility. It is widely used a measure of market risk and is often referred to as the "investor fear gauge." Generally, the movements of VIX are inversely correlated to the broad market. This makes it a great hedge in times of market shocks. The data demonstrating VIX's positive performance during these times is overwhelming.

Sudden spikes or drops in the VIX tend to revert over time. Therefore, the VIX is a good instrument for hedging purposes to buy when it is trading within its lower range, especially when there is a potential volatility spike tied to a specific event in the future, such as an election. This is arguably the most predictable aspect of volatility and it happens because fear is cyclical. Fear and uncertainty don't last forever, and neither do periods of calm. Markets can be in a state of fear, not permanently but temporarily. When markets are calm, some future event will inevitably bring fear back into the market.

The VXX, one of the most highly correlated investment vehicles for trading the VIX, is beneath its 5-year low given the strong confidence in the global financial system. This creates an opportunity for buying risk protection at a very discounted price. The 52wk range for the VXX is \$9.78 to \$31.48, with a current price of \$9.80.

Another way to directly hedge a portfolio and take advantage of the low VIX is by purchasing S&P500 puts, in other words, buying options to short the S&P500 which is trading at record highs. Equities are trading at inflated multiples and many valuations can no longer be justified, therefore these puts can serve as a great hedge for any potential downturn, and they are dirt cheap. S&P500 one-month options have priced in a 20% chance of a 5% move over the past six years. Today, these put prices have dropped so low that they only price in a 12% probability of a 5% drawdown, nearly half.

- Save Haven Currencies (JPY) (SGD) (CHF)

Safe haven currencies are fundamentally described as those with ample liquidity, stable political systems, strong country finances, and stable economic backdrops. Arguably more relevant is that safe haven currencies are safe havens because investors define them as such and everyone knows that they will be flooded with flows in risk off environments. On top of that, there may be technical factors at play. The Japanese Yen (JPY), for example, has been the global funding currency of choice for investors, as the Japanese economy has been in deflation for over 20 years and it has offered the lowest interest rates in the world. This implies taking a short position in the yen and when the "risk off" trade is on, many of these trades are unwound, which generates an abrupt short covering rally. In the third week of August 2015, when the markets corrected (the S&P 500 was down 11.1%), JPY was up 4.6%. In the days after Brexit was announced, the Japanese yen was up 3.7%, while the US equity market was down 5.4%. Other safe havens include the Swiss Franc (CHF) – Switzerland has always been considered the safe haven of Europe, thanks to its neutrality, economic and political stability. Although not a major currency, The Singapore Dollar (SGD) has become the safety currency in Southeast Asia, and has rallied every time the markets are in "risk off" mode.

➢ Gun Manufacturers (RGR) (SWHC)

Gun manufacturers have experienced enormous growth over the last decade given the rise in fear and uncertainty felt by individuals in the face of violent terror acts, both domestically and abroad. Whenever one of these acts takes place, gun sales shoot up as people want to arm and protect themselves. They also shoot up during talks of tougher gun legislation. Gun sales have soared since the inauguration of the Obama administration: manufacturers Sturm & Ruger's (RGR) and Smith & Wesson's (SWHC) stock prices have risen 1,019% and 936%, respectively (cumulative returns). From 2009 to 2013, the number of guns produced in the U.S. rose 94%. Mass shootings and legislative decisions on guns are both extremely correlated to the stock prices of gun manufacturers, presenting hedging opportunities. The day after the deadliest mass shooting in U.S. history that claimed the lives of 49 people in Orlando, Smith & Wesson's shares rallied by 7%. The days after the San Bernardino and Paris tragedies showed notable increases as well. Few industries are as politically linked as gun manufacturers. The day after the death of Justice Scalia, the looming possibility that an anti-gun majority could sit on the bench of the Supreme Court sent the stock up 3%. This further demonstrates how the presidential election might shake the markets, potentially creating hedging opportunities.

➢ Utilities (XLU)

The utilities sector provides customers with basic modern day needs such as electricity, gas and water. Regardless of the economic climate, these are services that will always be in demand because these serve basic needs and because there is a lack of large scale alternatives or substitutions. Further ensuring this demand is the fact that most utilities are governed by rates fixed by regulatory bodies in the states that they operate in. Utilities stocks provide a good source of income through an average dividend yield of roughly 4%, higher than the current yield on both the S&P 500 Index and the Barclays U.S. Aggregate Bond Index – very attractive in this world of low yield. Given the defensive nature of the sector in combination with high dividend payments, utilities act as a strong hedge in the short-term. Clients can invest in a diversified basket of utilities through the ETF XLU. Investors should note that utilities can be negatively affected by interest rate hikes given their high rates of capital expenditures and debt levels.

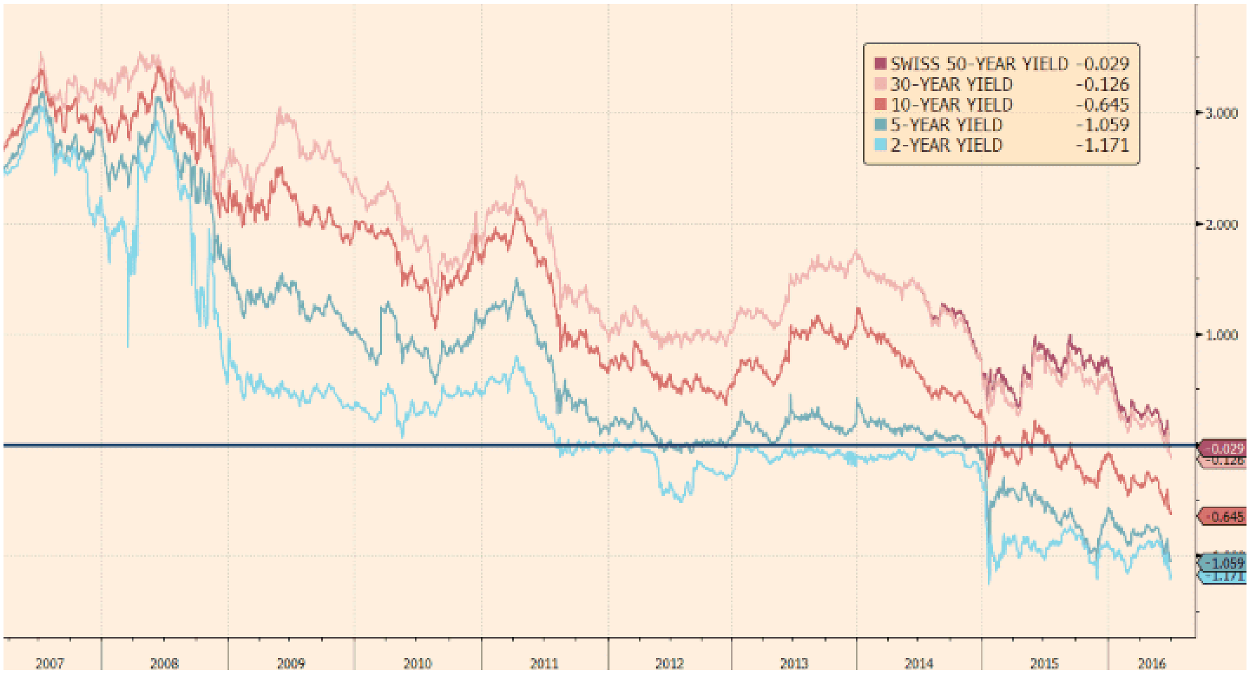
Conclusions

1. Interest rates are critical indicators in any economy. They help us measure the price of money, set investment hurdles and discount future cash flows. In today's world of QE, these prices are under the control of bureaucrats called central bankers, who are experimenting unlike any other time in recorded history. Today's rates lack common sense, as they should

be positive and in-line with the basic behavioral principle that humans will prefer $100 today over $100 tomorrow.

2. In this distorted world of QE, many hedging assets have the distinction of only serving as a good hedge in the short term, while not offering longer term intrinsic value. How can 10

Swiss Government Bond Yields – Negative Yields in All Maturities



Source: Financial Times, July 5, 2016

3. Using S&P500 puts is an effective way to hedge equity risk and simultaneously hedge other risky assets in a portfolio. In the world of QE, the VIX is at such a low level that it has also become quite a cheap way to hedge, while also offering good liquidity.

4. As central bankers are failing and are in the process of debasing their currency, Gold is a great hedge. It is also a promising hedge for European financial system crises and global geopolitical unrest.

5. Most investors are unwilling to budget, say, 10% of a portfolio for general hedging purposes, yet are willing to hedge for specific events with identifiable dates. This is what we define as event-driven hedging. The short-term hedges described in this paper proved successful during events such as Brexit and may serve the same purpose during the upcoming U.S. elections.

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