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Personal Finance

## Trade Like A Hedge Fund Master

Emily Lambert, 12.23.09, 10:50 AM EST

Simple techniques can limit losses--but at a cost.

Hedge funds are aggressive, leveraged, unregulated investment vehicles popular with high net-worth individuals. Or are they?

"That's the most ridiculous definition there is in the world," says Daniel Keegan, options instructor at [TheChicagoSchoolofTrading.com](#). A true hedge fund is one that hedges its bets, not one that doubles down, he says, echoing the industry's origins.

Keegan says some of the best hedging strategies are so simple that individual investors can carry them out from home and, if implemented correctly, they can protect a [nest egg](#) from suffering big losses.

Given his position at a school that's in the business of teaching people to trade, Keegan is obviously biased. Any discussion of hedging a stock portfolio should begin by noting that the cheapest and simplest way to protect yourself is simply to lighten up by, say, moving money you can't afford to lose into a [money market fund](#). Over the past decade, the Vanguard Intermediate-Term Treasury fund returned 6.7% annually, vs. the S&P 500's -1%.

That said, if you are convinced that the best place for a chunk of your savings is in stocks, there is a way to leave it there while limiting your downside: by buying options. Given the tools and market access available online these days, you don't have to be a [Goldman Sachs](#) ( [GS](#) - [news](#) - [people](#) ) or [Morgan Stanley](#) ( [MS](#) - [news](#) - [people](#) ) to do it either.

Like anything of value on Wall Street, they'll cost you. But in some cases, less than you might think. Keegan says the price of hedging falls as the market rises, and some hedges are getting cheaper as the market recovers from last year's rout.

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**Do you think the market will crash again? Share your thoughts in the Reader Comments section.**

Keegan recommends novices consider two strategies. One is to buy puts on the [S&P 500 index](#). Specifically, on the SPDR Trust, the exchange-traded fund representing all 500 of the stocks in the index, from [Abbott Laboratories](#) ( [ABT - news - people](#) ) to [Yahoo!](#) ( [YHOO - news - people](#) ).

A put gives you the right, but not the obligation, to sell at a specific price if the index falls. As with any other [insurance policy](#), your risk is limited to the cost of your premium. Recently, the SPDR Trust was trading at \$111.78 per share. You could pay \$23 for a put expiring the third Friday in January, or \$85 for a put expiring the third Friday in February, which would give you the right to sell 100 shares of the fund at \$100 per share. In other words, that would buy you insurance against a drop of 10% or in the market.

If you feel more strongly that the market is going to fall, another option is to buy calls on VIX futures, says Keegan. The VIX is the Chicago Board Options Exchange volatility index that, in simple terms, measures the volatility of the stocks in the S&P 500 index. The VIX tends to fall when the market rises and vice versa. When the market was tanking early this year, the VIX index hit 90. More recently it's been trading near 20.

The value of VIX options are based on the price of VIX futures. Recently you could pay \$285 to buy February VIX 25 calls (the right to buy the VIX when futures on the index rise to 25). Translation: if the market were to crash and the VIX futures contract expiring in February rose to 40, you'd be in the money by the difference between 40 and 25, or a total of 15. In dollar terms, your calls would be worth at least \$15 each, or \$1,500

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for the calls that you purchased, not counting commissions.

You pay for hedges, just like you'd pay for insurance. But hedges made with options expire regularly and need to be renewed, making them a continual cost.

"This is something you need to do consistently for it to pay off," Keegan says. If you have a stock portfolio and a strong conviction that the stock market is going to rise in the coming months, you may disagree.

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