



MONETARY & ECONOMIC REVIEW

Volume XXIV, No. 2

Winter 2009/2010

Hedging Your Stock and Mutual Funds

By Peter Georgantones and Timothy Roth

Editor's Note: Two futures specialists, Peter Georgantones and Timothy Roth of Investment Trading Services in the Minneapolis area, explain how to hedge your stock or mutual fund holdings that you may not control, such as those in a variable annuity, trust, 401-K, or pension plan of your employer. You may contact them at 1-800-757-0443 or by e-mail. See Information at the end of the article.

Futures contracts based on stock indices are known as stock index futures contracts. A stock index futures contract is a legal commitment to deliver or receive a fixed amount of a specific commodity or asset (in this case, the dollar value of the index) at a predetermined future date and price. A position in stock index futures is an efficient method of controlling a portfolio's exposure to stock market risk.

Whereas many futures contracts call for the physical delivery of a commodity or other asset, stock index futures contracts do not. Rather, when they expire or come to term they are settled in cash at the closing value of the spot or underlying index. This feature makes trading stock index futures less costly and more efficient. If an investor had to construct a proxy stock portfolio for delivery, the transaction costs, including commissions, would be quite high. Stock index futures contracts can serve both the investor/speculator and the hedger.

Although futures contracts based on stock indices offer many opportunities, they also carry the possibility for financial loss. A futures contract is a highly leveraged instrument, by which one can control, for a relatively small amount of good-faith deposit, a very valuable commodity or asset. As any reputable piece of futures literature points out, futures-market investments are not to be entered onto lightly and they are not for every investor. Before the introduction of stock index futures, portfolio managers faced with growing market volatility found it difficult to protect their portfolios.

The potential hedging uses of stock index futures are as varied as those of other commodity futures contracts. The short or selling hedge is generally used to protect against an expected decline in the price of a portfolio, in lieu of selling the stocks themselves. This can be accomplished through short futures or with put options. By its very definition, hedging is temporary. Futures contracts are typically used with the intent of offsetting the futures position prior to contract expiration – something that is very important from the viewpoint of a risk manager. Trading in commodity futures or options involves substantial risk of loss. Past results are not necessarily indicative of future results.

Investment Trading Services, Inc., 8030 Old cedar Avenue South, Suite 222, Bloomington, MN 55425.
Telephone: 952-854-1500, 800-757-0443. Fax: 952-854-1600. www.tradingservices.com E-mail:
its@tradingservices.com