

## >: How to Hedge With ETFs or Options

Thursday, March 1, 2007 / Chris Rowe

*Oh where, oh where has my widdle bull gone, oh where, oh where can it be? We used to be weaders, and now we are fawowers, oh where, ohwhere can it be?*

(Sorry, but these friken baby toys in my house are driving me crazy. Parents: Is this something that one can actually get used to?)

It seems to me, the times they are a'changin'. Global markets used to follow the lead of the US, but lately we seem to lag the others.

Either way, I'm happy because finally, I have interesting current events to talk about! I've been on this education kick, lately, since there hasn't been much going on that I considered to be impressive, but thank goodness, we've finally got some action! The Dow hasn't gone this long without a 2.5% correction in over 50 years, but now we're talkin'. This kind of market is the flavor I prefer, and I don't think I'm alone.

This is not even my definition of a correction. (Please keep in mind that I am writing this on Wednesday at 1:30 p.m. when the Dow is up 98.) In my book, a correction is something that is short, sharp and scary! But who's scared? Anybody? Beuler?

All I'm hearing as I call around to the different traders, or hedge funds, is the question of whether they should jump into the market today, tomorrow, or next week! Does that sound like a market that's fearful to you? This is nothing more than some long overdue excitement.

Does that mean I'm jumping in and converting to a bull? No. I'm never a bull or a bear. You probably know that I hedge my bets.

Now, I've been browsing a gazillion of your e-mail requests asking me for ways to profit from a downside move or how to at least hedge against it.

Whether you are a savvy trader or a conservative investor, you absolutely must understand how to profit from a downside move with minimum hassle. After all, the market does move **upand** down. Well, one way to either hedge your bullish stock portfolio or to simply profit from a downside move is to buy an Exchange Traded Fund called "*UltraShort QQQ ProShares*" (Symbol *QID* - Traded on AMEX.)

This ETF seeks daily investment results that correspond to twice (200%) the inverse of the daily performance of the NASDAQ-100 Index (Symbol: NDX.) Said differently, the NAV of the QID is calculated with a 2-1 inverse relationship with the NASDAQ 100 (NDX) on a daily basis. So basically, if the NASDAQ 100 is down 10%, this ETF should gain about 20%.

Now, you might notice, when you look at a quote on "QID," that the daily percentage change shown is actually based on the previous day's **4:15 p.m.** price. This is because the QID closes at **4:15p.m.** (as opposed to the general stock market which closes at 4:00,)

The NASDAQ 100's (NDX) percentage change however, is quoted based on the previous day's **4:00 p.m.** price. This is because the QID closes at **4:00** p.m. So if you compare the percentage gain of one to the percentage loss of the other, it may appear that there is NOT an 2-1 inverse relationship between QID and the NASDAQ 100, when in fact, there is.

For example: On Tuesday, the 4:00 price for "UltraShort QQQ ProShares - QID" showed a price of \$55.46. But the actual 4:15 close was \$54.90 (because stocks rose in after-hours trading.) So, although the NASDAQ 100 is up 0.81% (from its price at 4:00 Tuesday,) the QID *appears* to be down 2.43% *in reality*, it's down only 1.62% (from the previous day's 4:00 p.m. closing price.) Obviously the NASDAQ 100 0.81% compared to QID -1.62 is a 2-1 inverse relationship.

Confused? I'll keep it simple: When the NASDAQ 100 (Symbol: NDX) is up 10%, the QID is down 20%, and when the NASDAQ 100 is down 10%, QID is up 20%.

Taking a position in the QID is obviously a way of actually making a bet that the market moves lower. But what if you don't want to take a big bet against the market, or what if you don't want something like the QID to reduce your exposure to the next bull run?

Well, you can hedge yourself against a major disaster another way, but it isn't effective in a slight correction like the one we are witnessing... Something that I use as a hedge against all hell breaking loose (think 1987) and something that I am able to risk very little (dollar-wise) on are CBOE Volatility Index (Symbol: VIX) call options.

This is a completely different kind of hedge, as it's a hedge against *extreme conditions only*.

It won't necessarily trade lower based on the market's trading higher, but will trade lower based on time passing, since it's an option contract. And although you are risking 100%, as it's an option, you are committing a small amount as a "just-in-case" as opposed to an outright bet against the market.

When the market takes a beating, the VIX moves higher as it's considered to be the "fear gauge". CBOE Volatility Index (VIX) options don't act

like stock options, so you can't go into the trade expecting them to move up any time the VIX moves up. If you own April 12 call options, and the VIX moves 8 points higher from 12 to 20, it doesn't mean that the April 12 options will move up by 8 points, too.

Why? Because the VIX options are index options which are *European-style exercise* which means that they can only be SOLD *prior to expiration day* (not exercised.) They can only be exercised upon expiration. It is for this reason that VIX options trade based on where the traders think that the VIX will be on the option's actual expiration day (not where the VIX currently is.)

Since VIX tends to pop higher, and then move back down quickly, VIX option traders may not care that the VIX is up TODAY.

Am I talking over your head? Well, whether you understand options or not, it is absolutely imperative that you understand what the VIX is. I wrote two articles last May which helped readers of [The Tycoon Report](#) accurately predict the bottom of the 2006 correction. (Remember that you can always read past articles by going to [www.thetycoonreport.com](http://www.thetycoonreport.com).)

In these two articles ("[How you can see into the stock market's future](#)" and "[How you can see into the stock market's future - Part II](#)", ) I explain what the VIX is and how to use it. I told you to start nibbling on your strongest stocks when the VIX was at 20, and to go in and buy stocks more aggressively when the VIX gets to the mid-20s. Well, when the VIX topped out on June 13 at 23.81, the Dow Jones was within 13 points of the 2006 lows.

You definitely need to read both articles even if you already read them in May, as they are likely to help you make or save a large amount of money in this, or any market.

Like I said, the VIX, *aka* the CBOE volatility index, is considered to be a "fear gauge." It tracks options on the S&P500, and when people are fearful, S&P options become more expensive causing the VIX to move higher.

When the VIX is at levels below 20, it is associated with less stressful, complacent times in the markets. When the VIX is at levels greater than 30 (which is considered high,) it is associated with a large amount of volatility due to investor fear or uncertainty. The majority of the time, this is when you want to buy stocks.

On Tuesday, the Dow was down as much as 546 points, and the VIX only hit 19.01, and that's even as the phenomenon occurred at 3pm when the Dow dropped about 200 points almost instantly. Of course, this must have been a miscalculation of some sort, but it should have been pretty scary! The option floor traders that I spoke with seemed more confused than afraid.

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are poised to make money no matter which way the market trades. But that privilege is only for those who are willing to accept losses on some positions. If you focus on the big picture, you are able to make money no matter which way the market goes. The only trouble is that most individual investors don't have that ability.

I hope this article will help you make or save money in the future. Please let me know what you think by clicking below.

?Profit from the Trend?



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