



What is Hedging?

Protecting portfolios from uncertainty.



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1. INTRODUCTION

When it comes to investing, risk is unavoidable. As the old saying goes, “there’s no free lunch in finance.” Every investment carries some level of uncertainty, and the higher the perceived risk, the higher the return investors typically expect in compensation.

Risks can come in many forms, market risk, credit risk, interest rate risk, currency risk, and more. The real question for investors is not whether risk exists, but how best to manage it.

Broadly speaking, there are four key levers you can use to reduce the overall risk of your portfolio:

DIVERSIFICATION

Spreading investments across assets that are negative or lowly correlated to each other.

REBALANCING

Regularly adjusting your portfolio back to target allocations.

TACTICAL ASSET ALLOCATION

Making short-term shifts in asset classes based on market conditions.

HEDGING

Using derivatives to offset potential losses.

In this article, we’ll focus on hedging, and explore what it means, how it works, and why it matters for investors.

2. WHAT IS HEDGING?

The simplest way to understand hedging is to think of it as a form of insurance for your investments. Just as you insure your car to protect against unexpected accidents, you hedge your portfolio to protect against unexpected market losses.

When driving, you can’t predict exactly if or when an accident will happen, but if it does, you want the comfort of knowing you’re covered. Investing works the same way. We can’t know for certain how markets will move, but during severe negative downturns (often called “black swan” events, coined by Nassim Nicholas Taleb), we want to know that our investments are protected. This is what hedging does, it aims to protect or reduce the impact of negative events on your investment.

As shown in the chart, without hedging an investment in the S&P 500 would have suffered steep declines during market crashes, taking many years to recover back to previous levels (the red line).

Of course, just like car insurance has premiums, hedging also comes at a cost. You pay a premium to maintain that protection on your portfolio. This premium gives you protection to reduce potential losses on your portfolio but also slightly decreases your returns.



3. HOW DOES HEDGING WORK?

Hedging is essentially the action of protecting your investments. The tools investors use to do this are called derivatives.

A derivative is a financial contract whose value is linked to an underlying asset such as stocks, bonds, commodities, currencies, interest rates, or market indices.

Think of it as a bet on the future price of something. Because the value of the derivative is derived from that underlying asset, it allows investors to offset risks without necessarily selling the actual investment they hold.

4. TYPES OF DERIVATIVES

FUTURES CONTRACTS

A futures contract is an agreement to buy or sell an asset at a fixed price on a specific future date. These contracts are traded on regulated exchanges, which ensures transparency and standardized pricing. For example, if an investor believes the price of gold will rise, they might buy a gold futures contract to lock in today's lower price.

FORWARD CONTRACTS

A forward contract is similar to a future, but instead of being traded on an exchange, it is privately negotiated between two parties (known as "over-the-counter"). Which also forward contracts to be more customizable.

OPTIONS

An option gives the buyer the right, but not the obligation, to buy or sell an asset at a predetermined price before or on a certain date. To secure this right, the buyer pays a premium.



5. PROS AND CONS OF HEDGING

Every investment is different, and whether hedging makes sense depends on balancing the potential benefits against the costs involved.

ADVANTAGES

- Hedging with derivatives can serve as a short-term risk management tool for long-term investors.
- It allows investors to protect profits without having to sell their investments and trigger potential tax liabilities.
- Hedging can provide protection against various risks, such as commodity price swings, unexpected inflation, currency movements, or interest rate changes.
- Using listed derivatives makes hedging more liquid and transparent (due to daily pricing) and no counterparty credit risk.

DISADVANTAGES

- Hedging can be complex and involves costs that may reduce overall returns over time.
- Sometimes there is a mismatch between what you are trying to hedge and the derivative being used (e.g., hedging a specific stock with a broad index option).
- Timing is critical. Constantly paying for protection when markets are stable can erode returns unnecessarily.
- Hedging can become expensive during times of high market fear, when many investors are rushing to hedge, this can drive up the cost.

6. HEDGING STRATEGY CONSIDERATIONS

Hedging strategies are not one-size-fits-all. Hedging strategies are tailored to each investor's needs and goals. Some key consideration when deciding to hedge your portfolio:

LEVEL OF PROTECTION

Do you want full protection against extreme losses (such as "black swan" events), or are you comfortable absorbing some losses before the protection takes effect?

TRADE-OFF BETWEEN UPSIDE AND DOWNSIDE

Are you willing to give up part of your potential gains in exchange for downside protection, or would you prefer to pay a higher premium to keep your full upside potential?

TIME HORIZON

How long do you need the protection to last? The answer will depend on why you're hedging and how long you expect current market conditions to persist.

“Every smart investor knows:
risk managed is opportunity earned.”



7. CONCLUSION

Investing is inherently unpredictable, especially in the short term, and extreme “black swan” events are occurring more frequently than ever, often with severe consequences.

Hedging is an important risk management tool that can help investors protect their capital and secure desired outcomes. While it is not a replacement for core portfolio strategies such as strategic and tactical asset allocation, diversification, and rebalancing, it serves as a powerful complement that strengthens overall your portfolio’s resilience.

Knowing when to hedge, which derivatives to use, and how to navigate legislation and compliance requirements can be complex and overwhelming.

At GraySwan, we bring together deep technical expertise and a highly personalised approach, ensuring every client receives the guidance, attention, and insight needed to make informed

decisions with confidence. GraySwan is committed to safeguarding your wealth and helping you achieve your long-term investment goals.

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Contact GraySwan today and connect directly with Gregoire Theron and Duncan Theron. Collectively, they boast more than 50 years of investment experience and have been working together for more than 20 years as a dynamic and cohesive decision-making unit, supported by our highly experienced and stable investment team. Their insights can help you navigate complexity, manage risk, and invest with confidence.



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