RESEARCH MEMO

Buying Protection

A hedge is a purchase of certainty over a window, and almost all of the work is deciding how much and for how long

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One of a set of companion pieces to Options in a Portfolio, which establishes the framework this memo assumes. Illustrative throughout; no client facts are described. Nothing here is tax, legal, or investment advice. Options carry risk and are not suitable for every investor.

1 · SUMMARY OF CONCLUSIONS

Hedging is usually discussed as a strategy, which is the wrong category. A hedge is a purchase. The client buys a floor under a specified exposure, for a specified period, at a price quoted in advance, and the only question that matters is whether the certainty is worth what it costs.

Framing it as a strategy produces conversations about whether to hedge, which is nearly unanswerable in the abstract. Framing it as a purchase produces three answerable questions instead: what is being protected, how much of it, and until when. Most hedges that go wrong went wrong at one of those three, not at the choice of instrument.

> The most common failure is a hedge with no end date. A protective position put on against a specific worry and then left in place becomes a permanent cost, compounding quietly against a position it was supposed to protect temporarily. If the protection is wanted indefinitely, holding less of the asset is almost always cheaper than insuring all of it forever.

Findings

1 · The premium is the price of the certainty, not a cost of doing business. A hedge that costs 4% of position value over its life has set a floor that must be worth at least 4% to have been worth buying. That comparison is available before the trade and is skipped surprisingly often. (§2)

2 · Size from the loss that cannot be absorbed, not from the premium that can be afforded. Working forward from a budget produces a hedge sized by what was convenient. Working backward from the consequence produces one sized by what was needed, and frequently reveals that less protection is required than assumed. (§4)

3 · Partial hedging is usually correct. A fully hedged position is one the client no longer owns in any economic sense, and if that is the goal, selling is cleaner, cheaper, and permanent. Hedging exists for the cases where the client wants to keep the exposure and cannot accept its full downside over a particular stretch. (§4.2)

4 · The window is the decision most often skipped. Hedges driven by a catalyst have natural end dates: an earnings date, a lockup expiry, a pending transaction, a known spending need. Open-ended hedges have none, and they are the ones that become permanent. (§5)

5 · Protection is cheapest when it feels least necessary. Implied volatility rises as demand for protection rises, so a hedge bought into a decline can cost several times the same hedge bought before one. This is the single largest determinant of hedging cost and it is almost entirely a function of timing rather than skill. (§6)

Three standing rules

1. **Name the loss being protected against before looking at a strike.** “Protect this position” is not an instruction. “This position cannot be worth less than X when the tuition payment is due in September” is.
2. **Give every hedge an end date when it is put on.** Not a review date, an end date. A hedge that will be reassessed indefinitely has no end date.
3. **Compare the cost over the intended life against simply holding less.** If insuring the whole position for two years costs more than the loss avoided by trimming it today, the hedge is the expensive answer to a question that had a cheap one.

What would change these conclusions

- **A position that genuinely cannot be sold.** Lockups, insider restrictions, and control-person constraints remove the comparison in rule 3 entirely. Where selling is not available, hedging stops competing with anything and the analysis becomes pure cost minimization. That case is treated in the concentrated-position memos rather than here.
- **A tax-deferred or tax-exempt account.** The embedded gain is usually the reason the client will not sell. Remove it and most of the demand for hedging disappears with it, because the cheaper alternative is available again.
- **A sustained period of cheap volatility.** Everything in §6 is a statement about price. If protection were persistently cheap relative to the risk transferred, hedging would be warranted far more often and the bar in rule 3 would fall.
- **A packaged product that matches the needed shape.** A defined-outcome fund with the right buffer and the right window can deliver a similar result with no approval, no assignment, and no management. Where the shape fits, it often should be preferred.

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2 · WHAT A HEDGE ACTUALLY BUYS

A long put gives the holder the right to sell at a chosen price until a chosen date. That is the entire mechanism, and everything else in this memo is a consequence of it. Below that price, further decline belongs to whoever wrote the contract. Above it, the position behaves as it always did, less the premium paid.

Two things follow immediately. First, a hedge does not reduce risk in general; it transfers one specific risk over one specific period. A put expiring in March says nothing about April. Second, the transfer has a market price that is visible before committing, which makes hedging one of the few risk decisions in a portfolio that can be priced rather than argued about.

The useful reframing for a client conversation is insurance, and the analogy holds further than most analogies do. Nobody insures a house for more than it is worth, or for a peril that would not matter, or in perpetuity without noticing the premiums. The deductible is the gap between the current price and the strike. The term is the expiration. The premium is the premium. Clients who find options abstract usually find this version immediate.

Where the analogy breaks is worth stating too: unlike insurance, the hedge can be sold at any time for whatever the market will pay, and it retains value even if the feared event never happens. A put bought at a calm moment and sold into a frightened one can be closed at a gain without the underlying ever reaching the strike. That optionality is real, and it is the reason hedges are sometimes worth putting on even when the floor itself is unlikely to be reached.

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3 · THE INSTRUMENTS

Four structures cover nearly all of it. They differ in what they cost and in where the protection stops, and the second of those is where presentations are least careful.

3.1 The protective put

The baseline. Buy a put at the level below which losses become unacceptable. Protection is complete from that strike down to zero, for the life of the contract, and the cost is known at entry and cannot increase.

This is the cleanest instrument in the set and usually the most expensive. The expense is the reason the other three exist, and each of them is a way of paying less by accepting a worse version of the same protection.

3.2 The put spread

Buy the put, then sell a second put at a lower strike to offset part of the premium. The result costs materially less and protects a band rather than a floor.

The honest description is that the client is protected against a moderate decline and unprotected against a severe one. That is backwards relative to what most people want from a hedge, and it should be said plainly rather than buried in a payoff diagram. A put spread is appropriate where the realistic bad case is a drawdown of a known rough magnitude — a sector derating, a disappointing quarter — and inappropriate where the worry is a catastrophic single-name event, which is precisely the worry most concentrated holders have.

3.3 The collar

Fund the put by selling a call above the current price. The cash cost falls toward zero, and the payment is made in upside rather than in premium.

This moves the cost from a line item to an opportunity, which is why it is popular and why it is frequently mispresented as free. It is treated at length in the collar memo, including the tax consequences that often decide whether it was worth doing. The relevant point here is that a collar is a protective put with a different payment method, not a different kind of protection.

3.4 An index hedge against a single-name exposure

Buy puts on a broad index rather than on the position itself. Index options are liquid, spreads are tight, the contracts are standardized, and for a large portfolio this is often the only practical way to hedge at all.

The cost is basis risk, and for concentrated single-stock exposure the basis risk is usually the whole problem. An index hedge protects against the market falling. It does nothing about the company missing a quarter, losing a patent, or replacing a chief executive while the index is flat or up. For a client whose anxiety is about their one position rather than about equities generally, an index hedge insures against a risk they were not asking about and leaves the one they were.

Where it does fit: hedging broad portfolio exposure ahead of a known liquidity need, or reducing market beta across a diversified book. Those are genuine uses. Substituting it for single-name protection because it is cheaper is not.

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4 · HOW MUCH

4.1 Start from the consequence

The question that determines sizing is not how much protection the client wants, because the answer to that is always all of it, and not what premium they will tolerate, because that number is arbitrary. It is what outcome they cannot live with.

That outcome is usually concrete and usually smaller than the full position. A down payment due in eighteen months. A concentration that becomes genuinely dangerous below a certain portfolio weight. A retirement plan that works at one asset level and does not at another. Each of those defines a floor, and the floor defines the strike. Working in this direction also surfaces the cases where no hedge is needed, because the consequence turns out to be tolerable.

4.2 Hedge the part that matters

A client holding a position worth four times what their plan requires does not need all four parts protected. They need the part that the plan depends on. The remainder can decline without changing any decision they will make, and insuring it is paying to remove a risk that was not doing harm.

This is where the instinct to hedge the whole position does the most damage, because premium scales with the notional covered while the benefit does not. A hedge on the portion that matters can cost a fraction of a full hedge and deliver nearly all of the usable protection.

The general case: full hedging and outright selling converge. A position fully protected for an extended period has had its economics removed, and the client is holding a share certificate and paying for the privilege. If that is the desired state, selling achieves it permanently and without recurring cost. The reasons not to sell — embedded gain, a restriction, genuine conviction, a timing constraint — are exactly the reasons partial hedging exists, and each of them argues for protecting part rather than all.

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5 · FOR HOW LONG

Every hedge has a term, and the term should be chosen by the problem rather than by the option chain.

Catalyst-driven hedges are the straightforward case. A lockup expires on a date. Earnings land on a date. A transaction closes or fails in a window. A tuition payment, a house purchase, a tax bill arrives on a schedule. The protection should extend past the event and then stop, and the decision is a calendar question rather than a market one.

Open-ended hedges are the problem. The client is uneasy about a position, protection is put on, and nothing in the structure says when it ends. A six-month hedge rolled indefinitely is a recurring expense with no terminal date, and at a few percent per year it compounds against the position it is protecting. Over a long enough horizon the cumulative premium can exceed the decline that was feared.

A hedge with no end date is almost always a signal that the position should be smaller. The client is telling you, through their discomfort, that they are holding more of this than they want to hold. Protection converts that into an ongoing cost; trimming resolves it. Where selling is genuinely blocked, the hedge is the right answer — but then it is a response to the blockage rather than to the anxiety, and it should be sized and scheduled against whenever the blockage lifts.

The practical discipline is to write the end date down when the position is opened. Not a review date, which converts into an indefinite rolling program through ordinary inertia, but a date at which the protection expires and is not replaced absent a new reason.

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6 · WHEN TO PUT IT ON

The cost of protection depends on the level of implied volatility when it is purchased, and implied volatility rises when people want protection. That relationship is reliable, it is strongest in exactly the conditions that prompt clients to call, and it dominates almost every other cost consideration in hedging.

The consequence is uncomfortable. Hedges are cheap when nothing appears to be wrong and expensive once something is. A client who watches a position fall and then asks for protection is asking to buy insurance on a house that is already smoking, and the price reflects it. The same floor, bought a quarter earlier, might have cost a fraction as much.

Which makes hedging largely a planning activity rather than a reactive one. The hedges worth having are put on when they feel unnecessary, against events that are known to be coming, before the market has repriced the risk. Lockup expiries are visible years ahead. Earnings dates are published. Concentration builds gradually and visibly. In nearly every case where a hedge turns out to be valuable, the need was foreseeable well before it was urgent.

None of which means hedging after a decline is always wrong. A client who genuinely cannot absorb a further fall should protect against it regardless of what it costs, and telling them they missed the cheap window helps nobody. But the cost should be stated plainly, and the conversation should include the alternative — selling part of the position — because at elevated volatility that comparison shifts considerably toward selling.

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7 · WHEN NOT TO HEDGE

Three cases, and they account for a large share of the hedges that should not have been put on.

The position can simply be sold. No embedded gain worth managing, no restriction, no particular attachment. Selling is faster, cheaper, permanent, and requires no approval or ongoing management. A structure built here is complexity substituting for a decision.

The loss is affordable. A position that could fall by half without changing a single decision the client will make does not need insuring. Discomfort and consequence are different things, and the work is helping the client see which one they are experiencing.

The cost approaches the risk. If protecting a position over the intended horizon costs an appreciable fraction of the decline being insured against, the hedge has stopped being insurance and become a transfer of most of the feared loss into a certain one. There is no fixed threshold here and the comparison depends on the client's view of the odds — but it should be made explicitly, in dollars, before the structure is recommended rather than after.

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8 · HOW THE COMPANION MEMOS FIT

This memo covers hedging as a purpose. The framework it assumes is in the hub, and the adjacent purposes are treated separately.

- **Options in a Portfolio** — the framework memo: what the instrument set does, what the complexity actually consists of, and why it goes unused.

- **The Collar** — the single-position collar in full, including the straddle and holding-period consequences that frequently determine whether the structure was worth building.
- **Writing for income** — the other side of the same contracts, where the premium is received rather than paid.
- **Entry and exit** — using written options to take or leave a position on terms set in advance.

Framework memo prepared for illustrative purposes. Not tax, legal, or investment advice. Options carry risk and are not suitable for every investor; the standardized options disclosure document describes those risks in full. Constructive sale treatment, straddle treatment, and the holding-period consequences of hedging an appreciated position are legal determinations and should be confirmed with qualified counsel.