Alternatives Sector: Creating a hedge against the S&P500

What is an Inverse ETP?

Like all ETPs (exchange traded product) or ETFs (exchange traded funds), an inverse ETP is a derivative product that tracks the value of an underlying asset. Inverse ETPs specifically are designed to profit from a drop or reduction in price of the underlying asset. This is similar to shorting the underlying security, but the key difference is that an investor or mutual fund does not have to "short-sell" a security to gain this exposure. By law, certain mutual funds cannot take short positions and use inverse ETPs to engage in "regulatory arbitrage." This practice allows funds to gain the desired exposure with derivatives when "going short" or buying the asset is illegal. Two other uses of derivative products are speculation, and hedging. Speculation is used when the investor holds none of the underlying asset and this is inherently a risky position; a good example of a speculative position is buying a naked credit default swap. Since the BIF has large exposure to the US equities market, an inverse S&P 500 product is best suited to hedge the fund's current exposure.

Figure 1 – An instance of an inverse ETF with 3x leverage. It is utilized to hedge the downside of the SPY index

Strategically speaking, this hedge is comparable to buying insurance on the fund's current assets. Instead of viewing the cost and long-term variance of the ETP as an *alpha* generating asset, view the cost as an insurance premium. The purpose of this investment is to protect the fund against a bear market and unexpected market influencing events such as war or natural disaster.

AGGRESSIVE RATE INCREASES

Recently, the Federal Reserve approved of a 0.25-point rate hike, being the first since December of 2018. This marks a sharp turn from previous Fed decision making used to help bolster economic growth. Fed chairman Jerome Powell warned that the most recent rate hike is only the first and more are likely to occur

at the forthcoming meetings. Fed officials agree that aggressive action is necessary in order to curb inflation and keep the price of goods stable. Just this week, officials stated a 0.50-point rate increases is possible as soon as the next meeting as concerns over inflation continue to rise. A 0.50 rate increase hasn't been seen since 2000 and consecutive rate hikes are sure to leave investors on edge. From the meeting, we can expect the fed to tap into their $9 Trillion asset portfolio, and wall street believes this alongside rate increases may lead to a recession.

LOOMING RECESSION

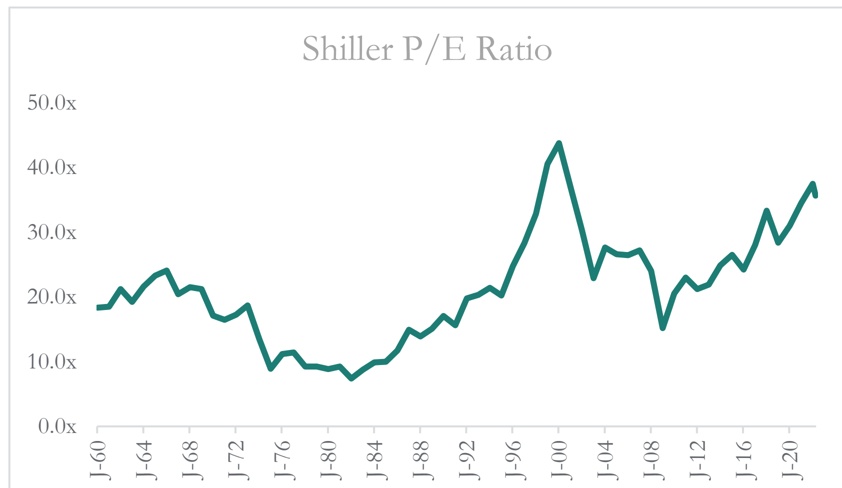
Consumer Price Index - Urban

According to Surveys ran by the Wall Street Journal, Economists have the probability of a recession occurring within the year at approximately 28%. This number is up almost 10% from January and up 15% year-over-year. Alongside rates and the Ukraine crisis, many Economists blame supply-chain shocks and tense labor market for the high probability. In Europe, the cost of energy is reaching all-time highs and China's recent endeavors to contain the virus has hindered trade. With many factors leading to a recession in place, aggressive action from the fed, although necessary, will only bolster economic fear.

GLOBAL UNCERTANITY

COVID-19 has caused a great deal of uncertainty, putting a strain on the economy as well as society at large. A major source of uncertainty is the potential spread of new variants of interest such as Omicron BA.2. Additionally, as central banks & governments sought to fight the economic impacts of the pandemic, disposable income as well as inflation rates have soared, sparking a great deal of uncertainty as well as efforts to mitigate inflationary factors. Due to significant inflation, the Fed has announced rate raises and had hawkish gesturing, causing many to be bearish. For over a decade, much of the Fed's

monetary policy has been dovish—keeping lending rates at historic lows and utilizing various quantitative easing initiatives to boost confidence and lower Treasury bond yields. As of the most recent Bank of America Global Fund Manager Survey, 60% of respondents expect a bear market, a notable shift from 30% the prior month. In addition to sentiment, valuation also comes into focus—begging the question if equities are overvalued. For example, the Shiller P/E ratio was at 40 when entering 2022, more than double the average for the past 150 years, 16.9.



PROSHARES SHORT S&P 500 (SH)

Proshares Short S&P 500 (SH) will be an effective hedge moving forward as it will decrease the risk in our portfolio and provide support throughout the summer and year end. Utilizing our access to Blackrock Aladdin software, a $5.0k allocation would decrease portfolio risk by 1% if large cap stock would fall. However, we believe an allocation of $25k or about 5% would be more beneficial as it would have more of an impact and decrease our risk even further.

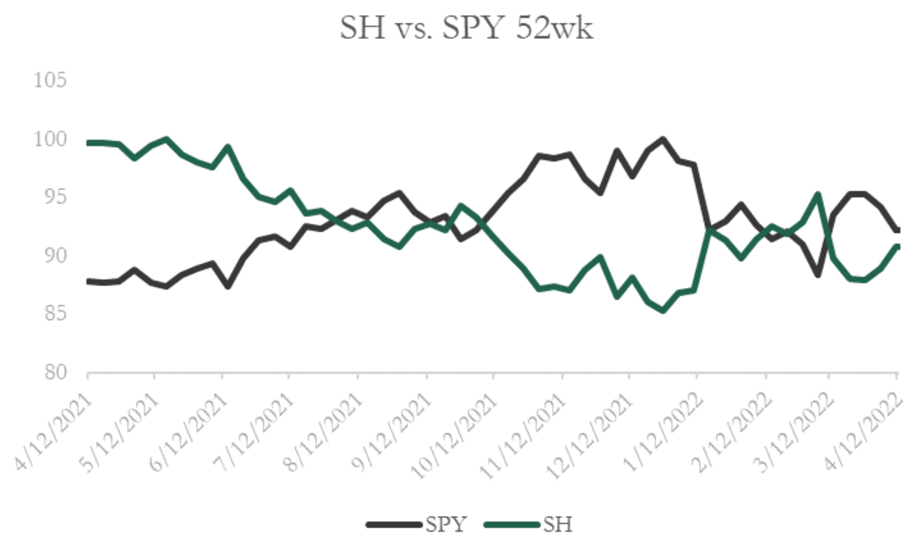


Figure 2 – Compares the SH ETP to the S&P 500. As an investment idea, we prefer to use an inverse ETP with no leverage to mitigate the premium paid for ETPs that contain embedded leverage

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