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RESEARCH · 08 | RISK MANAGEMENT

Hedging a client's position: what each choice costs

A concentrated stock, a portfolio that falls with the market, a client who cannot afford a bad year. Each calls for a different hedge, and each hedge has a price in premium, tax or return.

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Every hedge costs something. An option costs premium. A sale costs tax. A position held to avoid that tax keeps its risk. A good hedging conversation with a client starts with that cost and with the risk the client most wants to remove.

We built two tools for this: one for options overlays, and one for hedges without options, starting with concentrated positions. Here is what we learned building them.

Name the risk first

Three different risks often get the same name:

- **Concentration.** One stock is a large part of the account, often with a large gain.
- **Market risk.** The whole portfolio falls when the market falls.
- **Correlation.** The holdings look diversified but move together.

Each needs a different answer. An index put protects a portfolio that moves with the index. It does little for a single stock that does not.

Concentrated positions: compare the speeds of sale

For a client with one large, low-basis stock, the question is usually how fast to sell, and what each speed costs in tax. We compare five plans on the same account:

PLAN	SALE RULE
Hold	No sale. The comparison base
Sell all now	Sell every lot on day one

PLAN	SALE RULE
Equal steps	The same number of shares each year
Tax budget	Sell each year until that year's tax reaches a budget
Tax budget with harvest	As above, with losses harvested elsewhere paying part of the tax

The proceeds of each sale go into a direct index that leaves out the large stock. That index harvests losses, and those losses offset part of the gains from the sale. The client can reduce the position faster within the same tax budget.

Lot order matters. Each sale takes the highest-cost lots first, then long-term lots before short-term. This gives the smallest gain for each dollar sold.

Facts, not a single score

Before the plans, we show the facts that make a position a concern: its weight in the account, its unrealized gain, the tax of a sale today, its volatility against the rest of the account, and its correlation with the rest. Each fact is scored against a rule you can change. We do not add them into a single score, because the weight of each fact depends on the client.

Options overlays: know the price of protection

Options can protect, earn income, or both. Common overlays include covered calls, protective puts, collars, cash-secured puts, put-spread collars and short put spreads. The question for each is the same: what does it cost, and what does it leave unprotected?

On real prices in mid-2024, a one-year put about 6% below the price of an S&P 500 fund cost 2.67% of the position. That is the price of capping a one-year loss at about 6%, before the cost of the put. Some clients will pay that. Others will prefer a collar, which gives up some upside to pay for the put.

An index hedge works only on what moves with the index

When a stock has no liquid options, the usual answer is an index hedge sized by the stock's beta. That works only when the stock moves with the index. Over 2023 to 2026, several large defensive stocks had almost no correlation with the S&P 500. An index put would not have protected them. We show how much of each holding's movement the index explains, so you can see where an index hedge helps.

Check the tax before you place the trade

Options on a stock with a large gain can create tax problems:

- A collar with a narrow band can count as a constructive sale.
- A protective put can stop the holding period from growing toward long-term.

- Some covered calls are not "qualified" and can affect the holding period or dividend treatment.
- A new position bought within 30 days of a loss sale can be a wash sale.

We flag each of these on the trade ticket for you and the client's tax advisor to review.

Test with real prices, and check the data

A backtest is only as good as its prices. Stock prices are adjusted for splits, but historical option chains are not. One early backtest showed a protective put on a stock that had split earning $751,000. With the prices adjusted correctly, the result was $7,000. We now adjust every chain for splits and trade whole contracts at the real bid and ask.

How AdvisorXLS helps you hedge

- **Your client's account and lots.** Plans use real cost basis and purchase dates.
- **Plans that meet the client's limits.** Target weight, longest time, and a tax budget for each year.
- **Real option prices.** Backtests at real bid and ask, with whole contracts and round lots.
- **Tax flags on every trade.** For your review and the client's tax advisor.
- **You give the advice.** AdvisorXLS calculates the choices. You decide which one suits the client.

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