Diversification Beyond The Stock Market

Most retail investors only trade stocks, but there is an entire world of financial instruments that professional investors rely upon to diversify & hedge their risk.

The 3 most important to understand?

Options, Futures & Bonds

Options Overview

Options are financial derivatives which allow investors to speculate on the future price of an asset over a specified period of time. The 2 main types of options are **Puts & Calls**.

- **Puts** give investors the right to sell a stock at a certain price.
- **Calls** give investors the right to buy a stock at a certain price.
- The price that an option may execute at is known at the **Strike Price**.

For every option contract, there is a Buyer, a Seller, and an expiration date. The price of the option is determined by the how close the strike price is to the market price and how long until the option matures.

- If a stock's market price is lower than the strike price of a Call Option, then the option to buy the stock at a higher price is worthless at expiration.
- Similarly, if a stock's market price is higher than the strike price of a Put Option, why would you want to sell at a cheaper price?

The Different Types of Options

Call Options

Gives the buyer **the right to buy** the underlying asset at the strike price. Buy calls when you think underlying asset's value will increase

Put Options

Gives the buyer **the right to sell** the underlying asset at the strike price. Buy puts when you think underlying asset's value will decrease

Option

A kind of **derivative**-a financial contract that gives the investor **the right**--**not the obligation**--to buy or sell an asset by a certain date at a specified price (**strike price**)

US Options

can be exercised at any time **prior to expiration date**

European Options

can only be exercised **on expiration date**

How Options Made Mark Cuban Billions

After selling his company to Yahoo during the Dot Com Bubble, Mark Cuban thought that the technology market was overvalued. This was a problem because most of what Mark had been paid by Yahoo was in Yahoo's stock.

To diversify his risk, Mark invested in a massive options position to protect his $1.4 billion stake.

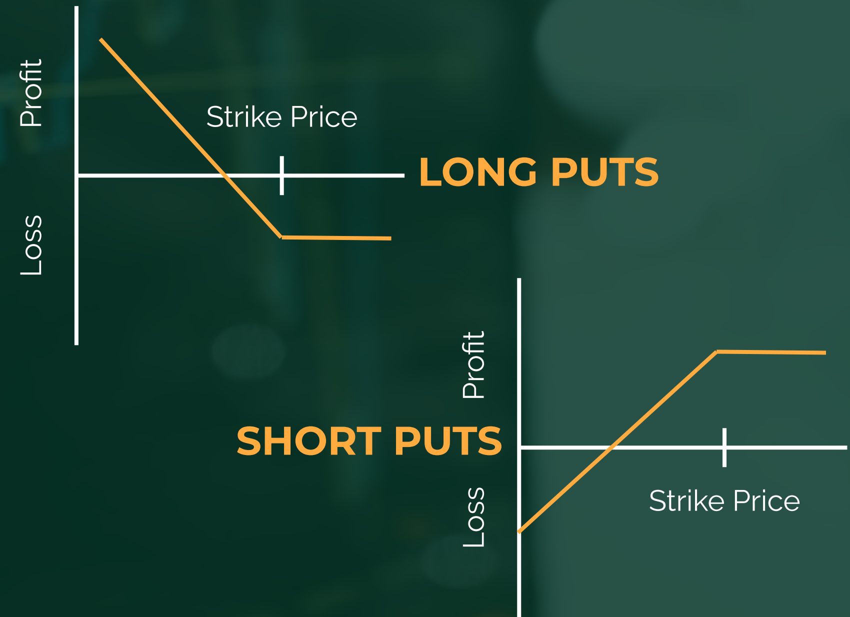
With Yahoo's share price at $95, Cuban sold Call Options with a strike price of $205 and used the proceeds of this sale to buy Put Options with a strike price of $85.

The options both had an expiration date of 3 years and meant that if Yahoo's stock plunged (which it did) Cuban's Put Options would be worth a fortune (they were!)

If Mark Cuban hadn't understood risk diversification, and the value of options, his stake in Yahoo would have been worth a lot less after 2000.

Mark Cuban
$4.4 Billion
Net Worth

Options Graphically



Reducing Risk Through Futures

A futures contract is an agreement between 2 parties to exchange an asset at a specified time in the future at a certain price. Unlike options, futures contracts are always exercised and do not expire with strike prices like options.

Futures are an essential part of the economy because they allow for producers & consumers of commodities to hedge the risk of price changes.

For instance, most large agriculture companies sell futures contracts to lock in prices for their crops. Additionally, nearly every airline uses oil futures to hedge against rising energy prices. How else can they sell you tickets for a flight in a year, if they don't know the price of the fuel?

The Good

Futures can be used to **hedge risk**, They remove uncertainty about the future price of an asset by locking in the price the investor will buy/sell at

The Bad

Futures are inherently **riskier than stocks and bonds**, as their prices depend on those of the underlying assets,

Example

If an oil producer wants to sell their oil and the spot price of oil today is $75/barrel and they anticipate oil prices to go down in the future, they can enter into a futures contract to sell their oil for $75/barrel in 1 year

Bonds Overview

Bonds are a financial instrument that are created when an investor makes a loan to a borrower, typically a corporation or government entity.

The borrower uses the capital finance operations or expenses and, based on the likelihood that the borrower can repay the loan, the investor charges an interest rate.

Key Terms:

Principal: The amount of capital initially lent to the borrower through the bond.

Maturity: The length of time until the principal is scheduled to be repaid

Face Value: The net present value of all future cash flows related to an existing bond. This is used to show how much the bond owner will receive through maturity.

Coupon: The dollar value of the periodic interest payment promised to bondholders (usually paid semiannually)

Coupon ($)=Coupon Rate x Face Value

Yield to Maturity: The rate of return assuming the investor holds the bond until its maturity date. It rises and falls depending on the market value of bond and number of payments left until maturity

Internal Rate of Return (IRR): The rate of return that sets the net present value of an investment equal to zero.

Other Asset Classes...

There is a whole world (literally) of things to invest in, including commodities, early-stage companies & real estate.

Although these investments are not typically paired with stocks to reduce risk, they do offer investors an opportunity to diversify their investments beyond equity markets.

Plus, if you wanted to invest in Facebook when it first started... you wouldn't be able to find it listed on the stock market.

The Importance of Commodities Markets

Commodities Market

Market for buying and selling natural resources or agricultural products. On the exchanges, commodities are traded through buying into a futures contract

Traders

Traders use commodity futures to speculate on future price movement. This is done based on projected change in supply and demand for the underlying asset

Producers

Producers of commoditized products sell or receive futures contracts as a hedge i.e they protect themselves against any fluctuation in availability/quality of their product

Investing in Early Stage Companies

Seed Funding
Funding: up to $3M
Angel investors provide funding to launch the product and build traction as revenue starts coming in

Series B and C
Funding: up to $3M
2nd and 3rd rounds of VC funding used to increase market share, build quality teams, and beat competitors

Pre-Seed Funding
Funding: $50K
Start-up owners alongside friends and family pull resources to get an operation off the ground

Series A
Funding: approx $15M
Venture capital funding brought in to scale the business after initial product market fit and revenue is established

IPO
Funding: up to $3M
Shares are offered to the general public for the first time and anyone can invest in the company at this point

Investing at earlier stages of the company comes with greater potential return as well as the opportunity to direct the future of the company. However, this also comes with greater risk.

The Big One: Commercial Real Estate

Purchase Commercial Property

The types of commercial real estate properties are retail, multi-family, industrial, and office. Each comes with different risk and return considerations

Collect Rental Payments

These rental payments from tenants represent periodic cash flows. These cash flows are factored into the valuation of the property as operating income

Sell for Capital Gain

To sell the property at a profit, investors often make improvements to the property or choose a location growing in popularity

Asset Allocation

So with all of these possible investments, how should one invest all of their money in time?

If you wouldn't invest all of your money in one stock, perhaps it doesn't make sense to invest all of your money in the stock market as a whole?

That's where asset allocation comes into play... And if you become good at it, you might become a portfolio manager at a hedge fund.

The 100 Rule

As you grow older, **your investment priorities should change because you are no longer able to ride out dips for as long and don't have as much time to wait**. It should shift towards safer and less risky assets.

One easy way to allocate your assets based on age is the Rule of 100. The rule states that you should **subtract your age from 100 and that is the percentage of money you should allocate into stocks.** The rest should be harbored in fixed-income investments that are considered safe. For example: if you were 25, you would be expected to invest 75% of your capital into the stock market and the rest into safe securities.

As you grow older you invest in less risky assets because you cannot afford to lose your invested capital, however, at a younger age, you can afford more volatility because long-term investing capitalizes upon time.

Rapunzl Investments LLC
http://www.rapunzlinvestments.com

Another Consideration: Taxes

Something to consider when investing is the **implication of taxes.** If you are trading stocks and are selling as fast as you are buying, you'll end up with a mess in taxes as each sale is accounted for in your income. **Short term capital gains taxes take effect for any asset that is held for less than a year. After an asset has been held for a year and is sold it is taxed as a long-term capital gain, which gets better tax treatment.**

Sometimes you can defer taxes through various means including **carrying over any loss from a previous year to reduce your gain, investing in an annuity or investing in stocks with your IRA.** This either reduces the taxes you owe or makes them due at a later date.

The key to staying in the market is that every time you trade a stock for a profit, you pay taxes on the gain. If you hold a stock for longer then you pay a lower tax rate called the capital gains tax. This is a critical reason why you should stay invested in the market long term.

Key Takeaways From This Module

CORE & FUNDAMENTALS

- There are various asset classes outside of stocks available to investors such as commodities and real estate.

APPLIED KNOWLEDGE

- You can define the level of risk you are comfortable with using tests like the 100 Rule
- There are many avenues to hedge against risk.

RELEVANCE FOR YOU

- Options are an interesting and potentially profitable asset for advanced investors.
- Diversification can protect your overall portfolio from short-term market fluctuations.
- There's a whole world of financial instruments that extend beyond the stock market so you can spread your risk!