Beating the S&P

Most investors are familiar with the S&P 500 Index, which represents this country's 500 largest publicly traded companies and has outperformed most international and domestic stock indexes and actively managed mutual funds. When attempting to evaluate the performance of one's stock portfolio, the S&P 500 is the most used benchmark.

Whenever an investment manager can beat the S&P 500 index they are lauded with praise. There are two ways to outperform the S&P 500 index. One way is to lose less during the down periods and the other is to make more than the index during the up periods. Although it is difficult to do on a consistent basis, one way to outperform during the up periods is to pick the best stocks. A more reliable way to outperform is to use leverage.

By using derivatives (put and call options) investors can guarantee outperformance during the up periods. However, this may result in underperformance during the down periods. One way to reduce losses during the down periods is by using hedging strategies which also utilize derivatives. In many cases, when you use hedging strategies you limit your upside.

However occasionally by using a combination of hedging strategies and leverage, you can beat the markets when they are up and lose less when they are down. Under current market conditions, most major banks like JP Morgan, Goldman Sachs, and Citibank offer notes linked to the S&P futures index that do just that.

The S&P 500 futures index has a very high correlation to the S&P 500 index. By using derivatives these banks can offer notes that track returns of the S&P 500 futures index that will pay twice the return of the index to the investor upon maturity. One would think that a strategy like this would be riskier than simply investing in the S&P 500. However, the bank notes also use hedging strategies, so the notes not only double the performance of S&P 500 futures index, but they also have 20% downside protection. At the end of the term, if the index is down, the first 20% of losses are eliminated.