JAY PESTRICHELLI • WAYNE FERBERT

"This book is an absolute must read for investors in today's markets. ...Don't just buy and hold—**Buy and Hedge!**"

—Joe Moglia, Chairman and former CEO, TD Ameritrade

BUY AND ~~HOLD~~ HEDGE

THE 5 IRON RULES FOR INVESTING OVER THE LONG TERM

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Buy and Hedge

The 5 Iron Rules for Investing Over the Long Term

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To my girls: Abby, Ella, Grace, and Linda
—Wayne

To my wife and son, Lynn and Zander
—Jay

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Foreword

Investing on your own can be intimidating. But remember when you were seven? So was learning to ride a bike. How did you feel about learning to drive? I remember when I moved to Chicago from Nebraska to start college; the thought of driving in Chicago traffic was mind-blowing. A few years later, I had a sales job in Chicago and was driving all over the city, focused on my next sales call and not the traffic. You could add flying for the first time, buying your first home, and a whole list of other things you have never done before. Or even if you *have* done them, you know you need to continue to learn to advance. You must play against a better racquetball player to improve, not against inferior opponents. The key to all these activities is that someone who knew what he or she was doing taught you the skill, and then you practiced it.

My family has been involved in the securities industry for more than 40 years. I grew up with it around the dining room table. I worked at our family company, Ameritrade, as a summer job and then for more than a decade. I am still on the board of directors. When I was the Chief Operating Officer for Ameritrade, Jay Pestrichelli and Wayne Ferbert worked for me. Jay oversaw our largest client segment and came to Ameritrade through one of our many acquisitions. Wayne ran our product development efforts. For years they were responsible for developing, building, and rolling out many of the products we delivered to our clients. They were a great team and always focused on putting the clients first. Wayne was so focused on his projects that, more than once, he forgot to change his bonus goals with me before the end of the bonus period when our priorities changed, to the detriment of his income. When Jay and Wayne approached me with the idea for this book, I was not surprised. Both had always been extremely interested in helping our clients learn how to invest more effectively.

The product of their collaboration is this book, *Buy and Hedge*, and it is a great one. I wish I had this book when I was learning to invest. It would have saved me a lot of money. It also would have been especially useful these last three or four years. At its simplest, this is a guide to how you can insure your portfolio against downturns in the market. That makes a tremendous amount of sense. We insure many of our large, important assets. We insure our car, our house, and even our lives. Why wouldn't we want to insure our nest eggs, retirement, savings—our securities investments?

I was educated at the University of Chicago, where Modern Portfolio Theory was born. The basic idea of Modern Portfolio Theory is diversification to reduce risk. This book takes that idea one step further. Yes, you want to diversify your investments, but you also want to hedge them against a downturn or insure them. Having been in the industry for so long, I have seen numerous ups and downs. The strategies that this book teaches are straightforward and essential to the self-directed, individual investor.

Two key themes are important in this book. The first, and most important, is discipline. Jay and Wayne state that the only successful investors they have seen are the ones with discipline, and I wholeheartedly agree. Discipline is the prerequisite for success. The individual investor who has a plan and follows it will have the best opportunity to acquire great returns. If you don't have a plan, or if you let your emotions influence your portfolio management decisions, your investment decisions will end up following the crowd. Following the crowd is a recipe for selling low and buying high and will lead to poor performance. The second key theme of this book is risk. Too many investors, including myself, fail to appreciate the times when we take on too much risk for the expected returns. This is, of course, understandable. As Jay and Wayne point out, it is relatively easy to measure the return, but getting a handle on the risk is something else entirely. The authors will teach you new ways to measure and monitor risk in your portfolio. This is truly a lost art in the world of retail investing. Too many other sources, and investment advisors, fail to even address it. The last few years have demonstrated this. You need to take risks to get a return, but too much risk leads to volatility in your portfolio and the potential for sleepless nights. Jay and Wayne help you think about how much risk you are taking and how to limit the volatility in your portfolio. This book is worth reading just for the methodology of thinking about risk.

Finally, this book is about not just theory but practical application. Although you might enjoy the intellectual stimulation that the market can provide, you invest to preserve and grow your capital. To help you reach your goals and implement their advice, the authors offer the Immutable Laws of Investing. These may seem like common sense, such as "After-tax returns are the ones that matter," but it is certainly worthwhile to articulate them and be reminded of them. Jay and Wayne also describe the Five Iron Rules (see, I told you—discipline!). These rules include how to hedge your investments, a detailed discussion of risk metrics, and how to calculate the risk in your portfolio. I guarantee you very few individual investors do this precisely. If you are one of the few who do, you will have a huge advantage over everyone else who doesn't. This part of the book alone is pure gold (which, if you haven't noticed, is going up like crazy!). In addition, the authors provide tactics and advanced tactics to make it all work. Have you used a married put before? What about a collar or a diagonal spread? One of the best features of their strategy is that you can implement it gradually, one position at a time if you like, and get a feel for how to use options to hedge a stock or ETF.

I wrote this foreword in August 2011 after one of the most volatile weeks the market had seen in years. This is a great reminder of why when we buy, we must hedge. With the markets becoming more unpredictable and more difficult to navigate, a book like this gives you the tools to succeed. Jay and Wayne are instructors who know what they are doing, and they can guide you through the process. Then it will be up to you to practice and gain experience. This is not a "get rich quick" book. You won't find any stock recommendations here. You will not find yourself asking, "If these guys are so smart, why don't they just do it instead of writing a book?" In fact, they *are* doing just what they explain in this book. And so are institutional investors. Now, the instruments are available to everyone, and the authors provide this how-to manual to teach you how to use them. In all, this is a must-read for the self-directed, individual investor. If you are a beginner, this book will introduce you to concepts you may never have considered in a straightforward, easy-to-understand manner. Even if you have been investing for yourself for years, you will still find the discussion of risk and the advanced tactics enlightening. *Buy and Hedge* is a great resource that you will consult time and again as you master each tactic. Enjoy reading it. I wish you the best with managing your portfolio. Remember, nobody is more interested in how you do than you are—and now you have the tools to be successful.

—Pete Ricketts, TD Ameritrade Board member
Chicago Cubs Board member
Former COO, Ameritrade

Acknowledgments

First and foremost, we want to thank our families for supporting us through our efforts to write this book and launch our new business. Our families worked around our schedule, and we appreciate it. Thank you, Lynn and Linda. And thank you, Zander, Abby, Ella, and Grace!

In creating the Buy and Hedge methodology, we routinely sought the opinions of our former colleagues at TD Ameritrade. The list is long, but we'd like to call out Mick Brokaw, Felix Davidson, Don Elliott, Bryce Engel, Joe Faber, Asiff Hirji, James Kostulias, Dave Lambert, Mike McGrath, Pete Ricketts, Matt Sadowsky, and Bill Wymer.

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Wayne would like to thank his parents for instilling in him a passion for learning that includes a shared appetite for reading.

Jay would like to thank his parents for teaching him the value of a strong work ethic and the power of an entrepreneurial spirit.

A wise man once said, "All a man has is his name and his word."

We want to thank our parents for teaching us how to properly honor our family name. And we thank our wives and children, who keep us true to our word. This wouldn't be possible without all of their encouragement.

About the Authors

For years, Wayne and Jay partnered at TD Ameritrade to launch innovative new products for its online clients. Today, Wayne and Jay have left TD Ameritrade to work with clients on a more personal level. Meeting your personal life goals requires you to meet your financial goals. This book is your key to meeting your financial goals.

Wayne Ferbert is a cofounder and principal of ZEGA Financial, LLC, a Registered Investment Advisor. He has spent his entire 17-year career in financial services, with 10 of them in the online brokerage segment with TD Ameritrade. In addition to managing business development as a member of the Senior Operating Committee at Ameritrade, which included M&A and market research, he ran product development. Prior to Ameritrade, he worked in planning and analysis roles at a Fortune 500 insurance firm and then a Fortune 500 bank. Wayne has an MBA in finance from Loyola University (Maryland) and a BSBA in finance from Bucknell University. He has his series 65 license. He resides in Ellicott City, Maryland, with his family. He has three daughters, ages 6, 8, and 9, and coaches their soccer team.

Jay Pestrichelli is a cofounder and principal of ZEGA Financial, LLC, a Registered Investment Advisor. He has 20 years of experience in business management, with 12 years in the online brokerage field with TD Ameritrade and Datek Online. As manager of the Active Trading business, he helped drive it to become number one in trade volume of U.S. brokers. During that time he was a regular contributor as a subject matter expert on CNBC's *Fast Money*, provided video interviews for CNN, and has been regularly quoted in publications such as *The Wall Street Journal* and *SmartMoney*. Licenses include series 7, 63, 65, 24, 4, and 3. Jay resides in Omaha, Nebraska, with his wife, Lynn, and son, Zander.

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Introduction

Join the authors on a brief but instructional journey back in time—but not too far back. Think about the year 2008. More specifically, think about your investment portfolio in 2008. Warning: This journey might be upsetting and/or emotionally painful. If you are like most investors, your portfolio suffered losses that were historic in size and scope. Believe me, we are reluctant to take you on this journey. After all, this is the first paragraph of the first chapter of the first book we have ever written. Putting you in a bad mood in the first paragraph is a little risky. But we hope this exercise will prove enlightening.

Next, think about the investment destruction that continued through early 2009. Unbelievably, the markets sank to even lower lows. Along with these new market lows came historically high market volatility. Respected financial institutions were on the brink of failure. Every day was a new adventure in the market. Finally, mercifully, the markets recovered sharply in mid-2009, and they have been on a steady rise in the two years since.

Consider for a moment the investment climate back in the fall of 2008. The market crash was precipitous and calamitous. Think about the investment decisions you faced with your portfolio. If you are like most American investors, you thought about doing one or two of the following:

- Curling into the fetal position and hoping it would all go away
- Calling your investment adviser and screaming at him to do something
- Selling everything
- Looking for ways to find any tax advantages from your investment losses

For 90% of investor households in this country, one or several of these decisions were an implicit or explicit outcome of the 2008–2009 market collapse. But of these four actions, the only one that was even modestly productive was the last one. At least the investor who looked for tax efficiency from the losses might have saved himself a bit of money. But it's hard to save on taxes when you don't have any gains to offset the losses. You can at least admire the person who tried to find tax efficiency for his "glass half-full" attitude.

The other investment options would have been counterproductive. An investor who runs and hides from his portfolio might as well dismiss any chance he has for achieving his investment goals. Screaming at your adviser won't help, especially because he owns some of the responsibility for your portfolio's poor performance. Maybe yelling at him made you feel better. But did it make your portfolio perform better?

Last, selling everything in your portfolio is not a long-term solution. Pulling your money out of the market might have made you feel better in the short term. In fact, you might even have missed the continued market declines through early 2009 if you liquidated your portfolio right after the crash in September/October 2008. But did you get your portfolio reinvested in 2009 in time to enjoy the sharp reversal in the market? You probably didn't. Timing the market is a difficult proposition. The best traders in the world time the market—and the data says that fewer than half of them succeed. Is that the portfolio strategy you want to rely on? Always being right about timing the market?

The authors promise this painful journey is almost over. We have one last question for you to consider in light of the recent stock market performance. Do you think the recent activity, volatility, and turmoil in the market are the new normal? Or do you think we just survived the equivalent of the market's 100-year flood? Or do you think the answer lies somewhere in between?

If you think we just survived the 100-year flood, this book isn't for you. You can invest your money in the broad markets and sit back and wait for it to appreciate. You can put this book down. And, by the way, good luck!

If you think the market has the potential for significant turmoil and volatility, this book fits you like a glove. Even if you just think that the markets are uncertain, and you worry that it is possible that this is the new normal, this book will work for you. If you are just uncertain about the markets in general, the lessons you will learn in this book will work for you in any market.

The Buy and Hedge strategy is a new way to invest. It is an all-weather portfolio approach to help you beat the markets. Our Five Iron Rules of Buy and Hedge, when implemented effectively, will provide you with a portfolio that you can feel secure owning. And by "secure," we mean you will sleep well at night knowing that you have limited the potential destruction that market volatility can create in your portfolio.

Buy and Hedge the book is for the investor with a long-term outlook who wants to take control of his or her portfolio. It will teach you to build and manage a balanced, diversified, and *hedged* portfolio. By hedged, we mean a portfolio that limits its downside losses in a violent and volatile market. Hedge fund managers and professional money managers use these techniques. And we teach them in this book using straightforward and easy-to-understand language. Most important, the book shares techniques that can be implemented quickly and efficiently. In other words, you don't need to be a full-time money manager to make this portfolio work for you. It does help to have a basic understanding of financial markets and to already be a do-it-yourself investor.

The authors worked together at TD Ameritrade (TDA), where we were employed for over a decade. TDA is the largest online brokerage in terms of total investor transactions executed. We spent our time at TDA building the trading and investment platform that is used by millions of clients today. In fact, collectively we launched over 100 tools and enhancements while at TDA. And we led the initiatives that spent nearly 750 million acquiring several companies. Each of these companies was acquired so that we could unleash their new investment tools for our clients. We estimate that together we met more than 10,000 individual clients at client functions and events. Simply put, we were intimately involved in the expansion and growth of the fantastic online brokerage industry.

The main competitors in this space have really democratized the investing industry. The little guy can now manage his money in a way that only institutional investors could have achieved 10 to 15 years ago. The main players—TD Ameritrade, E*TRADE, Charles Schwab, and Fidelity—all deserve kudos for tearing down the barriers and reducing the friction for the individual investor to take control of his or her financial future.

In our combined 22-plus years in this new industry, we have learned an important series of lessons, which you will benefit from. The first lesson is that it is very difficult to beat the market. Even professional money managers have a hard time picking stocks that beat the market. We have tried—and we can attest to our scars and bruises. The second lesson is that it is supremely difficult to stay disciplined within an investment strategy. Discipline is the key to being a successful investor. And the third lesson is that we have never met an investor who consistently beat the market without following a disciplined investment strategy. We have met disciplined investors who did *not* beat the market. But we have never met an *undisciplined* investor who consistently beat the market over the long term.

We have experimented with many investment strategies over the years. In fact, our jobs at TDA encouraged us to use the tools and products. And being product developers at heart, experimenting with different trading systems and investment strategies came naturally at a company like TDA. Both of us will even tell you that we had a lot of fun being two of the more active users of the tools and products within the industry. After our testing and experimenting with different investment strategies, we developed the Buy and Hedge strategy and now endorse it for the do-it-yourself investor. We have successfully driven market-beating performance using this strategy for over three years now—and these were a very hard three years.

Buy and Hedge is your path to investment success!

Before you begin the first chapter, we want to explain a few terms we use:

- When we use the word "Option," we almost always capitalize it because we are referring to the financial instrument called an Option. An Option is a financial security that is a derivative that represents a contract sold by one party (the Option writer) to another party (the Option holder). The Option gives the holder the right to either buy or sell an underlying security for a set price by a set date. When "option" is not capitalized, the word is being used in the traditional sense: a choice between two or more things.

- This book often uses the words "investment" and "position," but we do not use them interchangeably, even though the industry often does. Instead, for clarity, we have created a hierarchy between the two. Investment is the parent of positions. An investment is made up of one or more positions. Here's an example: I am bullish on Microsoft, but with a small hedge. The positions could be 100 shares of MSFT *and* one Option contract on MSFT that provides the hedge. The investment is the exposure you want to create to some investment vehicle. The positions are the specific investment vehicles you want to own in your portfolio to make that investment a reality.
- This book uses the word "we." "We" always refers to the authors. It is not the collective "we." It is the authors only. When we use "you," "investor," or "one," we are referring to the reader—the individual investor who will implement the Buy and Hedge strategy after reading this book.

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