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The Hedge Fund Playbook for Market Volatility:

My Masterclass on Risk Management

ENRIQUE
ABEYTA

Dear Reader,

The market's been choppy lately. I'm sure you've noticed.

Ever since the rotation kicked off in mid-October, the number one question hitting our inbox is some version of the same thing: *How do I manage risk right now?*

Fair question. And it's one I've spent the better part of 25 years obsessing over.

Before I joined Paradigm, I ran hedge funds and managed over a billion dollars.

At the first one, I served as head of risk and quantitative research alongside two other portfolio managers. My job, day in and day out, was building the analytics to minimize our mistakes and amplify what we did well.

At the next fund — which I co-founded with Marc Intrieri, my current partner on the Signal Trader Pro software — I was the managing partner.

I had three portfolio managers underneath me, and we migrated all of our risk management directly into proprietary software. That same software now powers every position we track at Paradigm through Signal Trader Pro.

So when I say I take this seriously, I mean it.

It wouldn't be unfair to say that for the last 25 years, a massive chunk of my time and focus has been directed strictly at risk management.

This framework got me through '97, '99, the 2008 global financial crisis, COVID, and the 2022 bear market. And today, I want to share my holistic, three-step approach with you.

Here's how you can apply it to your own portfolio starting today.

Part I: The Foundation (70% of Risk Management)

Here's the part most people miss entirely: somewhere between 70% and 80% of risk management happens before you ever run into trouble.

Think about building a house. Nobody in their right mind pours a foundation in a flood plain, or at the base of a mountain that drops avalanches every winter. You don't build where there's no water or electricity. You pick the right spot. You plan for the worst before the worst shows up.

The structure of your portfolio going in is paramount, because by the time a flood actually hits, you've already eaten half the losses. You don't scramble for insurance when the water's rising — you bought it months ago, hoping you'd never need it.

Your portfolio works the same way. We've hammered on a few core principles for years, and they haven't changed:

Constructive Diversification. Don't pile everything into a single position. You want a balanced portfolio of, call it, 20 liquid ideas. That gives you room to absorb damage in any one name without getting knocked out across the board.

Time-Horizon Matching. You must match the money you have allocated to your actual risk tolerances. The cash earmarked for a house down payment in 12 months? That's a completely different animal than what's sitting in a retirement account you won't touch for 30 years. These two pots of money demand entirely different approaches.

The Discipline of Selling High. Easiest concept in the world. Hardest thing to actually do. Bull markets run about 70% of the time, and during those stretches you feel invincible — periods of ebullience where you feel like you can do no wrong. You actually start craving more risk. Everything you touch turns to gold, so why not double down? That's the exact moment you need to be trimming exposure. You have to sell into strength when things are going great so you're prepared for when the market inevitably turns.

Part II: Portfolio Triage (Battlefield Medicine)

Let's say you built a portfolio last year. It probably did very well early on. Then over the past six months, things started to dribble down. And in the last month? It's been actively taking on water.

When this happens, you enter the second step of risk management. This accounts for about 15% to 20% of the equation, and I call it *triage* — because it's exactly like battlefield medicine.

When they pull a wounded soldier off the field and put him in triage, the immediate goal isn't to fix everything. It's simply to stabilize the patient and make sure they don't die. You need to do the exact same thing with your portfolio.

The "Theoretical Loss" Stress Test

To stabilize, you need a clear-eyed look at your overall exposure. Ask yourself one simple question: *If my exposure went to zero, how bad is it for my life?*

If you're entirely in stocks, the percentage that could go to zero is basically nothing. If you're entirely in options, that percentage could be everything.

To figure out your true risk, here's what I want you to do. Wait for the weekend when the markets are closed, put all your positions on a piece of paper or a spreadsheet, and run my simple stress-test model:

- **Options positions:** Assign a maximum loss of 100%.
- **Small-cap stocks (under $3–5 billion market cap):** Assign a potential loss of 30%-60%.
- **Large-cap stocks:** Assign a potential loss of 15%-30%.

One critical rule: do *not* look at how much you've already lost in any of these positions.

The stock doesn't know how much money you lost in it, and the market doesn't know either. Every day is a new day, and those previous losses are a sunk cost. Apply this math only to your current exposure.

Finding Your "Despondency Number"

Once you apply those percentages — 100% for options, 30%-60% for small caps, 15%-30% for large caps — sum up the total. I call this your *despondency number.*

Look at that total dollar amount and ask yourself honestly: *If that happened, am I jumping out the window? Is my wife going to divorce me?*

If that number irrevocably changes your life — if it means you have to sell your house or abandon your lifestyle — you must bring your exposure down.

Begin reducing your positions until that total potential loss reaches an amount where, if it happened from here, you'd be absolutely bummed… but you're okay.

Here's the secret: your worst expectations are not going to happen.

But by visualizing the absolute worst-case scenario and incorporating it into your structure, you emotionally accept it.

Wayne Gretzky said he was great because he skated to where the puck was going, not where it had been.

When the market gets killed, you might feel like you suck and nothing works. But the reality is the exact opposite - everything is about to work.

By vanquishing the fear intellectually, you stop yourself from making the classic mistake of buying high and selling low at the absolute bottom.

Part III: The Upgrade (Playing Offense)

Once you've triaged your portfolio and reached a state of calm, you are in a position to get ahead of the curve.

I've made money in every major down market that's ever happened. And the way I did it wasn't strictly because of great shorts. The way I made money was buying stuff when the world got absolutely friggin' crazy.

When the market was down 10% in a month, my long-short funds would only be down 3%. Because we'd lost so much less money, we would cover our super oversold shorts and aggressively buy our super oversold longs. When the market snapped back, we absolutely crushed it.

Here's how you can use this kind of weakness to upgrade your own portfolio right now.

1. Harness Short Put Exposure

If you don't have enough short exposure, now is a good time to fix that. You might consider buying put options on stocks that are most vulnerable to a sharp downward move.

If the market really slides, these specific names could make 200% or 500%. Having those winners in your book changes everything, psychologically and financially.

For example, I might be down 50% on my Palantir options. But if I'm up 100% on my Oklo puts, I'm up 50% overall between the two.

I can easily sell my winning Oklo puts and use the cash to buy more of the long options I love at better prices.

2. The Reallocation Strategy

When things get nuts, go through your portfolio and selectively upgrade. Picture this: you've got $100 spread across 20 stocks, and they're all down.

You might have one stock that's off 10%–20% and you think it'll bounce. But then you look over at another stock that's down 36%, and the pricing is absolutely insane.

What I do in that situation is sell the stock I think can go up 10%–20%, and use that capital to buy the one I think can run 40%–50%.

Your actual theoretical exposure to the market doesn't move very much, but you generate tax losses and reallocate heavily into your highest-conviction ideas.

That's a massive upgrade for essentially the same risk profile.

3. The Moving Average Roadmap

To execute this effectively, pull up the charts on Fidelity, Robinhood, or wherever you trade, and look at the 50-day, 100-day, and 200-day moving averages.

Break your stocks into two categories:

Group 1 - Strong Stocks: These are trading above their 200-day moving average. I wouldn't necessarily sell these, but if the gap between the stock price and the 50-day moving average is greater than 10%, you should take profits.

Group 2 - Oversold Stocks: These are below their moving averages. Look at the distance up to the 50-day and 100-day moving averages. Sell the ones that aren't very far below the line, and buy more of the ones that are very far below it.

One major proviso: I'm giving you these ideas assuming nothing has changed in the fundamental story of the stock.

I feel very comfortable making these calls on the open recommendations at Paradigm, because the core thesis is intact.

If fundamentals change, we slap a sell on it and get the hell out of Dodge. But as long as the story holds? Sell the losers that lost you a little. And aggressively buy the losers that lost you a lot.

Part IV: Simplification and Exposure Traps

When you're managing your own portfolio, it's easy to start with five stocks, add a few more, and suddenly find yourself staring at 23 positions you can barely follow.

In a bull market, it doesn't really matter. When you're getting your butt kicked, it's overwhelming.

There is never any downside to simplification. If you've got 35 positions, your portfolio will almost always do better with 20.

Take your smaller, marginal hanger-on positions and just get rid of them. Take the money out of your 15 lowest-return ideas and allocate it strictly to your 20 highest-return ideas.

The Gross Exposure Trap

Let me share one last concept that's a bit in the weeds, but worth understanding if you want to think about risk the way hedge funds do.

When a hedge fund's portfolio goes against them, they often layer on a bunch of short exposure as a hedge. Their net exposure stays the same — looks fine on paper. But their gross exposure, the total capital at risk on both sides of the book, keeps climbing.

This is a huge mistake.

Going into the big sell-offs in 2008, my fund was at roughly 100% gross exposure: 50% long, 50% short. At the absolute bottom of the market, we were at 45% gross exposure: 45% long, 0% short.

My net exposure actually went *up*. But my gross exposure — the total amount of things that could go wrong — was cut in half.

A lot of hedge fund managers fail here because they think they're paid to stay 100% invested at all times. They won't cut their gross exposure because it feels like admitting defeat.

You don't have that problem. It's your money. You only report to yourself and potentially your spouse. You have the freedom to make these rapid moves to protect yourself — use it.

Part V: Position Sizing and Profit Targets

People ask me constantly about strict rules. "Should I cap options at 1%–2% of my portfolio?" "Should equity positions top out at 5%?" I don't love these kinds of blanket rules, because everyone is different.

If someone has $20 million and they put $250,000 into an account saying, "I don't care if I lose the whole thing," then let's roll. Load it up with 20 options positions. If they hit a bad streak and lose everything, it won't change their life. But I can't turn around and apply that same rule to everyone.

This is exactly why you must use the despondency number to figure out your incremental exposure.

If you want to layer on five new options positions, you have to accept the reality that you could lose 100% of that money. Add that potential loss to your current despondency total. If it pushes you over the edge and ruins your life, don't do it. Only operate within the number you're comfortable with.

And remember: $30,000 at risk in large-cap stocks is a very different beast than $30,000 at risk in options. You must treat them differently.

A Simple Rule for Options Profit Targets

When it comes to taking profits on options, things can get highly complex. Sometimes you should sell when you're up 15%. Sometimes you should wait to go up 1,500%.

But if you want a really clever, simple rule of thumb: with any options position, when it's up 50%, 75%, or 100%, sell 50%-60% of your position.

By doing this, you book the majority of your initial capital and let the rest ride. You must understand that the near-term risk of our options positions is 100% of your capital.

That's a feature, not a bug. You don't get those asymmetrical, massive returns without taking on that kind of risk. But booking half your profits early neutralizes that risk beautifully.

The Bottom Line

These mechanisms and methodologies I've walked you through? They shouldn't be something you dust off only when you're getting your butt kicked.

They should be something you practice when things are going great.

Whether it's raining, snowing, a bright sunny day, or you're sitting at the beach, these are all things you should be doing consistently.

Build these steps into your process. Get comfortable with your risk. Do that, and you'll be ready to thrive in any market condition.

To Making YOU Money,

Enrique Abeyta