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ETFs that go up when the market goes down; Just remember that no hedge works perfectly all the time

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Illustrations: Color Photo: Simon Hayter For National Post, File Photo / All investors look for ways to manage their portfolios' downside risk.

Many of you have probably thought about it -- how to take a little money off the table and preserve some of the gains made over the past few years. It is only human; we always think of these types of things during times of market stress.

Let's tackle this situation from a different perspective by asking what wealthy people do with their money.

Wealthy investors have one thing in common: They have already made vast sums of money. They generally like to have some downside protection, so if a recession, depression or any other traumatic economic event happens, they can generally preserve capital. They don't have to make a lot, they just don't want to lose a lot.

A few years back, John Templeton, one of the masters of investing, was being interviewed about his philosophy. The king of value investing, to my surprise, trumpeted the virtues of hedge funds, and, in particular, market-neutral hedge fund investing. Saying that he was quite cautious on the markets, he laid out a way for investors to help protect themselves on the downside should things go awry.

He also added that much of his own net worth was in these strategies.

How can an average investor do it? Three ways come to mind, all of which are related to each other.

(1) You can, of course, invest in a hedge fund, allowing a (one hopes) competent manager the ability to go long and short different types of securities.

(2) You can buy stocks you like, and short stocks that you think will do less well, or go down in value. This can be tricky for even the most talented stock pickers, as shorting individual stocks improperly can cause an investor to "get their head kicked in," as one accomplished hedge manager said to me recently.

(3) That brings us to the third method, and one suggested by Sir John Templeton as a reasonable path for the average investor: He said an individual could own the stocks they like and short the market against their long positions.

The first thing to understand is that there are two types of risk when investing in stocks --market risk and non-market risk.

Non-market, or stock-specific, risk is easy to understand, and something most of us have been exposed to. Simply, it is picking a lousy stock, having it do poorly, independent of the market.

On the other hand, market risk occurs when the great stock you own goes down simply because the market does. You may remember how your whole portfolio crashed a few weeks ago, simply because the market dropped.

So the logical question comes up: How do you keep the great stocks you own but reduce the market risk that can pound even an excellent portfolio into submission?

The solution just got a whole lot easier. Now, you can buy a bunch of securities that go up when the market drops, and thus hedge off the part of your portfolio returns that can't be controlled.

Enter into the equation Horizons BetaPro ETFs, and specifically the Horizons BetaPro S&P/TSX 60 Bear Plus ETF (HXD/TSX). HXD gives an investor two times the inverse of the market. In other words, if the S&P/ TSX 60 drops 1%, the HXD net asset value will rise 2%, and vice versa. I use it frequently in discretionary accounts that I run for clients. Owning some blue chip, out-of-favour, high-dividend stocks as a core of my portfolio, I became concerned a few months ago about the "risk" in the market. Not wanting to sell my stocks -- as I thought they represented great value--I took a 10% position in HXD in my model portfolio. This did three things for me: First, it helped to instantly offset some market risk. Second, it provided a means to make money, from a declining market, and third, it allowed me to use a limited amount of capital as HXD gives a leveraged inverse exposure.

Trust me on the numbers, because I spent the better part of a weekend figuring this out a while ago, but a 10% position in HXD is approximately equal to a 30% cash position in your account. Having 10% HXD would result in about the same return as having 70% of your portfolio invested, and 30% of your portfolio in cash.

Before any of you money-management types have a fit, there are a few assumptions I am making, like the fact that your invested money is similar to the market index.

Here is a bit of a different take: Let's say you are a hot junior oil and gas stock picker. You may decide to stay long the oil and gas stocks you like, because this is your "alpha," or your expertise.

On the other hand, you are negative on the price of oil or you want to "hedge" away the risk of oil prices. You can isolate your expertise by buying Horizons BetaPro NYMEX Crude Oil Bear Plus ETF (HOD/TSX), which is a short on the Nymex crude oil futures, and going long your junior oil and gas stocks. HOD is a bear ETF and aims to give an investor daily investment results, before all costs, that endeavour to correspond to two times (200%) the inverse (opposite) of the daily performance of the NYMEX light sweet crude oil futures contract for the next delivery month.

Simply, you will make the return between how your stocks do, and what the price of crude oil does. But remember, it is not as easy as it seems. Always remember that with these bear products, you are using leverage, so factor that into the equation, and run some scenarios on paper so you can get familiar with how things work in different environments.

Also remember that no hedge works perfectly all the time, and sometimes your junior oil stocks go down, and the price of crude goes up. The market is crazy that way.

I haven't even scratched the surface of how these work. If you don't want to take the risk of decision-making yourself, you can always employ a hedge fund manager to do it for you. I know that with my model portfolio, in which I employ hedging techniques, I have to stay on top of it, always looking at my exposure in various areas, and the inherent re-ward-to-risk characteristics.

A word of caution: Employing these principles without a full knowledge of the strategies can be hazardous. Make sure you consult a financial advisor.

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