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4 ETF Strategies For A Down Market

by Hans Wagner (Contact Author | Biography)

Exchange-traded funds (ETFs) are rapidly becoming a popular investment tool for many investors. As with any investment, it is important to understand the downside risks. ETFs are traded like stocks, so they inherit many of the same risks as stocks. However, there are several strategies that ETF investors can use to protect their capital during a down market. These strategies include knowing when to sell, knowing how to allocate your assets, following the rotation of sectors and using hedging techniques. (For the basics, review our *Exchange-Traded Funds* tutorial.)

Sell Your ETF

Knowing when to sell your ETF is just as important as knowing when to buy it. Many investors do not know when to sell and they tend to hold on to their shares hoping things will improve. Unfortunately, it may be a long time before they fully recover. During a down market, there are several reasons investors should consider selling their ETFs:

- *Risk Tolerance:* Every investor should know how much risk he or she can tolerate. If you are having trouble sleeping at night due to concerns over the market, then you have reached your limit and it is probably a good time to sell. You've already made the losses, so now it's time to save what's left. (To learn more, read *Personalizing Risk Tolerance*.)

- *Stop Orders:* Stock investors have long used stop orders to protect their portfolios. Fortunately, investors in ETFs can use the same stop techniques available for stocks, such as trailing percent stops, limit stops, volatility stops or some other variation that helps close out a position at a predetermined amount. (For more on arranging stop orders, read *A Logical Method Of Stop Placement*.)

- *Ready Money:* If you will need the cash for some purpose in the next couple of years, it is a good idea to reduce your risk and move your money to a low-risk investment now. Investors can move to less volatile ETFs or sell for cash to preserve gains should the market turn down.

- *Balancing Act:* Rebalancing your portfolio is always a good idea. Should your ETF run up in value, providing a nice gain, it might overweight your portfolio toward one sector or industry. A good strategy is to sell part of the ETF to capture the profits and then diversify your reinvestments. This approach protects your profits should the market take a dive. (Learn more about fine-tuning in *Rebalance Your Portfolio To Stay On Track*.)

- *Expectations:* Investors who beat the market may find that their initial reasons for purchasing an ETF have changed. Maybe it failed to meet your expectations, or the fundamentals underlying the investment changed for the worse. When this happens, it is a good time to sell and move on to another opportunity.

One of the best ways to protect your ETF portfolio is to know when to sell before a market tumbles, or to have your wits about you to sell before further losses occur. If investors follow sound selling principles during up markets, these same principles will serve them well during down markets.

Allocate Your Assets
Sophisticated investors use asset allocation strategies to protect their portfolios against negative moves. ETFs now offer the everyday investor the tools to allocate assets to gain exposure to a wide range of asset classes, equity market capitalizations and sectors. These ETFs permit investors to construct portfolios that are consistent with their tolerance for risk and their investment horizons.

Sample strategies to help reduce exposure in a down market include:

- Reducing your portfolio's exposure to sectors, asset classes or equity capitalizations that are likely to perform badly in a down market

- Filling voids in a portfolio with ETFs that fill out your allocation strategy. You can do this by buying or selling short sectors that are likely to over- or underperform relative to the overall market. If you are concerned that the market may get weaker, then buy an ETF that shorts a sector and/or the market.

- Over- or underweighting a portfolio to gain exposure that will reduce the downside risk. Let's say an investor's portfolio is composed of stocks from many sectors in the S&P 500, but he or she is concerned that a market downturn will hurt the portfolio. This investor could purchase a consumer staples sector ETF to increase exposure to a sector that typically does better in a down market.

ETFs provide investors with the tools to allocate their assets to reflect their portfolio strategies, especially in a down market. For these strategies to succeed, the bear market ETF must have high negative correlation to your long portfolio. (Read more in *Five Things To Know About Asset Allocation*.)

Follow Sector Rotation
Another strategy for providing downside protection is to follow the rotation of industry sectors. Based on the theory that industry sectors follow economic cycles, investors can use ETFs to reposition their portfolios and adapt to a down market.

The business cycle is a long-term pattern of changes in gross domestic product (GDP), which follows the four basic stages: expansion, prosperity, contraction and recession. After a recessionary phase, the expansionary phase starts again. According to investor Sam Stovall's 1996 book "Sector Investing", each sector is stronger at different points along the business cycle. Investors can identify the sectors that align with the business cycles and invest accordingly. ETFs are excellent choices when employing this strategy, especially during a down market.

Investors who follow this strategy adjust their portfolio's sector weight to align with the sectors that are most likely to perform best. Sector-oriented ETFs give these investors an efficient way to redirect their portfolios. When faced with a market that is trending down, these investors can use ETFs that invest in sectors that normally outperform a down market, such as consumer staples, utilities and healthcare. Investors who are more aggressive could use ETFs that short the market or a sector that is likely to perform worse than the market. (Get details on how ETFs enable these techniques at *ETFs Smooth Road For Sector Rotation Strategies*.)

Employ Hedges

A hedge is a position designed to mitigate risk that bets for or against an expected future trend or event. Hedges are particularly useful if an investor is facing a down market. To be effective, hedges need not make money, they must only limit risk.

ETFs that short an index or a sector give investors new ways to employ hedging strategies. For example, if your portfolio is long the market and you are concerned that the slowdown in the economy will cause the market to fall, you could either move part of your portfolio to cash or acquire an ETF that shorts the market. In this way, you could realign your portfolio to be 75% long and 25% short, using an ETF that shorts the market. This would be similar to a portfolio that is 50% long and 50% cash.

Options on ETFs offer investors another proven way to hedge their positions. Two conservative approaches involve covered calls and protective puts. Covered calls allow investors to lock in profits and/or provide some downside protection in the event the market turns. The seller of a covered call receives downside insurance equal to the amount of the option premium. If the ETF falls by more than the premium, the position will lose money but still outperform holding the ETF alone.

Investors seeking insurance against sharp ETF declines who want to hold the shares to avoid negative tax consequences can purchase "protective" put options. A put on an ETF allows an investor to sell if the share price falls below the strike price. The put typically increases in value as the ETF declines. If the ETF stays flat or increases in value by the end of the option period, the put expires worthless. (You can learn the basics of these contracts in our *Options Basics Tutorial*.)

The Bottom Line

Investors often find down markets to be a major challenge. ETFs provide additional ways to reduce the negative impact on your portfolio during a market decline, but you still need to do your homework. The options available to individual investors are similar to what professionals have enjoyed, so you are the only limit to your own plan. Design your strategy around what helps you sleep well at night.

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As a long time investor, Hans Wagner was able to retire at 55 by following a disciplined process using sound investment principles. After his children and their friends graduated from college, Hans began helping them to invest in the stock market. Soon, friends and acquaintances also began to seek advice, so Hans created a website, Trading Online Markets, which provides information on investing topics, along with sample portfolios that consistently beat the market.