Banking Profits In Bull And Bear Markets

by Chris Seabury (Contact Author | Biography)
Both bear markets and bull markets represent tremendous opportunities to make money, and the key to success is to use strategies and ideas that can generate profits under a variety of conditions. This requires consistency, discipline, focus and the ability to take advantage of fear and greed. This article will help familiarize you with investments that can prosper in up or down markets. (For another take on bull and bear markets, read *Digging Deeper Into Bull And Bear Markets*.)

Ways to Profit in Bear Markets
A bear market is defined as a drop of 20% or more in a market average over a one year period, measured from the closing low to the closing high. Generally, these types of markets occur during economic recessions or depressions, when pessimism prevails. But amidst the rubble lie opportunities to make money for those who know how to use the right tools. The following are some ways to profit in bear markets.

1. **Short Positions**
   Taking a short position, also called short selling, occurs when you sell shares that you don't own in anticipation that the stock will fall in the future. If it works as planned and the share price drops, you must buy those shares at the lower price to cover the short position. For example, if you short ABC stock at $35 per share and the stock falls to $20, you can buy the shares back at $20 to close out the short position. Your overall profit would be $15 per share. (To learn more about short selling, read *Short Sales For Market Downturns*.)

2. **Put Options:** A put option is the right to sell a stock at a particular strike price until a certain date in the future, called the expiration date. The money you pay for the option is called a premium. As the price of the stock falls, you can either exercise the right to sell the stock at the higher strike price, or you can sell the put option, which increases in value as the stock falls, for a profit (provided the stock moves below the strike price). (For more on this strategy, read *Bear Put Spreads: A Roaring Alternative To Short Selling*.)

3. **Short ETFs:** A short exchange traded fund (ETF), also called an inverse ETF, produces returns that are the inverse of a particular index. For example, an ETF that performs inversely to the Nasdaq 100 will drop about 25% if that index rises by 25%. But if the index falls 25%, the ETF will rise proportionally. This inverse relationship makes short/inverse ETFs appropriate for investors who want to profit from a downturn in the markets, or who wish to hedge long positions against such a downturn. (For more insight, see *Inverse ETFs Can Lift A Falling Portfolio*.)

Ways to Profit in Bull Markets

A bull market occurs when security prices rise at a faster rate than the overall average rate. These types of markets are accompanied by periods of economic growth and optimism among investors. The following are some of the tools that are appropriate for rising stock markets.

1. **Long Positions:** A long position is buying a stock or any other security in anticipation that its price will rise. The overall objective is to buy the stock at a low price and sell it for more than you paid. The difference represents your profit.

2. **Calls:** A call option is the right to buy a stock at a particular price until a specified date. The buyer of a call option, who pays a premium, anticipates that the stock's price will rise, while the seller of the call option anticipates it will fall. If the price of the stock rises, the option buyer can exercise the right to buy the stock at the lower strike price and then sell it for a higher price on the open market. The option buyer can also sell the call option in the open market for a profit, assuming the stock is above the strike price.

3. **Exchange-Traded Funds (ETFs):** Most ETFs follow a particular market average, such as the Dow Jones Industrial Average (DJIA) or the Standard & Poor's 500 Index (S&P 500) and trade like stocks. Generally, the transaction costs and operating expenses are low and they require no investment minimum. ETFs seek to replicate the movement of the indexes they follow, less expenses. For example, if the S&P 500 rises 10%, an ETF based on the index will rise by approximately the same amount. (To learn more about ETFs, see the *Exchange-Traded Funds (ETFs)* tutorial and *Introduction To Exchange-Traded Funds*.)

How to Spot Bear and Bull Markets

Markets trade in cycles, which means that most investors will experience both in a lifetime. The key to profiting in both types of markets is to spot when the markets are starting to top out or when they are bottoming. The following are two key indicators to look for.

- *Advance/Decline Line*: The advance/decline line represents the number of advancing issues divided by the number of declining issues over a given period. A number greater than 1 is considered bullish, while a number less than 1 is considered bearish. A rising line confirms that the markets are moving higher. However, a declining line during a period when markets continue to rise could signal a correction. When the line has been declining for several months while the averages continue to move higher, this could be considered a negative correlation, and a major correction or a bear market is likely. An advance/decline line that continues to move down signals that the averages will remain weak. However, if the line rises for several months and the averages have moved down, this positive divergence could mean the start of a bull market.

- *Price Dividend Ratio*: The price dividend ratio is the ratio that compares the share price of the stock with the dividend paid out over the past year. It is calculated by dividing the current price of the stock by the dividend. A decline in the ratio in the area of 14-17 could indicate an attractive bargain, while a reading above 26 may signal overvaluation. This ratio and its interpretation will vary by industry, as some industries traditionally pay high dividends, while growth sectors often pay little or no dividends.

Conclusion

There are many ways to profit in both bear and bull markets. The key to success is using the tools for each market to their full advantage. In addition, it is important to use the indicators in conjunction with one another to spot when both bull and bear markets are beginning or ending.

Short selling, put options, and short or inverse ETFs are just a few bear market tools that allow investors to take advantage of the market weakness, while long positions in stocks and ETFs and a call option are suitable for bull markets. The advanced decline line and price dividend ratio will allow you to spot market tops and bottoms.

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