How things work

Marc Lamontagne / October 01, 2008

"Is there a bear in your portfolio?" screamed the ad with the picture of a mean-looking grizzly. It sure got my attention. Bear or inverse ETFs are a new breed of leveraged instruments, which move opposite to the direction of a given market or sector.

Offered in Canada by Horizons BetaPro, these bear-market versions are designed to give investors an inverse of 200% of the daily return of a particular market or sector, before fees and other expenses such as interest accrual.

So, if you held the HBP S&P/TSX 60 Bear Plus ETF on a day that the TSX 60 index was down 2%, then you'd have earned a positive 4% rate of return for that day, before fees.

This is made possible by using derivative products known as forwards. Unlike futures products, which trade on commodities exchanges south of the border, forwards are contracts that aren't traded on an organized exchange, and are not settled by an organized clearing corporation. In essence, a forward is a contractually negotiated agreement with a counterparty (usually a bank) based on delivery of return that is derived from an underlying commodity, financial instrument, or in this case a stock investment strategy.

The risk involved with this type of forwards agreement is counter party risk—a scenario where the bank itself runs into solvency and liquidity problems. The end result: the bank becomes incapable of holding its end of the forwards agreement.

With the advent of hedge funds and their growth in popularity, coupled with the retail investor demand to have access to strategies that seem to perform in both up and down markets, it was only a matter of time before product manufacturers introduced a retail class of hedge strategy tools.

There are several advantages to using inverse ETFs compared to traditional downside strategies such as put options and shorting. The client doesn't need a margin account; the risk is limited to the amount invested; there is no expiry date; and the advisor doesn't need an options licence. There's also a certain amount of tax efficiency— year-end distributions would typically be capital gains.

So how are advisors using these products? "They really don't fit into a traditional strategic asset allocation strategy," says Dave Paterson, director of research investment funds with Paterson and Associates. "They tend to use them more as a tactical overlay of a portfolio."

One simple strategy for aggressive investors is to buy an inverse ETF of a particular market or sector to take advantage of a falling market. These are typically short-term trades—the average holding period of these securities is about two weeks.

Though Mark Taucar, associate portfolio manager with R.N. Croft Financial Group Inc., uses many downside strategies, including bear ETFs, he suggests any type of leveraged investment strategy should not exceed 10% to 15% of a portfolio.

A more sophisticated strategy would be pair trading—essentially, holding two securities that are very negatively correlated to gain from both the upside and downside of a market. Say for example you're holding the S&P/TSX 60 index but are concerned the banking sector still has some room to fall. In that case you'd keep the long position, but would also buy the HBP S&P/TSX Financials Bear Plus ETF. That way, you're now getting a 200% inverse exposure to the banking sector, so you would only need to hold half the percentage that the sector makes up of the index.

While inverse ETFs have become popular very fast, they're still mainly used by institutional investors.

But until recently, down-market strategies typically haven't played a major role in most long-term portfolios.

Filed by Marc Lamontagne
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