Direxion ETFs | Funds

All time highs. Time to build an ark?

Inverse ETFs can help protect against a squall

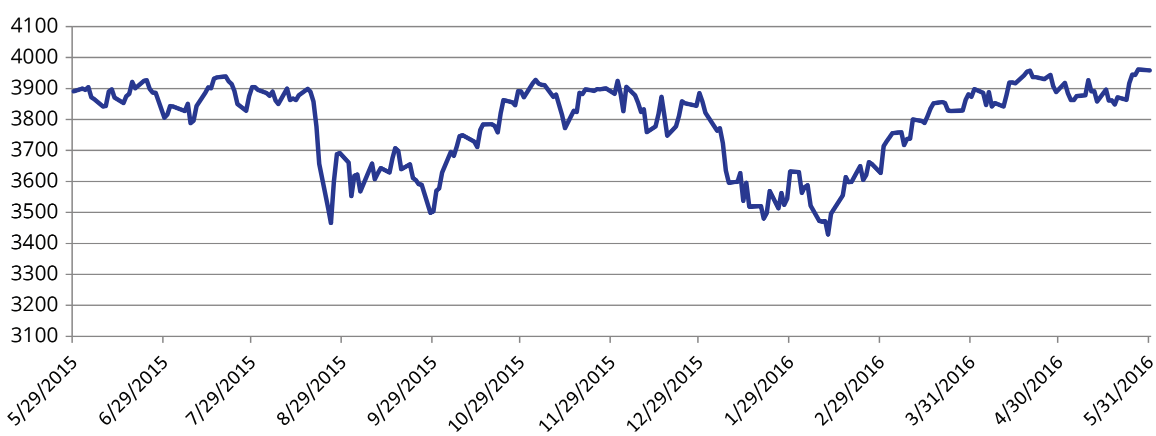
U.S. stocks bumped up against all-time highs again this year. After hitting a new intraday high of 2,178 on August 1st, the S&P 500 was unable to hold onto the gains. Sector performances offer a glimpse of where we are in the market cycle. The top performing sectors over the past 12 months have been telecommunications, consumer staples and utilities. While energy, materials and financials have brought up the rear, even though their most recent rally. What's striking is that these performances fall in line with what you might expect to see during an economic contraction, with defensive sectors leading the market. Some already felt that this was a sign that the market is already preparing for recession.

The vote by Britain to leave the European Union is having enormous effects across global markets. Market reaction in the first two trading days after the vote reflects that there was almost no expectation of a Brexit and, thus it was not adequately priced into the market. As Prime Minister David Cameron announced that he will resign by this fall, the perceived flight to safety is in full swing, as global investors move to shelter capital in the face of uncertainty.

Double bottom?

From a technical standpoint the current environment may have been viewed as either bullish or bearish. Those on the bull side of the equation, took heart in a technical indicator known as the double bottom. The double bottom reversal is a bullish reversal pattern that traders use to anticipate possible upside movements. As its name implies, the pattern is made up of two consecutive troughs that are roughly equal, with a moderate peak in-between. A double bottom looks like the letter "W". It usually features a more severe correction but no more than a 50% drop from its peak. The middle peak in that W-like structure should also be in the upper half of the base. U.S. large cap performance since May 2015 has formed a classic double-bottom pattern through the past 13 months and counting.

S&P 500 Index

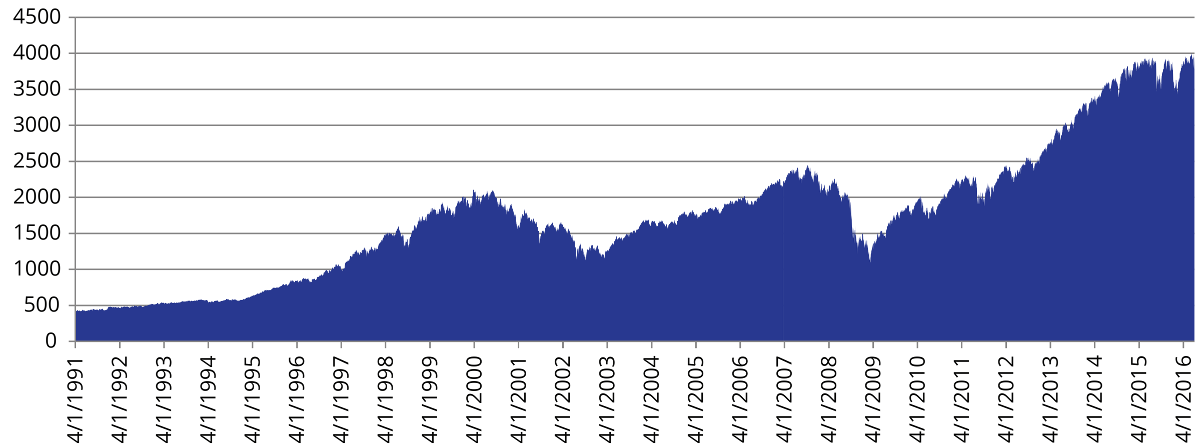


Source: Bloomberg. Past performance is not indicative of future returns. One cannot invest directly in an index.

Triple top?

Of course markets by definition are places of opposite opinions. In the first quarter of the year, stocks were in full retreat and very few investors thought we would be rapidly approaching all-time highs for the S&P only a few months later. Some investors see another technical indicator, this triple top chart for the S&P 500, with its ominous, looming peak and may conclude that U.S. stocks are long overdue for a correction. What will be the catalyst for the next bear market?

S&P 500 Index



Source: Bloomberg. (4/1/91-6/30/16) Past performance is not indicative of future returns. One cannot invest directly in an index.

At least grab your umbrella.

What now if you think the market is due for a correction? How do you make gains when market goes down? Warren Buffet is quoted as saying Rule No. 1 is "Never Lose Money."

Occasionally markets go through periods of extreme volatility and declines. It's easy to ride out small fluctuations when you have a long time horizon. But in the case of large declines, experienced investors like to seek protection or hedge. Considering the correction that just happened, it's never bad to consider a hedge.

In fact for active investors, hedging might be considered as another form of diversification. Similar to having a bond or gold allocation, having non-equity-correlated or inversely correlated assets can improve returns.

So how does one hedge? There are many ways; each with pros and cons so there is no strategy that's always right or wrong. Here are some common approaches:

Stay in cash

One simple strategy is to sell some equities and move to cash. Cash doesn't lose value in the very short term and can be quickly redeployed when you think the time is right. Of course, this is less a hedge and more avoidance. And cash is generally a poor long-term option since market timing is difficult to get right, meanwhile you lose out on any asset returns. Selling into cash, may stem potential losses but leaves zero chance of gains. Market timing is virtually impossible. If you guess right on the exit, when do you get back in?

Defensive rotation

Trading into defensive sectors and assets like consumer staples, utilities and bonds is another strategy. But like cash, this strategy is more a mix between tactical diversification and hedging rather than a true hedge. It's perhaps the most practical and comfortable option for many since it maintains exposure to assets but tactically shifts the portfolio to favor low or negative beta assets. But it is simple to execute before and as an actual decline happens. In designing more active hedging strategies, investors can choose from a variety of tools and approaches. Each has pros and cons.

Derivatives trading

For sophisticated investors, there are multiple strategies for hedging using derivatives trading. But these carry significant risk and should only be employed by those familiar with them.

Short selling

The short-selling process requires a handful of steps:

1. Set up a margin account with your broker. A margin account is a brokerage account in which the broker lends the customer cash to purchase securities. The loan in the account is collateralized by the securities and cash. Because the customer is investing with a broker's money rather than his own, the customer is using leverage to magnify both gains and losses.
2. Place your order.
3. Your broker borrows the shares.
4. Your broker sells the shares and gives you the money.
5. You buy back the shares at a later date, when prices have dropped. You hope.

In most cases, how long you stay in a short position is up to you. Traders may enter and exit a short sale on the same day, or they might remain in the position for several days or weeks, depending on the strategy and how the security is performing.

Infinite Loss Potential:
The losses from short selling are potentially infinite. You should have a stop-loss price in mind, based on how much you invest. If you bet $1,000 against the market or a stock, consider having $2,000 ready in case it goes up. If the market rises, you have to cover it and take your loss.

You will have to pay interest on borrowed shares. That can start out in single-digit percentages of the money placed on the short position, that rate may increase if the stock becomes a popular one to short, as demand for borrowed shares will increase.

Though you're not obligated to buy the shares back until you're ready —each broker dealer has their own rules and time limits.

Hedge with an inverse ETF

Finally, there are exchange-traded funds. These tools may be used when seeking to hedge the market. As their name reveals, inverse ETFs go up when the market goes down, and they go down when the market goes up.

Inverse ETFs allow you to seek the opposite return of specific sectors, asset classes. For instance the S&P 500, Financials, Energy and Tech.

Again, the thing to remember about these funds is that they'll lose value so long as the market keeps going up. But the potential rewards can be attractive if the market suffers a setback.

At the very least they may serve as a hedge. It's important to note that an -1x ETF which seeks 100% of the inverse performance of an index, is subject to daily compounding. However, basic math dictates that the compounding would be less than the compounding in a -2x or -3x leveraged ETF.

Used appropriately, even a small allocation of your capital could help make up for any losses you sustain in a market crash. And of course, individuals should consult a financial professional before engaging in hedging activity.

Investing in each Fund may be more volatile than investing in broadly diversified funds. The use of leverage by each Fund increases the risk to the Fund. The Funds are not suitable for all investors and should be utilized only by sophisticated investors who understand leverage risk, consequences of seeking daily leveraged investment results and intend to actively monitor and manage their investment. The Funds are not designed to track the underlying index over a longer period of time.

Worriers Welcome.

Hedging Using Inverse or Leveraged Inverse ETFs

Direxion inverse and leveraged inverse ETFs from Direxion are funds that seek to provide an inverse multiple (e.g., -1x or -2x or -3x) of the daily return of a benchmark before fees and expenses. Inverse and leveraged inverse ETFs cover a broad range of equity, fixed-income, commodity and currency benchmarks. Many investors consider inverse ETFs to be attractive hedging instruments for the following reasons:

Inverse Correlation:
An inverse ETF seeks to achieve the inverse of the one-day performance (or a multiple thereof) of the ETF's stated benchmark index before fees and expenses. So buying an inverse ETF may provide index returns with the negative correlation, on a daily basis, necessary to implement an effective hedge, without requiring investors to short securities or use derivative-based strategies.

Accessibility:
Inverse and leveraged inverse ETFs trade much like stocks on security exchanges and are generally bought and sold in the same way. Unlike derivatives trading, there are no special accounts or other special arrangements are needed.

Intraday Pricing and Liquidity: Since inverse and leveraged inverse ETFs trade much like stocks, they are priced throughout the day to reflect market fluctuations. For some investors, this can make it easier for monitoring and rebalancing.

No margin account needed:
Since you are essentially taking a long (owning the asset vs. borrowing an asset to sell short, as explained previously) position in a fund that provides inverse exposure, there's no margin account needed to purchase an inverse ETF.

No chance of losing more than the initial investment:
You can never lose more than your initial investment when using leveraged funds. This is in stark contrast to buying on margin or selling stocks short, a process that can cause investors to lose far more than their initial investment.

Broader diversification as compared to individual stocks:
Inverse ETFs may offer a more diversified approach to hedging than shorting an individual stock. Of course if you are acting on the anticipation of news on a specific company, an ETF may not be the right trade. But if you are considering betting against a sector or asset class, inverse ETFs may be a simpler way to execute your strategy.

Able to use in retirement accounts:
You cannot short stocks of any type in an individual retirement account (IRA). The Internal Revenue Service (IRS) does not allow any form of borrowing in an IRA. You can however, trade inverse ETFs.

For the average investor, these basic strategies can be used to help protect their portfolios from excessive losses. Each strategy carries pros and cons in timing risk, degree of downside coverage, ease of execution, and capital outlay.

Click here for a complete list of Direxion Inverse or Leveraged Inverse ETFs