VOTED THE WORLD'S BEST INVESTMENT ADVISORY

Investor's Digest of Canada

July 22, 2016 Vol. 48, No. 14

S&P 500 BECAME FLAT AND CHOPPY AFTER FED STIMULUS ENDED IN 2014

On reducing risk in the portfolio

Keith Richards

Call it a case of having your cake and eating it too: investors want to hold stocks and reduce risk at the same time. Is that possible?

Let's first look at the equity markets. Current market volatility may continue until late summer or fall. Seasonal studies have shown a tendency for markets to underperform between the spring and fall of each year ("Sell in May and go away!").

Gloom and doom surrounding the outlook for the U.S. economy, the U.S. election, the uncharted territory of post-Brexit, uncertainty surrounding Europe including Greece and Spain, and slowing growth in China worsen this tendency. And let's not forget the questionable valuations on the broad market indices. The S&P 500 recently traded near a trailing price-to-earnings (P/E) ratio of 24 – a level that's been seen only a few times over the past century!

Another risk factor has been the end of the U.S. Federal Reserve's monetary stimulus programs in 2014. From 2009 to 2014, the Fed initiated quantitative easing (or "QE"), "Twist" (bond buying and selling), and low-interest rate monetary easing programs.

Markets became volatile for a few weeks following the end of each of these programs as you will note on the chart below.

It's no coincidence that the recent flat and choppy pattern for the S&P 500 began with the ending of the Fed stimulus incentives in late 2014. With no new monetary stimulation plans on the horizon, stocks have been, and quite likely will continue to be, sideways and choppy for a while to come.

In light of these factors, defensive moves such as holding cash and focusing on high-dividend and low-beta (an indicator of low volatility) equities make sense.

The obvious way to reduce risk in an uncertain environment is to hold cash. For example, the ValueTrend Equity Platform, which I manage, has been holding between 25 per cent and 35 per cent cash since the spring.

When it comes to knowing what stocks to hold, sectors that tend to hold up well in volatile markets include Canadian and U.S. utilities, REITs and the U.S. consumer staples sectors.

The Canadian utilities sector has a beta of about 0.8, meaning it's 20 per cent less volatile than the broader markets.

Both the **iShares Capped Utilities ETF** (XUT-TSX, $22.50) and the **BMO Equal Weight Canadian Utilities ETF** (ZUT-TSX, $16.94) hold mixtures of Canada's prominent power and utilities companies. Both pay around four per cent in current dividend yields.

U.S. utilities can be owned through the **iShares U.S. Utilities ETF** (IDU-NYSE/Arca, $129.93), which currently offers a three per cent dividend yield and a beta of about 0.70.

Investors can trade in the U.S. consumer staples sector via the **SPDR Consumer Staples Select Sector ETF** (XLP-NYSE/Arca, $55.11). Big-name soft drink makers Coca-Cola and Pepsi are in this ETF, along with other staples like Kraft, Philip Morris, Procter & Gamble and Wal-Mart.

XLP's 2.4 per cent dividend yield and low volatility (its beta sits at 0.80) make it an attractive position to hold when times get tough. Our ValueTrend portfolio holds a position in this ETF.

REITs (real estate investment trusts) are securities based on either commercial or residential rental properties. They tend to be higher-yielding securities that investors have been favouring over more volatile sectors during the recent market malaise.

While we at ValueTrend have been focusing on holding some individual names within this sector, an ETF will also do the trick for investors who prefer a broader and more diversified investment.

The **iShares S&P/TSX Capped REIT Index** (XRE-TSX, $17.25) currently offers a diverse collection of Canadian REITs with a yield of five per cent. The beta on that ETF is a very low 0.65, indicating that it has been about one-third less volatile than the broader market.

Hedging strategies can also help offset the negative impact of market volatility. Portfolio managers will sometimes estimate the beta (risk) relationship of their portfolios. From there, they attempt to neutralize negative returns by allocating some capital into assets that are inversely correlated to the markets.

By allocating some room in your portfolio for an ETF that has a negative performance correlation to stocks, you can offset some or all of the losses your stock portfolio would suffer otherwise.

By owning a proportional component of an inverse ETF for a stock index, losses incurred during a correction will be offset by gains on the inverse ETF.

Unleveraged single inverse ETFs, such as **Horizons BetaPro S&P/TSX 60 Inverse ETF** (HIX-TSX, $7.58) or its sibling, the **Horizons BetaPro S&P 500 Inverse ETF** (HIU-TSX, $38.07) will rise in a falling market, and can be an excellent hedging strategy if held over a short period of time. In fact, we managed to offset much of the Brexit vote's negative effect on the markets by owning the HIU units. We sold the position after it had risen on the Monday following the vote.

Another way to offset at least some of the market-driven losses on the portfolios I manage is through VIX ETFs (that is, funds tied to the S&P 500 Short-Term Volatility index).

Often called the "fear index", the VIX represents Chicago Board Options Exchange (CBOE) options traders' expectations for stock market volatility for the next 30 days.

ETFs and ETNs (exchange-traded notes) that mirror this index, such as the **iPath S&P 500 VIX Short-Term Futures ETN** (VXX-NYSE/Arca, US$13.31) or the **Horizons BetaPro S&P 500**

VIX Short-Term Futures ETF (HUV-TSX, $18.75) are examples of such securities.

An allocation to a VIX ETF allows you to profit by the very activity that is causing pain to most investors. Because volatility tends to be greatest during corrective periods on the market, these ETFs can be an excellent hedge for a stock portfolio.

I tend to watch for extremes before playing these ETFs. The VIX seems to be near the bottom of its trading range at or near a level of 12, and it tends to reach a top of that range at or near 20. You have to be careful with the duration of time that you hold any VIX-oriented ETF.

Time erodes the value of these ETFs. This time erosion is known as contango.

So you need to be pretty sharp with your entry and exit strategy. For this reason, I tend to recommend that investors stick with a straightforward inverse ETF if they are looking to hedge the risk out of some of their portfolio.

If you want to hold equities and yet reduce risk at the same time, then why not use the current market volatility to your advantage? Hold low-volatility stock sectors and conservative allocations of negatively correlated ETFs.

You will stand a good chance of having — and eating — your cake.

Keith Richards, portfolio manager, can be contacted at krichards@valuetrend.ca. He may hold positions in the securities mentioned. Worldsource Securities Inc., sponsoring investment dealer of Keith Richards and member of the Canadian Investor Protection Fund and of the Investment Industry Regulatory Organization of Canada. The information provided is general in nature and does not represent investment advice. It is subject to change without notice and is based on the perspectives and opinions of the writer only and not necessarily those of Worldsource Securities Inc. It may also contain projections or other "forward-looking statements." There is significant risk that forward looking statements will not prove to be accurate and actual results, performance, or achievements could differ materially from any future results, performance, or achievements that may be expressed or implied by such forward-looking statements and you will not unduly rely on such forward-looking statements. ETFs may have exposure to aggressive investment techniques that include leveraging, which magnify gains and losses and can result in greater volatility in value, and be subject to aggressive investment risk and price volatility risk. ETFs are not guaranteed, their values change frequently, and past performance may not be repeated. Please read the prospectus before investing. Every effort has been made to compile this material from reliable sources; however, no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please consult an appropriate professional regarding your particular circumstances.