Opinion: You may be too late to short or hedge this market downturn

By Dave Fry
Published: Oct 16, 2014 5:01 a.m. ET

Checking out an ETF geared to bearish investors

With market volatility high and stock market declines steep in recent weeks, investors are naturally wondering how long the downturn will last.

Some investors may have already determined that adding a hedge or shorting to protect their long positions was in order. However, this may already be too late, as markets have moved sharply lower and the damage may have already been done.

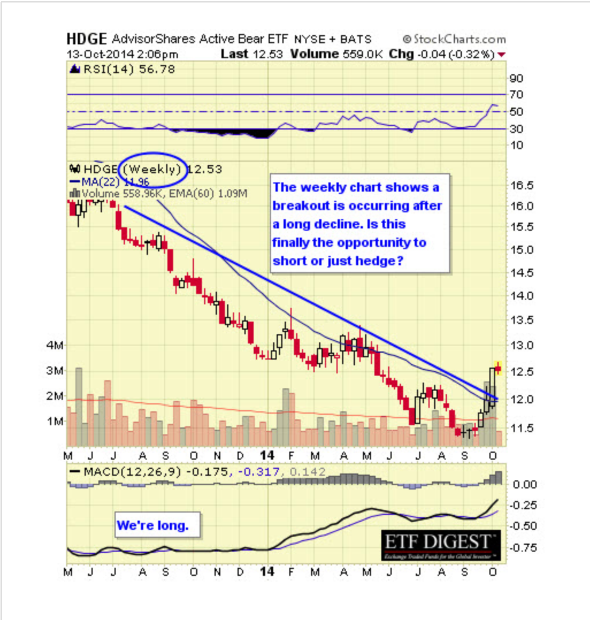
That said, one potential play is AdvisorShares Ranger Equity Bear ETF (HDGE) HDGE, -0.64% an actively run exchange-traded fund. Here's my edited interview with co-portfolio anagers John Del Vecchio and Brad Lamensdorf.

Dave Fry: What's your overall investment strategy and how do you implement it?

John Del Vecchio: It's two-pronged. First, we look for companies that may be vulnerable to earnings misses or a reduction in guidance either through aggressive accounting or deteriorating fundamentals. We do this two ways. First, is quantitatively, where we've built our own earnings quality models that assess risk in areas such as revenue recognition, cash flow quality, earnings manipulation, and shareholder yield among other factors.

The number one factor would be the quality of a company's revenue recognition. There's a notion that revenue is hard to manipulate, but that is completely false.

And, we use outside research to generate ideas or confirm what we're already seeing in a company's financials. Then we overlay with Brad's technical and views of the market



Brad Lamensdorf: I look for companies that are undergoing "distribution," meaning that we want to see stocks falling on heavy volume and rallying on light volume. As much as possible we want to avoid "momentum stocks". We build a portfolio around both fundamental and technical factors.

Fry: How do you decide how much exposure to take and when to cover a position?

Lamensdorf: Our overall exposure is dictated by general market conditions. For example, if the market is much overbought with excessive bullish sentiment and insider selling, we will want to be fully short. On the other hand, if the market has suffered a material decline and investors are predominantly bearish, then we raise cash

Del Vecchio: On an individual stock basis, if our thesis is wrong we will cover, no matter what. If our thesis plays out and Wall Street reduces their expectations and ratings such that they are aligned with our own thinking, then we will cover as well. We want to hold an opposing view rather than confirming view with Wall Street. Technically, if a stock is going against us we will tend to cover some of the position to wait for a more timely opportunity.

Fry: Given the type of strategy you've outlined, what's the best way for someone to use your fund?

Del Vecchio: I think there's several ways. First, use it as an insurance policy. Most people have insurance for their homes or cars but not their portfolio. Your house doesn't burn down every day, but it seems like the 100-year storm has been hitting the stock market every five years or so in recent history. Obviously, hedging hasn't worked well in the last few years, but the thing with insurance is you'll never know when you're going to need it.

Second, use it as part of an overall asset allocation plan. More and more advisers are allocating to alternatives. Shorting stock should be part of that. Generally, alternatives are designed to provide higher returns with lower risk over time. This is especially useful in bear markets or markets that are not in powerful up-trends.

Third, use it as a timing device. If you're bearish, then you may want to add short exposure to your portfolio. If you're bullish, then take the position off.

Fry: As you say, this is not an inverse fund, so what would be the ETF’s advantages over an inverse fund?

Del Vecchio: There's a couple of advantages, in my opinion. First, we do not use leverage. Leverage works until it doesn't. Then you blow up. Levered inverse funds are inherently flawed because they reset their exposure every day. They're designed to be held for one day. Bear markets don't occur in one day unless there is a crash. So, the volatility of the market kills levered funds over time.

When volatility increases — and it's typically much higher in bear markets — it benefits HDGE because there's less liquidity in the midcap stocks. They get hit harder. There's no "flight to safety" in non-blue-chips. These companies have less room to maneuver in tough environments as well.

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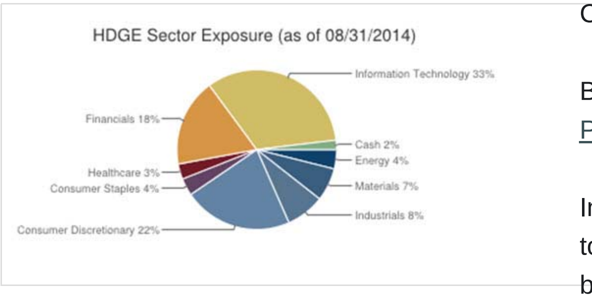
HDGE Sector Exposure (as of 08/31/2014)
Information Technology 33%
Financials 18%
Cash 2%
Energy 4%
Healthcare 3%
Consumer Staples 4%
Materials 7%
Industrials 8%
Consumer Discretionary 22%