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How to Protect Your Stock Portfolio From the Spreading Credit Crunch

by Martin D. Weiss, Ph.D.

The credit crunch we've been warning you about is likely to be so severe and so widespread, it could be next to impossible to hide from its potential impact.

Some stocks, mutual funds and ETFs — bolstered by growing foreign economies, rising foreign currencies or soaring natural resources — will be affected only temporarily. But many sectors are likely to suffer more permanent damage.

The big dilemma: You can't know for sure how much or for how long your stocks will go down until after the fact. So no matter how smart your selection, the time for portfolio protection (hedging) is now.

I'm not recommending you invest in a hedge fund. Rather, what I'm talking about is your own, personal hedging strategy.

Think about it: The credit crunch is now spreading beyond the confines of the housing industry and subprime mortgages. It's beginning to impact a wide range of sectors that most analysts thought would *not* be affected. Moreover, *even if it's a sector that we ourselves have recommended, that alone does not guarantee it's invulnerable to a crisis of the magnitude we are witnessing today.*

How do you protect your portfolio?

In the past, it was complicated. You had to sell short. Or you had to use futures markets. And in either case, you could expose yourself to unlimited risk.

Today, fortunately, thanks to the advent of a new kind of exchange traded fund (ETF), you can take advantage of a simpler, risk-controlled hedging strategy.

The vehicle: Inverse ETFs — special ETFs designed to go *up* when a particular stock index or sector goes *down*.

The good news: You can buy these inverse ETFs just like any other ETF — through your same broker, with the same low commissions and the same flexibility to get in and out as you please.

More good news: You can buy single-leverage ETFs, designed to go up 10% for every 10% decline in the index. Or you can buy double-leveraged ETFs, designed to go up 20% for every 10% decline.

The best news: A whole new series of inverse ETFs are now available that you can use for protection against declines in many major sectors: Real estate, financials, consumer goods, semiconductors, technology, emerging markets and even China.

This allows you to match our hedges more closely to the sectors or styles you're heavily concentrated in. For example ...

- If you have a lot of technology stocks, you could use the inverse ETF with the symbol **REW**.
- If you have a lot of small caps, you could use an inverse small cap ETF such as **SDD**.
- If you have a broadly diversified domestic portfolio, you could use **DOG** or **DXD**, which move inversely to the Dow Jones Industrial Average ... or ... **SH**, **SDS** or **RSW**, which move inversely to the S&P 500 Index. And ...
- If you're heavy into emerging markets, you could use **EUM** or **EEV**.

At the end of this report, I'll guide you to additional information on each of these, plus many more. But first, here are the steps I recommend:

Step 1. *Determine how much money you want to set aside for portfolio protection.* To help you think that through, let me first show you what the different possibilities are, and then I'll tell you which ones I prefer.

Possibility A. Let's say you have a \$100,000 stock or ETF portfolio that is broadly diversified and approximately matches the performance of the S&P 500. And let's say you want to protect the entire amount using an inverse ETF that's single-leveraged — designed to go up 10% for every 10% decline in the S&P 500.

Problem: That could be very costly. For every dollar in your portfolio, you'd have to invest another dollar in the inverse ETF. And to do that you'd have to come up with *another* \$100,000 from some other source to throw into the game.

If you were in Las Vegas, that would be tantamount to betting \$100,000 on the red ... and then finding another \$100,000 to bet on the black. You may think you can't lose. But the reality is ...

- You can't win either;
- You're incurring costs or commissions; and
- No portfolio protection is perfect. And in the unlikely event of a "double-zero" doomsday scenario, you could wind up losing something on both the red and the black.

Possibility B. Instead of full protection, why not settle for half protection? In other words, for every \$1 of current value in your portfolio, you'd put up only 50 cents of your money into the inverse ETFs. Assuming a stock portfolio worth \$100,000, that would mean investing another \$50,000.

Possibility C. Use an inverse ETF that gives you double-leverage. Now, to protect half of your \$100,000 portfolio, all you'd need to invest is \$25,000. Assuming your portfolio falls 10% in value, here's what you'd have:

Hedging only HALF Your Portfolio with Double-Leverage

	Your Stock Portfolio	Your Hedge Portfolio
Before 10% Market Decline:	\$100,000	\$25,000
After 10% Market Decline:	\$90,000	\$30,000
Loss/Gain	-\$10,000	\$5,000

End result: A \$10,000 loss in your stock portfolio, a \$5,000 gain in your hedge portfolio, and a \$5,000 loss overall. That cuts your risk of loss in half. Not bad. But you ask: Can't we do better than that? The answer: Absolutely, as you'll see with the following steps ...

Step 2. *Rather than invest new money in the inverse ETFs, raise that money by liquidating one third of your stocks.* Then, here's what you should wind up with:

SELLING 1/3 of Your Stocks: THEN Hedging with Double-Leverage!

	Your Stock Portfolio	Your Hedge Portfolio
Before 10% Market Decline:	\$66,667	\$33,333
After 10% Market Decline:	\$60,000	\$40,000
Loss/Gain	-\$6,667	\$6,667

You'll have \$66,667 left in your portfolio, and \$33,333 available to invest in an inverse ETF with double-leverage.

If the market falls 10%, you'll have about a \$6,667 loss in your portfolio and about a \$6,667 gain in your inverse ETF. End result: No loss (except for commissions and costs).

This simple step brings you two advantages: First, you won't have to dig into your cash assets to fund your hedge strategy. And second, you'll get *close* to full protection for the balance of your portfolio.

Again, the reason I stress the word "close" is because no portfolio protection can be perfect. You'll still have to pay commissions and some costs. And the double-leverage inverse ETFs do not always deliver exactly the *full* double-leverage they're designed to provide.

You could stop there and you'd have achieved your goal of risk protection. But if you want to apply some additional intelligence (with some additional risk), you could do even better by following a couple of advanced steps ...

Step 3 (advanced). Instead of liquidating one third of your stocks randomly, strictly get rid of the ones that are in the *riskiest* sectors, while holding on to those that are in the *strongest* sectors. In our regular publications, we tell you which ones we believe they are. But let's assume we're only half right and we get the following results:

Overall market: Down 10%

Weakest sectors: Down 20%

Strongest sectors: Down 5%

In this scenario, we're half right in the sense that the strongest sectors outperform. But we're also half wrong because, instead of rising as we expected, they still go down, although not as sharply. I think that's a reasonable expectation. But even in this situation, you wind up a winner:

SELECTIVELY Selling 1/3 of Your Stocks: Then Hedging!

	Your Stock Portfolio	Your Hedge Portfolio
Before 10% Market Decline:	\$66,667	\$33,333
After 10% Market Decline:	\$63,333	\$40,000
Loss/Gain	-\$3,333	\$6,667

Since your portfolio is strictly in the strongest sectors, your loss is reduced from 10% to 5%, or only \$3,333. Meanwhile, you're still gaining 10% on your hedges, or \$6,667. End result: Despite the market's overall decline of 10%, you actually come out ahead.

Step 4 (more advanced). Assume the same scenario as the previous example. And assume the same steps to liquidate the riskiest sectors while holding the strongest.

But, in addition, instead of using strictly an inverse ETF that matches the S&P 500, use inverse ETFs that are designed to make you money when specific sectors are going down, targeting those that we believe to be the weakest. Again, there's no guarantee that we're going to be right. But, assuming we're half way right (as in Step #3), here's how it would turn out:

You'd still have a \$3,333 loss in your stock portfolio. But, on the other side of your portfolio — the inverse ETFs — the bad sectors fall 20%. So your double-leveraged ETFs give you a gain of 40%, or \$13,333 (minus commissions and costs, of course).

Your net gain overall: \$10,000!

End result: You've just turned what could have been a \$10,000 loss in your portfolio into a \$10,000 gain instead. That's what I call *turning lemons into lemonade*.

SELLING 1/3 of Your Stocks: THEN Hedging with Double-Leverage!

	Your Stock Portfolio	Hedge Portfolio
Before Market Decline:	\$66,666	\$33,333
After Market Decline:	\$63,333	\$40,000
Loss/Gain	-\$3,333	\$6,667

Your Next Steps

Fortunately, virtually all of the ETFs you'll need for this program are now available for purchase. And to help you find the ones that best match your portfolio, my team has compiled a complete and current listing for you. Here's what to do:

1. Use our accompanying table entitled, "Our Comprehensive List of Inverse ETFs."

[Click here](#) to download the table as a pdf, or

[Click here](#) to download it as an Excel spreadsheet.

2. Search in alphabetical order for the indexes or sectors that you would like to use as hedges, based on my instructions above.

3. In the next column, find the names of the inverse ETFs that match those indexes.

4. In the column "leverage," please note most are double-leveraged inverse ETFs, which is what we recommend for this strategy. But some single-leveraged inverse ETFs are also available.

5. For the latest chart of these ETFs, enter the symbol at Yahoo! Finance, www.BigCharts.com, or your favorite Web charting program.

6. And, for further information from the provider of each ETF, just click on the name of the ETF in the spreadsheet to view its Web page. Or visit:

Profunds at <http://www.proshares.com/funds> and

Rydex at http://www.rydexfunds.com/etfcenter/home/etf_profiles.rails.

Good luck! And be sure to act swiftly before you suffer any significant damage to your portfolio.