Profiting from Volatility using Leveraged and Inverse ETFs

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Global financial markets have been erratic throughout 2019. Market cycles are seen to be sharper and shorter as of late moving on news flow and expectations. With volatility back and investors bracing for a bumpier ride ahead, instruments like leveraged and inverse exchange-traded funds (L&I ETFs) can be used to capitalise on such market conditions.

With the fresh listing of the country's first L&I ETF on Bursa, local investors now have access to a popular strategy that was until recently only available in more developed markets like the US, Hong Kong or South Korea.

Last November saw the simultaneous listing of 4 L&I ETFs by Affin Hwang AM that would provide investors the opportunity to profit from both bearish and bullish market trends.

The 4 ETFs are the TradePlus NYSE® FANG+™ Daily (2x) Leveraged Tracker, TradePlus NYSE® FANG+™ Daily (-1x) Inverse Tracker, TradePlus HSCEI Daily (2x) Leveraged Tracker, and TradePlus HSCEI Daily (-1x) Inverse Tracker.

Benchmarked against the Hang Seng China Enterprises Index and NYSE® FANG+™ Index respectively, the ETFs will provide investors the option to either gain a (2x) leverage or hold an inverse (-1x) position on the 2 indices.

It would provide investors with the opportunity to either double their investment returns through a Leveraged ETF in up markets, as well as the opportunity to gain returns/hedge against losses by shorting the market through an Inverse ETF in down markets.

All these without the common hassle that comes with derivative trading through warrants/futures such as margining or expiry.

Here's a breakdown of how investors can employ L&I ETFs as part of their portfolio strategy to potentially profit no matter which direction the market goes.

Tactical Exposure – Trade on Market News/Noise

2019 has been a trading market throughout the year as volatility surges whether stemming from trade tensions, recessionary fears or geopolitical tensions (e.g. Hong Kong riots, Brexit). The smartest strategy is to buckle-up, stay disciplined and invest consistently to ride the market peaks and troughs.

But, for investors looking to unleash their inner-trader and want some tactical exposure, then L&I ETFs are the ammunition to do so. L&I ETFs should be primarily viewed as daily trading tools for investors to express their short-term market views and potentially profit from intraday swings of the index.

For instance, investors can trade on both positive/negative news or employ technical analysis to determine the prevailing index trend and capitalise on the benchmark's movement over the short-term to reap higher returns.

Take an example this year when markets were whipsawed by the on-again off-again trade negotiations between US and China. Investors were wringed throughout 2019 guessing either side's next move. US President Donald Trump's penchant for Twitter diplomacy also did not help and injected more volatility.

But for investors who want to take a tactical view because they have a clearer read on the market's true fundamentals, they can opt to magnify their exposure through leveraged ETFs and make bigger wins in the market over short time frames.

An investor might be able to just profit off Trump's tweets and the president tweets a lot.

Hedging Instruments – Portfolio Protection

Inverse ETFs are also an efficient way for investors to hedge their investments by offering portfolio protection especially during bearish market trends.

To illustrate, what if a basket of stocks that an investor owns in a specific sector is seeing some signs of stress due to market noise (e.g. threat of tariffs, increased regulatory oversight), but the investor still holds a long-term positive outlook on the sector due to its strong fundamentals?

An inverse ETF would allow an investor to hedge against losses and still maintain their portfolio intact by squaring-off their market position. This is particularly for investors with a long position of the market who can then use the inverse instrument as a hedging tool.

A key investment mantra has been always to ride your winners and cut your losers. Sounds like a simple rule, but at periods of extreme volatility, investors often do the opposite. By utilising inverse ETFs, investors no longer need to dispose their long position. Instead, investors can net-off their exposure and prevent losses in a portfolio.

Volatility Welcomed

Both the Hang Seng China Enterprises Index and NYSE® FANG+™ Index have seen some major volatility this year after getting caught in the crossfire of the US-China trade negotiations. Whilst volatility is not something one would appreciate for longer-term investments, it is definitely welcomed for trading instruments like L&I ETFs.

In order to provide investors with the opportunity to capture both market upside and downside, the 2 indices were picked for its highly volatile and secular trend.

Over the long-term, the outlook on China is positive in view of its shift from a manufacturing to a consumption & services-led economy. The rise of its middle-class population and its spending power is expected to play a large role in the country's economic growth going forward.

However over the shorter-term, global sentiment may put some road bump in its upward trajectory. But these market swings provide investors the opportunity to capitalise from movement of the index, whether due to trade tensions or ongoing protests in HK. So long as volatility stays, L&I ETFs allow investors to tactically capture gains whether the index is up or down.

Similarly, the tech sector has been in focus with its growing ubiquity. The NYSE® FANG+™ Index which tracks the performance of the top 10 innovators across the tech industry such as Amazon and Facebook continue to advance and grow market share.

However, concerns over data security and privacy breaches could potentially stir up volatility in the technology space. Any short-term price reaction would provide investors a tactical window to capitalise from intraday volatility and give them an edge in their portfolio.

Taking Advantage of Volatility

Like how a moving sail needs the ocean currents to ebb and flow, markets need volatility to move higher or lower.

The L&I ETFs serve as a tactical window for investors to express their market views whether by taking bolder moves through amplified exposure or even bet against the market. Either way, it given them an opportunity to invest with stronger conviction, regardless of the direction of the market.

With volatility returning with a vengeance, investors would do well to embrace it to their advantage.

After all, there is wealth to be made in both directions of the market.
