Investing In 2018: Defensive Funds

As the previous article suggests, 2018 might be a difficult year for stock market investing. Yes, a 9-year bull market could stretch to 10 years. However, the longer the bulls keep running, the greater the chance that they'll have to pause for breath, and an exhausted equities market will sag. Risk reduction can be just as important as profit potential at current stock values.

One approach to risk reduction is to sell stocks and put the proceeds into cash. That may turn out to be a good move now, but it's also possible that you'll miss another good year in the market while earning virtually nothing in cash.

Another way to play defense is to review your asset allocation. If your investment plan is to have a 60/40 portfolio, stocks to bonds, equity gains might have moved that ratio to 70/30, for example. Trimming stocks and increasing bonds to get back to 60/40 probably would make your portfolio less volatile.

Safety in Numbers

One additional defensive tactic could be to reduce your holdings of individual stocks, then shift some assets into mutual funds and ETFs. A fund with 50 holdings is not as likely to be decimated as a portfolio with only 2 or 3 stocks. Funds often are managed by experienced professionals, backed by analysts who spend considerable time seeking desirable issues.

That said, there are many thousands of stock funds from which to choose. There is no certain way to predict results of a given fund, but some strategies might boost the likelihood of finding one that can provide some cushion in a down market.

Crafty Capturing

One possible approach is to use "capture ratios" to evaluate funds that you're considering. There are two types of ratios: downside capture and upside capture. The downside capture ratio shows a fund's losses in relation to a relevant market benchmark during downturns. The upside capture ratio shows a fund's gains in relation to a relevant market benchmark during upturns. This information can be found online on Morningstar.com.

Example 1: XYZ Fund's 10-year downside capture ratio shows that it held losses to about 80% of its benchmark's decline during market drops, while its 10-year upside capture ratio reports that it's returning about 90% of the market's gains during upward moves. This positive spread indicates the fund has held down losses while delivering largely positive results.

Comparing capture ratios can be useful but it's not a guarantee of success. If it were, everyone would simply look up capture ratios online, invest in the funds with the best positive spread, and mint money.

Nevertheless, the idea of comparing upside with downside performance can be useful. A fund that has done relatively well—that is, limiting losses—during the bear markets of 2000-2002 and 2008-2009 may be a fund that could do the same in the bear market of 2018 or 2019, or whenever the Ursidae family comes out of hibernation. If a fund that has done well defensively also has registered strong growth in rising markets, it may be a fund worth further evaluation.

Winning the Numbers Game

Underlying the approach of investing defensively is some basic math that investors may overlook.

Example 2: John Lucas holds $100,000 in XYZ Fund. The market drops 25% in the next year, but XYZ only falls by 20% to $80,000.

At the same time, John's cousin Linda James holds $100,000 of ZYX Fund, which drops the full 25% to $75,000.

Going forward, John needs a 25% gain to get back to $100,000, and Linda needs a 33.3% gain to recoup her losses. It's certainly possible that Linda's fund will outperform John's in the recovery, but it has significantly more ground to make up.

Carrying this example further, investors need a return over 40% to recover from a 30% loss, a 67% return after a 40% loss, and so on. Holding down losses can put you in a better position to build wealth when market cycles turn bullish, as you'll have more assets left to participate in future growth.

Stress Reduction, Too

Defensive funds may have non-mathematical attributes as well. Historically, bear markets have proven to be buying opportunities. Stock prices are "on sale," after steep declines. Yet, many investors sell during downturns and subsequently are late to get back in, forgoing potential profits. This sort of selling may be less likely after, say, a 10% decline in asset values than with a 20% drop.

If you decide to seek a fund with a good record of playing defense, see if the manager or managers who held down losses during bear markets are still in place. Read the fund's materials to find out if its investment philosophy meshes with yours, or discuss the fund's approach with your investment adviser. When stock market records are falling regularly, patience and prudence can pay off.