KIM: Bear-market funds can maul investors' long-term returns

Mickey Kim
September 12, 2015

Bear-market funds are designed to profit during market sell-offs. Given the recent frightening, violent sell-off, would it be wise to allocate a portion of your portfolio to this type of fund?

"For the vast majority of investors, bear-market funds just don't make sense," said Morningstar's Karen Wallace. "These types of tactical funds might be useful to a sophisticated few," according to her colleague Josh Charney, an analyst who covers alternative strategies. Charney warned, "But selling a portion of your portfolio and allocating it to a bear-market fund is beyond hitting the panic button; ***it's selling a piece of your portfolio and then betting against your portfolio."***

Bear-market funds typically have higher costs than traditional funds and are managed either "actively" (i.e. betting against individual stocks, like the Federated Prudent Bear Fund) or "passively" (i.e. betting against an index, such as the S&P 500). Most bear-market funds are passively-managed and some increase the magnitude of their bets by two- or even three-fold by using borrowed money (like the Direxion Daily S&P 500 Bear 3x Shares).

I warned of the dangers of investing in funds that borrow money to "juice their returns" in my August 13, 2013 column, "Steer clear of leveraged exchange-traded funds (ETFs)." Thanks to issuers like Direxion and ProShares, you can place a magnified bet (leveraged ETF) on an index or sector, either up or down (inverse ETF).

What most investors fail to realize is, unlike traditional buy-and-hold mutual funds or ETFs, leveraged ETFs are ***designed to be held no longer than one day***. The SEC issued an alert in 2009 that warned inverse and leveraged ETFs are "highly complex financial instruments" that "typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets."

Bear-Market Fund Performance					
	1-Day	**1-Week**	**1-Month**	**3-Months**	**YTD**
Bear-Market Category	5.57%	15.68%	15.21%	19.20%	6.89%
S&P 500	-3.94%	-9.91%	-8.77%	-10.49%	-6.81%
	1-Year	**3-years***	**5-years***	**10-Years***	**15-Years***
Bear-Market Category	3.21%	-18.30%	-22.11%	-15.63%	-9.07%
S&P 500	-2.82%	12.65%	14.88%	6.81%	3.52%
Data as of August 24, 2015. Source: Morningstar Direct. *Annualized					

As shown in the table, bear-market funds have indeed outperformed during this short-term period of market weakness. However and more importantly, when you go out to 3-years and beyond, the performance of bear-market funds has been nothing short of abysmal.

Using bear-market funds effectively requires market-timing prescience that is simply unattainable. Christine Benz, Morningstar's Director of Personal Finance and fellow Illinois alum, says if you want to reduce your portfolio's exposure to stocks, consider diversifying by holding more cash and/or bonds instead of buying a bear-market fund. According to Benz, "Volatile markets can be a breeding ground for knee-jerk investment decisions motivated by emotions more than fundamentals; undertaking a major portfolio renovation in such trying times is usually not a good idea."

In other words, don't be "that investor" who reacts to bad-news headlines and nervous market calls and both misuses bear-market funds and has horrible timing while doing it.

Kim is the chief operating officer and chief compliance officer for Kirr Marbach & Co. LLC, an investment adviser based in Columbus, Ind. He can be reached at (812) 376-9444 or mickey@kirrmar.com.