Leveraging short strategies in volatile markets

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This blog is part of our educational blog series on investment strategies and asset classes. Today we discuss short strategies as investment tools among exchange traded products.

When assessing new investments, even the most optimistic investors should have one eye on downside risks. In theory, growth assets like shares should appreciate steadily over time as companies mature and improve their profitability. Sadly though, markets do not always go up in value—and as we have seen time and time again, negative drivers can assert themselves just as strongly as positives ones.

Looking at the price of oil, for example, shows us that while oil was above US$100 per barrel for most of 2013 and into 2014, the price fell and stayed depressed for the past 4 years. While it has been rising bit by bit over the past year or so, we are still a far cry from US$100 per barrel. This extended trend (at least before the upticks) may have been an ideal time to incorporate a short strategy.

Figure 1: Price per Barrel of Brent Crude Oil

Source: Bloomberg. Price per barrel of Brent Crude Oil shown in US Dollars and over period from 4 September 1998 to 31 August 2018.

Historical performance is not an indication of future performance and any investments may go down in value.

The long and short of it

When you buy and hold an investment hoping that it will increase in value over time, you are said to be "long."

When you are "short," however, you are hoping that the investment will decrease in value. Traditionally, when thinking in terms of equities, the short selling mechanism works like this:

1) You borrow shares on margin and sell them

2) At a given point in time, you will have to buy the shares back and return them

- If the share price drops, as you are hoping, you buy them for less than you sold them and profit from the difference
- Of course, if the share price increases, you may have to buy them at a higher price than you sold them

Investors unfamiliar or not able to access this mechanism might have disregarded the possibility of going short, without understanding the relative ease with which they can do so by investing in a short exchange traded product (ETP).

Shorting made simple

Consider that the oil example above is simply one illustration of when going short can make sense. There are numerous other examples every day. And you may want to at least consider short strategies when there seems to be little upside in the market. Short ETPs enable you to implement a sophisticated shorting strategy without stock borrowing on a margin account.

One of the most important attributes of ETPs is that they provide pure exposure to underlying investments. For example, if you believe the oil price to be unsustainably high, you might consider a short strategy. If you took a short stock position in a specific oil company, you could experience losses even if the oil price goes down if the price of the company stock goes up. Buying a short oil ETP instead, however, would provide the opportunity to benefit from the fall in the oil price, without the external stock risks.

The ABCs of short ETPs

There are many kinds of short ETPs, including commodity, equity and currency options. They are often available in 1-5x short. Put simply, this means that at 2x and 3x and even 5x short, you receive double or triple or even five times the opposite return of the asset, respectively. If the asset goes down $1.00, at 2x the ETP increases $2.00 and at 3x it increases $3.00. Of course, the opposite is also true. If the price of the underlying asset increases, your losses are magnified. At 1x, the ETP moves the same amount as the underlying asset.

When it comes to the return period, daily ETPs reset each day. This means that gains or losses are factored into an ETP's price at the end of each trading day, and a new reference point is established from which to calculate any future returns. The most singular aspect of this feature of the daily reset is that as an investor's holding period increases, the returns that they experience may not be what they expect—which could be 2x, 3x or 5x the opposite return of the asset over that full period.

This is important because in trending markets — i.e., ones that rise or fall steadily — compounding generally enhances ETP returns, resulting in larger gains and smaller losses relative to the index return multiplied by the leverage factor. In volatile and sideways-trading markets, compounding usually has a negative effect, producing smaller gains and larger losses relative to the index return multiplied by the leverage factor. It is therefore important to have a short-term and very attentive approach to these strategies.

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