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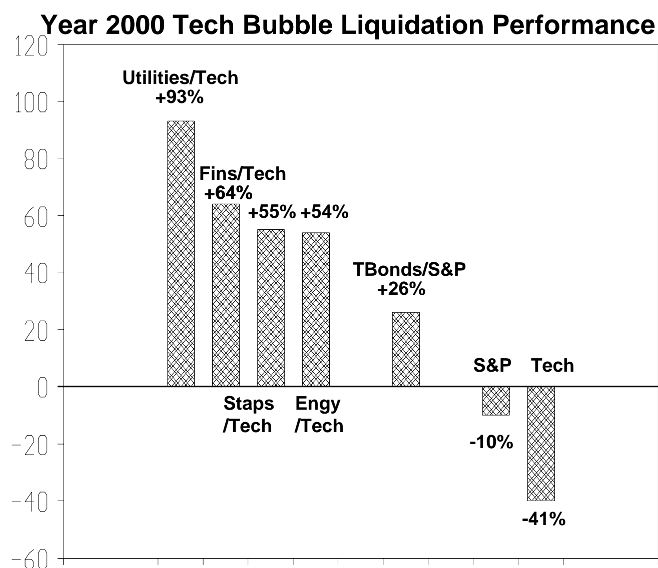
How To Harvest Alpha In A Bear Market



By now it should be obvious to everyone that equities are in a bear market. If you are waiting for the S&P500 to be down 20% to meet that definition of a bear market (down 20% from peak) you will be very late at taking defensive action. Morgan Stanley reports that 40% of S&P500 stocks are already down at least 20%. Now is the time to prevent portfolio destruction.

Here are some concrete steps to take to make money and minimize losses in a bear market. First of all, recognize that US stocks are in a tech bubble similar to that of 2000. All that hype and pressure to buy FANG stocks earlier this year is reminiscent of the pressure to buy internet stocks in late 1999 - early 2000. FANG was the most crowded hedge fund and momentum fund trade until September 2018.

FANG holders are getting crucified, our equal weighted FANG index is down -26% from its July 25th peak, having underperformed the S&P500 by -20% since that date. So much for that consensus FANG trade. But it does not look like FANG stocks have been flushed out yet, on the contrary our model forecast is the FANG decline is accelerating and *FANG stocks have near-term downside risk of another 27% to their 200 week average,* and that is just for starters. Furthermore, there is minuscule short interest in FANG stocks, almost nobody is short FANG and benefiting from the FANG wipeout. Short interest (% of float) is just 1% for FB, 0.6% for GOOG, 0.7% for AAPL, 1.6% for AMZN and 4% for NFLX. That is nothing. For comparison, TSLA has short interest of 26%, it's a crowded short and the stock hasn't fallen much. *FANG is an extremely uncrowded short and thus has no support from short covering.*

If we go back to the first year of the tech bubble liquidation in 2000, we find a massive rotation out of tech into defensive sectors, which were relatively depressed then just as they are now. In 2000 S&P sector performance, tech had negative alpha of -31%, while utilities had +62% alpha, health care +46% alpha, financials +34% alpha, consumer staples +25% alpha and energy had +23% alpha.

While consensus tech lovers got annihilated in 2000 (like now), hedge funds and long-only fund managers who had the foresight to short tech and buy defensive stocks made a killing. A long utilities/short tech sector spread was up +93% in 2000, long financials/short tech was up +64% in 2000, long staples/short tech was up +55% in 2000, long energy/short tech was up +54% in 2000. Those are all market-neutral pure alpha gains. See chart above left.

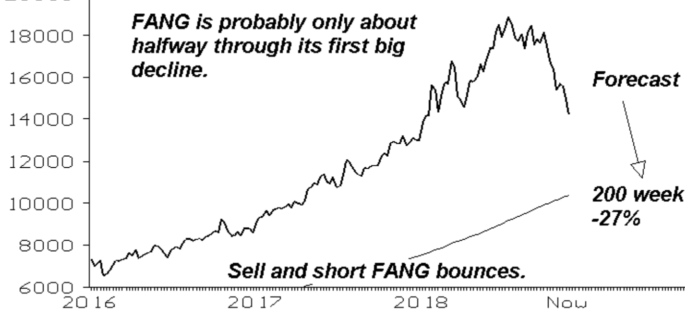
Our model forecast suggests a similar theme is now taking place beneath the surface of the equity market. We forecast a major rotation into defensive sectors months ago and it has been happening in spades. S&P utilities have +16% alpha since Sept 26th, consumer staples has +16% alpha since Oct 3rd, financials have +5% alpha since Oct 3rd, real estate has +14% alpha since Oct 3rd, the GDX gold stock ETF has +18% alpha since Sept 11th and the tech sector has -7% alpha since Jun 6th.

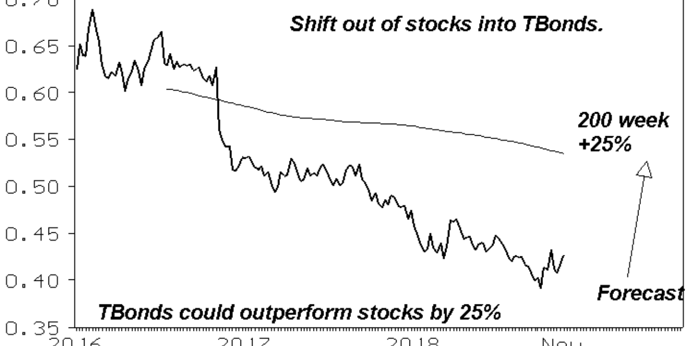
Put the positive and negative alpha together and long utilities/short tech is up +21%, long staples/short tech is up +21%, long GDX/short tech is up +25%, etc. Not bad for a market neutral trade in just a few months. This is not a consensus position at all, has anyone else repeatedly told you to buy utilities, staples, real estate and gold stocks and short tech? Probably not, that's one big reason why this strategy has a long way to go and it is not too late to buy defensive and short tech.

Another way to look at this rotation theme is long value/short growth, which we recommended in the July 30th Belkin Report. The value/growth spread (IWD/IWF) has really taken off in the past few days, it is up 9% from its recent lows. The intermediate and long term model forecast points up with conviction for value/growth. We strongly recommend long IWD/short IWF and/or however you might implement a long value/short growth strategy.

In conclusion, *there are concrete steps you can take to defend and actually profit from a serious bear market.* Other than the obvious tactics of selling, shorting and going to cash, market-neutral relative value trades offer serious alpha potential for hedge funds and long-only overweight/underweight positions. Buy defensive sectors and short tech. Buy value and short growth. Buy gold stocks and short tech. Buy TBonds (TLT) and short the S&P500. That bond/stock spread was up 26% in 2000, a triumph for asset allocators who switched out of stocks into TBonds.

FANG, Defensive Sectors, Tech, Value/Growth, GDX Gold Stocks — Belkin Report — Nov 19, 2018





Defensive sectors are having massive outperformance that is forecast to continue.