Be Ready for the Next Investing Crisis

Four things that could go wrong, and how you can protect your portfolio

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Get ready for the next crisis.

Six years into a bull market for stocks and bonds, there is no shortage of reasons to prepare for trouble.

U.S. stocks are close to their most expensive levels since 2004, even as interest rates seem headed higher. China’s economy and financial markets have turned fragile, Brazil is under pressure and a bailout of Greece might not work. The U.S. tech-stock boom could go bust and high-profile investors are gearing up for a crisis in the expanding world of exchange-traded funds.

It isn’t time to sell everything and head for the hills. Longtime investor Jeremy Grantham, chief investment strategist at GMO LLC in Boston, says stocks need to rise another 10% or so before they reach bubble territory. Still, Mr. Grantham, who counts 28 financial bubbles around the globe since 1920, argues that stocks are overvalued.

Whether one agrees that stocks are approaching bubble territory or not, well-planned investment portfolios require a dose of protection. Currently there are few obvious ways, however. Gold prices keep falling, safe investments have puny expected returns. Bonds with any risk attached to them increasingly move in the same direction as stocks, reducing their ability to hedge a portfolio.

Below are some potential storms on the horizon, and possible ways to prepare for them.

Tech Stocks Pull Down the Market, Again

The stock market is up so far this year, led by tech stocks. But the sector is rising on the backs of just a few stocks. More than half of the gain of the Nasdaq-100 index—which tracks the 100 largest Nasdaq nonfinancial companies—is because of just two stocks, as of Friday’s close: Amazon.com Inc. and Google Inc. says Mike O’Rourke, chief market strategist at JonesTrading in Greenwich, Conn.

When relatively few stocks are leading the way, trouble could be around the bend for the entire market. That is what happened in early 2000 when highflying tech shares soared and then collapsed. Today, one or two ugly earnings reports from the tech titans could be enough to disrupt the broader market.

Another reason for caution: The S&P 500 is trading at almost 18 times its companies’ profits for the past 12 months, well above its long-term average of 15.7. “The only time the multiple has expanded beyond
this level for an extended period of time has been during bubbles or recessions,” Mr. O’Rourke says, arguing that investors need to be prepared for rougher markets.

**The Solutions: Bold and Boring**

The first defensive move is to make sure a portfolio isn’t overcommitted to technology or any single sector, of course. But shorting, or betting against, tech shares can be dangerous. These stocks could keep climbing, crippling any bearish trades.

Instead, some advisers recommend active investors buy long-term “put” contracts on PowerShares QQQ Trust Series 1 (symbol QQQ), a heavily traded ETF tracking the tech-intensive Nasdaq-100. These put contracts, which give holders the right, but not the obligation, to sell the index at a set price, should appreciate in a market downturn.

Puts can be expensive, notes Jack Rivkin, chief executive of Altegris Advisors in La Jolla, Calif. A three-month put contract to protect against a more than 10% downdraft in a $100,000 portfolio would cost about $635, or more than 2½% of the value of the holding if the protection were purchased every quarter for a year, based on recent prices. If the QQQ were to fall 10% during the period covered, an investor would make about $3,000 from the put contract, assuming there’s about two months until the contract expires.

Gregory Curtis, chairman of Greycourt & Co. in Pittsburgh, is a fan of placing stop-loss orders on tech stocks, a standing order to automatically sell if they drop 15%. If they do, investors should then shift that money to an ETF that tracks value shares, he says. One idea: Vanguard Value ETF (VTV).

For all investors, including those mainly in the market through a 401(k), holding safe investments is a must. A smattering of cash, CDs and short-term Treasurys can help stabilize a portfolio in a crisis. They also discourage investors from dumping riskier holdings with better long-term prospects, says William Bernstein, an investment manager and author in Portland, Ore. Turn the clock back to, say, early March 2009 and ask yourself just how much in cash, CDs and Treasurys” would have been enough to help you hold off on selling riskier assets at low prices, he says.

Cash also lets investors hunt for bargains when markets stabilize.

**China Goes Downhill and the Greek Bailout Fails**

The Chinese stock market is down about 31% since mid-June, the worst performance in more than eight years. If troubles persist, questions could grow about the Chinese government’s ability to steer the debt-laden economy.

Meanwhile, investors are increasingly nervous about Brazil’s weakening economy, and Europe’s agreement regarding Greece’s debts might not have more success than two earlier bailouts.

**The Solution: Volatility Plays**
If geopolitical events cripple the market, a fund that sticks to low-volatility stocks, such as PowerShares S&P 500 Low Volatility ETF (SPLV), could hold up well. But the biggest payoff likely will be from investments that rise as the market’s volatility surges, argues Robert Gordon, president of Twenty-First Securities Corp. in New York.

These strategies aren’t for novices. Mr. Gordon recommends call options—which give holders the right to buy shares at a specified price—on the volatility index known as the VIX. These options can be bought through any brokerage. Options can move quickly and cause big losses or they can expire worthless.

Other investments that aim to profit when volatility rises: exchange-traded notes such as iPath S&P 500 VIX Short-Term Futures ETN (VXX), which track the CBOE Market Volatility Index; and ETFs like ProShares VIX Short-Term Futures (VIXY), which tries to match the performance of the S&P 500 VIX Short-Term Futures Index.

For those looking to bet against expensive Chinese shares, some advisers recommend shorting KraneShares CSI China Internet ETF (KWEB), which tracks the CSI Overseas China Internet Index, or Global X Nasdaq China Technology (QQQC), which tracks the Nasdaq OMX China Technology Index. But be careful: China’s government is trying to prop up its stock market. If it succeeds, shorting these funds could lead to losses.

Central Bankers Bungle It

Markets have faith in central bankers fighting to generate global growth. In the U.S., the Federal Reserve is expected to begin raising rates, though few expect a recession soon.

But the recent slide in commodity prices could portend a global economic slowdown, some say. And corporate bonds could be hurt if the U.S. economy slips or the Fed raises rates at a faster pace than economists expect.

The worst part of the 2008 financial crisis “was seeing high-grade corporate bonds, munis, and even TIPS—which most folks considered safe—get slammed,” says Mr. Bernstein.

The Solutions: Long-Term Bonds and (Gulp) Gold

As the Fed raises rates, investors should shift into—not away from—long-term Treasurys, argue some managers, including Jeffrey Gundlach, chief executive officer of DoubleLine Capital LP in Los Angeles.

Instead of reacting to Fed moves, these bonds tend to respond to forecasts of inflation. Inflation currently is subdued and will face further headwinds when the Fed raises rates.

“Rising short-term rates could lead to lower long-term rates as the marketplace signals the increased likelihood of a recession,” says Darren Pollock, portfolio manager of Cheviot Value Management in Los Angeles, who says it is unusual for the Fed to increase rates when the economy remains sluggish.

Gold prices are down about 40% since peaking at nearly $1,900 in 2011. But if markets lose confidence in the ability of the Fed and other central banks to prop up markets, gold will perk up, predicts hedge-
fund manager Bob Wiedemer, who notes that gold tends to attract interest when doubts grow about values of leading currencies. Just don’t keep more than a few percentage points of a portfolio in gold, which generates no income or dividends, advisers warn.

**Bond ETFs Blow Up**

Recently, high-profile investors including Carl Icahn warned of a potential crisis in the expanding world of bond-focused exchange-traded funds.

Because Wall Street bond dealers play a smaller role in markets today, a bond-market scare could spark a rush of selling by individual investors in ETFs and mutual funds. In such a scenario, these vehicles could find they have fewer buyers to sell to.

Bill Gross, who helped found Pacific Investment Management Co. and now runs a fund for Janus Capital, recently wrote that “mutual funds, ETFs, and even index funds” are vulnerable in a downturn. “The obvious risk—perhaps better labeled the ‘liquidity illusion’—is that all investors cannot fit through a narrow exit at the same time,” he wrote.

**The Solution: Mortgages and Bearish Bets**

Sreeni Prabhu, chief investment officer of Angel Oak Capital Advisors in Atlanta, recommends shifting to bonds that are less frequently found in funds and ETFs, such as residential mortgages. One mortgage-focused fund recommended by Maury Fertig, chief investment officer of Relative Value Partners in Northbrook, Ill., is TCW Strategic Income Fund (TSI), a closed-end fund with a chunk of its portfolio in residential and commercial mortgage bonds, as well as other asset-backed bonds, investments that most individual investors have limited access to. Today, lenders no longer court risky borrowers, making the mortgage market safer than in the housing crisis in 2008.

Buying put contracts on iShares iBoxx $ High Yield Corporate Bond (HYG), the most liquid junk-bond ETF, is a way to profit if there’s a run on junk bonds, according to hedge funds placing this bearish trade. Others say bank loans could be hurt in a bond crisis because there can be limited trading in these investments. They are shorting or buying put contracts on PowerShares Senior Loan ETF (BKLN), which tracks an index of loans made to debt-heavy companies.