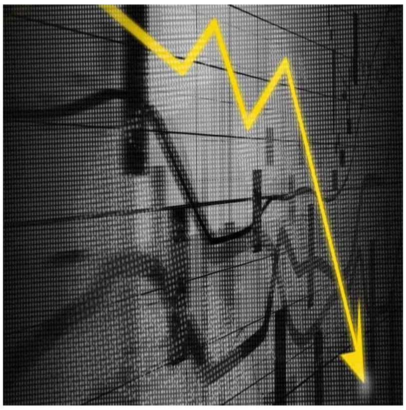

TFSA Investors: How to Outperform in a Bear Market

Description

You can expect a correction this year and a bear market within the next three years.

I'm not making a shallow economic forecast or trying to alarm investors of a shock scenario. Instead, I'd like to remind overly complacent investors that such stock market declines are healthy. The markets are inefficient, and the corrections, bear markets, and all the sort are to be expected, and investors need to deal with them accordingly.

Whether that means hoarding a cash pile in your TFSA (like Warren Buffett), so you'll have enough to buy when the sale on stocks begins or constructing a "risk-parity" or all-weather portfolio (like Ray Dalio) with a favourable risk/reward, investors should always have a plan to tame the bear when it inevitably comes out of hibernation. You wouldn't go into the woods without bear repellent, so it's only prudent to not invest with an overconcentration in the cyclical areas of the market!

While hoarding cash may seem like the most prudent course of action, the opportunity costs of doing so are high, with upside risks that are seldom considered by investors.

In this piece, I'm going to look into the construction of a risk-parity portfolio — a portfolio that will not only hold its own when the markets crumble like a paper bag but also deliver satisfactory returns regardless of what the market "weather" will end up being in the future.

If you're looking to "weatherize" your portfolio for a bear market without compromising significantly on the front of the returns in the event that stocks continue surging higher, you should seek to improve your Sharpe ratio and lower your portfolio's beta.

When the markets tank, you'll want stocks that are less likely to follow the moves made in the market. That means low-beta stocks that have a low correlation to the broader markets. Consider **BMO Low Volatility Canadian Equity ETF** (TSX:ZLB), a one-stop-shop basket of securities that allows certain investors to reduce their portfolio's average beta.

ZLB owns Canadian securities within sectors of the market that are more likely to trade in their own worlds and are less likely to follow in the footsteps of the broader indices. Think utilities, consumer defensives, telecoms, REITs, and lowly-correlated insurers like **Fairfax Financial**.

The mix of assets isn't just more likely to zig when the markets zag; they're likely to outperform the TSX Index over prolonged periods of time. You see, ZLB isn't just the results of a screener for the lowest-beta Canadian securities. Securities are hand-picked based on the quality of their underlying businesses, with consideration for growth prospects, value, and financial health, among other traits — smart beta in a nutshell.

The key to ZLB is the implementation of the *smart* beta strategy.

As you may know, a stock of a distressed company that does nothing but tank while the markets rally will have a low beta, and the last thing you want is a stock of a rancid company that'll stink up your portfolio (that would be dumb beta investing!). As such, investors should strive to ensure they only invest in "wonderful" businesses that just happen to possess low long-term betas.

ZLB will buoy your portfolio in the event of a bear market, but don't expect to be unscathed if we fall into another crisis like in 2007-08 that sent stocks falling over 50%. Low beta means lower volatility and potentially lower downside risk, not complete immunity from declines. What you can expect, however, is a smoother ride and significantly reduced downside relative to the broader markets. Think of ZLB as standing to take on X% less damage relative to the indices in the event of a violent downturn!

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