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Voices: J. Camarda, On Downside Protection

J. Camarda is Chief Investment Officer of Jacksonville, Fla.-based Camarda Financial Advisors.

In the wake of the events of 2008, my firm has noticed a profound shift in investor psychology. Investors have become more driven by fear, and they want downside protection in order to avoid significant losses. We've found that the old "buy and hold" and asset allocation approaches aren't very appealing to today's investors. Clients want to know how to make money in a declining market. They're interested in sophisticated technical trading and non-traditional investments.

In response to these changing preferences, we've developed techniques that weren't particularly compelling before the crash but now provide us with a unique advantage. These techniques represent what today's investors want and what most firms don't provide. They include short vertical options spreads, synthetic long-short repair and downside protection using stop-loss orders.

This last technique is the most attractive. Stop orders don't guarantee execution at a specific price–for that you have to pay for a put–but stops are free and offer a high probability of getting out at a decent level. We start by using fundamental analysis to assemble a group of stable stocks that we can buy at significantly discounted prices. Using tactical analysis, we set the stops below where we expect the anticipated trading range to be. We then move them up or down depending on investment and market conditions.

In a rising market, we slowly adjust stop losses upward to stay just below the normal trading range. This creates a safety net, but still allows profits to be protected going forward. When the market's volatility has a sharp down leg, our stops can get most stocks out at pretty attractive levels. This allows us to deliver significant returns to our clients, even after fees and expenses.

J. Camarda

In order to implement this technique, advisers need to be familiar with tactical analysis. They need to know where to set the exit points and reinsertion points. The big danger is triggering a stop loss during routine trading.

While most firms focus on market timing, we actively manage downside risk. It takes a robust staff of trained analysts to execute this approach well. But when done correctly, it provides clients with meaningful downside protection in a cost-effective package. It doesn't increase investment costs nor does it curtail upside appreciation. Our clients really appreciate the peace of mind this downside protection mechanism affords them. It's been an effective way to attract new clients and keep old clients happy.

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