



ETFs Provide Cover When Markets Get Crazy
ETFs, EXCHANGE TRADED FUNDS, PERSONAL FINANCE

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Exchange-traded funds have emerged as a popular tool to manage risk at a time when the stock market continues to set new standards for unpredictability.

The funds, more commonly known as ETFs, allow investors to put money in areas where many usually dare not go-- commodities, foreign markets, and even get into short-selling with funds that can pay double if the market falls.

Rydex Investments, one of the leaders in ETF offerings, recently rolled out eight new funds that play both upside and downside moves in the markets.

"If stocks aren't expected to have a lot of directionality, what's an investor to do?" David Reilly, Rydex's director of portfolio strategies, said at a recent news conference in New York announcing the rollout.

ETFs have become in vogue to hedge risk in a crazy day like Monday, when the major indexes started sharply higher then moved just as quickly and just as far into negative territory, only to whipsaw back again. The Dow Jones Industrial Average was up more than 100 points just before noon then was down nearly 150 points before recovering.

The flexibility of ETFs, combined with their lower fees and risk reduction, are making them into some of the hottest plays on the market right now. ETFs are a pool of securities that mostly track sector indexes, like transports, utilities, energy or commodities.

"The reality is retail investors should not be taking the kinds of risks that industrial investors take," says Nadav Baum, managing director of investments at BPU Investment Management in Pittsburgh. "That doesn't mean they shouldn't be in the same types of asset classes."

Baum has long been an advocate of playing the wild upsurge in oil prices through an ETF that tracks energy producers. The play shields investors from fluctuations in individual company stocks while capitalizing on the industry trends.

The **Energy Select Sector SPDR** fund has gained nearly 9 percent in 2008 and is up more than 27 percent over the past 12 months.

Baum advises clients to play the fund rather than cherry-picking individual energy stocks that can be volatile over time, especially if oil starts falling or geopolitical issues weigh on company profits.

ETFs also provide greater flexibility than mutual funds in that investors can exit at any time.

"You can get in and out of there quicker because they trade like a stock," Baum says. "I think ETFs are really revolutionizing the entire market."

Even for Bears

ETFs offer an easier pathway for investors who feel the stock market is going to continue to fall.

Short-selling is one of the riskiest trades investors can make, and advisers traditionally have tried to dissuade their clients from doing making such difficult bets. Over time the stock market always goes up, so timing is critical and few retail investors can put in the amount of effort it takes to determine market dips.

But ETFs provide safety from some of the risk that shorting the market entails.

Inverse funds reward investors when the market falls, and some funds even provide double the return for those willing to stick their necks out on a market drop.

Rydex in June debuted eight new ETFs, half of which are listed as 2x inverse, meaning double returns for a drop in the indexes. The new Rydex funds offer straight and inverse plays on the energy, financial, health care and technology sectors. The firm believes its offerings help guide investors through times of uncertainty and volatility in the markets.

Reilly said the ETFs allow investors to have broader sector exposure with the same amount of capital, something that resonates these days with money managers.

For someone like Kathy Boyle, president of Chapin Hill Advisors, who believes there is more downside risk to the markets, inverse ETFs provide an ideal vehicle. Her investors increasingly are asking for them.

"It's a constant demand. We comb through these things all the time," she says. "If I can do an ETF or a (mutual) fund, I'm going to do an ETF because I can control the pricing."

Boyle likes ETFs offered by ProShares that short not only the major indexes but also individual industries. Among them: the **Ultrashort Financials ProShares**, which has gained more than 10 percent this year and more than 66 percent in the past 12 months by betting against the battered banking sector.

But short-selling, even when doing so through ETFs, remains a risky business.

"You have to be paying attention," Boyle says. "It's not for a novice and it's not easy to do on your own."

"You could get whipsawed very easily," Baum adds. "I think that by shorting these ETFs they're adding a whole new dimension to the game and it's very hard to monitor."

Too Crowded?

There's some sentiment that ETFs could become oversaturated soon, and Boyle questioned whether Rydex isn't "late to the party, because ProShares ate up a lot of their volume."

But their popularity is undeniable and investment advisers think the market may still have room for more.

"There is such a bevy of new offerings that continue to come at us that there's only so many tools an investor needs in their toolbelt," says John Schloegel, vice president of investment strategy at Capital Cities Asset Management in Austin,

Texas. "At some point there's too much supply and supply will meet demand. Ultimately there probably will be a shakeout from an ETF-provider perspective."

Nevertheless, Schloegel likes a variety of ETFs, with exposure to alternative energy, materials, commodities and utilities.

Some of his favorites include: **iShares Dow Jones Basic US Materials** , up nearly 12 percent this year and nearly 23 percent over the past 12 months; **Poweshares Water** , which tracks domestic water-oriented businesses and is up 11 percent in the past year, and **Claymore S&P Global Water** , which is like PHO but is focused internationally.

Schoegel also points to one of the more popular ETFs, the **SPDR Gold Shares** fund, which tracks the commodity's movement as a good diversification tool. The fund is up about 34 percent over the past 12 months.

"We utilize them to a great degree," he says. "We like the ease and efficiency, and the baskets and sectors allow us to invest appropriately for our customers."

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