BusinessWeek

BusinessWeek

Portfolio Protection from Exchange-Traded Funds

Friday August 1, 8:08 am ET

The bad economic and market news is coming from every direction. But thanks to a torrent of financial innovation in exchange-traded funds (ETFs), investors have more ability than ever to cope with market turmoil, whether by accessing alternative assets, hedging existing positions, or just snapping up oversold bargains. So how can investors use the more than 700 ETFs available in the U.S. to address their greatest concerns now?

One of the biggest threats to the economy -- and to a U.S. investor's portfolio -- is inflation, which, if it accelerates, will further erode the value of everything denominated in dollars. The Fed typically fights inflation by raising interest rates, but this year it has been cutting rates to bolster teetering financial institutions.

The most reliable hedge against rampant inflation is precious metals, says Peter Schiff, president of Euro Pacific Capital in Darien, Conn. The SPDR Gold Shares Trust (NYSEArca:GLD - News) has risen 11% in 2008, as inflation has gained momentum. The iShares Silver Trust (AMEX:SLV - News) is up 17%. Most financial advisers say only a small position in precious metals, about 5% to 10% of an investor's assets, will provide an adequate inflation hedge.

Schiff isn't a fan of U.S. Treasury Inflation-Protected Securities (TIPs), which pay a modest yield plus a return linked to the consumer price index (CPI). The government index understates the true magnitude of inflation, he argues: "It's the financial equivalent of allowing the fox to guard the henhouse." But other advisers point out that TIPs are the only investment guaranteed to correlate with the CPI. Gold prices can rise or fall depending on various factors, such as demand for the metal, which fell earlier this year. The iShares Lehman TIPS Bond Fund is up 3% in 2008.

Since rising inflation and low interest rates also hurt the value of the dollar, many advisers suggest investors diversify currency exposure, too. Using ETFs, investors can access money-market-like funds denominated in currencies such as the Swiss franc or Japanese yen. The CurrencyShares Swiss Franc Trust (NYSEArca:FXF - News) is up 10% this year. Global bond ETFs also provide a low-cost way to benefit from a weak or falling dollar. The SPDR Lehman International Treasury Bond Fund has gained 5% this year. And the SPDR DB International Government Inflation-Protected Bond Fund combines all of these themes by investing in inflation-protected debt issued by countries including Britain, France, and Poland in their local currencies. It's down 0.7% since it opened in March.

Diversifying away from the U.S. will help investors weather the current storm. But some advisers recommend taking further steps to protect a typical portfolio. A variety of exchange-traded funds rise when markets or sectors fall, sometimes using leverage to move twice as much as their targeted index. Alan Rosenfield, managing director at Harmony Asset Management, an ETF-focused money manager in Scottsdale, Ariz., says he has been buying funds that short the Standard & Poor's 500-stock index and the Russell 2000, as well as the financial sector and Chinese stocks, to hedge against the long positions his firm holds in similar markets.

Shorting through ETFs is less risky than shorting stocks directly, since an investor can't lose more than she puts into the fund. (When shorting a stock, potential losses are unlimited.) When using an ETF that moves twice as much as its benchmark index, investors should only buy half as much of it as they have in the position they are hedging.

Hedging with ETFs won't always work because the holdings of the fund may not mirror the stocks in an investor's portfolio. The Short Financials ProShares (AMEX:SEF - News) is tied to an index that includes a mix of banks, insurance companies, and real estate investment trusts, for example, so if you're trying to hedge a brokerage stock you own, the broad ETF is an imperfect solution.

Some pieces of a portfolio might be better off replaced than hedged. Many investors have sought out stocks paying above-average dividends, which historically outperformed lower-yielding stocks in bear markets. But this time around, since so many financial companies are among the big dividend payers, that strategy has been a disaster. The PowerShares HighYield Dividend Achievers (AMEX:PEY - News) ETF, for one, is down 27%.

Michael Krause, president of AltaVista Independent Research in New York, favors a diverse dividend strategy with a more international focus. He uses the WisdomTree Emerging Markets High-Yielding Equity Fund (NYSEArca:DEM - News). The underlying index has a higher yield and a lower price-earnings ratio than U.S.-centric dividend funds.

Beaten-Down Values

Beyond merely defensive moves, money managers see some more opportunistic plays. The iShares S&P U.S. Preferred Stock Index Fund (PFF) is one way to benefit from an eventual rebound in financials that is less risky than buying ordinary stocks, says Krause. The fund is heavily invested in preferred shares issued by financial companies -- 75% as of June 30 -- which should gain as the sector recovers. Meanwhile, investors collect a yield of almost 8%. Preferred dividends can't be cut unless a company eliminates its common dividend first.

Brazil's stock market is another good beaten- down value, says Morningstar (NasdaqGS:MORN - News)'s director of ETF analysis, Scott Burns. The iShares MSCI Brazil Index (NYSEArca:EWZ - News) is down almost 15% over the past month in unison with other emerging markets, even though Brazil's economy is still strong, Burns notes. Standard & Poor's (NYSE:MHP - News) boosted the country's credit rating at the end of April, a huge new oil field was discovered off the coast last November, and gross domestic product is growing briskly without stirring inflation.

There's less value to be had when fund sponsors jump on hot trends by issuing new funds. Advisers point to funds investing in "frontier" stock markets -- those of the most risky, least developed countries -- which have come out in the past few months. "Normally you want to look at the fundamentals of the companies underlying the fund," says AltaVista's Krause. "For these frontier funds, we couldn't find any information at all about many of the holdings." And in this market, flying blind isn't recommended.