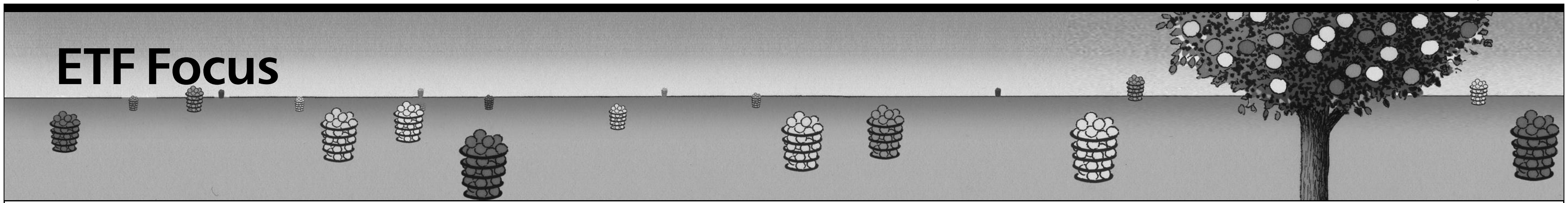

Time to Hedge Your Stock Bets?

By Eric Uhlfelder

STOCKS ARE IN THE SEVENTH YEAR OF A BULL RUN—LONG BY any measure. And with share prices again nudging up against record highs, it's reasonable for investors to think about hedging against a downturn.

So where should an investor start his or her search? For active traders, Mohit Bajaj, director of ETF Trading Solutions at New York-based WallachBeth Capital, which develops and implements strategies for institutional investors, suggests one possibility: inverse ETFs. These funds offer short market exposure that "can be an effective tactical hedge for investors concerned about near-term portfolio risks." Bajaj recommends using these products like a jet uses reverse thrusters–only at times when an investor feels threatened.

Bajaj, who works with pensions, endowments, insurance companies, and large-money managers. estimates that there are about 75 such ETFs providing protection on various U.S. equities, corporate and government debt, commodities, and foreign markets. The more obscure the underlying securities, however, the less liquid they tend to be, trading with wider spreads and coming with higher management expenses.

ETF Table, Barrons.com

But for U.S. equity indexes–the Standard & Poor's 500, the S&P MidCap 400, and the Russell 2000–the cost of this kind of insurance is surprisingly affordable. If you bought the **ProShares Short S&P500** ETF (ticker: SH), Bajaj estimates the carrying charges would run between 1% and 1.5% for a six-month period. The costs of holding the **ProShares Short MidCap400** (MYY) and **ProShares Short Russell2000** ETFs (RWM) run a bit more. Costs include management fees, the decaying value of the underlying swaps needed to create the short, and the accrued dividends that an investor would owe.

Calculating the value of inverse shorts isn't an exact science because of market volatility, but Bajaj estimates that if the market dropped 10% over several months, these ETFs would return between 8% and 8.5%. So far this year, the S&P 500's total return is 1.7%, while its inverse ETF counterpart is down 2.6%; the S&P Midcap index is up 4.3%, while the inverse mid-cap ETF is down 5.5%; the Russell benchmark is down 1.7%, while its inverse ETF is off 0.4%.

These products are usually short-term bets. Ben Johnson, Morningstar's director of global ETF research, worries that retail investors would fail to appreciate exactly how these vehicles work. And the ill-effects can be magnified if the ETFs are leveraged. Instead, Johnson recommends that investors rethink their overall asset allocation—for example, by dialing back equity exposure—to reflect more bearish concerns.

Two ways to protect yourself: inverse ETFs or simply changing your asset allocations.

Alternatively, to establish a hedge, investors could selectively short individual flagship stocks. But an easier way would be to sell short any of the long ETFs that actively trade. This involves borrowing the ETF from your custodian, which will cost slightly less than inverse ETF management fees. You would also be responsible for paying dividends if there was a payout during your holding period. For less than a month, Bajaj thinks the cost between the two strategies is a wash. But for more than a month, shorting ETFs would offer a small savings.

Eventually we will find ourselves in a bear market. Bajaj insists that judicious use of inverse ETFs can be an effective means of offsetting losses on long bets. But like most things in life, timing is everything. ■

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