Print Close

INVESTORS.com
POWERED BY INVESTOR'S BUSINESS DAILY®

INVESTING

Hedge Funds Increasingly Use ETFs For Shorting

By PAUL KATZEFF, INVESTOR'S BUSINESS DAILY
Posted 10/26/2012 05:30 PM ET

When it comes to ETFs, hedge funds have a clear preference.

"Funds rely on stock picking on the long side," said Charles Gradante, co-founder of Hennessee Group, an adviser to hedge fund investors. "When they run out of stock ideas or want to protect themselves from market risk, they use ETFs to short."

Hedge funds use a variety of tools and techniques for shorting, Gradante says. And the use of exchange traded funds is increasing.

That's because as the hedge fund industry has grown, the demand for stocks to borrow for shorting purposes has outstripped the supply available on Wall Street, Gradante says.

"So funds are moving more to ETFs for that reason," he said.

ETFs let short sellers buy in bulk.

"The typical hedge fund manager has core positions that are buy and hold," Gradante said. "Increasingly they use ETFs on the short side."

Many diversified small-cap hedge fund managers would satisfy shorting needs by betting against **iShares Russell 2000 Index ETF** (IWM) rather than individual stocks or by buying an inverse ETF, he says.

IWM has $18 billion in assets and trades 37 million shares a day. It tracks 2,000 stocks that are most of the smallest issues in the Russell 3000 Index, which represents 98% of the U.S. equity market.

Only tiny hedge funds, Gradante says, would short the Russell 2000 by investing in inverse ETFs such as the triple leveraged **ProShares UltraPro Short Russell2000** (SRTY), with $71 million in assets and average daily volume of just 598,000 shares. It's the same for $465 million **ProShares Short Russell2000** (RWM), which trades 1.1 million shares a day.

Many hedge fund managers focused on technology short with **PowerShares QQQ** (QQQ), which tracks the tech-heavy Nasdaq 100 Index, rather than using its inverse counterparts for the same reason.

Likewise, **SPDR Gold Shares** (GLD) is preferred over the inverse versions by deep-pocketed funds looking to short the precious metal. Two-thirds of the money in hedge funds is invested long and/or short, says Gradante, whose firm publishes hedge-fund performance data.

That other 33% of hedge fund assets, he says, makes use of leverage and inverse (involving shorting) strategies. The funds can do that on their own. They can also use leveraged or inverse ETFs.

Hedge funds that use leveraged and inverse ETFs may be better equipped than individuals to handle the risks, says Brad Thompson, chief investment officer of Stadion Funds, whose funds invest primarily in ETFs. "Leverage is fine for hedge funds," he said. "But leverage magnifies volatility."

And leverage and inverse ETFs require daily rebalancing.

"Hedge funds don't mind trading daily," added Thompson, whose firm caters to long-term investors who don't want to do a lot of baby-sitting for their positions. "But it's very risky for someone who can't keep track of the daily reset of leverage."

Stadion funds employ some techniques used by hedge funds. One of his funds mixes long options and short options with individual stocks and fixed-income ETFs. But Thompson won't touch leverage and inverse ETFs.

"You have to be prepared to trade daily with them, and we do not want to do that," he said. "And we don't want the volatility. We want less trading and less volatility."