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Wenning Investments, LLC

Wenning Advice

Vol. 1 - Issue 8

July 2009

Exchange-Traded Funds Have Grown Up

Not long ago, exchange-traded funds (ETFs) were hardly ever considered as an investment option for retail investors. While many investors had heard of them, they were generally considered to be just another type of index fund.



Still, led by the popularity of the SPDR (aka Spider), which is based on the S&P 500 stock index, ETFs grew to \$610 billion in assets by May 2008. By then, there were 680 ETFs for every index imaginable.

With last year's introduction of actively managed ETFs, they are likely to become even more popular. There are already as many varieties of ETFs as there are of mutual funds and their numbers are growing rapidly.

ETFs, like mutual funds, are professionally managed and each fund represents an index or group of investments with specific characteristics in common.

Like mutual funds, ETFs range from very low risk to very high risk investments. Unlike mutual funds, though, ETFs are priced continuously, not daily, and are traded on exchanges. ETFs also provide an opportunity for investors to gain exposure to alternative investments, adding diversification to their portfolio.

Because ETFs are traded like stocks and bonds, they provide the same level of trading flexibility and can be used for hedging strategies. They also are lower priced than most mutual funds and are more tax efficient, as there is little turnover in their portfolio securities and they don't have to sell securities to meet investor redemptions. These advantages may fade somewhat as actively managed ETFs proliferate.

Overall, ETFs offer advantages over mutual funds and cost less - so what's not to like?

An Investment For Pessimists

When it comes to investments with exotic sounding names, it's hard to beat inverse-leveraged exchange-traded funds.

Then again, it's also hard to beat them when the market is sinking.

Given their potential for performing well in down markets, it's worth knowing what they are and how to use them.

The article above explains exchange-traded funds (ETFs). Put what about that "inverse-leveraged" part?

An inverse fund moves in the opposite direction from the underlying securities. For example, an inverse fund for the S&P 500 would move up when the S&P 500 moves down. Unfortunately, of course, it would move down when the S&P 500 moves up.

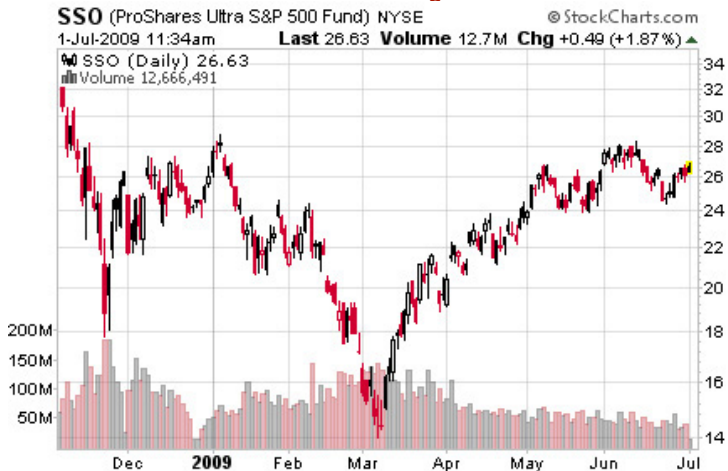
If the inverse fund is also leveraged, it will move farther. For example, if the fund is "double-beta" leveraged and inverse, it will move up two points for every point the underlying securities move down. That's great if the market is dropping in value, but you won't be too happy if the market jumps 200 points and your ETF drops 400 points.

Inverse-leveraged ETFs can be risky, but they can also help reduce risk if they are used as part of a hedging strategy. Consider that having a percentage of your investments in an inverse-leveraged ETF can balance losses in the rest of your portfolio if the market drops in value. As such, they can reduce the overall risk in your portfolio.

Conversely, day traders (*see below*) are also using them to speculate on market movements or the movement of specific sectors.

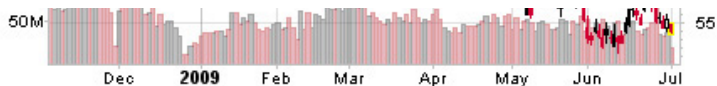
Regardless, inverse-leveraged ETFs, as well as inverse ETFs and leveraged ETFs, are proliferating rapidly. ProFunds introduced the first six leveraged and inverse international ETFs, and registered another 48 inverse and leveraged commodity and currency ETFs. Rydex, which already has similar offerings, has added a half dozen of an expected 55 inverse and leveraged domestic ETFs that are based on specific investment styles and sectors.

S&P 500 Long



S&P 500 Short





Recent performance of two inverse leveraged exchange-traded funds.

Q&A

What's the difference between active investing and day trading?

There is a great difference between the two.

Active investing is a disciplined approach that seeks to take advantage of market gains while avoiding market losses. Active investment managers typically use both fundamental analysis and technical analysis of securities; fundamental analysis provides in-depth information about individual stocks and other investments, while technical analysis provides information about how market and economic conditions may affect the stock.

Active investment managers also typically use tools such as "stop losses," which trigger automatic selling of securities when prices fall below a predetermined level.

Active investment managers may buy and sell securities more often than "buy and hold" investment managers, but that's not saying much. They still trade far less often than the typically day trader.

Day trading, conversely, is a broad term that encompasses many strategies, but it typically refers to highly speculative trading. Day traders usually make frequent, high-risk trades in the hopes of making big returns, but they often end up with huge losses.

Technically, day trading refers to the practice of buying and selling investments within the same trading day. Day trading strategies are typically designed for quick gains, but such strategies also can typically result in quick losses.

For example, day traders often engage in margin trading, which involves borrowing money to trade. Since interest on margin trading is charged on overnight balances, day traders may engage in margin trading without paying fees, but they run the risk of a margin call, which can result in significant losses. Margin trading is fine for very knowledgeable investors or investment managers, but many day traders lack the training and experience to use such risky trading tools.

Learning From Your Investing Mistakes

We've discussed the importance of being careful about buying stocks or other securities that are overpriced. We've also talked about the importance of accepting losses, and selling investments before they hit bottom.

Today's topic is, in many ways, related to both of those common mistakes.

Mistake #6: Getting Emotionally Attached to Investments. Investing should be dispassionate. Ideally, it should be based primarily on financial and economic information. It is best to invest based on what we know, not what we feel.

Still, many investors buy or hold on to stocks because they are emotionally attached to them. Maybe they have fond memories about General Motors during better days and can't face selling their GM stock. Maybe certain stocks have performed well in the past and, as a result, they're reluctant to sell them today. Or maybe they're compelled to invest in companies that are in the alternative energy industry or the healthcare industry and represent something they believe in.

Too often, investors become emotionally attached to certain investments and fail to sell - even when it's obvious that they should. Whatever the reason for holding a losing stock - sentimental attachment, pride and ego, or even denial - you're only hurting yourself.

Consider that a decline in stock price is difficult to make up. After a 25% decline in price, for example, you'll need a 33% increase just to break even. If a stock declines 50%, you'll need a 100% gain to break even. Review your investments regularly and take corrective action when necessary.

If you're investing in a company because you believe in its cause, pay attention to its financials, and any market or economic factors that may affect it, and don't invest what you can't afford to lose.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

Contact Brenda P. Wenning, principal of Wenning Investments, LLC of Newton, Mass. She can be reached at Brenda@WenningInvestments.com or 617-965-0680.

Visit her Web site at www.WenningInvestments.com.

Visit Brenda's blog at www.WenningAdvice.com.

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Wenning Investments, LLC | 275 Grove St., Suite 2-400 | Newton | MA | 02466