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ETF Investing, With a Twist

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For years, hedge funds plied strategies out of most investors' reach. As the exchange-traded-fund bandwagon rolls on, however, financiers are following the trend to try to mimic more of those strategies. For one manager, literally.

ETF Portfolio Management is using ETFs to create a twist on a hedge-fund strategy called "trend following," which bets on sustained price movements to make returns with low correlation to the broad market. Trend-following funds are part of a group managing $92 billion that returned 18% last year when broader markets plunged, according to Hedge Fund Research. ETF Portfolio Management's funds and the broad group of trend-following hedge funds have slightly negative returns in 2009.

Most trend-following funds trade futures contracts. ETF Portfolio Management exclusively trades highly liquid ETFs. And rather than creating a hedge-fund structure, the firm manages individual client-brokerage accounts. It soon plans to create an ETF squared, an exchange-traded fund that invests exclusively in other ETFs.

That would mean investors pay two sets of fees, another boon for the firms creating ETF products. But it still would be a fraction of the cost of management and incentive fees levied by hedge funds attempting to do the same thing.

The bigger question for ETF investors is the black-box nature of a trend-following strategy. Trading decisions are made according to undisclosed rules that aren't based on fundamental analysis. ETFs are being used to democratize investing. But as they are used to pursue strategies further from their index-tracking roots, the warier individual investors need to be.

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