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MarketWatch

Chuck Jaffe

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How to buy stocks high and sell them low

Commentary: Biotechnology-sector ETF is the Stupid Investment of the Week

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — Nothing speaks to an investor like performance, especially great results.

There's also nothing quite as dangerous, because investments that produce terrific numbers for awhile often bite investors who waited to see some results before they took the plunge. As a result, they buy high and sell low.

By the numbers

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It's hard to realize that when you get halfway through the year and see the dazzling performance of an exchange-traded fund like ProShares Ultra Nasdaq Biotechnology (NASDAQ:BIB) .

The specialized fund is up almost 30% so far this year, topping its peer group, according to investment researcher Morningstar Inc., and ranks second among all U.S. equity ETFs, according to Nashville-based New Constructs Inc.

The biotech ETF is also the Stupid Investment of the Week.

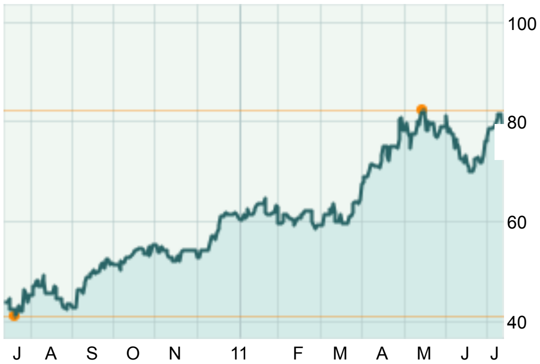
Stupid Investment of the Week showcases concerns and characteristics that make a security less than ideal for the average investor, in the hope that spotlighting trouble in one situation will make it easier to avoid elsewhere. The one tradition for the column -- which is not intended as an automatic sell signal -- is that a fund that is at the front of the pack as the year reaches its midpoint always earns a booby prize for its fast first-half results.

Put to the test

The basic premise is that a hot fund with fabulous but volatile short-term performance will regress to the mean, and those investors who buy after the hot streak will get hit in the next downturn. That said, there is no denying that the calendar itself does not dictate the sustainability of an investment track record, and there are times when momentum can be sustained long enough so that a shareholder might be happy for awhile.

BIB **78.75**, -2.60, -3.19%

But if you dig deeper into ProShares Ultra



Nasdaq Biotech, there's plenty of reason to believe the hot results not only can't be sustained, but that an investor who believes biotech is a great investment would have a tough time sticking around long enough to benefit from their convictions about the industry.

While the fund tops the year-to-date charts, the truth is that its rally is a bit longer in the tooth, as the fund has gained close to 80% over the last 12 months. That has obviously been great for investors, but it also changes the value proposition of the underlying stocks, something many investors don't think about.

Typically, an ETF investor thinks they are buying a diversified index fund, but that's not always the case, particularly when the fund specializes in biotech. The ProShares fund holds 126 issues, which sounds like a lot but compared to an index of, say, 500 stocks it's pretty thin. That means the fund's future direction is more likely to be influenced by a few good or bad issues.

Morningstar currently has the biotech sector at its fair value, "neither too rich nor undervalued," said Paul Justice, the firm's director of ETF research. "But keep in mind that a fairly valued fund is hardly the type you want to put new money into. … You may choose to hold the fund — especially if you'd realize a taxable gain by selling — but you wouldn't likely put more money in."

Bad medicine

David Trainer, president of New Constructs, takes it further. His firm recently started evaluating ETFs, breaking each fund down to its stock holdings and then applying its long-standing stock methodology to value those securities.

By this method, New Constructs has ProShares Ultra Biotech on its debut list of "dangerous" ETFs based on the quality of earnings and valuation of the stocks it holds.

Nearly 40% of the fund's assets are devoted to securities that New Constructs rates as "dangerous or worse," said Trainer, while just 32% of the fund's money is in stocks rated "attractive or better."

What's important to note from New Constructs methodology is that its stock ratings have a solid record of predicting future success; apply them to the holdings of a fund and aggregate the ratings and you've got a good chance at predicting the future success of the ETF.

That process of digging into the underlying holdings is something few investors actually do, preferring instead to think of the fund's as holding units of an index, rather than the securities the index owns.

Mark Salzinger, editor of The Investor's ETF Report, doesn't look on the holdings in BIB with quite such a jaundiced eye. Noting that the index has 50% of its assets in the top 10 stocks — including some high-quality names and some acquisition targets that could help to hold up the value of the industry — Salzinger said it is other factors that stand out as negatives to him.

ProShares Ultra Nasdaq Biotech is a leveraged ETF, built to provide twice the daily returns of the index it mimics, but Salzinger notes that someone expecting a simple "double the index" has reason to be disappointed.

"According to ProShares' website, from inception on April 7, 2010 through March 31 of this year, BIB gained 14.11% … when double the index return would have been about 18%," Salzinger said. "In other words, instead of gaining twice the index's return, BIB gained only about 55% or 60% more. This was due partly to its relatively high expense ratio of 0.95%, as well as to the deleterious effects of daily compounding."

Further, Salzinger noted that using a leveraged biotech fund "obliterates one of the advantages of investing in a diversified portfolio of biotech stocks: namely the diversification."

He added that since the biotechnology sector tends to trade independent of the broad stock market and the economy, these stocks may fall a lot less during a bear market. For example, in 2008, the non-leveraged iShares NASDAQ Biotechnology ETF (NASDAQ:IBB) fell about 13%, vs. a loss of about 37% for the Standard & Poor's 500-stock index. (SNC:SPX)

Added Salzinger: "But if one had leveraged that loss in BIB — had the ProShares product existed — the loss probably would have been closer to 30%. In other words, there's much less diversification advantage in the returns."

The leverage also increases the fund's volatility, which dramatically alters the risk-reward profile; even if you can look at the long-term returns of the Nasdaq Biotech index — over 9% annualized for the last 15 years — and assume it will continue, you won't get that kind of return consistently in a leveraged fund. Instead, you will go through feasts and famines.

Most investors have a tough time sticking it out with such a volatile fund unless they have strong conviction that they are right. Picking a fund by seeing what tops the mid-year charts — and hoping to catch a rocket in launch stage — can send an investor plummeting back to earth in a hurry.