THE JOURNAL REPORT

 THE WALL STREET JOURNAL. Monday, December 6, 2010 R1

Know the Limits of Inverse Funds

BY CAROLYN T. GEER

Other investment options for those anticipating higher interest rates are inverse and leveraged-inverse bond funds. But as with bank-loan funds, these products carry risks that some investors may not understand.

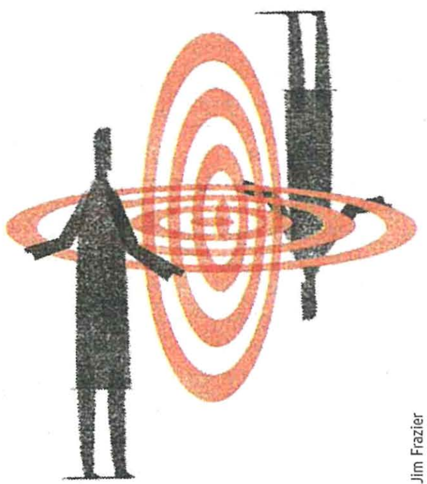
One area of confusion, according to analysts, is that the inverse funds may be more useful to short-term traders than long-term investors. That's because most of these funds aim to accomplish their objective—say, matching the inverse of the performance of a certain bond index or some multiple of the inverse—on a daily or monthly basis. Over longer periods, because of the effects of compounding, their cumulative returns can be much different than what one might expect.

Take **ProShares UltraShort 20+ Year Treasury.** This ETF seeks daily investment results of twice the opposite of the daily performance of the Barclays Capital U.S. Treasury 20+ Year Index. In the third quarter, when the index was up 4.99%, the ProShares ETF was down not twice that, or 9.98%, but nearly 2½ times that, or 12.4%.

In 2009, when the bond index fell 21.4%, the ProShares leveraged-inverse fund rose not twice that, or 42.8%, but 1½ times that, or 32.2%.

Another example is **Rydex-SGI Inverse Government Long Bond Strategy.** In 2009, this inverse mutual fund rose more than its benchmark fell; in 2008, it lost more than the index gained.

Alan Sparer, a San Francisco lawyer, says he is representing two individual investors who lost approximately $743,000 in the Rydex fund. The pair made multiple purchases totaling approximately $6 million during the economic collapse of 2008 and held on to virtually all of their shares until this year.



Jim Frazier

In the suit, the investors allege Rydex-SGI misled them by, among other things, failing to disclose that the fund is inappropriate for investors who plan to hold it for longer than a day.

A spokesperson for Rydex-SGI says it is the company's policy not to comment on pending litigation. But in a motion to dismiss the suit, Rydex says it never claimed the fund would match the inverse of the benchmark's cumulative price movements over time, and that the effects of compounding on the fund's cumulative returns were spelled out in the prospectus.

Leveraged, inverse and leveraged-inverse funds also have been a subject of concern in the stock-fund world. Worried that investors might be using them inappropriately as long-term investments, the Financial Industry Regulatory Authority and the Securities and Exchange Commission last year issued an alert explaining how the products work.

Timothy Strauts, an ETF analyst at Morningstar Inc., isn't sure the message has gotten through. "I think many people buying these funds are holding them," he says.

Funds that compound daily should be held a few days at most, he says, while funds that compound monthly should be held a few months at most—which mostly limits their market to active traders.

For ordinary investors, Mr. Strauts prefers the newer exchange-traded notes, such as **iPath U.S. Treasury 10-year Bear.** These are designed to avoid the compounding risks that plague most inverse bond funds—though because they are debt securities, they are subject to the credit risk of the issuing bank.

Ms. Geer is a writer in Fairfield, Conn. Email her at **reports@wsj.com**.