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ALTERNATIVE INVESTING

Unstable Condition

Investors can not only manage volatility but can bet on it, too

By GREGORY ZUCKERMAN11

Q: Are there ways an investor can protect against a *rise in the market's volatility-or even profit from it?*

Journal Report

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A: Investors have endured a bumpy few years. The market tumbled in 2008, then rose sharply in the subsequent two years, leaving some investors with virtual whiplash.

Now, with markets uncertain and growing fears of a new economic slowdown, some investors are searching for ways to protect their portfolios from a new bout of volatility. And some are even looking for ways to profit from renewed turmoil.

The traditional advice for those seeking shelter is to create a diversified portfolio featuring companies in stable businesses such as tobacco, utilities and consumer staples, or to shift into bonds and dividend-paying stocks. But the market downturn in 2008 hurt all kinds of companies and corporate bonds, including those that seemed safe. Indeed, there's evidence that markets around the world are more in sync than ever, making it harder to escape downturns.

Some advisers now recommend investments like the iPATH S&P 500 VIX Short-Term Futures ETN, an exchange-traded note designed to gain in value during sharp moves in the broad stock market by tracking the CBOE Market Volatility Index. These particular notes have a longer track record and more trading volume than similar vehicles . Some advisers prefer exchange-traded funds-like ProShares VIX Short-Term Futures VIXY -2.35% and ProShares VIX Mid-Term Futures VIXM -0.84% -to ETNs for volatility protection, partly because the funds often trade more than the notes, making them easier to move in and out of.

None of these three vehicles have done well this year amid relatively placid markets. The iPATH notes are down more than 30%, while the short-term ProShares ETFs are off about 30% and the mid-term ETFs have lost about 16%. Recent market instability has helped the investments, however.

Another idea: index-put options, or options that pay off if an index, such as the Standard & Poor's 500, tumbles abruptly. VIX options pay off if the Volatility Index surges. But options aren't ideal for many individual investors because they can move quickly, causing abrupt and extensive losses. Some new volatility products are designed for pros, not individual investors, because they can move 5% in a day. One example: VelocityShares Daily 2x VIX Short Term ETN.

Matthew Tuttle, president of Tuttle Wealth Management LLC in Stamford, Conn., also is cautious about ETFs that aim for low volatility, or "managed volatility," such as the and , because even these funds can be volatile during market upheaval. They dropped sharply in 2008, he notes, even though they beat the market.

Mr. Tuttle says investors should keep only a small part of their portfolio in volatility-related investments-10% or less-since they can move a lot in a single day, especially leveraged exchange-traded funds and notes that promise a return of one or two times he movement in a volatility index. They can lose a lot of value very quickly, just like options.

"You would have to be a real adrenaline junky to buy a leveraged" volatility product, Mr. Tuttle says.

Q: What's the best way to hedge against troubles for municipalities and muni bonds? And can these bonds be shorted?

A: The mounting debts of cities, states and local municipalities have sparked worries among investors, leading to a rash of selling of municipal bonds earlier this year. More recently, these bonds have rallied as fears ebbed and tax revenues improved. But some analysts say the recent bullishness has gone too far, and investors still should be cautious about many muni bonds.

Bearish investors can't short individual municipal bonds, so some analysts recommend shorting municipal-bond exchange-traded funds, which can be done with the help of a broker.

Rather than wagering against a broad muni-bond ETF, a better idea, analysts say, is to target ETFs that track higher-yielding munis, which can be riskier. For instance, some recommend shorting the Market Vectors High-Yield Muni ETF, HYD +0.80% invests in below-investment-grade issues.

Some hedge-fund managers say California municipal bonds are overpriced, given the

state's heavy debts. If that's the case, a short of SPDR Nuveen Barclays Capital California Municipal Bond ETF CXA +0.76% could act as a hedge against problems for muni bonds from that state, some say. One catch: This ETF sometimes doesn't have large trading volume, so it can be a challenge for a broker to borrow shares to short. Stephen Todd Walker, a managing director at Oppenheirmer & Co., notes that in general ETFs' holdings may include some bonds that are backed by specific revenue streams or are insured, so they may hold up well even if a state comes under new pressure regarding its debt.

For those looking to create the safest muni-bond portfolio, Bob Andres, chief investment officer at Merion Wealth Partners, recommends service bonds-those issued for water and sewer facilities, electric facilities and individual school districts-and sticking to the two highest rating categories, AM and AA.

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Correction and Amplification:

Stephen Todd Walker, a managing director at Oppenheimer & Co., does not recommend selling or buying the Market Vectors High-Yield Muni ETF. An earlier version of this story said that Mr. Walker recommends shorting the ETF, based on a statement that Mr. Walker says he didn't authorize from his public-relations firm at the time.