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Investing Commentary

Best ETF for 2012: Market Vectors Mortgage REIT Income

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This article is part of our Best ETFs for 2012 series, in which we're seeking out the top-performing ETFs for the coming year.

Most of the time, if you want to make money in stocks, you need to pick stocks whose prices will soar through the roof. But if you're tuned into the market's hottest dividend plays of the past several years, then you know that in some cases, you can earn double-digit returns even if share prices don't move one red cent.

That's the philosophy behind my pick for the best ETF for 2012: **Market Vectors Mortgage REIT Income** (NYSE: MORT). Although I'm somewhat more skeptical than many about the ETF's long-term prospects, a unique combination of favorable factors should give it a good chance to deliver great income and good total returns for at least the next year.

Tapping into mortgage REITs

Once an obscure niche of the market, mortgage REITs have grabbed the spotlight with their incredibly high dividend yields. With the help of an almost perfect storm of favorable economic conditions for the investments, mortgage REITs are making hay while the sun shines — and rewarding their shareholders accordingly.

Here's how it works: Mortgage REITs borrow money in order to buy mortgage-backed securities. They then use those securities as collateral to obtain more loans, repeating the process until they have a highly leveraged portfolio of securities. With many popular mortgage REITs, including **Annaly Capital** (NYSE: NLY) and **Invesco Mortgage Capital** (NYSE: IVR), that leverage produces debt-to-equity ratios in the 4 to 6 range. But in some extreme cases, including **ARMOUR Residential** (NYSE: ARR) and **American Capital Agency** (Nasdaq: AGNC), you'll see even greater amounts of leverage.

The bet that mortgage REITs make is that the short-term rates at which they borrow will stay low, keeping their financing costs well below the income that their mortgage-backed securities produce. Since the end of the credit crisis in 2009, that's been a very good bet to make, as shareholders have enjoyed not only high dividends but also rising share prices.

Looking forward, though, counting on low interest rates to last would be a very risky bet, especially if you believe that the economy may finally recover more strongly in the next year. But just a few months ago, persistent economic weakness led the Federal Reserve to make an unprecedented promise: It would keep the short-term interest rates it controls at low levels until mid-2013. That gave mortgage REIT investors a precise window of opportunity with which to take advantage of these unusually good conditions.

The right way to play

There are many different ETFs that focus on REITs. But when you look at the holdings of some of the most popular ones, you'll find little or no specific exposure to mortgage REITs. For instance, **iShares DJ US Real Estate** (NYSE: IYR) has less than 9% of its assets invested in mortgage REITs. The **Real Estate SPDR** has no mortgage REIT exposure at all.

Even the **iShares FTSE NAREIT Mortgage Plus ETF** (NYSE: REM) doesn't own mortgage REITs exclusively. Among its holdings, you'll also find shares of banks and other financial institutions that are related to the mortgage industry but don't have anywhere near the yields that mortgage REITs produce.

Watering down a fund's mortgage REIT exposure shows up in yields. While the broader iShares REIT has a trailing dividend yield of 4% over the past year and the iShares mortgage ETF's yield weighs in at 11.3%, the Market Vectors ETF's yield from its first quarterly distribution implies an annual yield of nearly 12% — and the ETF wasn't even in existence for the entire quarter. The Market Vectors website lists an estimated SEC yield of over 15% — matching or exceeding what several individual mortgage REITs pay.

Know the risks

Of course, high yields don't come without risks. Several proposals have suggested legislative changes that could force mortgage REITs to reduce their leverage or lose their favorable REIT status — a move that would effectively destroy the business model for these entities. That's a big part of why mortgage REIT shares have fallen sharply in recent months.

But I think that regulators have bigger fish to fry among big Wall Street banks and will therefore leave the relatively small mortgage REIT industry alone — at least for a year or so. That's why I'm comfortable choosing Market Vectors Mortgage REIT Income as the best ETF for 2012 — comfortable enough to make a CAPScall for the ETF to beat the S&P 500 over the next year.

Stay tuned throughout our series on the Best ETFs for 2012 to find out about all of the picks our Foolish contributors have made. Click back to the series intro for links to the entire series.