

Buyer Beware: All ETFs are not created equal

Leveraged and inverse ETFs may not be appropriate for long-term investors

Exchange-traded funds, or ETFs, are becoming more and more popular with individual investors partly because of their simplicity. Most ETFs are portfolios that track a major index, charge low fees, and can be bought and sold easily on familiar stock exchanges. For all these reasons, many investors consider ETFs to be ideal “buy and hold” investments.

However, investment products are developing so rapidly that more specialized and complex types of ETFs are already emerging. These include leveraged and inverse ETFs. Leveraged and inverse ETFs are usually designed to achieve their stated performance objectives on a daily basis. Many investors would assume that an investment designed to achieve its objectives every day must also do well over the long term, but this is not necessarily the case. In fact, the performance of these ETFs over a period longer than one day can vary significantly from their stated daily performance objectives.

What are Leveraged and Inverse ETFs?

Leveraged ETFs attempt to multiply the performance of the index they track by combining investor funds with an equal or greater amount of borrowed money. Inverse ETFs use the technique of short selling to capitalize on negative performance from the index they track. Leveraged inverse ETFs (known as “ultra short” funds) use short selling and borrowed money together to multiply the performance of an ordinary inverse ETF.

Most leveraged and inverse ETFs need to “reset” daily, and it is this process that creates variance with the long-term performance of the index they track. Resetting means different things for different leveraged and inverse ETFs. For instance, leveraged ETFs need to rebalance the ratio of borrowed money up or down based on the performance of the market that day. Some ETFs may need to go partly to cash to fund redemptions. Many leveraged and inverse ETFs also use strategies that involve swaps, futures contracts, and other derivative instruments.

Regardless of the strategy, the bottom line is that leveraged and inverse ETFs do not necessarily start the day based on the previous day’s closing numbers - they start with a clean page of their own making. This chops up the continuity in the long-term performance of the index, and can create a totally new and different direction.

How much variance?

Courtesy of the U.S. Financial Industry Regulatory Authority (FINRA), the following two real-life examples illustrate how significant the variance in performance can be.

- Between December 1, 2008, and April 30, 2009, a particular index gained 2 percent. However, a leveraged ETF seeking to deliver twice that index's daily return fell by 6 percent - and an inverse ETF seeking to deliver twice the inverse of the index's daily return fell by 26 percent.
- Within that same period, an ETF seeking to deliver three times the daily return of a different index fell 53 percent, while the underlying index actually gained around 8 percent. An ETF seeking to deliver three times the inverse of the index's daily return declined by 90 percent over the same period.

Remember that these examples measure leveraged and inverse ETFs by a standard that is not in line with their stated investment objectives. These ETFs are legal and do meet the objectives of some investors. However, it is important for long-term investors to understand the nature of leveraged and inverse ETFs, and to avoid them if they do not match personal risk tolerance and investment objectives.

You may ask, what kind of investor would choose a leveraged or inverse ETF? These ETFs represent very aggressive strategies primarily intended to capitalize on market events such as rapid upswings and steep downturns. The rewards can be high, but the risks are also very high. Investors in these ETFs also pay a price in terms of higher fees and relative tax inefficiency. The important thing is that long-term investors do not buy a leveraged or inverse ETF when they think they are buying something else; or, that they do not believe that aggregate daily performance is the same thing as regular long-term index performance. It pays to do your homework.

Leveraged ETF: A hypothetical example

On Day 1, an index starts with a value of 100 and a leveraged ETF that seeks to double the return of the index starts at \$100. If the index drops by 10 points on Day 1, it has a 10 percent loss and a resulting value of 90. Assuming it achieved its stated objective, the leveraged ETF would therefore drop 20 percent on that day and have an ending value of \$80.

On Day 2, if the index rises 10 percent, the index value increases to 99. For the ETF, its value for Day 2 would rise by 20 percent, which means the ETF would have a value of \$96. On both days, the leveraged ETF did exactly what it was supposed to do - it produced daily returns that were two times the daily index returns. But let's look at the results over the 2-day period: the index lost 1 percent (it fell from 100 to 99) while the 2x leveraged ETF lost 4 percent (it fell from \$100 to \$96). That means that over the two-day period, the ETF's negative returns were 4 times as much as the two-day return of the index instead of 2 times the return.

Source: FINRA