ETF insight

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Leveraged and inverse ETPs gaining momentum

Know what you're buying before pulling the trigger

Leveraged and inverse Exchange-Traded Products (ETPs) are gaining momentum. Independent provider Boost ETP says that global short and leveraged ETP assets rose 15% in the first six months of 2013 to $50.9 billion in assets under management. Trading volumes have increased 71% from $114 billion to $195 billion per month.

Trading in leveraged and inverse Exchange Traded Funds generated a discussion paper from the Federal Reserve, studying the implications for financial stability in the markets. Researcher Tugkan Tuzun concluded "Price-sensitive and concentrated trading of LETFs results in price reduction and extra volatility in underlying stocks" and suggested that they contributed to stock market volatility during the 2008-2009 financial crisis and the European sovereign debt crisis in 2011.

Given that these products are such a small part of the nearly $2 trillion dollars invested in all ETPs, and generally only provide access to the most liquid underlying markets, the likelihood of such an impact seems slim. And, as Credit Suisse pointed out two years ago, ".... leveraged ETF rebalancing is concentrated at the end of the day and a function of how much volatility there already was in the market". Be that as it may, the daily rebalancing should cause the average investor to think very carefully before buying leveraged and inverse ETFs.

Appreciating the concern begins with understanding the math. In the simplest terms, leveraged ETFs are designed to provide a return that is a multiple of an underlying benchmark on a daily basis, often in a 2:1 or 3:1 ratio. For example, if the underlying index returned 1%, in theory the ETF would return 2% or 3% gross of management fees and costs. Likewise, if the index dropped 1%, the ETF loss would be 2% or 3%.

That's the theory, and it sounds simple enough, but the power of compounding plays an important role. While leveraged and inverse ETFs may provide the advertised multiple of return on one-day changes in the benchmark price, significant divergence can occur when they are held for longer than a day.

Consider a benchmark index trading at 100 and a 2:1 leveraged ETF also trading at 100. If the benchmark rose 10% in one day to 110, then the leveraged ETF should theoretically rise 20% to 120. If the index were to go back down to 100 the following day, the downward movement would represent -9.1% for the index but -18.2% for the ETF. The price for the ETF would be 98.16 though, representing a -1.84% loss. The effects of compounding are immediate.

The average investor should be very wary of leverage and inverse ETFs. They are complicated hedges best left to those who have both the time and expertise to use them properly. Although the ETF industry discloses risks in their prospectuses

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and marketing materials, the sad fact is that a large percentage of investors don't read them. Given the volatility of today's global stock markets, investors should focus on reducing the risks to their portfolios, not increasing them.

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