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Leveraged exchange-traded funds can be risky

The market for exchange-traded funds (ETFs) has grown dramatically. According to Credit Suisse, they account for approximately one quarter of total US equity volume and the numbers are growing. Disillusioned by poor returns during market turmoil, many investors have turned to ETFs as a way of diversifying their portfolios; realizing they can still participate in market upswings but on a more cost effective, risk-adjusted basis.

However, while ETFs certainly offer a number of important advantages, investors need to be aware that they are not all created the same – particularly where risk is concerned. Leveraged and inverse-leveraged ETFs, for example, are designed to provide a return that is a multiple of an underlying benchmark on a daily basis. Many advertise performance of double (+/-200%) or triple leverage (+/-300%) the daily return of their underlying benchmarks, gross of expenses and fees.

In essence, leveraged ETFs allow investors to place bets on market movements by opting for either the bear or bull case. If an investor thought a particular benchmark was going to rally, they could purchase the related bull ETF. The concept is that a one-day 1% gain in a benchmark would cause a +2x leveraged bull ETF to increase by 2% with a decrease of 2% in the -2x leveraged bear ETF counterpart.

It sounds simple enough, but the key words are "on a daily basis" because the results can be very different over a longer time-frame. Consider the performance of two leveraged ETFs during October 6, 2008 to July 15, 2009. This period was marked by significant volatility but the S&P/TSX 60 Index wound up essentially flat, posting a 0.4% gain.

During the same period the Horizons S&P/TSX 60 BetaPro Bull dropped 14.0% and the Horizons S&P/TSX BetaPro Bear fell by an astounding 40.9%. In spite of their significant declines, these ETFs performed exactly as advertised - they provided a return that is a multiple of their underlying benchmark *"on a daily basis"*.

Due to the mathematics of compounding and rebalancing, leveraged and inverse-leveraged ETFs may provide the advertised multiple of return on one-day changes in the benchmark price. However, they are unlikely to provide the same multiple on returns held for longer periods. They will likely be much more varied as divergence takes place.

In spite of the risks, leveraged ETFs are becoming increasingly popular among retail investors. According to Credit Suisse, leveraged ETFs account for nearly 5% of US equity volume, and their market share has been growing significantly. There are now almost 200 leveraged and inverse ETFs in the North American marketplace.

The boom in leveraged ETFs has resulted in calls from various securities regulators to ensure suitability. The Investment Industry Regulatory Organization of Canada has reiterated "leveraged and inverse ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets". Some firms have even banned leveraged ETFs from their books, stating that the products are simply not suitable for their wealth-management clients.

While leveraged and inverse ETFs may have a place in the investment industry, they are not suitable for the average retail investor who has neither the time nor

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financial background to make proper use of them. Caution is the key. Do not risk your money on these products without a full comprehension of how they work and an in-depth understanding of how the underlying benchmarks are derived.

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