Why Inverse ETFs are not for Everyone

With the ongoing global concerns about inflation, higher interest rates, commodity prices and falling stock markets, the last few months have seen falls in almost all investment portfolios.

Against this backdrop, long-term investors are (rightly, in my view) sitting tight. However, that does not mean these investors are unthinking, or passive. Several have asked me; “If markets are going down at the moment, why not benefit from a falling market by buying Inverse ETF’s?”

Leveraged and inverse ETF's are certainly available. Of the 2,600-plus US-listed ETF's, some 89 are inverse ETF's, and 135 are leveraged or 'geared' products. And some are both leveraged and inverse, like SPXU, the ProShares UltraPro Short S&P500 (SPXU), offering minus 3x daily returns of the S&P500 - if the index drops by $1, the value of this ETF will rise by roughly $3 - This ETF has nearly $1 billion in assets and an expense ratio of just less than 1%.

For more information, see also my earlier article about leveraged ETFs here.

Inverse ETFs

An inverse ETF is an index ETF that gains value when the index it tracks loses value.

It does this by holding assets and derivatives, like options, that are used to generate profits when the underlying index falls. For example, the Short DOW 30 ETF (DOG) profits when the Dow Jones Industrial Average goes down. The DOG's profits are proportional to the Dow's losses.

Investors can use inverse ETFs in their investing strategy to gain when markets are going down, and buying an inverse ETF can be a less risky way to to take a bearish stance on an index or sector than shorting stocks.

Advantages of Inverse ETFs

Inverse ETFs have many of the same benefits as a standard ETF, including being easy and low-cost to buy, and with lower fees than mutual funds.

The traditional way of investing for gains in a falling market is to ‘short’ a stock.

This exposes the investor to the potential of unlimited losses. (See ‘The Volkswagen Short of 2008’, which you can find at the end of this article).

The benefits of inverse ETFs is that they offer an alternative way of placing bearish bets.

Purchasing shares in an inverse ETF gives them the same investment position you would have by shorting an ETF or index. However, an investor can only lose as much as they paid for the ETF with inverse ETFs.

The inverse ETF becomes worthless in a worst-case scenario, but at least you won't owe anyone money, as you might when you short an asset in a traditional sense.

Inverse ETFs are considered to be riskier than traditional ETFs, as they hold derivatives, not real assets, but they are bought outright. This makes them less risky than other forms of bearish bets. There is often unlimited risk when an investor shorts an asset in the traditional sense, and the investor could end up losing much more than they had anticipated.

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Disadvantages of Inverse ETFs

One of the main risks of inverse ETFs is their lack of popularity. You can buy many types of ETFs, but you won't find a huge selection of inverse ETFs.

The US ETF market has only about 3% inverse ETFs, and by market value, their proportion of the ETF market is much smaller still. It therefore follows that Inverse ETFs have less liquidity than other ETFs due to much less demand.

As mentioned above, Inverse ETFs typically do not hold real assets, but derivatives, and this makes them intrinsically riskier than their index-tracking counterparts. Unlike passive equity index-tracking ETFs, these inverse ETFs rely on the active management of the derivatives to make gains.

The most popular inverse ETFs will have an expense ratio of about 1.0%, which is double the typical expense ratio for all equity ETFs. This high expense ratio is basically a management fee, and it will impact on profits, regardless of the direction of the underlying market index.

Another risk is that major stock indexes have historically risen when the timescale is long enough. This makes it risky to use inverse ETFs as part of a long-term investment strategy.

History suggests that the index will bounce back sooner or later from any losses. Inverse ETF investors need to keep a close eye on the markets. They can attempt to exit their position before the corresponding index rallies, but given the limited liquidity, this may not be as simple or quick as they assume.

For every seller, there must be a buyer, but who wants to buy the inverse of a rapidly-rising stock market?

The Reality

Inverse ETFs do, of course, have their place.

If you are willing to invest full days in studying market trends, understanding markets, and are prepared to take the gamble, then inverse ETFs can present a great opportunity, but they are still high-risk.

But if you are a long-term investor, avoid them like the plague.

Generally designed for short-term plays on an index or sector by active traders, they should be used in that way, otherwise, they will simply eat away at your capital.

For us long-term investors, sit tight and the wait for the bulls to return - As history predicts they surely will.

Volkswagen in 2008 and the Dangers of Shorting Stocks

Volkswagen AG (OTC: VWAGY)

Volkswagen AG (OTC: VWAGY) and Porsche were involved in perhaps one of the most famous short squeezes of all time in the middle of the 2008 financial crisis.

The two carmakers had a history going back over seven decades. In the early 2000s, Wendelin Wiedeking, the chief of Porsche, signaled his intent to take over Volkswagen. Through share purchases, his stake in the firm soon reached 35%.

The shares of Volkswagen were classed into two categories, ordinary and preference. Hedge funds noticed the disparity in prices between the two classes, and took positions on them.

Soon, Porsche announced that it had acquired a more than 74% stake in Volkswagen AG (OTC: VWAGY). The state of Lower Saxony already owned more than 20% of the firm, making the short-sellers panic as it meant not all short-sellers could hope to cover their positions on the stock.

With Wendelin Wiedeking's 35%, Porsche's 74% and Lower Saxony's 20%+ totalling at least 129%, it was clear that hedge funds with short positions needed to buy 29%+ of the total shares, which did not exist, so to close positions any shares scavenged from the market needed to be bought, regardless of the cost.

As chaos ensued, the share price of the carmaker climbed to a high of €999 for a brief period, making Volkswagen AG (OTC: VWAGY) one of the largest companies in the world for a brief stint.

It also meant that a hedge fund which 'sold short' on, say 1st March 2008 at a price of €15.13, had to pay as much as €999 to close the position, making a loss of €983.87 or -6,503%.

However, the share price fell soon afterwards.

Volkswagen AG (OTC: VWAGY) eventually hit record lows as environmental scandals hit the firm in late 2018.

It is estimated that hedge funds lost close to $30 billion on the Volkswagen AG (OTC: VWAGY) bet.

Porsche, the apparent winner, did not come out strong after the ordeal, as debt and declining car sales hit the business, and was ironically bailed out by Volkswagen AG (OTC: VWAGY) in the coming months.