Why Leveraged ETFs Are Not Long-Term Assets

Most professional traders, analysts, and investment managers love to hate leveraged exchange-traded funds (leveraged ETFs), which are funds that use financial derivatives and debt to gear up the returns of an underlying index.

However, ETFs don't always work the way you may expect based on their names, which often feature the terms ‘ultra-long’ or ‘ultra-short.’

Several of my clients have looked at the index-tracking ETFs they hold in their portfolios, and said ‘why not simply buy the leveraged (geared) version, and make double, or treble the profit?’

But when you look at the returns of a leveraged ETF, compared to its respective index, the numbers don't seem to add up. Investors need to know a few things about this type of ETF.

How Leveraged ETFs Work (or Don't)

If you look into the descriptions of leveraged ETFs, they promise two, or even three times the returns of an underlying index. Leveraged ETFs boost results, not by actually borrowing money, but by using a combination of swaps and other derivatives.

There are a few historical examples of how ETFs don't always work the way you might expect.

For example, the ProShares Ultra S&P 500 (SSO) is an ETF designed to match or exceed ***twice*** the S&P 500's single-day return. If the S&P 500 returns 1% on a particular day, the SSO should return about 2%. However, real life, particularly in the longer term, can look very different.

During the first half of 2009, the S&P 500 rose about 1.8%. If SSO had behaved as expected, it would have shown a 3.6% return. In reality, the SSO went down from $26.27 to $26.14. Instead of returning 3.6%, the ETF was more-or-less flat.

It's even more concerning if you look at SSO along with its inverse counterpart, the ProShares UltraShort S&P 500 (SDS), which is designed to return ***twice the opposite*** of the S&P 500's return for a single day.

Over the 12 months ending June 30, 2009, the S&P 500 was down nearly 30%. The SSO behaved pretty well and was down about 60%, as you would expect. The SDS, however, was down about 20%, not up the 60% you would expect.

Where did the Performance go?

These examples show how these geared ETFs don't always do what they are expected to do, so why?

They are really designed and marketed to track the daily movements of a corresponding index.

You may ask yourself why that would matter since, if it tracks its index properly each day, it should work over any extended period of time. But this is incorrect.

One reason is the expense ratio. The most popular leveraged ETFs will have an expense ratio of approximately 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. This is, however, only a small part of the problem.

Daily Leverage Resetting

At least a high expense ratio is transparent. What many investors don't realise, is that leveraged ETFs are rebalanced daily. Since leverage needs to be reset on a daily basis, volatility is your greatest enemy. At first glance, this seems a bit strange.

In most cases, volatility is a trader's friend, but not with leveraged ETFs.

That is because the compounding effects of daily returns will actually make a mess of the maths, and will do so in a very dramatic way.

For example, if the S&P 500 moves down 5%, an ETF like SSO should move down 10%. If we assume a share price of $10, the SSO should be down to about $9 after the first day. On the second day, if the S&P 500 moves up 5%, over the two days the S&P 500 return will be -0.25%. An unsuspecting investor would think the SSO should be down 0.5%. The 10% increase on day two will bring shares up from $9.00 to $9.90, and the SSO will, in reality, be down by 1%.

Typically, the more volatile the benchmark (the S&P 500 in this example) for a leveraged ETF, the more value the ETF will lose over time, even if the benchmark ends up flat or had a 0% return at the end of the year. If the benchmark moved up and down drastically along the way, you may end up losing a significant percentage of the value of the ETF if you bought and held it.

For example, if a leveraged ETF moves within 10 points every two days for 60 days, then you are likely to lose more than 50% of your investment.

Upside and Downside

Compounding works on the upside and the downside.

If you do some research, you will find that some bull and bear ETFs that track the same index performed poorly over the same time frame.

This can be very frustrating to an investor, if they don't understand why it's happening and deem it unfair.

But if you look closer, you will see that the index being tracked has been volatile and range-bound, which is a worst-case scenario for a leveraged ETF. The daily rebalancing must take place in order to increase or decrease exposure and maintain the fund's objective. When a fund reduces its index exposure, it keeps the fund solvent, but by locking in losses, it also leads to a smaller asset base. Therefore, larger percentage returns will be needed to get you back to even.

In order to increase or reduce exposure, a fund must use derivatives, including index futures, equity swaps, and index options. These are not the safest trading vehicles due to counterparty risks and liquidity risks.

Long-Term Investors

If you are an investor, not a short-term trader, it really is best to avoid leveraged ETFs.

They might be tempting at first sight because of the high potential returns, but if you are investing, and holding the asset for a while, the end result will almost always be unexpected and miserable losses. Part of the reason for this will be holding on to a leveraged ETF for too long, always waiting and hoping for things to turn around.

All the while, your capital is slowly but surely being chewed away. I strongly recommend that you avoid this situation.

Long-Term Investing Risk

Up until this point, it's obvious that leveraged ETFs are not suited for long-term investing.

Even if you did your research and chose the right leveraged ETF that tracks an industry, commodity, or currency, that trend will eventually change. When that trend changes, the losses will pile up as fast as the gains were accumulated.

On a psychological level, this is even worse than jumping in and losing from day one, because you had accumulated wealth, counted on it for the future, and let it slip away.

The simplest reason leveraged ETFs are not for long-term investing is that everything is cyclical, and nothing lasts forever. If you are investing for the long term, then you will be much better off with straight-forward ETFs.

Of course, it is unwise to invest in only one ETF or one niche sector. A broad, diverse portfolio is likely to see gains that far exceed that of a leveraged ETF.

Leveraged ETF Potential

Why do leveraged ETFs even exist, then, and why would anybody want them?

Perhaps the most obvious reason to buy is to short without using margin.

Traditional shorting has its advantages, but when opting for leveraged ETFs, including inverse ETFs, you are only risking your initial investment.

Although a loss is possible, it will be no more than the cost of the purchase - You can lose no more than your investment. This is fundamentally different to ‘shorting’ a stock or index. Shorting is effectively when you ‘borrow’ an asset and sell it, on the premise that you can buy it back at a lower price later and return the asset to its original owner.

Should you get it wrong, and the asset increases in value, rather than plummeting as expected, you may be in a situation requiring you to buy back at many times the initial sale price, to close the ‘short’ position.

But that’s not the only reason to consider leveraged ETFs. Another is the high potential return.

Whilst volatility is the enemy of leveraged ETFs, there may be times when an investor is convinced of the short/medium term direction of a market. In that situation, then he may buy a leveraged ETF and soon see exceptional gains. This is fraught with pitfalls, though.

The investor must not only be sure, he must also be correct in his assessment of market direction, and time both the purchase, and ultimate sale accurately. This is really a trend trade, with consistent market movements in the same direction on consecutive days. Any volatility can easily erode earlier gains.

The Reality

Leveraged 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 leveraged ETFs can present a great opportunity, but they are still high-risk.

If you are a long-term investor, avoid leveraged ETFs like the plague. Generally designed for short-term (daily) plays on an index or sector, they should be used in that way, otherwise, they will simply eat away at your capital.

Also see ‘ETFs – A safe way to invest? To read about the difference between ETFs and ETNs.