In Defense of Leveraged and Inverse ETFs

By Tom Lydon
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Leveraged and inverse exchange traded funds (ETFs) have been a lightning rod for controversy. Reasonable concerns underpin criticism of them, but these funds are largely misunderstood. Let's set the record straight and identify those investors for whom leveraged and inverse funds are appropriate.

The aim of leveraged and inverse ETFs has been to double or triple the moves of the market on a *daily* basis. For example, in a short double-leveraged fund, if the index goes up, then the fund goes down twice that. In a long doubled leveraged fund, if the index goes up, the fund then doubles that.

While these funds may have a reputation as risky and volatile – and it's true that they should not be used lightly or without understanding – they also serve some valuable purposes for investors, including:

- They're a hedge if an investor believes the market is due for a short-term correction but doesn't want to sell a position. By buying a leveraged or inverse ETF, the investor can effectively hedge what the market is doing.

- They can be used to capitalize on the movements of the market. If an investor believes that the market is going to go on a tear, a leveraged ETF can maximize their potential gain.

The Financial Regulatory Authority (FINRA) issued a warning about leveraged and inverse ETFs in July, reminding brokers to be mindful of the suitability of the products they offer to customers. While FINRA backed down from the July statement directed at professional investors, in August the body, along with the SEC, issued a statement aimed at retail investors:

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"These products are complex and can be confusing. Investors should consider seeking the advice of an investment professional who understands these products, can explain whether or how they'll fit with the individual investor's objective and who is willing to monitor the specialized ETF's performance for his or her customers."

Leveraged and inverse ETFs aren't for everyone. They don't work like typical ETFs, for at least two reasons:

- Compounding. Leveraged and inverse ETFs reset daily to replicate the intended performance (relative to their index) accurately each day. For example, on Aug. 12, the S&P 500 gained 1.2%. On that same day, the Rydex Inverse 2x S&P 500 (RSW) lost 2.3%. On Aug. 13, RSW resets and starts back at even again. In stable markets, the performance of these funds relative to their index will work over extended periods of time. But the funds will drift from their benchmark. The longer the holding period, the greater the drift. The effects of compounding generally were understood until 2008, when the markets were slammed with record volatility, causing excessive drift in some leveraged funds.

- Volatility. When you combine a few days of 500-point swings with a fund that's supposed to double or triple those movements, it could be a stomach-churning ride. The side effect of this volatility is that leveraged and inverse ETFs can veer from their benchmarks by wide margins. According to a study by ProShares, though, compounding works both ways, and the negative impact is simply heightened in wild markets. But in both up and down markets, compounding can work in an investor's favor.

Is the hubbub justified?

In a survey we conducted this summer at ETFtrends.com, the majority of our readers (62%) felt that the scrutiny of these funds was unjustified, while another 33% felt that the scrutiny was justified, but that they were appropriate for investors who understood them. The other 6% felt that they were not appropriate products for anyone.

There are a number of misconceptions about these ETFs. Much of it is inaccurate, confusing, and in some cases, wrong. A few points:

Misconception: Leveraged ETFs provide returns of 2x and 3x the annual return of the underlying index

Fact: This myth seems to be one of the biggest surrounding leveraged ETFs and one that may be at the root of much of the ongoing strife; it may simply be the result of poor

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marketing. The truth is no leveraged ETF or exchange-traded note (ETN) seeks to provide a multiple of the annual return of an underlying index.

Misconception: Leveraged ETFs increase overall portfolio risk

Fact: While many investors and advisors view leveraged ETFs as speculative and risky, if used properly they may actually lower a portfolio's overall risk. Leveraged ETFs and ETNs do not just allow for leveraged exposure, but can also provide an opportunity to access single exposure at half the price. For example, rather than going with the **PowerShares DB Commodity Long ETN (DPU)**, one could go double-long with the **PowerShares DB Commodity Double Long ETN (DYY)** and invest half of what they intended while still gaining roughly the same exposure to commodities.

Misconception: Leveraged ETFs are too readily available and the average investor will hurt themselves

Fact: Investors deserve to have options – the more, the better. Give investors some credit – they are a smart, educated, affluent bunch. It's up to the investor to acquire the education and information they need to move forward. If one's goal is to protect investors from making uneducated decisions, why not prohibit funds with excessive fees? Or funds that are not well-diversified?

Furthermore, the fund companies that issue leveraged ETFs readily admit that their funds aren't for everyone. They are very open about the risks. As much as the fund companies want to make money, they also want their investors to be successful with their products.

Misconception: They are buy-and-hold investments

Fact: They're not. But this isn't exactly news – many leveraged ETF investors have been able to successfully hedge their portfolios for short periods. These ETF providers readily acknowledge that these types of funds are meant to hedge risk, and they not funds around which one should plan their retirement.

Misconception: Leveraged ETFs don't work the way they are supposed to

Fact: Leveraged ETFs operate exactly as they should – they reset daily. Over a period of time, you're going to see internal compounding that will affect the returns. This isn't a flaw in the funds: this is a mathematical fact that is impossible to avoid. If you invested in a leveraged ETF over a period of months and the market went down 20%, a 2x short leveraged ETF wouldn't go up exactly 40%.

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FINRA and the SEC have said their piece. Inverse and leveraged ETFs are doing what they're supposed to do. They've proved to be immensely popular, and the regulatory authorities should not impose limits or consider doing away with such innovative products that thousands of investors and financial advisors have used with success.

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