



## Letters to the Editor Leveraged and Inverse ETFs

October 20, 2009

The following is in response to Tom Lydon's article, [In Defense of Leveraged and Inverse ETFs](#), which appeared last week:

Dear Editor,

In his recent article, Tom Lydon shares many well-founded insights. This letter concerns Lydon's statement that the regulatory authorities should not impose limits or consider doing away with these innovative and immensely popular products because "investors...are a smart, educated, affluent bunch. It is up to the investor to acquire the education and information they need to move forward." Lydon claimed that thousands of investors and financial advisors have used leveraged and inverse ETFs with success.

We strongly disagree with Lydon on this issue. In our opinion, leveraged and inverse ETFs are not aspirins to be sold over the counter; instead, they are prescription drugs that may cause serious adverse effects and thus warrant a black-box warning.

Let's take a look at some of the most popular leveraged and inverse ETFs:

Name	Ticker	Inception Date	Fund Size as of 9/30/09 (millions)	Net Inflows April 2009 (millions)
Direxion Daily Financial Bear 3X Shares	FAZ	11/6/2008	\$1,176	\$1,878
UltraShort S&P500 ProShares	SDS	7/11/2006	\$3,442	\$1,769
UltraShort QQQ ProShares	QID	7/11/2006	\$1,049	\$413

Source: Morningstar

UltraShort S&P500 ProShares (SDS) and UltraShort QQQ ProShares (QID) have been around for just over three years, while Direxion Daily Financial Bear 3X Shares (FAZ) is yet to reach its one-year anniversary. However, these funds have been "immensely popular" and quickly joined the club of "billion dollar funds" over the past few years. In the month of April 2009 alone, \$2.3 billion flooded into Direxion Daily Financial Bear 3X Shares and \$1.8 billion flew into UltraShort S&P500 ProShares.

These funds were not just popular – they were sizzling!



However, have investors and financial advisors used them with success? Let's review these funds' recent performance and their investors' returns.

Name	Ticker	Total Return YTD*	Total Return 1 Year	Investor Return 1 Year
Direxion Daily Financial Bear 3X Shares	FAZ	-94.12%		
Russell 1000 Financial Services PR USD		19.82%		
UltraShort S&P500 ProShares	SDS	-42.90%	-33.08%	-45.27%
S&P 500 TR	SPYZ	19.26%	-6.91%	
UltraShort QQQ ProShares	QID	-59.83%	-50.50%	-50.71%
NASDAQ 100 TR USD	IXNDX	42.65%	8.60%	

Source: Morningstar

Data as of 9/30/09. See footnote <sup>1</sup>.

\*Note: returns are not annualized

Direxion Daily Financial Bear 3X Shares lost 94.12% in the first 9 months of 2009; in other words, if an investor had put \$10,000 into this ETF at the beginning of this year, he/she would have ended up with \$588 by 9/30/09. During the same time period, Russell 1000 Financial Services, the index that Direxion Daily Financial Bear 3X Shares is designed to track, inversely and leveraged 3X, gained almost 20%.

Investors in UltraShort S&P500 ProShares and UltraShort QQQ ProShares were not much better off. Over the past 12 months, UltraShort S&P500 ProShares lost 33.08% vs. S&P 500's loss of 6.91%; UltraShort QQQ ProShares lost 50.50% vs. NASDAQ 100's 8.60% gain. More troublesome is that investors lost 45.27% (as measured by Morningstar Investor Returns<sup>2</sup>) in UltraShort S&P500 ProShares vs. the fund's reported return of -33.08% during the same time period.

In addition, as shown in a study by ProShares, leveraged and inverse funds are designed to achieve a multiple of index return only on a daily basis. For periods greater than one day, the fund returns can deviate from the one-day-target multiple. However, many investors in leveraged and inverse funds are not day traders – although they

<sup>1</sup> Index performance is presented for illustrative purposes only and does not represent the performance of any specific investment product or portfolio. An investment cannot be made directly into an index. Past performance is not a guarantee of future results.

<sup>2</sup> "Morningstar Investor Return™ (also known as dollar-weighted return) measures how the average investor fared in a fund over a period of time. Investor return incorporates the impact of cash inflows and outflows from purchases and sales and the growth in fund assets. In contrast to total returns, investor returns account for all cash flows into and out of the fund to measure how the average investor performed over time. Investor return is calculated in a similar manner as internal rate of return. Investor return measures the compound growth rate in the value of all dollars invested in the fund over the evaluation period. Investor return is the growth rate that will link the beginning total net assets plus all intermediate cash flows to the ending total net assets."



might not use these funds for their retirement planning, they often invest in these funds for horizons that are well beyond a day.

For example, the average monthly redemption rate<sup>3</sup> for UltraShort S&P500 ProShares was approximately 20% over the past two years; at the same time the average monthly new sales rate was around 25%. That is to say, the average holding period for investors in UltraShort S&P500 ProShares is approximately four to five months. In the five months ending September 30<sup>th</sup>, 2009, UltraShort S&P500 ProShares was down 37%, and Direxion Daily Financial Bear 3X Shares was down 75%. Enough damage was done.

How can we be convinced that investors and financial advisors have used leveraged and inverse ETFs with success?

FINRA and SEC's warning is not only justified; to a certain extent, it is insufficient. These products are so complex that they can confuse not only investors, but investment professionals.

FundQuest recently conducted a comprehensive study of ETFs. The white paper "ETFs Are Not All Created Alike-How to Navigate the Rapidly Evolving ETF Landscape" can be downloaded at: <http://www.fundquest.com/press-resea.htm>

Please feel free to [email](#) me if you have any questions.

Sincerely,

Jingying (Jane) Li, CFA, CAIA  
Manager, Investment & Research  
FundQuest Incorporated  
Boston, MA

[www.advisorperspectives.com](http://www.advisorperspectives.com)

For a free subscription to the Advisor Perspectives newsletter, visit:  
<http://www.advisorperspectives.com/subscribers/subscribe.php>

---

<sup>3</sup> Monthly redemption rate is calculated as a fund's redemption amount for the month divided by the fund's total asset at the beginning of the month. New sales rate is calculated in the same fashion