L E V E R A G E

The Pitfalls of Leveraged and Inverse ETFs

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As market volatility reaches historic highs, investors have responded in various ways, including investing in funds that aim to deliver returns that are either a positive or inverse multiple of a stated index.

One example is leveraged exchanged-traded funds (ETFs), which use borrowed money to try to double or triple market returns — or the inverse of market returns.

The financial crisis has seemingly shifted investor attitudes toward financial risk. While many investors have shunned investment risk entirely, others responded by increasing investment risk in a move akin to a gambler “doubling down” in the hope of recapturing losses. Such hope, however, may not translate into a solid investment strategy.

We all know that wealth accumulates by compounding discrete returns over many years. Less known is the fact that compound return *declines* as the variability of returns *increases*. Return volatility actually tends to punish investors over the long run.

A simple example: If a –10% return in one year was followed by a +20% return in the next year, the total return to the investor over two years would be 8%. Interestingly, over the same period, a 2X fund would return not the expected +16% but only +12%. In short, investors in a 2X fund carries twice the risk of the index but *less* than twice the return.

Leveraged and inverse ETFs may not be solid investment or hedging options for long-term investors.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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