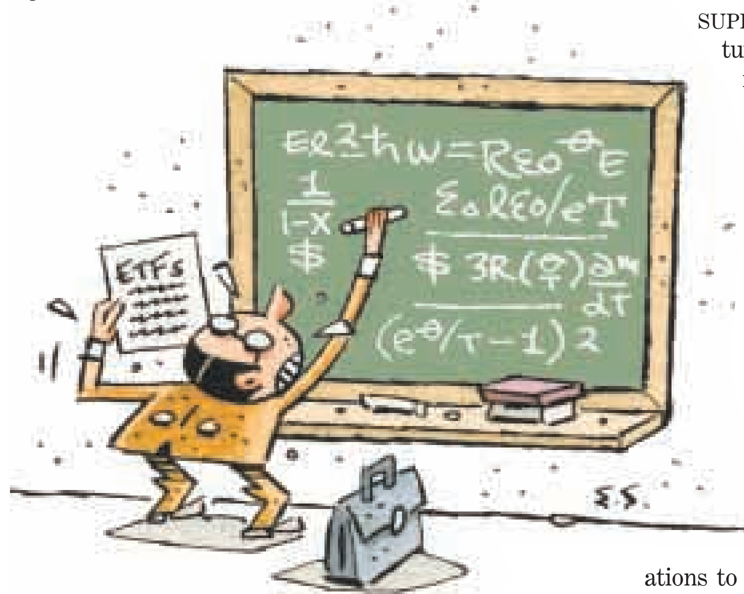
Leveraged exchange-traded funds seem to offer investors the ability to multiply stock-market gains if they bet correctly. But there's a huge catch.

One-Day Wonders

by Tom Eidelman



The math of leveraged ETFs may not add up for long-term investors, although it can work for traders.

Elwood Smith for *Barron's*

SUPPOSE YOU HAD PREDICTED—CORRECTLY, AS it turned out—that the Chinese economy would slow following last summer's Beijing Olympics, causing China's stock markets to tumble. Also suppose that, to profit from your insight, you had invested in the **ProShares UltraShort FTSE/Xinhua China 25**, a leveraged exchange-traded fund (ticker: FXP) designed to go up by as much as twice the percentage that the FTSE/Xinhua China 25 Index falls on a given day.

When Chinese stocks crashed by 34% over the following four months, shouldn't you have reaped a gaudy return around 68%? Not exactly. In fact, you would have *lost* 56%. How can this be? FXP message boards recently were filled with stupefied investors using colorful language to express their bewilderment. They blamed everything from currency fluctuations to tracking error.

A ProShares customer-service representative had the real answer: The performance of some leveraged funds, including China UltraShort, is based on only the *daily* performance results of the underlying index, not long-term returns. The problem: diverging base-index values. Once an index rises or falls and a leveraged ETF moves in the opposite direction, they no longer share their original mathematical relationship. Relative performance doesn't hold after that first day.

Let's say Index A goes up 10% on day one, then drops 9% on day two, for a two-day return of about 0%. On day one, a leveraged short fund based on this index would go down 20%. On day two, it would jump 18% (two times the index's 9% drop). But because that rise would be from a base equalling only 80% of your original investment, you would now have less than 95% of whatever you had anted up. In other words, while Traditional Index A broke even, the UltraShort Index lost 5.6%.

As time goes on, the divergences can worsen, to the benefit or detriment of the investor. For this reason, the ProShares rep stated, such funds "probably aren't a good long-term investment." In fact, they are better suited for traders. That probably would be news to many of the people who have poured more than $20 billion into ProShares' exchange-traded funds, which come in forms ranging from **Ultra Gold** (UGL), which offers gold bugs the chance to earn twice the return provided by owning gold bars, to UltraShort ETFs created to earn double the profit from declines in the U.S. dollar, relative to the euro, yen and other currencies.

Proshares touts its 76 short and leveraged ETFs as "simple-to-execute sophisticated strategies, like shorting or magnifying your exposure to major indexes. No margin account. No margin calls." But market volatility has knocked some of these leveraged ETFs off track, exacerbating losses instead of giving a hedge against them.

Leveraged ETFs are offered by other firms, too, including Rydex and Direxion, and they display the same potential dangers.

Example 1: On Nov. 5, Direxion launched eight funds offering three times leverage. One of them, the **Direxion Small Cap Bear Fund 3x** (TZA), is designed to get three times the opposite return of the Russell 2000 index. Anyone who invested in it just before the Russell 2000 fell 3% from Nov. 5 to Dec. 31 might have expected to gain around 9%. The actual return? A loss of 31%.

Example 2: The **Rydex 2x Russell 2000** (RRY) exchange-traded fund is built to generate twice the gain of the Russell 2000 index. Over the 10 trading days from Oct. 21 through Nov. 4, the Russell 2000 rose 2.9%. In that span, rather than advancing by twice that, or 5.8%, the RRY Ultra dropped 1.9%.

What's the lesson here? Investors seeking to profit from leverage might be better off doing it the old-fashioned way, by opening a margin account and buying or short-selling twice the amount of stock. There are dangers here, too, of course, and shorting stock is probably something only sophisticated investors should attempt. But at least investors would get the kind of performance they are paying for. With leveraged funds, in contrast, investors may get baffling long-term results that will leave them ultra-disappointed. ■

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It Doesn't Quite Add Up

Leveraged funds perform as anticipated for anyone using them only for one day. But those holding them for longer periods may be surprised--happily or miserably--by the results. Let's say an investor owns a short fund designed to rise by twice as much as its underlying index falls on any given day. The index rises 10% on the first day the investor owns the fund, but drops 9% on the second. In this example, the index starts with a value of 100, the fund with a price of $10 a share.

	DAY ONE			DAY TWO			
	Starting Value	Daily % Chg	Ending Value		Daily % Chg	Ending Value	% Change From Start
Index	100	10	110	**Index**	−9	100.10	0.1
Fund	$10	−20	$8	**Fund**	18	$9.44	−5.6

Result: By the end of the second day, the index is slightly above 100. To fulfill some investors' expectations, the fund would have to be back near its starting point, too. Instead, it has fallen 5.6% in value, to $9.44. The longer trading continues, the greater the divergence from the promised two-to-one results can become.