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The Demand for Leveraged ETFs Continues To Multiply

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Tickers: SDS, SSO, TBT

Leveraged ETFs are some of the most widely respected and feared investment vehicles to come to market in the last 10 years. They are lauded by hedge funds, professional investors, and day traders as excellent tools to access a specific index and quickly magnify your returns. However, they have also been derided by traditional Wall Street brokers and media outlets as a dangerous weapon in the hands of unsuspecting investors. Whichever side of the argument for leveraged ETFs that you come down on, you can't deny the continued demand and success of these sophisticated investment vehicles.

ProShares was the first company to introduce 2x leveraged ETFs back in 2006 when they released a wide ranging suite of both short and long offerings. These initial funds tracked some of the most well-known indices such as the NASDAQ-100 and S&P 500. The goal was to provide an inexpensive, liquid, and transparent ETF that would double the returns for a single day in the underlying index. In addition, several ETFs would also give you inverse exposure to the same strategy. This would allow you to short the market in virtually any investment account without having to bother with margin or trading restrictions.

Fast forward seven years and we now have hundreds of ETFs and ETNs that offer leverage in both 2x and 3x versions. Some of the biggest fund providers include ProShares, Direxion Funds, Barclays, PowerShares, and more. In addition, the indexes that these exchange-traded products track have expanded to include domestic stocks, international stocks, commodities, sectors, and even fixed-income. Fund providers are continuing to seek out new innovative strategies that will complement their current offerings as well. For example, United Kingdom based Boost ETP recently launched a new suite of leveraged commodity ETFs based on NASDAQ OMX Commodity Indexes that track gold, palladium, natural gas, and silver prices.

According to Index Universe the three biggest leveraged ETFs by asset size as of 6/30/13 include:

ProShares UltraShort 20+ Year Treasury (TBT) $3.79 billion

ProShares Ultra S&P 500 (SSO) $2.54 billion

ProShares UltraShort S&P 500 (SDS) $1.88 billion

There are some unique challenges with leveraged ETFs that investors must understand before they decide to purchase these funds. One common consequence of leverage is how its compounding effect over time erodes the tracking efficiency of the underlying index. Leveraged ETFs are only designed to track the DAILY price movement of an underlying index. Thus, investors should not expect that a 10% move in an index for a 2x leveraged ETF over a three month time frame is going to correlate perfectly to a 20% return. There can be periods of time when compounding works both for and against a leveraged product, so it is important to proceed with caution when using these tools.

In my opinion, leveraged ETFs should not be held for extended periods of time unless they are part of a sophisticated trading strategy or risk management philosophy. That might include using these funds to hedge a highly appreciated stock portfolio or to take advantage of what you believe to be a short-term trading opportunity in the markets. Remember that these positions can be both highly volatile and can magnify losses if the market moves in the opposite direction. That is why I recommend that you set a reasonable stop loss on these ETFs to define your risk and avoid potential costly mistakes.

Note: As of this writing I did not own any securities listed in this article.

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