

Lessons in leverage

Howard Atkinson believes the key to success is continuous learning: “The question is what you’re doing between five and nine to make yourself better at what you do.”

This applies as much to career advancement as successful investment management, he says. With little sign that financial market innovation is slowing, investors are faced with an ever-increasing range of tools to implement their views.

Although they have existed since 1993, leveraged ETFs are enjoying increasing popularity as the range of products on offer expands. Since launching BetaPro’s offering in 2007, assets in its 38 funds now exceed Canadian \$2.5bn (£1.6bn).

But leveraged ETFs, which are designed to amplify index returns by offering plus or minus two times (or more of) the return on an underlying index, have not had an entirely easy ride. Much attention has been paid to the negative aspects of leverage and the dangers of these widely available products due to misconceptions about how they perform in different market conditions.

Performance

Leveraged ETFs’ performance can diverge from their seemingly linear relationship to the index on which they are based, which is exacerbated the longer they are held.

The reason for this divergence is that 2x leveraged ETFs offer double the daily return of the index, giving a markedly different result over longer time periods. If an index rose 10% one day and then fell 10% the next, the net two-day result would be -1%. The leveraged ETF would, however, return -4% over the same period, as seen in the example below.

Index: (Day 1: $1 + 10\%$) x (Day 2: $1 - 10\%$) = $1.1 \times 0.9 = 0.99 = 1\%$ loss

Leveraged ETF: (Day 1: $1 + 20\%$) x (Day 2: $1 - 20\%$) = $1.2 \times 0.8 = 0.96 = 4\%$ loss

“Today’s unprecedented volatility has affected performance of leveraged ETFs,” Atkinson says. “If there is significant two-way volatility, the holding return from leveraged ETFs held for more than one day will deviate from two times the index, always for the worse.

But for those who correctly predict the market direction, the compounding effect means leveraged ETFs can return more than two-times the underlying index, he adds. Furthermore, by limiting potential losses to the amount initially invested, ETFs avoid margin calls, a considerable advantage over other leveraging methods such as derivatives.

For those who want leverage, ETFs are often the cheapest and most convenient way to do so. This is especially true for inverse leveraged ETFs, as borrowing securities has become increasingly difficult. “These ETFs offer limited downside risk and better economics, which is why they are so popular,” Atkinson says.

They do require careful monitoring, however. “If holding these products for more than a day, investors have to manage their exposure,” Atkinson warns. “Over time, the economic exposure changes depending on the market so those wanting to hang on to leveraged ETFs need to rebalance portfolios. You can’t let them ride. It is essential to monitor and rebalance in order that the holding period returns more closely matches the index performance.”

Given the short-term holding period, these products are most commonly used by active managers for specific tactical purposes. “Leveraged inverse ETFs, for example, can be used to smooth downside risk in a cost-efficient way for those who believe the market will correct,” Atkinson explains.

Howard Atkinson, president of Horizon BetaPro ETFs, talks to Emma Cusworth about the importance of education and learning the successful use of leveraged ETFs



“Even for those wanting to go long a benchmark, they can do so with half the capital usually needed, which frees up cash to invest in individual securities where they have more specific views.

“The most intelligent use of leveraged ETFs is in some sort of paired strategy,” Atkinson says. “For example, last summer energy stocks in North America had an implicit oil price of around \$70 per barrel built into the price. Oil was trading at \$120 per barrel meaning either the stocks were undervalued or oil was too expensive. Investors were using our products to go long energy and short oil, which was a very effective strategy.”

Short-term use

The focus on using leveraged ETFs in short-term, tactical portfolio management suggests they are more suited to institutional audiences. “Investing through leveraged ETFs gives much easier access to those strategies in a limited risk capacity. This explains the high institutional up-take and why we have seen explosive growth in this niche product area.”

“Most of these retail investors have above-average expertise and knowledge,” Atkinson says, “but, unfortunately, some who do not have also been using them and some have been getting it wrong. This is where the negative press is coming from.”

“The important thing is that they understand how and why these products work,” Atkinson stresses, “and that they are used in a suitable way in relation to investors’ risk tolerance.”

As a result, BetaPro has been working closely with regulators to improve levels of disclosure. “Even more important though,” Atkinson says, “is investors’ ability to access literature and information through websites and magazines, as most don’t delve into the nitty-gritty of long, complex prospectus documents.”

Ultimately, Atkinson believes the increased scrutiny is good. Shining a light on leveraged ETFs and educating investors about how they work and how they can be used will ultimately prove positive for both providers and users of these products.

“Leveraged ETFs are not as complex as people often think, but anyone who wants to use them must take the time to understand them. These tools can be very effective for managing risk in portfolios if they are used intelligently.

“There is no magic formula. It comes down to hard work and continually learning. The most dangerous thing,” he says, “is someone who thinks they already know everything.”

Biography

Howard Atkinson joined BetaPro in 2006 and has 21 years of investment experience. Prior to working at BetaPro, Atkinson was responsible for the exchange traded products business at Barclays Global Investors Canada Limited. He is a past president of the Toronto CFA Society board of directors and is a member of the S&P/TSX Canada Index Advisory Panel.