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Investors warned about niche ETFs

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Industry analysts and consumer advocates are warning investors of the dangers of a class of exchange traded funds that is “exploding“ in popularity.

Leveraged and inverse ETFs – which claim to generate two or three times the return of an underlying index or a multiple of the inverse of the index – have amassed $30bn (£19bn, €21bn) of assets in the past two years and now account for 40 per cent of the volume of US equity trading.

But many of these ETFs spectacularly fail to provide the expected return if held for more than a very short period – typically more than a day for equity-based funds.

“Very bad things can happen whenever you hold these ETFs longer than their indicated compounding period, typically one day for stock-based ETFs,” said Paul Justice, ETF strategist at Morningstar. “Many people are learning through horrible experiences.

“They are appropriate for less than 1 per cent of the investing community. Considering these funds have attracted billions of dollars over the past year, it’s obvious that too many people are using these incorrectly.”

Ermanno Pascutto, executive director of Canada’s Foundation for Advancement of Investor Rights, (Fair) which is calling for regulators to warn investors of the dangers of these products, said: “The longer you hold a leveraged or inverse ETF, the greater the likelihood that you will lose money, regardless of which direction you bet.”

In a report entitled Heads You Lose, Tails You Lose, Fair said that while an index of gold stocks rose 1 per cent in the year to March 31, a Horizons BetaPro Bull ETF, providing two times leverage, lost 46.4 per cent over the same period, while a two times inverse Bear ETF fell 86.7 per cent.

Similarly an Energy Bear ETF lost 25.4 per cent despite the underlying energy index falling 39.4 per cent, although other oil and natural gas Bear ETFs have produced strong returns.

Morningstar quoted the example of ProShares’ UltraShort MSCI Emerging Markets ETF, which aims to deliver twice the inverse of the MSCI EM index. While the index lost 54.5 per cent last year, the ETF fell 25 per cent. “It’s clear to me that many people have held these products and not understood how they work,” said Deborah Fuhr, global head of ETF research at Barclays Global Investors (BGI), which said in a recent report: “If volatility is sufficiently high, the median investor will experience a long-run erosion in value in a leveraged or inverse ETF.”

Mr Justice said it was not just novice investors that had been caught out: a number of US financial advisers had put their clients into these funds without understanding the consequences.

Leveraged and inverse ETFs have grown rapidly in the US, where there are 94 products, according to BGI, offered by the likes of ProShares, Direxion, and Rydex. The European market is much smaller, with 17 products and a little under €2bn.

Andy O’Rourke, marketing director of Direxion Funds, which has been singled out for having better disclosure than most issuers, accepted that leveraged and inverse ETFs were “niche products”, but believed “few” investors were using them inappropriately.

“Any financial adviser should really understand the basis of these products. No reasonable person would miss the disclosures,” he said.

However, Michael Sapir, chief executive of ProShare Advisors, the market leader, argued that leveraged and inverse ETFs were suitable for “sophisticated” medium-term investors, provided they monitored their positions closely.

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