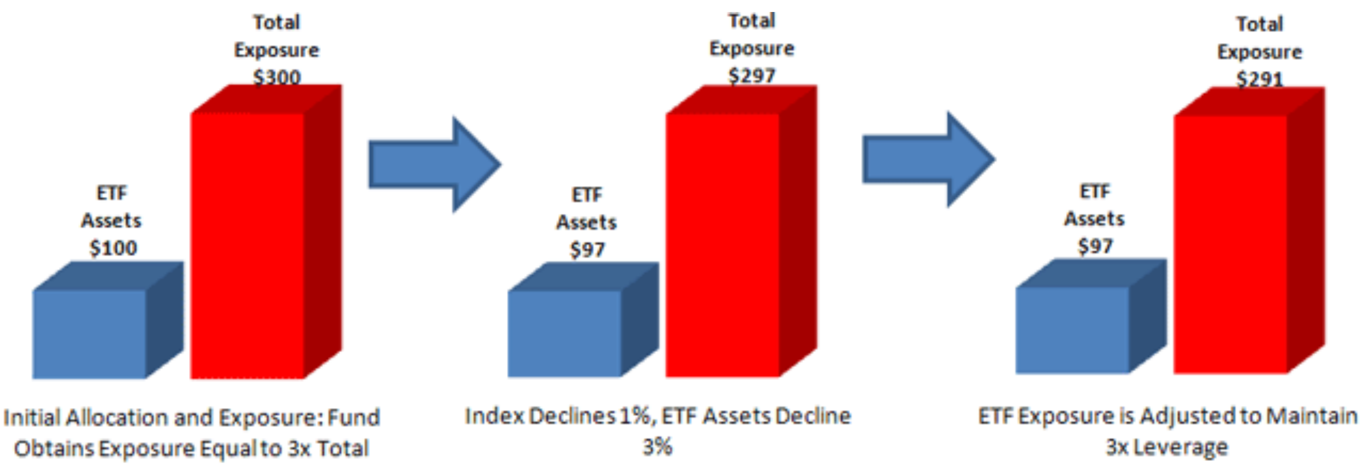
The Other Side Of The Leveraged ETF Coin: How Compounding Can (And Does) Work For Investors

At the height of the leveraged ETF controversy in recent years has been the performance of these products when held for extended periods of time. Because leveraged ETFs operate with a daily investment objective, their returns over any period longer than a single trading session depends not only on the change in the related index, but on the path taken by that index over the period in question. If the S&P 500 increases by 2% for the month, there is no guarantee that the ProShares Ultra S&P 500 (SSO) will be up 4% over that time.

In order to amplify daily results, leveraged ETFs "reset" their exposure on a daily basis. If a bear 3x fund loses 3% in a day (i.e., the underlying index loses 1%), the exposure of the fund must be adjusted to maintain 3x daily leverage. It works the same way on the upside: if a 3x bull fund jumps 3% on the day, the fund must add additional exposure so that it can still provide the promised leverage the next day.



So it becomes clear that oscillating markets — where winning sessions are followed by losing sessions and vice versa — can erode the returns to leveraged ETFs over multiple sessions. In such markets, leveraged ETFs increase their exposure before a decline and decrease exposure before a gain. In 2008, financial markets experienced unprecedented volatility, leading to significant return erosion in leveraged ETFs.

Other Side Of The Coin

It is also important to note that daily compounding of returns can work *for* investors in certain markets. And it often does. Because exposure is increased after a winning session (assuming a bull fund), a streak of consecutive gains in a leveraged ETFs can begin to amplify results further.

This concept isn't specific to leveraged ETFs by any means: it applies to everything from a savings account to a long only ETF product. If a stock gains 10% in two consecutive sessions, its cumulative increase in value over that period is not 20%, but 21%. Alternatively, investing in a leveraged ETF over time can be

Consider the following example in which an index rises 2% per day for ten consecutive sessions:

	Index		2x Leveraged ETF	
Day	***Daily Gain***	***Value***	***Daily Gain***	***Value***
Day 1	2%	100.00	4%	104.00

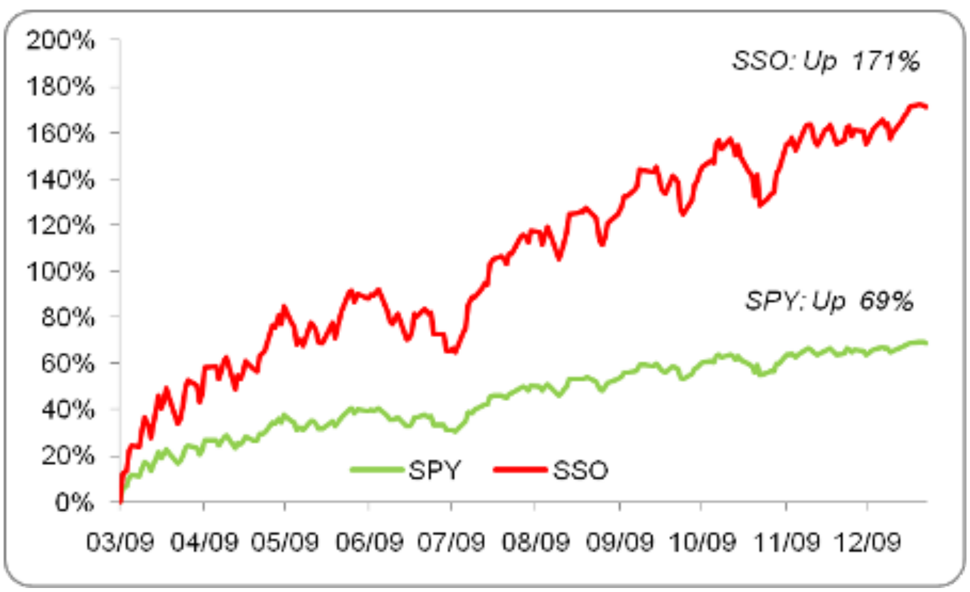
Day 2	2%	104.04	4%	108.16
Day 3	2%	106.12	4%	112.49
Day 4	2%	108.24	4%	116.99
Day 5	2%	110.41	4%	121.67
Day 6	2%	112.62	4%	126.53
Day 7	2%	114.87	4%	131.59
Day 8	2%	117.17	4%	136.86
Day 9	2%	119.51	4%	142.33
Day 10	2%	121.90	4%	148.02

At the end of the period, the index is up 21.9%, while the 2x leveraged ETF has gained 48.0%, or 2.2x the increase in the related index.

Beyond Hypothetical

The aforementioned is obviously a hypothetical example. But there are instances of the compounding phenomenon benefiting leveraged ETF investors over extended periods of time.

While the path down from all-time equity market highs to the bear market lows was a volatile one, the subsequent recovery was trending in nature, including several multiple day winning streaks. After finally scraping bottom in March of 2009, the S&P 500 SPDR (SPY) gained about 69% by the end of the year. The ProShares Ultra S&P 500, which seeks *daily* investment results that correspond to 200% of the daily performance of the S&P 500, was up 171% over that same period, delivering almost 2.5 times the return on the long only fund linked to the same benchmark.



Proceed With Caution

The potential to profit from holding on to leveraged ETFs during trending markets isn't permission to follow a "set it and forget it" strategy. The potential for losses from market fluctuations is very real, and the results can be very devastating, as shown by the performance of many leveraged ETFs during 2008. But if monitored regularly, and rebalanced as needed, holding leveraged ETFs for extended periods of time may be appropriate.

After initially expressing concern over the use of leveraged ETFs over multiple trading sessions, the Financial Industry Regulatory Authority (FINRA) **backpedaled on this position** in July 2009. "Leveraged and inverse ETFs can be appropriate if recommended as part of a sophisticated trading strategy that will be closely monitored by a financial professional," FINRA said. "At times, this trading strategy might require a leveraged or inverse ETF to be held longer than one day."

FINRA's guidance stating that leveraged ETFs should never be held for more than a single trading session was extreme, and doesn't apply to many investors.

Disclosure: No positions at time of writing.