Are Leveraged ETFs a Legitimate Investment?

Recently Larry Fink who runs Blackrock waded into the debate over leveraged ETFs at a Deutsche Bank investment conference. Fink was highly critical of such products, which he said had the potential to "blow up" the industry one day. The other side of the debate includes Direxion, a provider of leveraged ETFs (Blackrock has none).

There's probably little disagreement about how they actually work. Take the Direxion Daily S&P500 Bear 3X Shares (SPXS) for example. $1 invested gives you three times the inverse exposure to daily swings in the equity market. So if stocks are -0.25%, you should be up a little less than 0.75% (there are fees, after all). The leverage can sound attractive, but comes with an insidious long term result. Because the ETF targets constant leverage of 3X, it is always having to rebalance. And this rebalancing is always in the direction of the market's most recent move; if the equity markets falls (causing the ETF to rise in value) its leverage will drop below the target of 3X. At day's end it will need to increase its short equity position by selling stocks (or index futures) at lower prices. Conversely, if the market rises causing the ETF to lose money it will become over leveraged and will need to reduce its short position by buying stocks, just after they've gone up.

The perhaps surprising result of this is that given enough time and enough up and down moves, the value of the ETF will inexorably trend towards 0. There are certain special cases in which this may be delayed or (theoretically anyway) not happen, such as an underlying market that moves steadily in one direction with no fluctuations (i.e. the rebalancing causes less harm), but in the real world such things don't exist. And it can lose money over time even if the underlying equity market moves as the holder expected (i.e. falls) because of the rebalancing. It is, curiously, an investment product that will cost you money with greater certainty the longer you hold it.

This is fully understood by the providers and Direxion's prospectus (for those who read such things) provides ample warning that this is a short term, "tactical" fund. Although they do use the word "investment" as it relates to "daily investment returns", they don't describe it as an investment product.

So why do such things exist? The answer, of course, is that investors are consenting adults and if full disclosure is given then who's to say that an "investor" (since real investors couldn't possibly use these) shouldn't be allowed to buy one? In aggregate, the holders of inverse ETFs will lose money with virtual certainty, but of course they won't *all* lose money. In this regard, they are very much like blackjack or sports betting. A minority of users with skill (or luck) can profit but we all know that the casino always wins. But at least visitors to the blackjack table or the track presumably don't for one minute confuse what they are doing with investing. Do inverse ETFs users possess the same sense of reality?

Such products no doubt sell themselves, such is the interest in short term market direction and tools with which to bet on it. In fact, one would hope that being sold by themselves is the only way they are ever used. For while Direxion and other such providers can point to the ample disclosures in their documents which almost (but not quite) advise you to not use them at all, what of the brokers or advisers who recommend them to their clients?

It's hard to fathom why anyone would recommend that a client risk money in something that really is structured like a gambling bet. And in fact the Investment News article referenced above notes that many brokerage firms place strict limits on sales of leveraged ETFs. For those that still recommend their clients use them, one must presume that their business and demand for commissions need only satisfy the minimal standards of (1) is it legal, and (2) did the client agree.

The CFA Institute’s Future of Finance initiative which, among other things seeks a finance industry that puts investors first, clearly has plenty of opportunity.