https://www.wsj.com/finance/investing/how-booming-leveraged-funds-can-incinerate-your-money-68241a9c

MARKETS & FINANCE | INVESTING | HEARD ON THE STREET (Follow)

## How Booming Leveraged Funds Can Incinerate Your Money

Variants soon might include long-short funds resembling steel-cage matches

By Jonathan Weil Follow

Dec. 11, 2024 5:30 am ET



Michael Saylor, executive chairman of MicroStrategy PHOTO: LIAM KENNEDY/BLOOMBERG NEWS

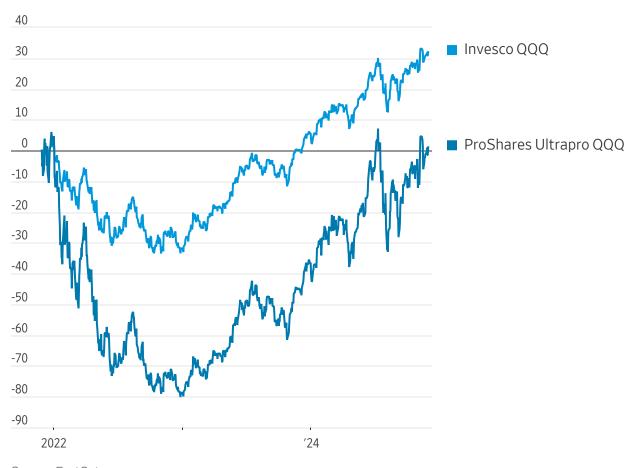
There is great appeal in the notion of a simple investment product that can reliably provide double or triple the returns of a popular stock or index. The results have been disappointing, vaporizing billions of dollars, but Wall Street keeps finding plenty of eager buyers.

Leveraged exchange-traded funds are having a moment about two years after the first leveraged single-stock ETFs were introduced in the U.S. They typically use derivatives to seek magnified gains. That also will magnify losses. Through November, the size of these funds in the U.S. grew 46% this year to about \$137 billion, according to Morningstar Direct. About \$20 billion of them were single-stock funds, up 11-fold year to date.

The biggest leveraged ETF, at \$25 billion, is the ProShares UltraPro QQQ. The fund's manager says it seeks "daily investment results, before fees and expenses, that correspond to three times (3x) the daily performance of the Nasdaq-100 Index."

The crucial word there is "daily." An investor who naively skipped over that nuance and held the fund for longer may have been disappointed with its relative performance. Through last month, the Nasdaq-100 gained 32% during the previous three years. But the fund was up only 1%.

## Performance of Nasdaq 100 ETF and 3x leveraged version through November



Source: FactSet

The daily results often don't go according to plan, either. On many days this year, the fund's performance has been significantly less than or greater than three times the index's move. The reason: Nobody's perfect. Every day the fund's holdings go up or down in value, while the fund's managers must keep its daily leverage at a constant level. This requires lots of complex trading, buying more when the index goes up and selling when it goes down.

Leveraged ETFs aren't new, and their foibles are well known to old hands. The noted fund manager Ted Seides in a 2010 paper, <u>titled "The Surprising Cost of Volatility,"</u>

highlighted the performance during the financial crisis of two leveraged ETFs tied to the Russell 2000 index of small stocks.

The Russell 2000 fell 16% from the start of 2008 to the end of 2009. One might think someone who was betting the index would go down during that same period would have profited nicely. Yet investors in a leveraged ETF called the Russell 2000 Ultra Short 2x *lost* 51%. That was almost as bad as the Russell 2000 Ultra Long 2x, which fell 53%, or more than triple the index's decline.

The drag mainly was due to the underlying holdings' volatility. "In markets that are more volatile than directional, the repeated process of rebalancing the ETF follows a pattern of buying high and selling low that takes a toll on asset value over time," Seides wrote.

The appetite for leveraged ETFs has grown nonetheless. Popular single-stock leveraged ETFs include two funds targeting 2x daily returns in the <a href="bitcoin buying machine MicroStrategy">bitcoin buying</a> machine MicroStrategy. After investors noticed they frequently were missing their daily targets, the funds' managers explained they <a href="couldn't get enough swap contracts">couldn't get enough swap contracts</a> from their prime brokers and had turned to less effective ways of getting daily leverage, including the options market. Skeptics have pointed out that a 51% one-day drop in MicroStrategy's stock price could wipe out the funds.

In a <u>research note</u> last month, Victor Haghani and James White of the investment firm Elm Wealth wrote that "even with the fullest disclosure possible, we struggle to find cases where these ETFs, particularly those based on single stocks, would make sense as investment vehicles for investors with typical risk preferences."

A jump-the-shark moment for the ETF industry could be approaching. Like a prowrestling promoter pairing a heel or a good guy against a jabroni in a steel-cage match, Tidal Investments has filed plans with the Securities and Exchange Commission for a lineup of eight leveraged ETFs called Battleshares, each pitting a popular disrupter against a company it is disrupting. One fund would have a leveraged-long position in Tesla TSLA -0.89% ▼ about twice as big as a short position in Ford. Another would be long Amazon AMZN 0.34% ▲ and short Macy's M -1.01% ▼ in the same way. And so on.

Unlike other leveraged ETFs, the proposed Battleshares funds make no pretense of seeking "daily" performance, stating instead that each ETF "seeks long-term capital appreciation." As with other leveraged ETFs, the constant rebalancing required as the stocks go up or down is likely to drag on returns.

White, the chief executive of Elm Wealth, at The Wall Street Journal's request estimated how the proposed Battleshares pairings would have performed if they had maintained 2x daily leverage over time.

For the three years through Nov. 30, one might naively have expected a 26% compounded annual return simply by netting Amazon's 2x long performance against Macy's 1x short performance. (On a compounded basis, Amazon grew 6% a year, while Macy's fell 14% a year). However, in a leveraged ETF structure, White estimated the trade would have lost 5% a year, including management fees and finance costs. That mainly was because of the stocks' volatility and the constant rebalancing needed to maintain the 2x daily leverage.

Likewise, over the same period, netting Tesla's performance against Ford's would have suggested a possible compounded annual return of 4%. In a 2x leveraged ETF structure, White estimated the pairs trade would have lost 28% a year.

While it may be brilliant marketing, these aren't investments for the serious-minded. They likely will be more fun to watch than to own.

Write to Jonathan Weil at jonathan.weil@wsj.com

Appeared in the December 12, 2024, print edition as 'Booming Leveraged Funds Can Incinerate Your Money'.

## **Videos**