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Your Fancy, New ETF Might Be a Little Too Fancy

Exchange-traded funds have mostly been great investments, but they are getting too complex for their own good

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Signage for BlackRock's iShares Ethereum Trust ETF in New York in July. PHOTO: VICTOR J. BLUE/BLOOMBERG NEWS

History teaches that financial complexity always creeps upward. Lately that trend has reached investor-friendly exchange-traded funds.

Last year, U.S.-based ETFs broke a record, surpassing $1 trillion in total inflows. They are cheap, liquid and, crucially, far more tax-efficient than traditional mutual funds. If you want to hold stocks and bonds, the flagship trackers from industry giants BlackRock BLK -0.07% ▼, Vanguard and State Street Global Advisors already do the trick for very low fees. It is tough, and not especially rewarding, to compete with those industry behemoths head-on.

So Wall Street has found a new gold rush: packaging even the most sophisticated products in ETF form. About 30% of ETFs launched in the U.S. in 2024 referred to some complex strategy in their names, an analysis of Morningstar Direct data suggests—double the average of the previous nine years. What it says on the label is becoming increasingly creative, and what happens inside of those funds is increasingly obscure.

That complexity sometimes delivers a poor return compared with the plain vanilla variety. After a dismal December, the Simplify Enhanced Income ETF—trading under the ticker HIGH—ended 2024 with a total return of 1.5%, despite its prospectus saying that “it seeks to provide significant supplemental income to T-bills.” The SPDR Bloomberg 1-3 Month T-Bill ETF, or BIL, returned 5.2%.

In addition to buying short-term paper, HIGH buys and sells “call” and “put” options to generate extra income, which amount to insurance policies against rises and falls in the price of some underlying asset. But this can create big losses whenever market volatility jumps, as happened in August and October. HIGH has the flexibility to venture into terrain such as the S&P 500, Nasdaq-100 and Russell 2000 indexes, and even gold ETFs.

Beating T-bills when interest rates are at 4.5% is no easy task, and HIGH has been making some risky bets. Its options contracts on the S&P 500 maturing this Friday, for example, will only yield a gain from here if the index rises more than 0.6% or falls more than 7.9% from Monday's close by expiration. The fund even traded options on MicroStrategy MSTR **0.15%** ▲ , the speculative bitcoin-buying machine, which fell 25% in December.

The similar NEOS Enhanced Income 1-3 Month T-Bill ETF, ticker symbol CSHI, managed to deliver a 5.7% return in 2024 by sticking to less-risky put options. The point, though, is that any product exposed to big drawdowns isn't a good alternative to cash, which is the typical use case for short-term bond ETFs.

Or take the JPMorgan Equity Premium Income ETF, or JEPI, and its Nasdaq-focused sibling, JEPQ: They received $5 billion and $11 billion in net inflows in 2024, respectively, putting them on par with the top U.S. equity ETFs. While their options-based strategies reduce volatility from owning stocks, they also cap the upside, are easy to front-run, are tax inefficient and don't shield against big selloffs. Arguably, they are products that almost nobody needs.

Even those offering investors the ingredients to shoot the lights out often wind up shooting them in the foot. The ProShares UltraPro QQQ, a $27 billion behemoth that promises to triple the daily return of the Nasdaq-100, has barely generated any return over the past three years as the technology-heavy index soared.

The issue with it and dozens of similar funds is that leveraged ETFs are usually reset daily. Each loss therefore reduces the base for future gains more than for the index, which measures returns cumulatively.

Since 2022, financial firms have been launching leveraged ETFs that target single companies, making this problem more egregious. Once again, MicroStrategy pops up: The Defiance Daily Target 2X Long MSTR ETF and the T-Rex 2X Long MSTR Daily Target ETF aim to amplify the returns of the stock but have barely done so, often missing even their daily targets.

The next frontier is building ETFs that replicate other assets without some of their undesirable characteristics.

The Alpha Architect 1-3 Month Box ETF, or BOXX, for example, tries to match or surpass T-bill returns with options so as not to trigger taxable distributions. Still, it was forced to do one last year under counsel from its legal advisers.

There is also demand to access so-called alternative assets in a cheaper, easier way. The University of Connecticut's endowment recently replaced most of its hedge-fund holdings with "buffered ETFs," which also offer some protection in down markets. Products such as the IQ Hedge Multi-Strategy Tracker ETF explicitly try to copy the performance of hedge funds without owning any.

In December, both BondBloxx and Virtus Investment Partners launched the first ETFs providing exposure to private debt, although in the form of relatively mainstream collateralized loan obligations. State Street Global Advisors has filed an application with U.S. regulators to launch an ETF that would invest a portion of its money in this illiquid form of credit directly. Its approval is uncertain because putting a liquid wrapper around less-liquid assets comes with obvious dangers.

Of course past innovation in ETFs has led to predictions of trouble that have time and again proved unfounded. In 2020, when corporate-debt markets froze, ETFs became a way to keep markets liquid during trying times.

Yet, by their very nature, financial markets will eventually push one too many complex features into ETFs. Perhaps it will happen to this recent crop of products, leaving holders with a mix of losses in cash-like funds, stranded private assets and ill-conceived tax strategies that prompt angry calls from the Internal Revenue Service. The tipping point could still be years away.

Regardless, investors need to be increasingly cautious about what they buy and who they buy it from. These are the times that will test ETF builders.

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