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# Doubling Down: Leveraged ETFs offer promise - and danger

By Chris Taylor, Reuters

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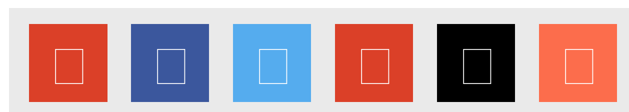

NEW YORK (Reuters) - In a volatile market, boring investments can be pretty darn sexy. That is why investors have plowed more than $4 trillion into exchange-traded funds, according to London-based research firm ETFGI.

They're drawn by low fees, tax efficiency and the simplicity and ease of index funds.

Exchange-traded funds, however, also have some swashbuckling cousins. So-called "leveraged" versions offer two or even three times benchmark returns. By using techniques employing swaps and derivatives, they offer the promise of multiplying your gains - or losses - on pretty much any sector you want.

Semiconductor bulls? Check. Energy bears? Check. In fact, there are a dizzying 222 U.S.-listed leveraged ETFs with more than $38 billion under management, according to Morningstar research.

"Based on the flow data we see, they appear to be mainly used for short-term periods in more aggressive tactical fashions," said Matthew Bartolini, head of SPDR Americas Research. "With that comes volatility. Just as one can be right, they can also be very wrong."

The risk may only be ramping up. The U.S. Securities and Exchange Commission is evaluating 4x leveraged ETFs, the first of their kind to quadruple potential returns. The SEC initially offered its approval this past spring, before putting that decision on hold.

For aggressive traders, the appeal of leveraged ETFs is obvious. If you are convinced that the

market (or just a particular sector) is going to make a big move, then the possibility of multiplying your returns in short order can be irresistible.

But compare the use of leveraged ETFs to handling fireworks. If pulled off successfully, it can be an impressive show. If handled clumsily, they can very easily explode in your face and leave lasting damage.

For long-term, individual investors in particular, there is no reason to crank up your portfolio risk (and potential losses) just because you can. Financial planner David Haraway of Colorado Springs, Colorado, has a simple suggestion for how often such investors should dip into leveraged ETFs: "Never."

The use of such risky products would be perfectly appropriate if we were all excellent investors, who manage to make the right call every time. Of course, we are anything but that.

Individuals are notorious for being subpar investors, regularly falling prey to our worst behavioral instincts. Among them: Being motivated by greed or fear instead of fundamentals; mistiming markets, buying at the top and selling at the bottom; and trading too frequently, which eats away at returns with investment fees.

Now multiply those sloppy instincts two or three times over, and you can see why highly leveraged products are potentially so dangerous.

"The magnification of returns could make it so a risk-loving person could be tempted to play around with leveraged versions," said Jodi Beggs, a behavioral economist and lecturer at Northeastern University in Boston. "But unless trading your own assets is your full-time job, my advice is to stay away."

She noted that management fees on leveraged funds tend to be higher than those of other ETFs - which erases some of the benefits of holding ETFs in the first place.

That in mind, it might be wise to give your portfolio a quick X-ray for any leveraged holdings. If

your adviser has placed you in such funds - maybe in an attempt to juice returns, or mask other losses - then perhaps you should be re-evaluating that relationship.

"Individual investors should not be handling these at all, and neither should advisers," said Kashif Ahmed, of American Private Wealth in Woburn, Massachusetts. "It is impossible to use these and not expose yourself to undue risk."

If you are nonetheless tempted, the pros have one practical tip: Place a hard cap on such speculative investments, as a percentage of your total portfolio. If you limit it to 10 percent, suggests San Francisco financial planner Steve Branton, then you contain any potential damage. Then, even if you lose it all in a worst-case scenario, the rest of your retirement funds would remain on course.

Also remember that equities themselves are inherently risky. Doubling or tripling down on that risk is essentially a dice roll - and as any gambler knows, there is always the possibility that you will come up snake eyes.

(Editing by Beth Pinsker and Dan Grebler)

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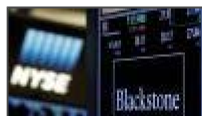


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