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ALTERNATIVE INVESTING

How to Gain Leverage

Using inverse ETFs can be easier than shorting stocks, but beware the risks

By GREGORY ZUCKERMAN

Q:I use inverse ETFs, like SDS. When I'm making money, who is losing money? Also, what are the pluses and minuses of using inverse ETFs?

A: ETFs, or exchange-traded funds, have emerged as a popular, low-cost investment vehicle, replacing mutual funds in many portfolios. ETFs are securities that trade throughout the day, much like stocks. But they usually aim to track a basket of stocks or an index, providing diversification and an ability to track specific markets or industries. The average ETF has an annual expense ratio well below that of mutual funds, another boon to investors.

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Inverse ETFs seek to deliver a return that is the inverse of an index's return. ProShares UltraShort S&P500, or SDS, is a "double-short" fund—it aims to achieve a return that is twice the inverse of the daily performance of the Standard & Poor's 500 index. Thus, if the S&P 500 drops 10%, this ETF is expected to gain about 20%.

As such, the fund is a "leveraged" ETF, or among those that aim to deliver a return that is a multiple of that of an index or other barometer. Leveraged ETFs give investors a chance to multiply their initial investment by several times without resorting to other steps to amplify their gains, such as buying shares on margin, or with borrowed money.

Buying securities on margin can be risky because the lender—usually the investor's brokerage firm—can demand quick repayment of the loan when a bet goes bad.

Inverse ETFs generally buy derivative contracts, such as "swaps," that gain in value when the market goes down and lose money when the market rises. Swaps are bespoke contracts with banks and other financial institutions in which both parties agree to make payments based on the movements of an underlying index. For SDS, it is the S&P 500.

The financial institutions either keep these contracts, assuming the risk that stocks rise or fall, or sell them to others who are comfortable with that exposure. If stocks do fall, the banks and investors on the other side of the swap contracts purchased by the ETF stand to lose money, while the ETF and its holders should benefit.

"Similar to options and future contracts, and unlike the stock market, this is a zero-sum game," says Scott Miller Jr., a managing partner of Blue Bell Private Wealth Management LLC, based in Blue Bell, Pa.

Some investors turn to inverse ETFs as a way to protect their portfolios against a falling market. Others use them to make an outright bet against the market.

Inverse ETFs can be easier than other ways of wagering against stocks, such as "shorting" shares. An investor can buy and sell most ETFs easily and with limited cost. And because an investor is wagering against a diversified group of stocks or other investments, rather than against a single company, there is less risk of a single piece of positive news sending a stock soaring, causing severe damage to a short position.

But keep in mind the dangers, particularly of inverse ETFs: If the market doesn't go in the direction an investor anticipates, losses can be multiplied. To wit, SDS has lost about 30% over the past year, as stocks have registered gains of about 15%.

Another concern about making long-term bets using inverse ETFs: Their returns over long periods often don't match the stated multiples of their benchmark indexes.

ETFs buy derivative contracts, rather than the components of the index itself, so the ETFs don't always perfectly mimic an index's returns. Because of that tracking issue, and because the ETFs provide a return that is a multiple of the indexes' return, over time the compounding effect of daily changes makes it even harder for these ETFs to track an index, especially one that is volatile.

Look at SDS again as a prime example. The S&P 500 has gained about 7% over the past five years, including dividends. But rather than drop 14%, or twice the inverse of the S&P 500, SDS has lost about 20%.

A spokesman for ProShares says SDS, like all other leveraged ETFs, aims to track a multiple of its benchmark over one-day periods only.

Mr. Miller recommends using inverse ETFs as a short-term hedge against big swings in the markets, rather than as a buy-and-hold investment.

"These should be used by experienced investors to profit from short-term market moves generally made within a day," says Mr. Miller, who recommends using stock options for longer periods.

Analysts and other investment professionals second that view.

"It can feel good to make money when the market is going down," says Matthew Tuttle, president of Tuttle Wealth Management LLC in Stamford, Conn. "But these ETFs are meant to be short-term trades," he says.

Mr. Tuttle recommends using inverse ETFs as a short-term hedging strategy, for example, when an investor doesn't want to sell stocks but wants to reduce portfolio risk.

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