

Errant ETFs

Scot Blythe / June 09, 2009

Over different market cycles, inverse ETFs have proven popular with some investors. But what they expected to get and what they got has become a source of consternation — and complaint.

Exchange-traded funds — essentially index funds targeted at broad market benchmarks or narrower sectoral plays such as gold or oil — are by now a familiar part of the investment advisor's toolkit. And indeed, their popularity is such that they account for an increasing volume on stock exchanges, not just on the long, buy-and-hold side, but also on the short side.

Inverse exchange-traded funds, such as those offered by Horizons BetaPro in Canada, or Rydex in the U.S., offer a double, or sometimes a triple, exposure to market movements — on the long side, and on the short side. Some investors have found, to their chagrin, that they haven't received nearly that profit, and in fact have lagged the index returns by considerable margins.

There are two basic reasons for this. The first is that inverse ETFs rely on futures contracts that are settled at the end of the day. The next morning is a fresh start. The investor gets double the exposure, bearish or bullish, for that particular day, and that day only.

The second reason is that markets may not trend. A trending market — bull or bear sees consistent, albeit non-cumulative gains on one side of the trade. A volatile market with no consistent direction, however, offers something different, deep disappointment probably being foremost.

"There are bodies and scar tissue all over the place to show this," says Mark Yamada, president and CEO of Pur Investing, a Toronto ETF shop.

Those two factors have upset many retail investors. Indeed, a group called the Canadian Foundation for Advancement of Investor Rights has demanded that inverse ETFs provide better prospectus disclosure on the behaviour of these instruments in various types of markets.

But Yamada thinks the concern is misplaced. The disclosure is there, but the deeper understanding is not, he told attendees at Information Management Network's eighth annual Canada Cup of Investment Management last week in Toronto.

But first he notes that Canadians have adapted much more quickly to leveraged ETFs than their U.S. counterparts — at about three times the pace. "As a bunch of supposedly conservative investors, what the hell is going on?"

Some Canadians wonder what the hell has gone on, thanks to disappointing returns.

Yamada cites the example of gold. The S&P/TSX gold mining index was flat last year, returning 0.9%. The leveraged bull ETF returned a negative 46.4%. The bear performed worse, with a loss of 86.7%.

How did that happen? Yamada offers a formula for tracking the behaviour of an inverse ETF, based on the volatility of the underlying index. The return path can be plotted as one-half the square of the standard deviation. If the daily volatility on the index was 5%, the volatility on the leveraged ETF would be 10% — and amount to an annual loss of 72%, a sum he calls the negative volatility drag.

"The index was flat and you've blown out your brains on both sides," he says. "You should short these puppies."

That doesn't mean, in his view, that leveraged ETFs should be avoided. In trending markets, profits increase exposure, and losses decrease exposure, depending on the trend. But "these are very powerful instruments that require watching every day."

Or perhaps not. One solution to the constant leverage trap may be extending the term of the contract. Martin Kremenstein, chief operating officer at Deutsche Bank Commodity Services, helped introduce three commodity-tracking products to the Canadian market last year. They're not ETFs, but a different sort of vehicle, an exchange-traded note.

Like ETFs, they track an underlying index. They are not immediately exchangeable for the underlying shares because they are based on futures contracts. Ultimately ETNs are debt obligations offered by a bank, and that leaves their ultimate tax status up in the air for now: trading in and out will likely attract capital gains treatment, but holding to maturity may instead receive income treatment.

Still, there can be advantages, particularly in hard-to-access commodities. Where leveraged ETFs have their futures contract reset every day, Deutsche Bank's ETNs are reset once a month. This, at least, gives investors time to ride a trend in the commodities market, and Kremenstein suggests that investing in the front month of a futures contract (exchange-traded futures contracts settle after three months) and simply rolling it would have produced 3% over the past 20 years.

All the same, that's only one part of the ETF debate. While many discuss the merits of active and passive investing, Laurent Wermenlinger, a vice-president and portfolio manager at Desjardins Securities, thinks it's a false debate. Managers will decide whether to target the specific risk associated with a stock, or the systemic risk associated with the market.

More than that, he argues, "you need to understand the index behind the ETF." Some, for example, will have concentrated positions; they may also be invested in esoteric fields, some of which have since been withdrawn from the market.

He finds the key benefit to ETFs — apart from being relieved of "the illusive game" of trying to pick the top stocks — is a "hidden alpha" — the ability to take tax losses by switching among ETFs. Beyond that, he thinks that rebalancing when exposure to a given asset class has climbed to more than 20% of the target can add 50 basis points of return.

But it's all in the trade. While some investors worry about the liquidity of an ETF, Claymore president Som Seif explains that there are two levels of trading. The first is the activity the investor sees on the stock exchange. The second, and more important, is the work of the designated broker who acts to keep bids and asks from gapping out beyond the net asset value by buying and selling the constituent stocks of the ETF.

Seif offers a number of tips for ETF investors. Among them, avoid buying an ETF in the first or last five minutes of the trading day; "that's when they're least liquid." Use a limit order, rather than a market order. And pay attention to the current bid-ask spread: the last trade may have a stale bid.

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Filed by [Scot Blythe, editor@advisor.ca](mailto:scot.blythe@advisor.ca)

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