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## Leveraged ETFs

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### Risk Warning:

Please carefully consider the ETF's investment objectives, risks, charges and expenses before investing. ETFs may be complex in nature, investing involves risk including possible loss of principal. Before investing, PSPL recommends investors to read the Prospectus from the respective Issuer's website carefully. The respective website for all SGX listed ETF Issuer is available in our FAQ. PSPL does not provide any advice on the funds.



Leveraged ETF is a relatively new kind of ETF that is vastly gaining in popularity. This is because leveraged ETFs aim to provide a multiple of the returns on a given index and hence attract many savvy ETF investors.

How do you distinguish leveraged ETFs from other ETFs? These funds usually have a multiple in their names, such as "2x" or "3x",

or a descriptor such as "Ultra." This means that the ETF aims to deliver two or three times the return on the index.

Short ETFs are ETFs that are designed to perform the inverse of whatever index or benchmark it is designed to track. Leveraged short ETFs enable investors to gain leveraged profits from declines in an underlying index without even directly selling short any securities. Investors who think an index will decline in the short run can purchase shares of the leveraged short ETF that tracks the index, and the shares increase or decrease by in value, times it's multiplier effect, inversely with the index; that is to say that if the value of the underlying index goes down by 1% that day, then the value of the 3x leveraged short ETF shares goes up by 3%.

### Structure of the Leveraged ETF

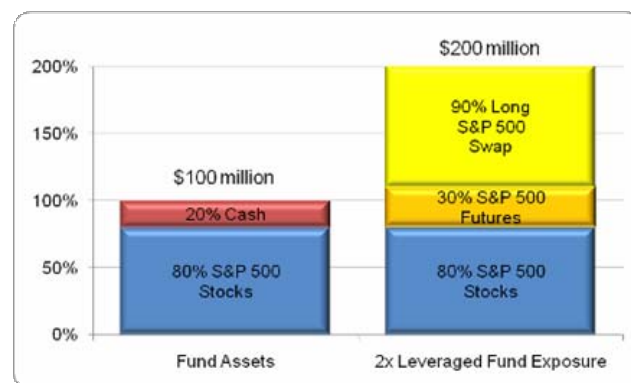
Leveraged ETFs are structured in a way where they are constantly balanced and managed using various financial derivatives like futures and swaps.

To explain, for example, a 2x long S&P 500 ETF may use a combination of equities, futures, and swaps to essentially double its exposure. A fund with \$100 million in assets might invest \$80 million in the underlying assets of the underlying benchmark (in this case the S&P 500), leaving \$20 million in cash. A portion of this cash could be used to purchase S&P 500 futures contracts — exchange-traded derivatives that provided exposure to a benchmark without direct ownership. A futures contract is essentially a standardized contract between two parties that agree to

buy (and sell) an underlying index at a future date at the market price. The buyer of a contract has a long position in the underlying, while the seller has a short position. A portion of the cash held by the fund could be used as collateral for the futures position.

In addition, a leveraged ETF may enter into an index swap agreement with a counterparty to increase its exposure to the underlying index. Swaps are customized agreements between two counterparties to exchange two sets of cash flows over a specified period of time. In an equity index swap, one party generally pays cash equal to the total return on the underlying index, while the other pays a floating interest rate.

By investing in a combination of these assets, a 2x leveraged ETF can establish \$200 million of exposure with \$100 million in assets:



Two popular ETF issuers that specialize in Leveraged ETFs are Direxion and ProShares. They have a wide range of leveraged ETFs that are accessible through POEMS in the "AMEX" market.

To view the list of ETFs these 2 issuers have, you can click the links below:

Direxion - <http://www.direxionshares.com/etfs>

ProShares - <http://www.proshares.com/funds/>

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## Daily Rebalancing

Investing in Leveraged ETFs might lead to unexpected losses of your investment value if you do not understand daily rebalancing. A leveraged ETF rebalances its assets daily to deliver the right multiple of the index's returns **only on that day**. If the ETF's trend keeps moving in the positive direction every single day, this will result in much better-than-expected returns for the longer period as compared with the index.

However, any reversals in the direction of the trend should leave a Leveraged ETF much worse off than would be expected based on its multiple. This is because daily returns on leveraged ETFs compound over time. As such, investors who plan to hold their investment for **longer than a day** should **be cautious** when approaching leveraged ETFs.

Illustration of the effects of a 2X Leveraged ETF.

### Good Situation

Day	Investment Value	Index Value	% Index Movement	% Return on Portfolio
0	\$100,000	100	NA	NA
1	\$120,000	110	10%	20%
2	\$108,000	99	-10%	8%

### Bad Situation

Day	Investment Value	Index Value	% Index Movement	% Return on Portfolio
0	\$100,000	100	NA	NA
1	\$80,000	90	-10%	-20%
2	\$96,000	99	10%	-4%

Notice that the outcome of the index in both situations is the same. However, while one situation leaves you better off, the other leaves you in a worse than expected state. This is why Leveraged ETFs are meant for short term investing.

## Summary

All in all, Leveraged ETFs, when used properly, can be powerful tools in various investment strategies. However, investors need to understand the mechanisms behind these ETFs and exercise caution when investing in them.

Now you know.