boost ETPs

5 THINGS TO KNOW ABOUT SHORT & LEVERAGED ETPs

Leverage has been around for hundreds of years and, today, there are many different types of short and leveraged instruments—from notes, to funds, to certificates—listed on exchanges globally.

Because of the combined features of leverage and daily compounded returns, these types of trading instruments can enhance returns and be a robust, transparent, secure and cost-effective trading tool.

As a provider of short and leveraged ETPs through our Boost product range, we want investors to clearly understand how these products work before trading them.

1. Leveraged returns allow an investor to magnify the returns (positive and negative) of an unleveraged investment.

For example, suppose you invest in an ETP which tracks the FTSE 100 and is 3x leveraged. When the FTSE 100 rises 1% in the trading day, then your ETP should rise by 3% (excluding fees and adjustments).

If you had invested in the 3x short ETP product tracking the FTSE 100, that ETP would have fallen by 3% (excluding fees and adjustments) on that same day.

To clarify, if the FTSE 100 rises or falls by 1% on any day, the ETPs offering 3x long or short exposure, respectively, will gain 3% on such day (excluding fees and adjustments). You can use leveraged ETPs to employ less capital for greater exposures, or to magnify your exposure on the same amount of capital.

2. How leveraged ETPs achieve their leveraged returns for investors.

To achieve a long exposure to an index, an investor can either invest the notional amount of the exposure in an unleveraged ETP or, alternatively, 1/3 of the required notional exposure in a 3x Leveraged Daily ETP.

For example, by having £100 in a 3x Leverage Daily ETP, the investor is getting £300 of exposure to the underlying index*. The ETP can attain such leveraged exposure itself is by aggregating the £100 received from the investor with a further £200 borrowed from a bank, then investing the combined £300 into the index securities.

Thus, if the index returns 1% over a whole day, the value of the ETP's assets will rise by £3, which represents a 3% rise compared to the £100 invested into the ETP. The cost of borrowing the £200 is incorporated into the 3x leveraged ETP's return. This procedure, whereby 2x the value of the ETP is borrowed from a bank in order to invest 3x of the ETP's worth into the index is repeated daily as part of the daily rebalancing of the ETP. This is the mechanism that ensures the leverage factor for the ETP is reset to 3x every day.

To achieve a short exposure to an index, investors may buy a short ETP. A geared short ETP allows the investor to attain a larger short exposure than an unleveraged short ETP.

For example, to gain £300 worth of short exposure to an index, an investor may invest £100 in a 3x Short Daily ETP*. The ETP can attain such short exposure itself through 'short selling'. This entails borrowing £300 worth of securities and then selling the borrowed securities to a 3rd party. The sale of the securities to a 3rd party generates £300, which together with the £100 invested into the ETP by the investor make up £400 of cash which is lent to a bank in exchange for interest. Since the borrowed securities must be returned, this generates a short exposure to the index.

* If the investment is done at NAV. If the investment is made over the trading day, before or after the close, the exposure will typically be different to 3x.

If the index rises over the day by 1%, repurchasing the sold securities in order to return them to their lender will cost the ETP £303, leaving only £97 in cash as the assets of the ETP (plus the overnight interest earned on the previous day's £400 cash balance). This procedure, whereby 3x the ETP's value of the underlying index securities are sold short every day and unwound the following day, is repeated daily as part of the daily rebalancing of the ETP. This is the mechanism that ensures that the leverage factor of the ETP is reset to -3x every day.

3. There's a reason why ETP providers incorporate rebalancing.

Leveraged ETPs seek to offer a stated multiple (that is, the leverage factor) of the performance of their benchmark over a period of time.

This period of time is typically one day. This means that leveraged ETPs need to rebalance the leverage at the end of each trading day to ensure they offer investors the same leverage factor on each new trading day. If weekly or monthly leverage was used, the leverage factor for investors would then depend on what day of the week or month they bought the investment.

Over time, daily rebalancing may lead to extreme results (for example, exposures greatly in excess of the stated leverage factor). The returns of a leveraged ETP will be path dependent on the underlying index over time. Since ETPs are open-ended and can be created and redeemed daily, daily rebalancing allows investors to buy and sell the ETP on any date and still receive the stated leverage factor.

4. Compounding needs to be taken into consideration for ETPs held over periods longer than one day and can have both negative and positive effects.

Consider a scenario where the FTSE 100 moves up and down with no clear trend.

You now know that if the FTSE 100 price is £100 and rises by +5%, your 3x FTSE 100 Leverage Daily ETP will rise by +15% to £115 (excluding fees and adjustments).

But then the next day, if the FTSE 100 falls by -5% that ETP will fall to £97.75. Over two days, the FTSE 100 would have an average return of 0% and a price of £99.75 resulting from a two-day compounded return of -0.25%. While you'd expect a return on the ETP of three times the index returns (or -0.75%), the two-day compounded ETP return is -2.25%.

Consider now a scenario where the FTSE 100 is trending upwards, returning +5% on each of two consecutive days. £100 invested in the FTSE 100 would return £5 on the first day and £5.25 on the second day, with an end of day value of £110.25 (or 10.25% return over the two days). Your 3x FTSE 100 Leverage Daily ETP would have returned £15 on the first day and then £17.25 on the second day, resulting in a two-day compounded price of £132.25 or a return of 32.25%.

This return would exceed three times the 10.25% return of the FTSE 100 (or 30.75%) because your leverage was reset on the second day and calculated upon the new base.

Daily rebalancing produces "compounded" returns, which can have a positive or a negative impact. The magnitude of this daily compounding effect depends on the length of a holding period, the volatility of the index and the leverage.

5. Different ETP providers and instruments offer varying degrees of protection for both your initial capital and consequent losses (or gains).

For that reason, you should always ask your provider about the underlying structure of their products.

For example, you may want to know what would happen if there was an extreme market move in the FTSE 100. Is there an intra-day rebalancing mechanism which would prevent your leveraged ETP tracking the FTSE 100 falling to £0 in one day? In the case of Boost ETPs the answer is yes.

Boost ETPs are over collateralised, transparent, exchange traded products and they have a built-in intraday reset mechanism designed to prevent the product from such eventualities.

Another thing to note is that Short & Leveraged Exchange Traded Products are not the same as CFDs, futures or options. Investors should always check whether more than their initial capital could be at risk. Investors in Boost ETPs can never lose more than their initial investment.

ETP issuers employ capital markets professionals to answer questions about the mechanics of their products. If you are a professional investor, please feel free to contact us with any questions.

Boost Exchange Traded Products ("ETPs") are suitable for financially sophisticated investors who wish to take a short term view on the underlying indices and can understand the risks of investing in products offering daily leveraged or daily short exposures.

ETPs offering daily leveraged or daily short exposures ("Leveraged ETPs") are products which feature specific risks that prospective investors should understand before investing in them. Higher volatility of the underlying indices and holding periods longer than a day may have an adverse impact on the performance of Leveraged ETPs. As such, Leveraged ETPs are intended for financially sophisticated investors who wish to take a short term view on the underlying indices and understand such risks. As a consequence, WisdomTree Europe Ltd is not promoting or marketing Boost ETPs to retail clients. Investors should refer to the section entitled "Risk Factors" and "Economic Overview of the ETP Securities" in the Boost Prospectus for further details of these and other risks associated with an investment in Leveraged ETPs and consult their financial advisors as needed. Neither WisdomTree Europe Ltd. nor the Issuer has assessed the suitability of any Leveraged ETPs for investors other than the relevant Authorised Participants.