LEVERAGING INVESTMENTS WITH EXCHANGE TRADED PRODUCTS

Christopher Gannatti — Global Head of Research, WisdomTree.
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Investors have always been advised (and learned from experience) to look to the long term. In fact, "buy and hold" has long been a core principle for investing. However, it is also possible to complement your "buy and hold" strategies with short-term, tactical trading that may enhance returns.

For many years, sophisticated investors have used leveraged products to express views on the market direction and momentum and to potentially magnify their gains.

What is leverage?

Traditionally, leverage uses financial instruments or borrowed money to increase the potential return of an investment. It's worth noting that both short and long positions can be leveraged, therefore, depending on view, allowing the enhancing of returns when markets or asset classes are moving either up or down.

For our purposes, let's focus on long leverage. This can enable you to invest £2, £3, or even £5 for every £1 that you have. How might this work?

- Say an investor has £250 in their own account but wants to invest £500. They can borrow £250 from a broker. For the sake of our example, let's imagine they borrow it with no costs and imagine they invest in Company ABC.
- If ABC's shares increase by 20%, the investor has £600. Returning the borrowed £250 leaves the investor with £350: a gain of £100. Investing only with the investor's own money would have yielded only £50 (a gain of 20% from £250 to £300).
- The attractiveness of making £100 instead of £50 goes without saying.
- Naturally, if the shares decrease, the investor will lose money—more than they would have if they had only invested their own money. Critically, in our example, the borrowed £250 would still be owed regardless of performance. So, while leverage can help enhance your returns, it can also increase the risks.
- Let's illustrate this by starting with our initial assumptions: £250 in the account and £250 of borrowed money. £500 in initial value. The market goes into a challenging period and the account drops 20%, leaving £400 in the account. The £250 still need to be paid back, leaving the investor with £150 remaining—a loss of £100 from their original position. Had the investor not used leverage, they would have started with £250 and the 20% decline would have led to £200 remaining in the account. In effect, the loss of £50 (not using leverage) compares to the loss of £100 (using leverage).

How investors use leverage

Leverage can help you achieve a level of exposure with less upfront cash, but it can also help you implement high conviction views, increase short term returns and take advantage of market pricing anomalies. A real-world example could be when you have a specific view that a market, industry or company will get a boost from an event like an election or an anticipated policy change.

In the past, investors would have to have a margin account to use leverage—and if the investment lost a significant amount, it was possible to lose more than the initial principal invested. Today, Exchange Traded Products (ETPs) make it a simpler matter to use leverage.

Leveraged ETPs

Leveraged ETPs allow investors to access leveraged returns via exchange traded, liquid, cost-efficient, collateralised financial products. Like other ETPs, leveraged ETPs are passive investments that replicate the return of an underlying benchmark or asset. These ETPs do not require direct borrowing, options trading or the maintenance of margin accounts by investors. Furthermore, investors cannot lose more than the initial amount invested. Additionally, leveraged ETPs provide the advantages of simplicity, accuracy, accessibility, transparency and liquidity.

Leveraged ETPs reference a wide variety of asset classes, including equities, fixed income, commodities and currencies. They are often available in 2x, 3x and 5x leverage. For example, a daily "2x" leveraged exposure means that the product is designed to reflect twice the daily percentage change in the unleveraged index level (before fees).

When it comes to the return period, daily ETPs reset each day. This means that gains or losses are factored into an ETP's price at the end of each trading day, and a new reference point is established from which to calculate any future returns. The advantage of a daily reset is that it ensures a relatively constant leverage ratio for all investors in the ETP, regardless of when they invested. If you hold leveraged ETPs for longer periods, compounding and volatility can distort the expected return.

To show how compounding affects leveraged ETP returns, let's consider a daily 2x leveraged ETP. At the start of the day, the ETP is priced at £10 and the index is priced at £100. At the end of the day, the situation is as follows:

- The index has gained 3% and is now priced at £103
- The return on the ETP is 6% (2 x 3%). The ETP is priced at £10.60

The ETP now resets, and all future returns will be applied to the new reference point of £10.60. At the end of the second day, the situation is as follows:

- The benchmark has again gained 3%, rising from £103 to £106.09
- The return on the ETP is 6% (2 x 3%). Its price has risen from £10.60 to £11.24

Over the two days, the benchmark has gained about 6%, while the 2x leveraged ETP has returned approximately 12.4%. In just a short period, the ETP return has diverged from the index return multiplied by the leverage factor (2x).

Similarly, let's explore what could happen in a decreasing benchmark environment:

- The index has lost 3% (starting again back at 100), so it is now £97.
- The return on the ETP is -6% (2 x -3%). The ETP is priced at £9.40.

The ETP now resets, and all future returns will be applied to the new reference point of £9.40. At the end of the second day, the situation could be as follows:

- The Index has again lost 3%, dropping from 97 to £94.09.
- The return of the ETP is -6% (2 x -3%). The ETP is now priced at £9.118.

Over the two days, the benchmark index lost 5.91% (started at 100, dropped to £94.09). The 2x leveraged ETP has returned approximately -8.82%. This is almost 3% more in terms of loss than one would see if just analysing the cumulative change in the Index. In effect, the leverage is magnifying the loss because each day the Index's return is being applied 2x to the new base level.

Of course, as we discussed previously, there are risks associated with leveraged ETPs. Interested investors would do well to actively monitor and manage their leveraged ETP investments. Potential losses in short and/or leveraged ETPs may be magnified in comparison to investments that do not incorporate these strategies. In consequence, they are only intended for investors who understand the risks involved in investing in a product with short and/or leveraged exposure and who intend to invest on a short-term basis.

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