Businessweek

The Big Take

Wall Street's Risky 'Razor Blade' Trade Is Making a Comeback

Everyday investors are piling into ETFs that make it easy to use leverage or short the market.

Photographer: Janelle Jones for Bloomberg Businessweek

By Denitsa Tsekova
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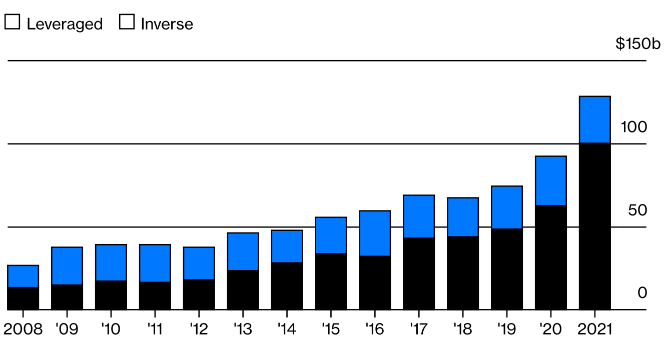
Ashley Howie sells houses at work, breeds butterflies in her spare time, and takes risks in her portfolio. "My parents are not in the stock market, and they're terrified for me," says the 31-year-old real estate agent from Pasadena, Calif. They'd probably be even more scared if they knew everything she was buying.

Howie is part of an army of pandemic-era retail investors powering a boom in leveraged exchange-traded funds and notes, investment vehicles that use financial derivatives to pump up returns. Like a normal ETF, these investments can be traded just like stocks and track the performance of an index. The twist is that they're designed to deliver two or three times the index's daily gain or loss, or even to pay the opposite return, allowing buyers to bet against the market. They're notorious for having gotten caught up in past market meltdowns, and regulators worry that many investors don't understand their risks. But amid meme-stock madness and crypto chaos, few on Wall Street seem to have noticed their resurgence.

Howie *Photographer: Joel Barhamand for Bloomberg Businessweek*

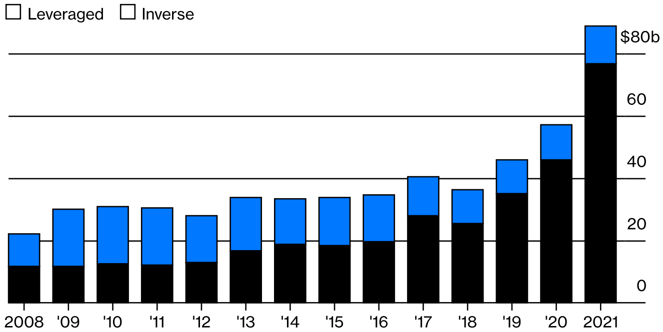
Global assets in leveraged and inverse vehicles almost doubled from yearend 2018 to $128 billion at the end of last year. In the U.S., inflows of $31.6 billion in 2021 spurred a 55% jump in assets, to $88.6 billion. Those numbers may understate their popularity, since cash often rushes in and out of such instruments. Trading volumes, a more powerful signal, reached a record in January at more than six times the average of the past five years. (Most of these vehicles are ETFs; others, called notes, have a different legal structure but work in a similar way.)

Assets in Selected Exchange-Traded Products, Global



Source: Compiled by Bloomberg

Assets in Selected Exchange-Traded Products, U.S.



Source: Compiled by Bloomberg

"Inverse and leveraged products tends to be catnip for day traders," says Dave Nadig, chief investment officer of data provider *ETF Trends*. "What we usually tell financial advisers is, if you're going to use those things, recognize you are reaching into the drawer full of razor blades."

Even before a surge in activity in the past few months, the Securities and Exchange Commission was mulling new rules to protect investors. SEC Chair Gary Gensler said in October that such products "pose risks even to sophisticated investors and can potentially create systemwide risks." Companies that sell the products say they're effective tools for knowledgeable traders, who may use them to hedge short-term risk as well as to bet big. "These funds have performed as designed in all different market conditions," a spokesperson for ProShares, the largest issuer of such funds, said in a statement.

Why are amateurs such as Howie so drawn to these risky investments? Put simply: They offer the chance to reap big returns quickly. Late last year, Howie decided the market was long overdue for a correction, so she invested as much as 10% of her portfolio into bets on the Direxion Daily Small Cap Bear 3X Shares ETF (ticker TZA) and Direxion Daily Financial Bear 3X Shares ETF (FAZ), which aim to deliver three times the inverse performance of the Russell 2000 Index and Russell 1000 Financial Index, respectively.

Since the ETFs trade just like stocks, it's also possible to trade options on them. Howie sold option contracts on TZA at the start of February with a 140% gain. She's still holding 100 shares in the fund. Howie has also day-traded options on the Direxion Daily Small Cap Bull 3X Shares ETF (TNA), a bullish bet on the Russell 2000, taking a small loss. She'll start betting on TNA again in March because she expects more upside. "This was a great experience," Howie says. "I do feel more comfortable and confident playing them."

On Fidelity's trading platform, popular with the retail crowd, the likes of the ProShares UltraPro QQQ (TQQQ) and ProShares UltraPro Short QQQ (SQQQ) are regularly among the most traded securities. TQQQ delivers three times the return of the tech-heavy Nasdaq-100 Index; SQQQ moves three times the opposite direction. The value of shares traded in 80 of the biggest, most liquid U.S. leveraged and inverse exchange-traded products hit $50 billion at the peak on Jan. 24, according to data compiled by Bloomberg. Before the pandemic it had topped $20 billion just once.

A crucial thing to understand about leveraged funds and notes is that they're only meant to deliver their target performance over a single trading day. Because of the math of compounding, over a longer period a twice-leveraged Nasdaq-100 fund could have returns very different from twice the index, especially in volatile markets. For example, if the Nasdaq-100 fell 5% one day and gained 5% the next, an investor in a normal index fund would lose about 0.25% overall. An investor in a twice-leveraged fund would lose not 0.5%, but 1%—or four times the market's fall. Over longer periods it's even possible to lose money in a leveraged ETF when its index has gained in value, depending on the pattern of up and down days in between. Although the funds' prospectuses and websites explain the effect—Direxion, for example, says the funds aren't for buy-and-hold investors—it's one of the risks Gensler expressed concern about.

Even investors who use leveraged and inverse products as intended—as day-trading tools—are likely to face an uphill battle. Short-term timing of the market is notoriously difficult even for professional money managers. "You hear about the successes, you hear about investors who have made great gains short term, but you hear less about the losers," says Christine Benz, director of personal finance at fund researcher Morningstar. "The successes tend to be noisier than the failures. We've had a very specific market environment over the last two years that generally has rewarded risk-taking."

Some of the more specialized leveraged vehicles can have an impact on the markets they track. In February 2018, the VelocityShares Daily Inverse VIX Short-Term note (XIV) melted from $1.9 billion in assets to $63 million in a single session—an event known as "Volmageddon." The fund bet against the Cboe Volatility Index, aka the VIX, a gauge of expected stock swings. Effectively a wager on calm markets, it gained as long as the prices of certain futures contracts remained low. But when volatility struck, prices surged–and demand for the contracts generated by the product itself drove prices and the index even higher. The VIX jumped by 20 points, one of the biggest one-day increases for Wall Street's "fear gauge," and XIV collapsed.

"You're putting these instruments in the hands of anyone, essentially," says Robert Whaley, a finance professor at Vanderbilt University, who created the VIX in 1993. "Some of the people that you're allowing access to these instruments are sophisticated enough to know what they're doing, and the risks they're taking on, but others are not." The industry also saw a lot of volatility amid the Covid-19 crash, after which exchange-traded vehicles were killed off in asset classes including bonds and oil. One issuer, Credit Suisse Group AG, delisted from national markets nine exchange-traded notes with almost $3 billion in assets, saying it wanted to "better align its product suite with its broader strategic growth plans."

BillyRay Haynes, a 34-year-old security manager from Tracy, Calif., was in one of them. He bought shares of the VelocityShares Daily 2X VIX Short-Term ETN for around $3,000, thinking he'd profit when stock volatility resumed. Before that could happen he found out it was going to be delisted, so he sold at a 70% loss. "I probably wouldn't want to buy into those products again," Haynes says. "There are a lot of risks."

Haynes *Photographer: Rachel Bujalski for Bloomberg Businessweek*

The stakes can be even higher beyond the U.S. The second-biggest market for leveraged exchange-traded products is Asia, where total assets reached $28.3 billion in 2021–a 73% increase from the previous five years. Investors there have access to a huge range of products, with some providing leverage of as much as 20 times–far greater than what's allowed in the U.S. In South Korea, leveraged vehicles represent 30% of the entire ETF market. "It's definitely more and more popular," says Bloomberg Intelligence analyst Rebecca Sin. "It's mainly driven by retail investors."

In February, asset manager AXS Investments filed plans for 18 new funds that would offer double the gain or loss of individual U.S. stocks –the first of their kind in the $7 trillion American ETF market. Like all leveraged ETFs, the proposed AXS products carry a warning. "The Funds are designed to be utilized only by sophisticated investors, such as traders and active investors employing dynamic strategies," the filing says.

Back in Pasadena, however, Howie doesn't feel like that leaves her out. She first heard about leveraged funds from the owner of her real estate brokerage. Part of a Discord online chat group that discusses markets, she credits that community and Twitter for helping her set an investment strategy. Having missed out on buying stocks during a pullback last year, Howie sees leveraged and inverse ETFs as a way to make more of the latest market moves.

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