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Leveraged and inverse products: What you need to know

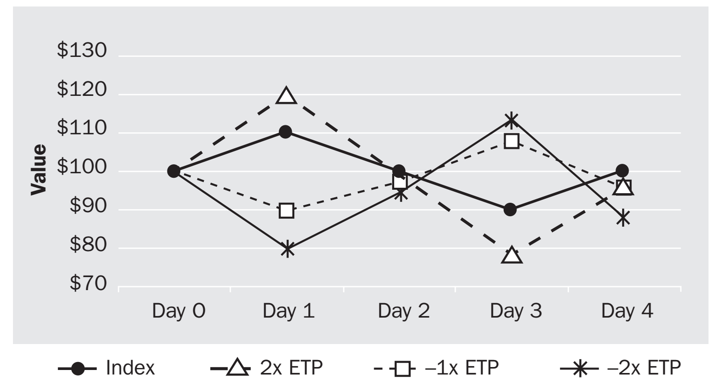
Leveraged products are mutual funds, ETFs (exchange-traded funds) and ETNs (exchange-traded notes) which typically use derivatives to attempt to multiply the returns of the underlying index. Both leveraged and inverse products mark returns based on the daily (or in a few cases, monthly) performance of the underlying index. These securities perform differently than other products. They have the propensity to be more volatile and are inherently riskier than their non-leveraged, non-inverse counterparts. It is important to remember that these products are generally designed for daily use only, and are not intended to be held for multiple days. These funds are not appropriate for most investors.

How to identify leveraged and inverse products

Leveraged products often have a multiplier in their name, such as 2x or 3x, or have a word such as “ultra” or “daily” in front of their name. These products attempt to deliver some multiple of an index’s daily returns (positive or negative). Please consider the implications to both the upside and the downside of multipliers. While it may seem that a 2x multiplier is a benefit in an up market cycle, it is important to remember that the same multiplier applies when the market moves against the product. This could potentially result in significant losses, and highlights the additional risk associated with leveraged products.

Consider the following example: A 2x leveraged S&P 500 fund would seek to double the daily return of the S&P 500. Therefore, if the S&P 500 closed up 10 percent, the fund would seek to return 20 percent. Conversely, if the S&P 500 were to close down 10 percent, the value of the fund could decrease by 20 percent.

Hypothetical performance of leveraged and inverse products



For illustrative purposes only.

Inverse products often have either a negative number like –1x or –2x or a term like “short” or “inverse” in their names. These products attempt to move in the opposite direction of an index each day, sometimes twice as much or three times as much in the opposite direction. A 2x inverse S&P 500 fund would seek to return twice the inverse of the S&P 500 for that day.

In this case, if the S&P 500 were down 10 percent, the fund would seek to increase by about 20 percent. Conversely, if the S&P 500 were up 10 percent, the value of the fund would decrease by about 20 percent.

Other risks associated with trading leveraged and inverse products

While leveraged and inverse products have documented risks associated with the use of leverage or shorting, a less-appreciated risk is the effect of compounding on your returns over periods longer than a day. Since these products deliver some multiple of an index’s returns on a daily basis, they must reset the amount of leveraged or inverse exposure they have each day.

This daily reset means that the products will not always deliver their expected multiple. As the markets generally display volatility to the upside as well as the downside, the daily resetting of these products will cause the products to perform worse than their multiple would suggest over any period longer than one day. The following example from June 30, 2016, illustrates how Assumptive Returns and Actual Returns can differ with these products.

Simply stated, there is a compounding effect associated with the daily resets which makes the performance unpredictable if the product is held longer than one day. However, sometimes this daily reset means that the products will do better than their multiple would suggest if markets trend steadily in one direction without reversals, but this is the exception.

Ultimately, while there may be occasions where a leveraged or inverse product may be useful for some types of trading strategies for advanced/professional traders, it is extremely important to understand that when holding for longer than a day, these products may not give you the returns you may be expecting. As with all investments, it is important to read the prospectus and fully understand the product's investment objectives, investment strategies, risks and costs.

Example: S&P 500 leveraged and inverse funds for a one-year period where the S&P 500 index returned 1.86%

Fund name	Ratio	Expected or Assumptive Return	Actual return
S&P 500 Fund A	2x	3.72%	-0.60%
S&P 500 Fund B	–1x	-1.86%	-4.92%
S&P 500 Fund C	–2x	-3.72%	-11.49%

Source: Morningstar. Trailing 12 month total NAV returns as of June 30, 2016. Returns do not take into consideration trading costs or management fees.

If you have questions, please call 800-435-4000 to speak with a Schwab representative.

You can also read further about some of these products via the SEC bulletin *"Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors"* via the following link: https://www.sec.gov/investor/pubs/leveragedetfs-alert.htm

Investors should consider carefully information contained in the prospectus, or if available, the summary prospectus, including investment objectives, risks, charges and expenses. You can request a prospectus by calling Schwab at 800-435-4000. Please read the prospectus carefully before investing.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost.

Leveraged products seek to provide a multiple of the investment returns of a given index or benchmark on a daily or monthly basis. Inverse products seek to provide the opposite of the investment returns, also daily or monthly, of a given index or benchmark, either in whole or by multiples. Due to the effects of compounding, aggressive techniques, and possible correlation errors, leveraged and inverse products may experience greater losses than one would ordinarily expect. Compounding can also cause a widening differential between the performances of a fund or ETP and its underlying index or benchmark, so that returns over periods longer than the stated reset period can differ in amount and direction from the target return of the same period. Consequently, these products may experience losses even in situations where the underlying index or benchmark has performed as hoped. Aggressive investment techniques such as futures, forward contracts, swap agreements, derivatives, options, can increase fund or ETP volatility and decrease performance. Investors holding these products should therefore monitor their positions as frequently as daily.

The S&P 500 Index includes the stocks of 500 leading U.S. publicly traded companies from a broad range of industries. Index figures do not include trading and management costs, which would lower performance. Indices are unmanaged, and you cannot invest in them directly.

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