

# Updated Investor Bulletin: Leveraged and Inverse ETFs

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Feb. 23, 2023

## Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors

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*The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin because we believe individual investors may be confused about the performance objectives of leveraged and inverse exchange-traded funds (ETFs).*

*Leveraged and inverse ETFs typically are designed to achieve their stated performance objectives on a daily basis. Some investors might invest in these ETFs with the expectation that the ETFs may meet their stated daily performance objectives over the long term as well. Investors should be aware that performance of these ETFs over a period longer than one day can differ significantly from their stated daily performance objectives and may potentially expose investors to significant and sudden losses.*

## What are exchange-traded funds (ETFs)?

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An ETF is a type of exchange-traded investment product available for retail investors. Traditional ETFs are a lot like mutual funds.

- ETFs offer investors a way to pool their money in a fund that makes investments in stocks, bonds, other assets, or some combination of these investments.
- ETF investors receive an interest in that investment pool. This means each ETF share represents an investor's proportionate ownership of the fund's portfolio and the income the portfolio generates.
- ETFs are investment companies that must be registered with the SEC. This registration requires the ETFs to provide ongoing disclosures and information to investors, among other things. It also provides protections for investors, such as limits on illiquid or hard-to-sell investments in an ETF's portfolio and restrictions on an ETF's borrowings and debt.
- ETFs can be index-based or actively managed. For a traditional indexed-based ETF, the adviser seeks to track an underlying securities index and achieve returns that closely correspond to the returns of that index. For an actively managed ETF, the adviser buys or sells components in the portfolio without regard to conformity with an index.
- Unlike mutual funds, shares of ETFs typically trade throughout the day on a national stock exchange at market prices.

For background information on traditional ETFs, you can read our [Updated Investor Bulletin: Exchange-Traded Funds \(ETFs\)](#).

*Be aware: Investors considering ETFs should evaluate each investment closely and not assume all ETFs are alike.* ETFs have evolved over the years, and some ETFs, such as leveraged and inverse ETFs, have become more complex than traditional ETFs. In addition, exchange-traded products (ETPs) can also have leveraged and inverse investment objectives. ETPs that invest primarily in commodities, currencies, or commodity- or currency-based instruments are not registered as investment companies and therefore do not provide the same investor protections registered funds do.

## **What are leveraged and inverse ETFs?**

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Leveraged and inverse ETFs are very different from traditional ETFs.

- *Leveraged ETFs* seek to deliver multiples of the daily performance of the index or benchmark they track. For example, a 2x (two times) leveraged ETF seeks to deliver double the daily performance of the index or benchmark that it tracks.
- *Inverse ETFs* (also called “short” funds) seek to deliver the opposite of the daily performance of the index or benchmark they track. Inverse ETFs often are marketed as a way for investors to profit from, or at least hedge their exposure to, downward moving markets.
- *Leveraged inverse ETFs* (also known as “ultra short” funds) seek to achieve a return that is a multiple of the inverse of the underlying index’s daily performance. An inverse ETF that tracks a particular index, for example, seeks to deliver the inverse of the daily performance of that index, while a 2x (two times) leveraged inverse ETF seeks to deliver double the opposite of that index’s daily performance.

Like traditional ETFs, some leveraged and inverse ETFs track broad indices, some are sector-specific, and others are linked to some other benchmark. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of swaps, [futures contracts](#), and [other derivative instruments](#).

## **Why do leveraged and inverse ETFs have extra risks for buy-and-hold investors?**

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Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis. Their performance over longer periods of time -- over weeks or months or years -- can differ significantly from the stated multiple of the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. This effect can be magnified in volatile markets. As the examples below demonstrate, an ETF that is set up to deliver twice the performance of a benchmark

from the close of trading on Day 1 to the close of trading on Day 2 typically will not achieve that goal over weeks, months, or years and may potentially expose investors to significant and sudden losses.

## What are some examples?

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The following two real-life examples illustrate how returns on a leveraged or inverse ETF over longer periods can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time.

- Over four months, a particular index gained 2 percent. However, a leveraged ETF seeking to deliver twice that index's daily return fell by 6 percent—and an inverse ETF seeking to deliver twice the inverse of the index's daily return fell by 25 percent.
- During that same period, an ETF seeking to deliver three times the daily return of a different index fell 53 percent, while the underlying index actually gained around 8 percent. An ETF seeking to deliver three times the inverse of the index's daily return declined by 90 percent over the same period.

## How can this apparent breakdown between longer term index returns and ETF returns happen?

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Here's a hypothetical example:

- Let's say that on Day 1, an index starts with a value of \$1000 and a leveraged ETF that seeks to double the return of the index starts at \$1000. If the index drops by 100 points on Day 1, it has a 10 percent loss and a resulting value of \$900. Assuming it achieved its stated objective, the leveraged ETF would therefore drop 20 percent on that day and have an ending value of \$800.
- On Day 2, if the index rises 10 percent, the index value increases to \$990. For the ETF, its value for Day 2 would rise by 20 percent, which means the ETF would have a value of \$960.
- On both days, the leveraged ETF did exactly what it was supposed to do – it produced daily returns that were two times the daily index returns.
- But let's look at the results over the 2 day period: the index lost 1 percent (it fell from \$1000 to \$990) while the 2x leveraged ETF lost 4 percent (it fell from \$1000 to \$960). That means that over the two day period, the ETF's negative returns were 4 times as much as the two-day return of the index instead of 2 times the return.

**Single-stock ETFs: An Additional Layer of Risk.** Recently, new “single-stock ETFs” have been introduced to the market. These single-stock ETFs typically seek leveraged or inverse investment results based on the daily performance of a single stock rather than an index, eliminating the benefits of diversification. Because leveraged single-stock ETFs in particular amplify the effect of price movements of the underlying individual stocks, investors holding these funds will experience even greater volatility and risk than investors

who hold the underlying stock itself. For more information read our [Statement on Single-Stock Levered and/or Inverse ETFs](#).

In addition, even if the long term performance of these funds doesn't differ significantly from their stated daily performance objectives, you can still lose a lot of money. This is because returns that are the multiple of an index (or inverse multiple) can lead to substantial losses.

## Things to Consider Before Investing

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**Understand the products.** The best form of investor protection is to understand these specialized ETFs before investing in them. No matter how you initially hear about them, it's important to read the prospectus, which provides detailed information related to the ETFs' investment objectives, principal investment strategies, risks, and costs. You can obtain the prospectus from the financial firm that sponsors the ETF, your investment professional, or the SEC's [EDGAR system](#).

**Consult a professional.** Consider seeking the advice of an investment professional. Be sure to work with someone who understands your investment objectives and tolerance for risk. Your investment professional should understand these complex products and be able to explain whether or how they fit with your objectives.

**Ask questions.** Before investing in these instruments, ask:

- How does this ETF fit with my investment objectives and comfort with risk?
- How does the ETF achieve its stated objectives? And what are the risks? Ask about—and be sure you understand—the techniques the ETF uses to achieve its goals. For example, engaging in short sales and using swaps, futures contracts, and other derivatives can expose the ETF—and by extension ETF investors—to a host of risks.
- What happens if I hold longer than one trading day? While there may be trading and hedging strategies that justify holding these investments longer than a day, these are specialized products that generally are not suitable for buy-and-hold investors. As discussed above, because most leveraged and inverse ETFs reset each day, their performance can quickly diverge from the performance of the underlying index or benchmark. In other words, it is possible that you could suffer significant losses even if the long-term performance of the index showed a gain.
- Is there a risk that an ETF will not meet its stated daily objective? There is always a risk that not every leveraged or inverse ETF will meet its stated objective on any given trading day. Be sure you understand the impact an investment in the ETF could have on the performance of your portfolio, taking into consideration your goals and your tolerance for risk.
- What are the costs? Leveraged or inverse ETFs may be more costly than traditional ETFs. Use FINRA's [Fund Analyzer](#) to estimate the impact of fees and expenses on your investment.

- What are the tax consequences? Leveraged or inverse ETFs may be less tax-efficient than traditional ETFs, in part because daily resets can cause the ETF to realize significant short-term capital gains that may not be offset by a loss. Be sure to check with your tax advisor about the consequences of investing in a leveraged or inverse ETF.

## **Additional Information**

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[Updated Investor Bulletin: Exchange-Traded Funds \(ETFs\)](#)

[Leveraged Investing Strategies – Know the Risk Before Using These Advanced Investment Tools](#)

[Statement on Single-Stock Levered and/or Inverse ETFs](#)

[FINRA Investor Insight: The Lowdown on Leveraged and Inverse Exchange-Traded Products](#)

[FINRA Non-Traditional ETFs FAQ](#)

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Modified: Feb. 23, 2023