

DECEMBER 23, 2008

## An Ultra Headache?

By Joseph G. Witthohn, Director of ETF Research

As advocates of Exchange Traded Funds, it is disappointing to see a monkey wrench tossed into one of the most impressive benefits of ETFs. Namely, we are referring to tax efficiency. We have long contended that the double (and – gasp – now triple) ETFs must be used cautiously and carefully as both counterparty risk and concern over actually tracking benchmarks as promoted are confusing at best. Now we can add the tax inefficiency of these enhanced vehicles to our recent cry of “caveat emptor” ... let the buyer beware. And the cry has recently reached a heightened decibel level.

Just to be clear, the “plain vanilla” ETFs are working like a charm with regard to tax efficiency (excluding those dealing in futures, currencies or precious metals).

For tax year 2008:

- Barclays, tops in ETF market share, reports that only 2 of their 178 funds are paying capital gains and both are under 1% of NAV.
- State Street SPDRS, reports that 3 ETFs out of their entire family will have capital gains and these will be under 0.1% of NAV.
- WisdomTree reports zero capital gains among its 41 equity funds.
- RevenueShares reports no capital gains for any of its funds.
- Van Eck has one very slight capital gain to report among its 13 funds.
- Claymore is reporting no capital gains in its universe of 21 ETFs.
- Northern Trust has zero capital gains for its 16 funds.
- Out of 120 ETFs, PowerShares is expected to pay a \$0.05 capital gain on one single buy-write ETF.

This is not to say that the plain vanilla ETFs will always provide such stellar results with regard to tax efficiency, but so far the claim to have a tax-efficient design holds water ... and plenty of water at that. We feel the “super-charged” ETFs belong in institutional trading portfolios and only in the retail accounts of sophisticated investors ... or at least those who understand and are willing to adopt the risks.

In a world where higher volatility in returns occur, an “ultra” fund might not behave as an investor believes it is advertised. We must keep in mind it is *daily return* that is targeted.

We will look at 2007 as an example. The S&P 500 index returned 5.5%. We question if the typical investor who purchased the “double the S&P” fund would truly understand when he or she learns the annual return on this “double fund” was not 11% but was, instead, 1.56%. Yet, it is spelled out in the Statement of Additional Information as follows:

*Estimated Fund Return Over One Year When The Fund Objective is To Seek Daily Investment Returns Before Fund Fees and Expenses and Leverage Costs That Correspond to Twice (200%) the Daily Performance of an Index*

One Year Index Return	Index Volatility								
	0%	5%	10%	15%	20%	25%	30%	35%	40%
5%	10.3%	10.0%	9.2%	7.8%	5.9%	3.6%	0.8%	-2.5%	-6.1%

Source: ProFunds SAI Supplement, 12/1/2008, page 19

In this day-and-age of concern over what the actual collateral is for a fund, a design situation stands out with regard to ultra funds. Not only are these leveraged (obviously, or how would you get double a return) but a question arises with who is “backing” (or standing behind) the investment. And here we certainly have counterparty risk. We have been told by ProShares that this risk is spread around among a number of counterparties, but it is important that investors are aware that among the listed risks (which includes “aggressive investment technique risk, concentration risk, correlation risk, liquidity risk and short sale risk”) counterparty risk ranks high in our view.

And now we get to today’s situation. If the high amount of capital gains was not bad enough (which it was), the lack of advance notice by ProShares to their investors was shocking. We emphasize to our clients that we do not put these double (and triple) ETFs in the same camp as the “plain vanilla” ETFs we follow and they remain a superb tax and cost efficient way to invest in targeted asset classes.

**ProShares ETF Capital Gains (with Short-term Gains greater than 10% of previous day close)**

Fund	Ticker	Dividend	Long-term Capital Gains	Short-term Capital Gains	Closing Price 12.22.08	Short-term cap gains % of NAV
UltraShort Industrials	SIJ	0.0564	0	47.85	108.46	44.12%
UltraShort Basic Materials	SMN	0.0088	0	26.58	69.48	38.26%
UltraShort Utilities	SDP	0.0475	0	28.42	75.78	37.50%
UltraShort Russell 2000 Growth	SKK	0.0973	0	39.74	110.86	35.85%
UltraShort Midcap Growth	SDK	0.0145	0	47.78	134.57	35.51%
Short Small Cap 600	SBB	0	0	32.3	91.65	35.24%
UltraShort Russell Midcap Value	SJL	0	0	50.35	144.27	34.90%
UltraShort Telecom	TLL	0.0193	0	30.09	87.58	34.36%
UltraShort Semiconductors	SSG	0.0408	0	42.35	125.1	33.85%
UltraShort Healthcare	RXD	0.0108	0	29.65	91.77	32.31%
UltraShort Russell 2000 Value	SJH	0.0175	0	30.54	103.9	29.39%
UltraShort Smallcap 600	SDD	0.1681	0	28.61	97.41	29.37%
UltraShort Russell 1000 Growth	SFK	0.038	0	32.96	119.99	27.47%
UltraShort Consumer Services	SCC	0.0086	0	33.91	124.92	27.15%
UltraShort Midcap 400	MZZ	0.0078	0	23.85	88.39	26.98%
UltraShort Russell 2000	TWM	0.0665	0	25.01	94.22	26.54%
Short Russell 2000	RWM	0.3574	0.2654	23.95	93.72	25.55%
Short Oil & Gas	DDG	0.0252	0	24.29	98.26	24.72%
UltraShort Technology	REW	0.0413	0	26.46	108.42	24.41%
UltraShort Dow 30	DXD	0.0276	0	16.03	73.12	21.92%
UltraShort Consumer Goods	SZK	0.0066	0	18.86	96.43	19.56%
UltraShort MSCI EAFE	EFU	0.0123	0	24.11	123.32	19.55%
UltraShort Oil & Gas	DUG	0.0191	0	6.06	34.67	17.48%
Short MSCI EAFE	EFZ	0.0063	0	16.24	105.49	15.39%
UltraShort QQQ	QID	0.0057	0	9.5	68.82	13.80%
UltraShort MSCI Japan	EWV	0.0263	0	12.13	87.98	13.79%
Short S&P 500	SH	0.0017	0.0385	11.94	86.71	13.77%
UltraShort S&P 500	SDS	0.0286	0	11.46	87.44	13.11%
Short Midcap 400	MYY	0	1.0864	10.22	83.68	12.21%
Short Dow 30	DOG	0.0279	0.2685	8.44	79.53	10.61%

Source: Profunds, Janney Montgomery Scott LLC

On a final note, we would like to address one point that we find ironic – and this relates to the intuitive effect of seeking to double (or even triple) returns.

For years, investors have sought ways to reduce risk in portfolios and risk is typically measured in terms of volatility. We find it certainly interesting that the pendulum seems to have swung into the opposite direction, and some investors now seek ways to increase volatility through the purchase of these types of funds. Maybe it is because we are entrenched in a bear market.

Yes, it certainly does add to returns if the purchaser guesses right (and we purposefully use the word “guesses”). But the risk-seeker must be prepared to accept the consequences if there is a flaw in their forecast of market or sector direction.

We will look at the effect of a quick 10% move up, then down, in a sector of the market (assuming the investor has a “double” and “triple” ETF).

*Assumption: Investor starts with \$100 and market moves up 10% one day, and falls 10% the next.*

### **Double and Triple Effect on Portfolio**

	Single Return	Double Return	Triple Return
Opening balance	\$100	\$100	\$100
Daily dollar move (10% market)	10	20	30
Ending balance day one	\$110	\$120	\$130
Daily dollar move (-10% market)	-11	-24	-39
Ending balance day two	\$99	\$96	\$91

And while it might be considered “theoretical” with what is seen above, we decided to review the last 1-month total return of 4 “triple” funds: Direxion’s 3X Energy Bull (“ERX”), 3X Energy Bear (“ERY”), 3X Financial Bull (“FAS”) and 3X Financial Bear (“FAZ”).

### **1-month Results of Select Direxion Exchange Traded Funds**

	symbol	1 month total return (NAV)
Direxion 3X Energy Bull	ERX	-11.60%
Direxion 3X Energy Bear	ERY	-18.88%
Direxion 3X Financial Bull	FAS	28.45%
Direxion 3X Financial Bear	FAZ	-70.15%

*Source: Morningstar data through 12.23.08*

The moral of our story above is that volatility could create havoc with expected results. Two investors with direct opposite opinions on energy both would have a portion of their investment lost. One financial investor would have had just under a 30% gain, while his oppositely opinionated counterpart would have met a 70% loss. This is certainly not a zero sum game by any means.

While we feel these leveraged funds have a place in certain accounts, we reiterate our belief that these are best for institutional accounts and for those clients who understand and can accept the many nuances along with the associated risks.