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Risk management news

For investment advisors and brokers | Vol. 3, 2012

Examination of leveraged ETFs

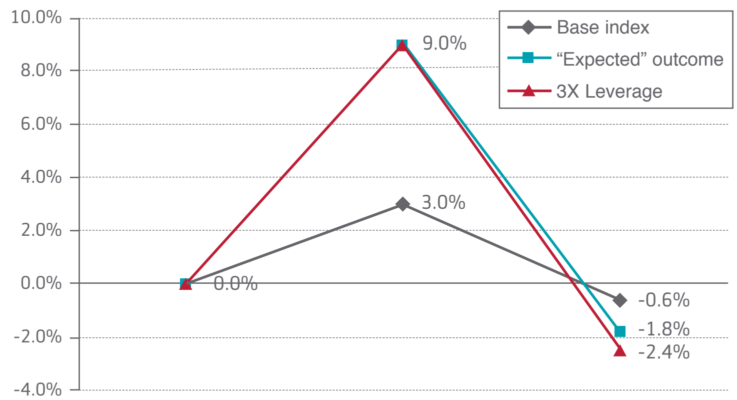
Exchange-traded funds (ETFs) have grown dramatically in popularity in the last ten years. In 2001 a total of 85 ETFs had a market value of $85 billion. Ten years later over 1,300 ETFs represent nearly one trillion dollars in market value.

ETFs can be a very useful tool to gain exposure to domestic and international market indices, as well as alternative investments like real estate and commodities such as gold. They allow intraday trading, and many have high levels of liquidity. For example, the most popular ETF (SPY) trades an average of 173 million shares per day.

One area that index funds of all types should be evaluated on is tracking error (also called basis risk). This is how effectively the value of the fund mirrors the performance of the benchmark it is attempting to track. ETFs making high use of derivatives or leverage can see this error magnified.

Not all ETFs are created equal, and many can be misunderstood and potentially dangerous. Leveraged ETFs are structured to return a multiple of the performance of the asset they are trying to track over one trading session. The funds use debt to achieve this effect, and are typically trying to produce two to three times the return of the underlying asset.

Another complicating factor with leveraged ETFs is the daily reset feature. The leveraged ETF returns a multiple of each daily return, so holding longer than a single trading session can result in unexpected returns. In the example below, a leveraged ETF is held for two trading sessions. The base index (shown in grey) goes up 3% in session one, and down 3.5% in session two, for an ending cumulative return of -0.6%. An investor holding a 3x leveraged ETF may expect that the return would be -1.8%, or 3 x -0.6 = -1.8%. The investor might be surprised to learn that the daily reset feature would result in a cumulative return of -2.4%. Of course, this divergence can occur in either direction. The longer the asset is held, the more this is compounded. When combined with the potential tracking error, the result is a total return over the holding period that strays from the ETF objective.



Best practice—avoid wire fraud

In recent months there have been an increasing number of instances of wire fraud targeting investment advisors and brokerage accounts. You probably know someone who has had their email account compromised. Once this occurs, the information stored in the email account is no longer private or secure. Criminals will email financial professionals impersonating the accountholder, and ask for a wire transfer out of the account. An advisor may be accustomed to clients using email and make the mistake of filling the request.

As a best practice, avoid accepting wire transfers over email, or confirm them via a follow-up phone call to a phone number you know and trust.

2012 regulatory and association calendar for RIAs

March 30	Deadline by which all RIAs must have filed new Form ADV, Part 1. This is also the date by which family offices that don't meet the exception and private fund advisers above $150 million in AUM must register and exempt-reporting advisers must report via IARD.
April 1	Department of Labor fiduciary-level fee disclosure rule takes effect. This concerns fee disclosures from plan service providers to plan fiduciaries.
April 25 - 27	2012 Fi360 Conference, Chicago, IL, fi360.com
May 5 - 8	FPA Retreat 2012, Financial Planning Association, Scottsdale, AZ, fpanet.org
May 8 - 11	NAPFA National Conference, National Association of Personal Financial Advisors, Chicago, IL, napfa.org
June	Department of Labor expects to implement new rules for ERISA fiduciaries to disclose fee and expense information to plan participants.
June 13	The SEC's ban on third-party solicitors takes place, according to its pay-to-play rule.
June 28	Date by which a mid-size SEC-registered adviser must file Form ADV-W to withdraw federal registration in the final shift to state oversight.
August 29	Hedge fund advisers with more than $5 billion in AUM must report their initial Form PF.
September 29 – October 2	FPA Experience 2012, Financial Planning Association, San Antonio, TX, fpanet.org
December 31	Sunset date for Advisers Act rule 206(3)-3T, the principal trades exception. This has been extended in the past.

Social media update

In January, the SEC provided some long-awaited guidance for advisors on the topic of social media. An exam alert recommended indexing and electronically storing all activity on social media sites like Facebook, Twitter, and LinkedIn. It also touched on the issue of testimonials, stating that having a "like" button on the advisory firm's web site could be interpreted as a testimonial, which is prohibited. While the guidance issued was not in the form of a firm rule, it would be wise to follow the guidance.

Many compliance consultants are recommending that advisors adopt a written social media policy. A good policy should address monitoring of business sites as well as personal use of social media sites.

Registration switch

If you're one of the 3,000+ advisory firms making the switch from SEC to state registration, you have until July to finish the process. If you have less than $90 million in AUM or are a newly registered firm with under $100 million in AUM, you must register with the state.

There are three exceptions:

- New York and Wyoming are exempted states.
- Your firm advises registered investment companies or business development companies.
- Your firm would be required to register in 15 or more states.

Many states will see of flurry of activity around the deadline, so try to complete the switch in advance. The worst case scenario is finding yourself in a position where your firm is not registered with the state or SEC. Most E&O policies suspend coverage for any time period where your firm is not registered.

Markel Cambridge Alliance can help

Do you have a question for our team?

Please contact your insurance professional or call us directly at 800-691-1515. markelcambridge.com