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ETFS

Tripling Down on Oil Is Paying Off in 2019, but Not Everyone's a Fan

Leveraged exchange-traded oil products are up nearly 90%, but profiting from them is harder than it looks

A pump jack in the Permian Basin oil production area near Wink, Texas. **PHOTO:** NICK OXFORD/REUTERS

By Asjylyn Loder

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Oil funds that use leverage to juice returns have been among the top-performing exchange-traded funds of 2019, gaining almost 90%.

Yet investors have pulled $325 million from the two biggest exchange-traded products that seek to double or triple the daily return of U.S. crude futures contracts, a sign there is more than meets the eye in this obscure and risky market.

Part of the reason is that profiting from leveraged exchange-traded products is harder than it looks. The products are pitched as tools for daily trading and can be disastrous for buy-and-hold investors who don't understand the mechanics. Correctly predicting oil prices will rise is just one part of the equation.

So far this year, crude has been a juggernaut. U.S. futures have gained more than 28% as fears of a global glut diminished. This week, oil got another boost as supplies from Venezuela tightened and Saudi Arabia, the de facto head of the Organization of the Petroleum Exporting Countries, signaled it would continue curbing oil production and exports. After a government report Wednesday showed a decline in U.S. stockpiles, oil futures rose to a four-month high, closing at $58.26 a barrel on the New York Mercantile Exchange.

Given oil's rise, doubling or tripling down on oil looks like a smart wager. The VelocityShares 3X Long Crude Oil exchange-traded note, which seeks to triple the daily return of U.S. crude futures, is up 89% so far this year, and the United States 3X Oil Fund has gained 88%, according to FactSet. The ProShares Ultra Bloomberg Crude Oil ETF, which aims for double the daily performance, has gained 54%.

Triple-leveraged bullish funds typically do well in a steadily rising environment, but they amplify losses when the market reverses. Adding to the confusion, the funds need to rebalance daily, which can erode returns even when oil prices have risen, especially in choppy markets. Unexpected losses can be a rude awakening for investors who don't understand the mechanics.

"To do well, you need to get two calls right," said Elisabeth Kashner, head of ETF research and analytics at FactSet. "The first is the overall market direction, and that's the call that's obvious to most investors. The not obvious piece is that you also have to get the path the price takes right, the consistency of the move."

Say oil prices gain 5% in a single day. A $100 investment in a triple-leveraged oil ETF would be worth about $115 at the end of the day. The fund then buys more oil futures to reset its leveraged exposure for the next day, which means the investor now has $115 riding on oil prices. If oil drops 5% the next day, the investor loses $17.25, ending up with $97.75—less than the initial wager made two days before.

"If you get a whipsaw pattern, even if it's moving overall in the direction that you pick, you could find yourself unpleasantly surprised because of all the buying high and selling low you did along the way," Ms. Kashner said.

Over time, the divergence can be significant. In the past year, for example, triple-leveraged products have lost almost 40% while oil prices are down just 7%, according to FactSet.

Those unpleasant surprises are part of the reason some brokerage platforms, like Schwab Corp. and Vanguard Group, impose guardrails on investors trying to buy leveraged products. The SEC warned brokers in 2012 that leveraged ETFs are potentially “unsuitable for long-term investors.”

Even fund investors who avoid leverage, and the daily rebalancing that goes with it, could be confounded by their results. That is because ETFs investing in oil don’t buy stockpiles of crude, but instead buy oil futures contracts. Futures expire each month, so the funds must sell the outgoing contracts and replace them. When near-month futures are cheaper than the next month, a condition known as “contango,” the ETFs are essentially buying high and selling low each month to maintain their exposure.

Oil futures have been in contango for most of the past decade, but that reversed early last year. That means ETFs like the U.S. Oil Fund sell high and buy low when rolling their oil futures each month, bolstering performance. From the start of 2018 until mid-October, when contango returned, the U.S. Oil Fund gained 23% while crude futures rose 15%, according to FactSet. Since then, futures have outperformed the fund.

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