CREDO

Leveraged and Inverse ETFs: Retail demand continues to grow

Retail demand for leveraged and inverse exchange traded funds (ETFs) has accelerated significantly during 2026. Although the sector remains relatively small, representing approximately US$248 billion of assets compared with the US$23 trillion global ETF market, it has attracted US$33.4 billion of net inflows year-to-date, exceeding the pace of the previous three years combined.

The increase has been driven by heightened market volatility, continued enthusiasm surrounding AI-related equities and greater accessibility through online investment platforms. More recently, single stock leveraged ETFs have returned to the spotlight, prompting the Korean regulator to introduce restrictions on products linked to SK Hynix and Samsung Electronics amid concerns around investor suitability and concentration risk.

While these products provide an efficient way to express a short-term market view, they are also among the most misunderstood investment vehicles available to retail investors.

DESIGNED FOR TACTICAL TRADING

Unlike traditional ETFs, which are commonly used as long-term investment vehicles, leveraged and inverse ETFs are primarily designed for short-term tactical positioning.

A leveraged ETF seeks to deliver a multiple of the daily return of an underlying index or security. For example, a 2x leveraged ETF aims to generate approximately twice the benchmark's return for a single trading day. Likewise, an inverse ETF seeks to produce the opposite of the benchmark's daily performance.

The emphasis on daily is critical.

At the end of every trading session, the fund resets its leverage exposure in order to target the following day's return. As a result, returns over periods longer than one day are not simply equal to the stated leverage multiple. Instead, they become dependent on the sequence of daily market movements, a characteristic known as path dependency.

This is why leveraged ETFs are generally considered trading tools rather than long-term investment holdings.

UNDERSTANDING COMPOUNDING AND PATH DEPENDENCY

The daily reset means that each day's gain or loss is applied to a new starting value. Over time, these daily returns compound, causing performance to diverge from what many investors might expect.

In a steadily rising market, this compounding can work in the investor's favour.

Using the example below, an index rises from 100 to 160 over six consecutive trading days. A 2x leveraged ETF begins at 100 and, because it earns approximately twice each day's gain, the returns compound on an increasingly larger investment value. Rather than rising by simply twice the index's total return (120), the ETF finishes at approximately 247.

The consistent positive trend allows compounding to enhance returns, creating what is often referred to as positive compounding or exponential growth.

However, the opposite is also true.

Consider an index that rises 10% one day before falling 9.1% the next. After two days, the index has returned to its original level. If this pattern repeats several times, the underlying index still finishes unchanged.

A 2x leveraged ETF does not.

Following a +20% gain on the first day, the fund must then absorb an 18.2% loss on a larger portfolio value. Although the percentage moves appear symmetrical, they are applied to different base values each day. Repeating this process gradually erodes capital, meaning the ETF finishes below where it started, even though the underlying index is flat.

This effect, known as volatility decay or negative drift, is one of the defining characteristics of leveraged ETFs and is often overlooked by investors who hold these products for extended periods.

The important takeaway is that market direction alone does not determine returns. The level of volatility and the path taken to reach the outcome can have an equally significant impact on performance.

UNDERSTANDING LEVERAGE

- There are a number of leverage and inverse products across all asset classes.
- The most important factor with these is when the leverage is struck, typically this is on a daily reset.
- The outcome of the performance you get is "path dependent" on how you get there.
- The returns have a compounding effect from the previous period's change, which can be greater or less.
- Looking at the two scenarios below, you can get Exponential Gain or Negative Drift from this.

HOLDING PERIOD MATTERS

Exponential Gain

Day	Index	Day %	ETF x2 Px
0	100	0.0%	100.00
1	110	10.0%	120.00
2	120	9.1%	141.82
3	130	8.3%	165.45
4	140	7.7%	190.91
5	150	7.1%	218.18
6	160	6.7%	247.2

Negative Drift

Day	Index	Day %	ETF x2 Px
0	100	0.0%	100.00
1	110	10.0%	120.00
2	100	-9.1%	98.18
3	110	10.0%	117.82
4	100	-9.1%	96.40
5	110	10.0%	115.68
6	100	-9.1%	94.64

- In the first example, the return from steady growth compounds to give you Exponential Growth. The overall move is greater than the index move because of the compounding.
- In the second example, the volatility from the underlying index gives a negative result despite the underlying returning to its original level.

HOLDING PERIOD MATTERS

The misconception that a 2x leveraged ETF will always produce approximately twice the return of its benchmark is only valid over a single trading session.

As the holding period extends, daily resetting and compounding mean performance can increasingly diverge from that simple multiple. During strongly trending markets, this divergence can be beneficial. During volatile or range-bound markets, it can significantly reduce returns, even when the underlying investment ultimately finishes unchanged.

For this reason, leveraged ETFs are generally better suited to investors seeking short-term tactical exposure, whether to express a conviction on market direction, hedge an existing portfolio or capitalise on near-term events such as earnings announcements or macroeconomic data releases.

They should not typically be viewed as long-term buy-and-hold investments in the same way as conventional equity ETFs.

CONCLUSION

The rapid growth in assets and inflows demonstrates that leveraged ETFs are becoming an increasingly important segment of the ETF market. Their accessibility has enabled more retail investors to implement sophisticated trading strategies without using derivatives or margin accounts.

However, increased accessibility should be matched by increased investor understanding.

For wealth managers and investment firms, educating clients on daily reset leverage, compounding and path dependency is essential. These products can be highly effective when used for their intended purpose, short-term tactical trading, but they can produce unexpected outcomes when held over longer investment horizons.

Ultimately, leveraged ETFs should be viewed as precision tools rather than core portfolio holdings. Understanding not only where the market finishes, but how it gets there, is fundamental to using them appropriately.