Investing in Passive ETFs? Be Aware of This One Huge Risk

Description

Passively managed exchange-traded funds (ETFs) are rapidly becoming the most popular funds in the world. Growing rapidly year in and year out, they're projected to overtake actively managed funds by 2021.

Studies have shown that over the long term, actively managed funds fail to the beat the market when fees are taken into account.

So it's inevitable that low-fee funds that replicate the market would gain in popularity. With a combination of low fees and average returns, they're virtually guaranteed to beat most active funds most of the time.

However, passive ETFs aren't without their risks. As you're about to see, there is a huge risk factor lurking in even the most passive of funds that could wreak havoc on your portfolio in a bear market.

This risk factor is not exactly a secret, but it's one that's easy for inexperienced investors to overlook. Fortunately, it's also very easy to protect yourself against if you know what you're looking for.

Leverage in passive ETFs

Many passive ETFs use leverage to beat the market while also replicating it. Leverage amplifies returns, so if you use borrowed funds, you can beat the market without your holdings actually outperforming. This makes sense in theory.

If you believe that stocks will rise indefinitely, it should work out over time. However, leverage amplifies losses as much as it amplifies gains, and if you're prone to panic selling, that means that leveraged ETFs can cost you big time.

If you're holding a leveraged ETF like the **Horizons BetaPro S&P/TSX 60 2x Daily Bull ETF**, you could double the loss of the underlying stocks on any given day. For those prone to market jitters, it's a dangerous proposition, however.

What to do instead

The most obvious thing to do instead of buying leveraged ETFs is to buy non-leveraged ETFs. Although the potential returns are smaller, the risk is less as well, so non-leveraged funds help with preservation of capital.

However, if you're seeking to beat the market *and* avoid leverage, there are options available to you as well.

For example, you could pick individual stocks. Although stocks can be risky, many established blue chips have no more beta than the **Benchmark Index.**

The Canadian National Railway (TSX:CNR)(NYSE:CNI), for example, has a three-year average beta of just 1.09. That's just a tiny fraction more volatile than the **TSX** itself. However, over the past five years, CNR has delivered almost five times the return that the index.

While it's clear that past performance doesn't indicate future performance, it's easy enough to tell why CNR has beaten the market. With access to three North American coasts, it has a solid economic moat in long distance North American shipping.

With a profit margin of 29% and ROE of 25%, it's wildly profitable. And with rail's cost efficiency in shipping large amounts of goods by land, there will always be demand for its services.

Although CNR isn't guaranteed to outperform the market on upswings like leveraged ETFs, it stands a good chance of beating it over the long term. Ultimately, that may be a better way for investors to get superior results.

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