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MARKETS

ETFs Unlikely to Cause Widespread Market Disruptions, Research Shows

Rapid expansion of index investing has fueled investor concerns about the pressure passive funds exert on stocks and bonds

Traders working on the floor of the New York Stock Exchange on July 6. PHOTO: SPENCER PLATT/GETTY IMAGES

By Asjylyn Loder

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The deluge of money flooding into passive investments can swing stock prices, but fears of widespread market disruptions are overblown, according to a new report from S&P Global Inc.

Investors yanking cash out of index-tracking strategies exacerbated sharp declines in early February, when stocks plunged and volatility surged, according to the report from S&P Global Market Intelligence, the data and research arm of the company behind the indexing business that includes the popular S&P 500 stock index.

Strategies that mimic the S&P 500, including mutual and exchange-traded funds along with other index-tracking investments, may have accounted for as much as one-third of the benchmark's almost 3.8% decline on Feb. 8, wrote Daniel Sandberg, a director at S&P Global Market Intelligence, in the report.

"There is an impact and that impact can be significant," Mr. Sandberg said in an interview.

But the researchers also concluded that the money sloshing into and out of ETFs, in particular, is unlikely to cause widespread price disruptions.

research firm Morningstar.

The $3.6 trillion U.S. ETF industry has faced particular scrutiny. Like mutual funds, ETFs package stocks, bonds or other assets into a single share. But unlike mutual funds, ETFs can be bought and sold on an exchange just like shares of Amazon.com Inc. or Apple Inc.

“They attract investors that want to trade fast,” said Francesco Franzoni, professor of finance at USI Lugano and the Swiss Finance Institute, who co-wrote research showing that stocks included in ETFs become, on average, more volatile.

In the past decade, ETFs have been linked to unusual price swings in oil, Japanese stocks and high-yield debt. In February, ETFs that bet against the Cboe Volatility Index were blamed for a price spike in volatility futures contracts. Last year, a flood of cash into funds that invest in small mining companies was blamed for price gyrations in gold stocks from Sydney to Toronto.

Mr. Sandberg and his colleagues tried to measure the impact of money pouring into and out of passive strategies, and focused particular attention on ETFs. The research was prompted by S&P clients, mostly large institutional investors, who are increasingly concerned that the rapid growth of index-tracking funds may be distorting stock prices.

“Clients are asking, ‘How big do ETFs have to get before we get concerned?” said David Pope, a managing director at S&P Global Market Intelligence. “It’s everyone’s underlying fear, that one fund gets so powerful that it starts to move prices in a disruptive manner.”

They found that some stocks are more vulnerable to price moves driven by surges of investor cash. Like many traditional indexes, the S&P 500 is divvied up based on the stock-market value of the underlying companies. But market value has little to do with the availability of the stock, according to the S&P report.

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For example, Walmart Inc. accounts for 0.5% of the assets in an S&P 500 index fund, but only 0.1% of the average daily trading volume of S&P 500 stocks in June, according to S&P. By contrast, Netflix Inc. is 0.7% of the benchmark’s assets, but 3.3% of trading.

ETFs may buy more of a stock than is readily available, forcing prices higher to find more willing sellers. Or they may sell more than the market has an appetite for, pushing prices lower to attract buyers.

“The ETFs just consume everything that’s available,” Mr. Pope said.

The price impact was “modest” and tended to disappear within a few days, the report said.

“There’s not much cause for concern for systemic risk,” Mr. Sandberg said. “But we have been able to quantify that there’s some minimal impact.”

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