THE HILL

Investors and regulators: Beware of the seeming stability of ETFs

BY FRANCESCO FRANZONI, OPINION CONTRIBUTOR — 07/20/18 12:45 PM EDT
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Exchange-traded funds (ETFs) are investment companies whose objective is to passively replicate the performance of an index, similar to index mutual funds.

Unlike index funds, ETFs are listed on exchanges. Thus, investors can buy and sell ETF shares throughout the day in the same way they trade Apple stock. ETFs offer a cost-effective vehicle to track the performance of the whole market, or a segment of the market, and achieve portfolio diversification.

Because of their inherent benefits, and given the often-unsatisfactory performance of traditional mutual funds, ETFs have become more and more popular over the past two decades.

The assets under management (AUM) in ETFs have grown exponentially. Starting from around zero in the early 2000s, they have reached $4.5 trillion globally, of which about $2 trillion is in the U.S. only. ETFs now account for over 15 percent of the AUM in investment companies in the U.S and 50 percent of all passively managed assets.

In the past, financial innovation has often led to unintended consequences. For example, trading strategies meant to provide portfolio insurance were instrumental in the 1987 crash, while the securitization of mortgages played a dominant role in the last financial crisis. Aware of these events, academic researchers have put ETFs under close scrutiny.

My forthcoming article in the Journal of Finance, “Do ETFs increase stock volatility," coauthored with Itzhak Ben-David (Ohio State University) and Rabih Moussawi (Villanova University), contributes to this literature. We study whether ETFs abet investor behavior that can eventually lead to a deterioration in the quality of security prices.

The premise of this work is that ETFs attract investors wishing to trade at high frequency, typically intra-day. At these short horizons, there is hardly any new fundamental information that motivates a portfolio rebalancing.

Hence, these trades mostly reflect individual trading needs (e.g. liquidating an investment portfolio to buy a new car) or are the expression

of investors' mood (“I woke up feeling pessimistic about the market

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of investors' mood ("I woke up feeling pessimistic about the market today"), but they are unlikely to bring any relevant information to the market. ETF prices move as a result of this trading volume, but this action does not reflect any relevant news.

Because of the peculiar structure of ETFs, the movements in ETF prices are potentially transmitted to the securities in their baskets. This propagation can occur because some institutional investors take advantage of any discrepancy between the ETF price and the collective value of the underlying securities via arbitrage trades.

Among these institutions, the authorized participants are in formal agreements with the ETF providers and operate to maintain the ETF price virtually aligned with the value of the underlying index. This alignment is a desirable feature of ETFs. Unfortunately, the arbitrage trades may pass up also "meaningless" price moves to the securities in the ETF portfolios.

Our paper shows that this mechanism is indeed at work. In particular, the stocks that are tracked by ETFs display higher price volatility. Importantly, the increase in volatility does not reflect more efficient prices, i.e., an unbiased and timely view of the earnings potential of a company. Rather, prices are more "noisy," i.e., their moves do not reflect fundamental information.

The implications of these findings are several. On a daily basis, investors may trade at the "wrong" price because of the layer of noise that ETFs bring to the market. In more extreme situations, hiccups in the ETF market can bring disruption to the stock market itself.

The events of Feb. 5, when some ETFs that were tracking the VIX index suddenly dropped in value and the Dow lost 1,500 points, the largest one-day drop in the history of the index, can be interpreted within this framework.

Other researchers have highlighted additional dysfunctionalities brought about by ETFs. For example, the prices of securities in ETF portfolios react more strongly to market-wide news (e.g., changes in the Fed policy) but are less and less sensitive to firm-specific news (e.g., a positive earnings surprise).

Again, this evidence suggests that ETFs, and passive investments in general, lead to a deterioration of some dimension of market efficiency.

Researchers are also studying the possibly-false perception of liquidity that ETFs give to their investors. Trading an ETF that tracks hard-to-trade assets, e.g., corporate bonds or emerging market stocks, is very easy on U.S. exchanges.

Thus, almost magically, ETFs have given access to corners of financial markets that were previously inaccessible to most investors. However, academics and more experienced market participants doubt whether this accessibility will persist when the market goes through periods of stress.

Possibly, the magically-created liquidity will evaporate and investors will be stuck with hard-to-trade ETF shares.

In conclusion, ETFs have brought desirable diversification to investors' portfolios at low cost. Also to ETFs' credit, they have broken the monopoly of active funds, which to a large extent did not deliver on their promises.

As all forms of financial innovation, however, ETFs may have unintended consequences. Investors, as well as regulators, should pay special attention to the risks involved in these financial instruments to prevent them from becoming toxic.

Francesco Franzoni is a professor of finance at the Università della Svizzera italiana (USI) in Lugano and holds a senior chair with the Swiss Finance Institute (SFI). He obtained his PhD in Economics from MIT and directs the Institute of Finance at USI. His research concentrates on institutional investors, such as hedge funds and ETFs and their impact on asset prices.

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