Competition for Attention in the ETF Space

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By Tommi Johnsen, PhD | May 3rd, 2021 | Research Insights, Basilico and Johnsen, Academic Research Insight, ETF Investing

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- Itzhak Ben-David, Francesco Franzoni, Byungwook Kim, and Rabih Moussawi
- SSRN Working paper
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What are the research questions?

This article supplies a testable framework for making sense of the rapid expansion of the ETF market over the last 30 years. The authors argue that the ETF market is differentiated into two types of markets or products: broad-based ETFs and specialized ETFs. Based on the theory advanced by Bordalo, Gennaioli, and Schleifer (2016), innovators develop products based on either a price or quality dimension. In the Bordalo model, ETFs are commoditized and competition is based on the ETF offering the lowest fee (index ETFs, smart beta); or quality, where the ETF is distinguished by high fees and distinct ETF features (theme-based ETFs). Essentially, the explosive growth in ETFs is a function of ETF providers competing for market share by advertising a low price OR some unique feature of the ETF other than the price. Fee-conscious investors are attracted to broad-based ETFs because they provide cheap exposure to an asset class. Investors indifferent to fees, but desire exposure to an investment theme promising very high returns are attracted to specialized

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Note: If you attended this year's Democratize Quant, you heard a great back and forth discussion between the authors and Jay Jacobs.

What are the Academic Insights?

1. ***There was quite a bit of empirical evidence of segmentation in the ETF market along the lines of price*** which was consistent with the notion of "competition for attention" explanation. This framework is also consistent with traditional views of financial innovation wherein innovative products are responsive to the rational investor and improve investor welfare. Broad-based ETFs increase the ability to access portfolios that reduce the risk of exposure to an asset class at a low fee. Cheap diversification plus cheap hedging equates to improved welfare. Unfortunately, the results suggest that the same story does not fit specialized ETFs. They are certainly not diversified and only attract investors because they offer exposure to a specific theme, usually at a high price. Over the period studied (2000-2019), 2 clusters of ETFs were observed. Broad-based ETFs, with very similar characteristics and low fees, emerged early in the industry. Late in the period, specialized ETFs proliferated with differentiated characteristics and much higher fees which allowed for multiple types of funds to exist even with smaller AUM. Revenues for broad-based vs. specialized funds were generally equally distributed with the exception of the very far right tail of the distribution, where large players generated significant revenue due to their sheer size. State Street and SPYs come to mind.
2. ***Unfortunately, the results suggest that the same story on pricing or fees does not fit specialized ETFs.*** Remember that they are undiversified and only attract investors because they offer exposure to a specific theme. The decline in fees in broad-based ETFs was not matched in the specialized segment. As the themes were highly differentiated, there appeared to be little competition among new and old specialized ETFs with little pressure on fees as a result. Indeed, results of regression analysis indicated little to no sensitivity to fees with respect to fund flows into specialized ETFs. However, the sensitivity of flows to past return performance was significantly higher for specialized vs broad-based ETFs. Indicating that performance chasing is happening in the specialized segment of the ETF market.
3. However, the story with respect to quality (special features) and specialized ETFs is quite different. To their credit, the authors spend quite a bit of time exploring alternative explanations for the role of specialized ETFs. However, the case for quality (high fee, distinct feature) dimension for specialized ETFs is pretty bleak. Performance is poor. On a risk-adjusted basis, the authors report an alpha of

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such disappointing performance? The authors conclude that they bear more than a passing resemblance to the Glamour stocks of Lakonishok, Schleifer, and Vishny (1994). The "Overextrapolation" hypothesis developed and analyzed in the LSV article is rooted in sources of behavioral biases exhibited by the average investor and appears to be a better explanatory theory for specialized funds. That explanation does make some sense and if you haven't read the LSV piece yet, it's highly recommended.

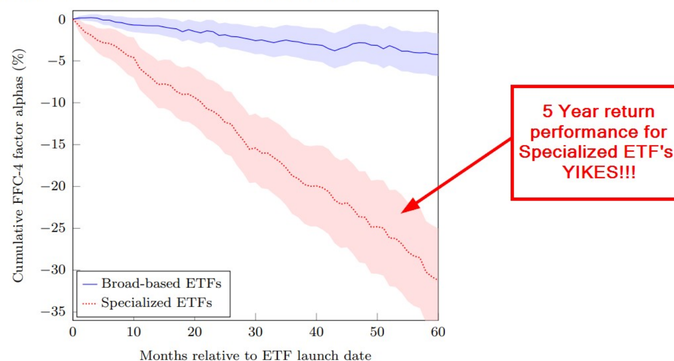
Why does it matter?

The article is interesting in that it provides analysis suggesting that the rise of broad-based ETFs makes theoretical sense in the context of the demand for low-cost, diversified portfolios that provide exposure to various asset classes. However, the argument falls apart when it attempts to explain the surge of specialized ETFs later in the financial innovation cycle. It's not quality, it's not performance, it's not diversification, and it's not insurance. But it might be another example of a behavioral bias exhibited by ordinary investors. Perhaps providers are simply capitalizing on those unfortunate tendencies? Of course, a counter to this argument is that a relatively diversified professionally managed thematic ETF is a lot better for an investor relative to "stock-picking" in their Robinhood account.

The most important chart from the paper

Figure 2. Performance of ETFs Around Launch

The figure shows the performance of ETFs around launch, split by groups of broad-based and specialized ETFs. We form 60 calendar-time portfolios that include returns of ETFs in their month +1, +2, ..., +60 since the launch date (month 0). The portfolio returns are value-weighted using one-month-lagged market capitalization. To adjust returns for risk factors, we estimate the Fama-French-Carhart four-factor model (FFC-4) alphas of the portfolios (Fama and French, 1993; Carhart, 1997). The lines represent cumulative FFC-4 alphas and the shaded areas represent 95% confidence intervals.



> *poorly as the hype around them vanishes, delivering negative risk-adjusted returns. Overall, financial innovation in the ETF space follows two paths: broad-based products that cater to cost-conscious investors and expensive specialized ETFs that compete for the attention of unsophisticated investors.*

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Dr. Tommi Johnsen, until retirement in 2017, was the Director of the Reiman School of Finance and a tenured faculty at the Daniels College of Business at the University of Denver.She has worked extensively as a consultant and investment advisor in the areas of quantitative methods and portfolio construction. She taught at the graduate and undergraduate level and published research in several areas including: capital markets, portfolio management and performance analysis, financial applications of econemetrics and the analysis of equity securities. Her publications have appeared in numerous peer-reviewed journals.

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