Are thematic ETFs stupid?

Alex Rosenberg / 18 March 2022, 11:31

A new paper finds that most 'specialized ETFs' are poor investments, and takes a crack at explaining why.

What would happen if you went out and bought whatever group of stocks was generating the most hype at a given moment, and then held onto them for several years?

If that sounds like a strategy destined to underperform, then we shouldn't be surprised to learn that thematic ETFs tend to generate terrible results for investors. After all, these are products designed to generate media attention and investor interest by aiming squarely at a topics that are in the crosshairs of public discourse and investor excitement – such as cannabis, space exploration, robotics and whiskey.

A new research paper confirms that suspicion:

> [O]ur evidence suggests that specialized ETFs appear to cater to overoptimistic investors. Specialized ETFs are launched just after the very peak of excitement around popular investment themes. Over the years following the launch, the underlying assets shed some of their initial overvaluation, and so do the prices of specialized ETFs.

That's from the conclusion of 'Competition for Attention in the ETF Space,' a research paper by Itzhak Ben-David, Francesco Franzoni, Byungwook Kim and Rahib Moussawi.

By 'specialized ETF,' the researchers mean thematic ETFs, as well as ETFs focusing on specific sub sector or niche industry. As compared to broad-market ETFs, they find that these specialized ETFs generate negative alpha of 3% per year. More generally, they found that 'over the first five years of their life, specialized ETFs lose about 30% on average in terms of risk-adjusted returns.'

What's going on here?

In an amusing attempt to map this patently irrational behavior onto the perfectly rational actors of economics textbooks, the authors write:

> Stocks in specialized ETFs... have significantly higher pre-launch market-adjusted returns, making them attractive to investors with extrapolative or diagnostic beliefs. Moreover, stocks held by specialized ETFs display more positive skewness, which would be appealing for investors who have a preference for lottery-like payoffs

'Why did you buy the Breakfast Commodities Strategy ETF, Billy Ray?' 'Well, Louis, it must have been those darn extrapolative or diagnostic beliefs of mine.'

A few paragraphs later, the researchers close in on the point:

> The characteristics of the securities included in the portfolios of specialized ETFs indicate that they are popular stocks, which attract investor attention... The conjecture that specialized ETFs focus on sectors and themes that capture investor attention is consistent with anecdotal evidence on recent ETF launches. In 2019, for example, new ETFs included products focusing on cannabis, cybersecurity, and video games. In 2020, new specialized ETFs covered stocks related to the Black Lives Matter movement, Covid-19 vaccines, and the work-from-home trend. In

> 2021, tracking the recovery after the Covid recession, new specialized ETFs covered the travel industry, and space travel as well as real estate and construction.

No surprise, then, that the researchers found evidence that 'securities in specialized ETFs are overvalued,' and that, indeed, 'the indexes underlying specialized ETFs exhibit a run-up in the period preceding the launch, and that specialized ETFs underperform after launch, potentially reversing an earlier overvaluation.'

Further down in the paper, the researchers put on their deerstalker caps to 'deduce that retail investors are likely to own a greater share of the specialized ETFs universe than that of the broad-based ETF universe, supporting the view that unsophisticated investors are more likely to be attracted to specialized ETFs.'

Morningstar's Ben Johnson is skeptical about thematic ETFs for similar reasons:

> Not all themes have staying power. Many thematic funds don't have portfolios that align with their theme to the extent investors might expect. And even if the first two pieces of the puzzle are in place, if investors' enthusiasm for the narrative has stretched valuations, then long-run returns are likely to disappoint.

To this end, Johnson's annual lists of the 'worst ETFs' has hosted such cringeworthy offerings as the Gabelli Pet Parents ETF (PETZC), Procure Space ETF (UFO), Direxion Work From Home ETF (WFH) and the VanEck Social Sentiment ETF (BUZZ). All of these have very badly underperformed the S&P 500 over the past year, with the exception of the Pet Parents ETF, which appears to have been put down.

All of this may lead you to wonder: If these thematic ETFs really perform so poorly, then why do issuers keep minting new ones? No offense, but that's a remarkably naïve question! Back to Ben-David et al.:

> By the end of 2019, broad-based ETFs accounted for about 82% of the assets invested in equity-based ETFs, and specialized ETFs accounted for the remaining 18%. Despite their relatively small market share, specialized ETFs at the end of the sample accounted for about 36% of the industry's revenues... The disproportionate share of revenues of specialized ETFs is due to the higher fees that they charge on average.

To be sure, specialized ETFs would underperform broad-market ETFs even if fees were the same, though the higher fees obviously don't help matters.

What does it all mean for investors? Sometimes we end these newsletter sections with overbaked philosophical ruminations, but today we can keep it pithy: Don't buy dumb things!

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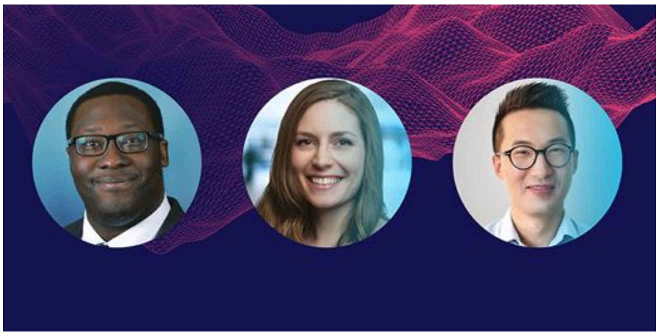

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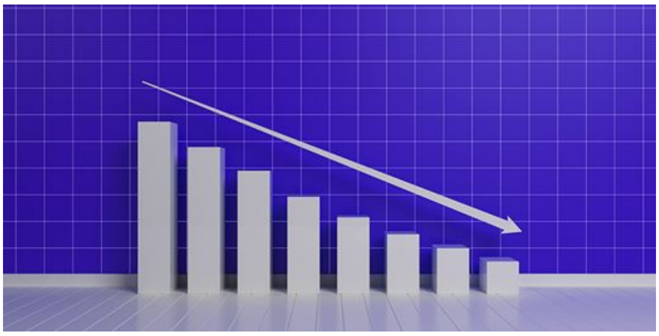

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