Markets

Day-Trader Frenzy for Trendy Stocks Is Defying Decades of Losses

By Yakob Peterseil
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- Pricey funds tracking investment trends are seeing high demand
- Thematic ETFs historically lost up to 5% annually, study shows

Day traders getting rich buying trendy companies from solar power to cloud computing are defying two decades of money-losing history in ETFs that follow the approach.

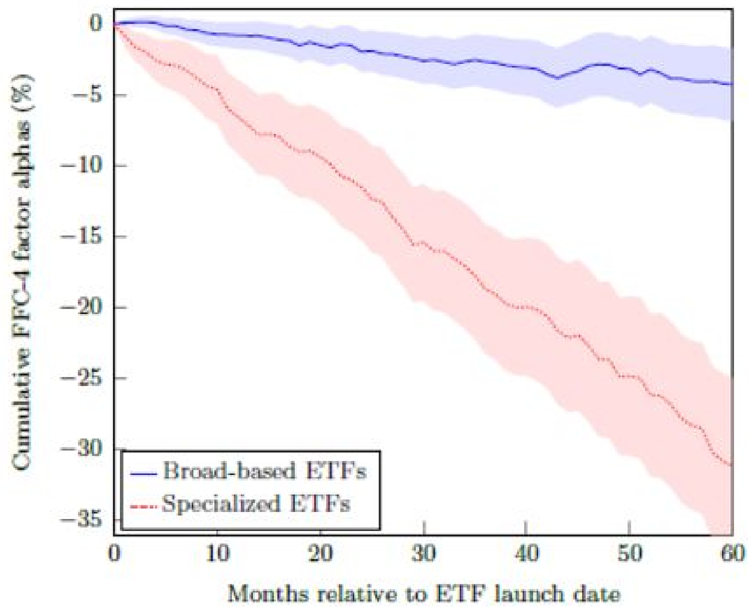
Stuffed with overvalued stocks, exchange-traded funds targeting the hottest investment themes actually lost as much as 5% per year on a risk-adjusted basis between 2000 and 2019, according to new research.

It should serve as a reminder that good times don't last, yet the speculative euphoria surrounding thematic funds keeps growing. One out of every three dollars flowing to U.S. equity ETFs in January has gone to the sector at $12.6 billion in total.

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, ..., to +60 since the launch month 0. The portfolio returns are value-weighted using one-month-lagged market capitalization as weights. To adjust returns for risk factors, we estimate Fama-French-Carhart four-factor model (FFC-4) alphas of the portfolios using squared roots of the number of ETFs in each portfolio-month as weights. The lines represent cumulative FFC-4 alphas of the 60 ETF portfolios, and the shaded areas represent 95% confidence intervals.



"Demand for specialized ETFs comes from unsophisticated investors who chase investment ideas that, in their view, will produce higher expected returns," academics at Ohio State University, Swiss Finance Institute and Villanova University wrote in the paper. In practice, "the underlying assets of these ETFs are overvalued and therefore underperform after issuance."

Thematic ETFs in the U.S. now manage a record $142 billion in assets after almost trebling from a year ago.

With ambitions in new, high-growth industries like robotics and space travel, they tend to hold companies surrounded by media hype with a corresponding run-up in the stock price, according to the paper. As a result, they typically include equities with tell-tale signs of over-valuation, like high market-to-book values or elevated short interest.

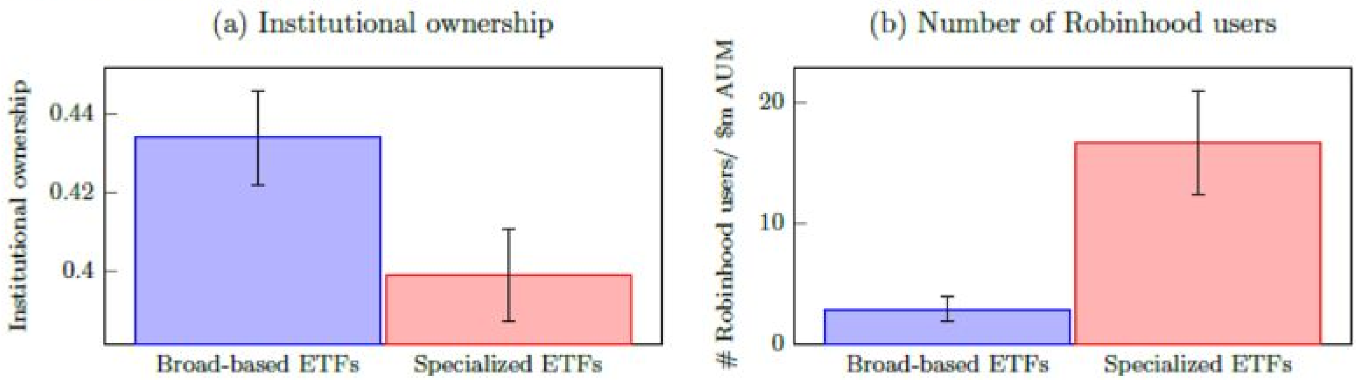
Read more: Robinhood Army Propels Thematic ETFs to a Record-Setting Year

The authors studied over 1,000 U.S.-listed equity products, tracking both broad-based funds following indexes like the S&P 500 and specialized ETFs tracking sectors and themes. Leveraged, inverse and actively managed funds were not included.

The results were striking: A portfolio of these thematic and sector funds lost 3.1% a year on a risk-adjusted basis after fees. Poor performance typically kicked in at launch. New ETFs fared even worse, shedding 5% per year.

Figure 8. ETF Ownership Around Launch

The figure presents the ownership structures of ETFs around launch, per ETF category. During the first year after launch, we calculate average ownership of 13F institutional investors and the number of Robinhood users scaled by assets under management ($m). Panel (a) reports 13F ownership, and Panel (b) reports the number of Robinhood users per AUM. Bar charts represent average ownership, and error bars represent 1.96 standard error confidence intervals.



The retail investor is likely to be bearing the brunt of these losses.

Using data directly from the Robinhood platform, the researchers found that users overwhelmingly favor thematic ETFs over broad-based products. Meanwhile, based on 13F forms, they showed average institutional ownership of broad-based ETFs shortly after launch was about 43%, yet for specialized funds it was just 0.39%.

Of course, it's possible that thematic funds have come of age. The study period ends before the unprecedented events of 2020, when some of the highest-profile themes were boosted by the global pandemic.

It also excludes active funds like those offered by Ark Investment Management, which have exploded in popularity after successful bets on the likes of Tesla Inc. and Bitcoin.

Either way, for issuers it's a no-brainer: The research notes that thematic and sector products held just 20% of assets in all ETFs at the end of 2019 -- but brought in a third of industry revenue thanks to their higher fees.

"ETF issuers attract investor attention by designing products that cater to investors' expectations of high future returns," wrote Itzhak Ben-David, Francesco A. Franzoni, Byungwook Kim and Rabih Moussawi. "The most important financial innovation of the last three decades, originally designed to promote cost-efficiency and diversification, has also provided a platform to cater to investors' irrational expectations."

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