Fears grow that popularity of ETFs is a ticking time bomb

By Ryan Vlastelica
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Biggest concerns seen as overblown, but small companies could be more vulnerable to ETF-driven volatility

Courtesy Everett Collection

It's a claim that has been hotly disputed, but which is being more fiercely debated by the day: ETFs have gotten too big for their own good, making them an unappreciated risk in the event of a market decline.

The rise of exchange-traded funds into a multi-trillion-dollar segment of the global financial system is one of the most consequential economic developments of the past 30 years. For the most part, analysts have praised the investment vehicle, which give investors the ability to make intraday bets on baskets of securities. They've been credited with driving fees lower and giving investors greater flexibility and tax efficiency. Such attributes have fueled their growth—from $1 trillion in global assets in 2009 to more than $4.4 trillion today, according to research firm ETFGI.

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ETFs are dominated by passive vehicles, which mimic the performance of indexes like the S&P 500 **SPX, -0.16%** by holding the same securities as the index, and in the same proportion. (This is in contrast to actively managed funds, where the holdings are individually selected by a portfolio manager.) According to FactSet, about a seventh of all ETF assets are held in funds tracking the benchmark equity index.

The popularity of such funds—according to Credit Suisse, 14 of the 15 most actively traded securities last year were ETFs—has raised concerns about what the fallout of this trend could be. Essentially, the fear is that if a stock's shares outstanding are concentrated within ETFs, its daily moves will be dictated more by the buying and selling of the funds, rather than by the company's own fundamentals.

'Blind mispricing'

Earlier this month, the short selling firm Spruce Point Capital Management issued a highly critical report on drone maker AeroVironment Inc. **AVAV, -0.30%** in part due to this issue. The stock's surge over 2017, it argued, was "fueled by billion-dollar inflows" into a fund that heavily owned the stock, giving it a valuation it called "nonsensical and distorted." The stock has fallen more than 16% in November but remains up nearly 60% year-to-date.

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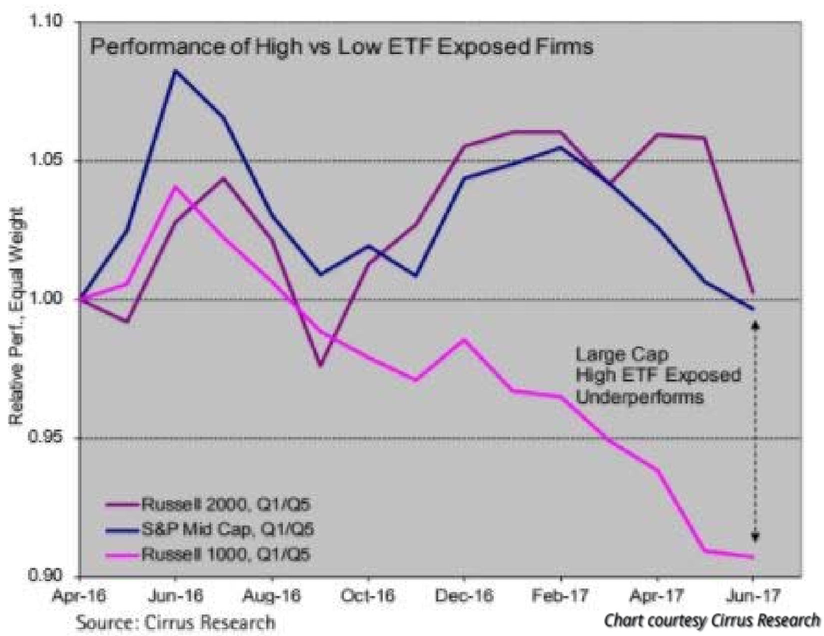
Heavy ETF ownership "may increase the nonfundamental volatility of the securities in their baskets," according to a recent research paper by Itzhak Ben-David of the National Bureau of Economic Research, Francesco Franzoni of the Swiss Finance Institute, and Rabih Moussawi of the Villanova School of Business. "A normal shock to ETF ownership shifts the volatility of the median stock in the S&P 500 to a place between the 55th and 64th percentiles."

According to a July report from Cirrus Research, "companies with higher ETF exposure have steadily underperformed their counterparts since last June." It added, "There is clearly a clustering in long-only ETF strategies that has resulted in blind mispricing."



Smaller companies, as a percentage of their total shares, tend to be more widely held by ETFs. According to an analysis of data from research firm XTF, the 15 smallest components of the S&P Small Cap 600 **SML, -0.06%** have an average of 12.2% of their shares outstanding held by ETFs, compared with the 5.8% average for the 15 largest components of the S&P 500. (More than 22% of

AeroVironment was owned by ETFs.)

Less trading on fundamentals

There is a related question surrounding passive investing and what impact that is having on overall market efficiency. According to September data from Goldman Sachs, passive funds now own an average of 17% of each component of the S&P 500, whereas it was "a rounding error" a decade ago. (Goldman's analysis includes both ETFs and passive mutual funds.)

As buying and selling index funds essentially means buying and selling every component of the underlying index, "less trading is stemming from views on company fundamentals," Goldman wrote. "Passive holders trade stock for different reasons than active managers, and at different frequencies. Passive's decision to buy or sell stocks is often directed by broader fund flows and larger rebalances and not typically company specific fundamentals."

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The investment bank calculated that for the average S&P 500 company, the share of its stock that might trade on fundamental views has dropped to 77% compared with 95% a decade ago. Those figures are based on a measure Goldman calls "passive-adjusted float," or the number of shares outstanding minus both restricted holdings and passive holdings.

'Extreme illiquidity'

"The hyperbolic growth in ETFs has created a situation of extreme illiquidity for many of the underlying stocks," wrote Jeff Marcus, founder of research firm Turning Point Analytics, which developed what he called an ETF liquidity alert.

As an example of the alert, the firm used Johnson & Johnson **JNJ, -0.58%** a stock where it calculates 6.36% of shares outstanding are held by ETFs. This translates to about 170.7 million shares, compared with its 30-day average trading volume of 5.6 million. Those 170.7 million shares, in other words, represent more than 30 days of average daily trading.

"Of course, not all of the stock in ETFs would be sold on any given day, but even if investors just tried to sell 10% in a big decline, ETF selling would still be 3 times the average daily volume for JNJ," Marcus wrote.

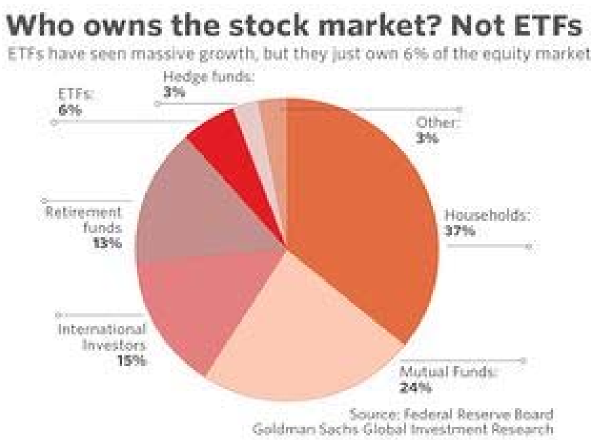
(Turning's figures differ from other sources, though the results are only marginally different. FactSet gives the 30-day average trading volume as 5.19 million, while XTF calculates that 5.9% of J&J shares are held by ETFs. This translates to 30.54 days, rather than the 30.34 Marcus cites.)

Per Turning Point's data, 6% of U.S. companies with a market capitalization over $1 billion have "30 or more days trading volume in ETFs." When the time period is shortened to 10 days, this is true of 54% of such companies.

ETF popularity has skyrocketed over the past decade. Meanwhile, the U.S. stock market has rose in mostly uninterrupted fashion with little in the way of major pullbacks or volatility since bottoming out in the wake of the financial crisis in March 2009. That means liquidity concerns have yet to be tested. However, other analysts dispute that their growing presence would exacerbate market declines.

'Battle tested'

According to Goldman Sachs data, ETFs own just 6% of the equity market, an amount that is dwarfed by mutual funds (24%), international investors (15%) and households (37%). While they are one of the fastest-growing categories, their relative small size is seen as limiting the downside impact they could have in the event of a sharp decline.



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Eric Balchunas, ETF analyst for Bloomberg Intelligence, estimated that on days with heavy selling pressure, ETFs comprise 40% of total trading volume. However, only 10% to 20% of ETF trading on those days actually involves the underlying securities, as opposed to simply exchanging shares of the fund.

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"If there is a 'rush to the exit' an ETF will likely trade to a discount that's influenced by the volatility and the liquidity of the underlying market," UBS wrote in September. However, "despite the growth in ETF assets, we believe the ETF market is better equipped to handle turbulent markets now than in the past."

The Swiss bank said funds had been "battle-tested," and added that the ETF investor base is more diverse than it had been in the past, "as there has been greater adoption among both retail and institutional investors. This means there's likely to be different investment views, objectives, and time horizons among investors, which helps to balance supply and demand."

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