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IMF calls on policymakers to re-examine ETF risks

Concerns centre around volatility, emerging markets and transmission of shocks, but industry figures insist they are overstated

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Policymakers should re-examine risks posed by exchange traded funds during periods of stress, the IMF says, even though the vehicles are less concerning than their open-ended mutual fund counterparts.

The authors of the IMF's recently published global financial stability report expressed their deepest concerns about mutual funds with exposure to illiquid bonds, calling on policymakers to ensure that the funds used adequate liquidity management tools.

However, it also said that policymakers "should further analyse exchange traded funds".

"The provision of intraday liquidity by ETFs makes them attractive for liquidity traders with short-term horizons. Together with the arbitrage activities of authorised participants who create and redeem ETF shares, this facilitates the transmission of non-fundamental shocks from short-term liquidity traders to securities markets," the IMF report said, referring to research on equities ETFs published in 2018.

"Consistent with this transmission, ETFs can increase non-fundamental volatility in asset markets and amplify the sensitivity of cross-border capital flows to global financial conditions," the report said.

The authors also note that in the case of emerging markets, the importance of benchmark-driven portfolio flows has increased significantly over the years. They argue this poses additional risk as these flows tend to be highly sensitive to global factors, potentially increasing the risk of excessive outflows at times of market stress.

However, industry figures said the IMF worries were overstated.

MJ Lytle, chief executive of Tabula Investment Management, a bond ETF specialist, said while it was understandable for the IMF to highlight every known concern, in reality the ETF wrapper had proved itself to be very robust, for example during the market meltdown that accompanied the beginning of the Covid pandemic in March 2020.

Lytle argued that ETFs had shown that their creation-redemption mechanism made them a better vehicle for investors who were concerned about liquidity.

"If you care about liquidity, and you're in a vehicle that says they are offering daily liquidity but they can't offer it [such as an open-ended mutual fund with illiquid holdings during times of market stress], there should be more stringent requirements," Lytle said, pointing out that long-term investors in mutual funds bear the trading costs of those who enter and leave the vehicles.

Kenneth Lamont, senior fund analyst for passive strategies at Morningstar, agreed: "Advocates of traditional active management with an axe to grind have long warned against the "time-bomb" of liquidity in ETFs. And yet, when put to the test the structure has performed admirably time and time again," Lamont said.

“The built-in market-maker process means that some ETF transactions can be netted without buying or selling the underlying assets, an advantage which is not open to most equivalent managers of traditional mutual funds,” Lamont pointed out, adding that this enabled ETFs to effectively become price discovery vehicles during March 2020 — continuing to trade even though the underlying market had seized up.

That price discovery advantage was also noted by Carolyn Weinberg, global head of product, iShares and index investments, at BlackRock.

“Fixed income ETFs have been tested in numerous stressed market scenarios and have proved they offer price discovery and the ability to access liquidity during volatile markets,” Weinberg said.

Lytle argued was no such thing as a perfect mechanism for trading securities, but ETFs made more sense. He pointed out that most ETFs are passive index trackers, which come with certain advantages during times of market stress. ETFs that track passive benchmarks are focused on minimising tracking error in all environments, which means they would not skew toward selling liquid assets before less liquid ones.

This also means they would try to sell a perfect slice of the fund against any redemptions.

“I don’t think ETFs are the panacea to all problems. But I do think the creation-redemption mechanism makes a lot more sense,” said Lytle.