Passive Funds Ruffle Stock Prices

Fears, however, of wide disruptions from ETFs are overblown, S&P report concludes

BY ASJYLYN LODER

The deluge of money flooding into and out of passive investments can have a very active effect on stock prices, new research says.

The report, from the data and research arm of S&P Global Inc., a major provider of financial-market indexes, is the latest salvo in a long-running debate about the pressure index funds exert on the stocks and bonds they are meant to track. The resurgence of market turbulence this year intensified concerns that an exodus from index funds could trigger an avalanche of forced selling.

Assets in passive funds that try to match the market rather than beat it have quintupled in the past decade to $6.9 trillion, according to research firm Morningstar. Exchange-traded funds, perhaps the most visible manifestation of the index-investing trend, have been linked in recent years to unusual price swings in oil, Japanese equities and high-yield debt.

While the S&P report found that the money sloshing into and out of passive strategies does move asset prices, S&P researchers concluded that fears of widespread market disruptions because of ETFs are overblown.

“Any strategy in the financial markets is fine when there is a small number of people doing it, but when a large number of people do it, it can cause distortions,” said Jared Dillian, an investment strategist with research firm Mauldin Economics.

Size is especially important in an industry where the cheapest funds garner the most assets. The bigger the strategies grow, the more money fund companies make. Investors yanking cash out of index-tracking strategies exacerbated sharp declines in early February, when stocks plunged and volatility surged, according to the report published this week by S&P Global Market Intelligence, in the report.

“There is an impact and that impact can be significant,” Mr. Sandberg said in an interview at the show. He added: “Are there enough traders to absorb all that money?”

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The $3.6 trillion U.S. ETF industry has faced particular scrutiny. Like mutual funds, ETFs package stocks, bonds or other assets into a single share. But unlike mutual funds, ETFs can be bought and sold on an exchange just like shares of Amazon.com Inc.

In February, ETFs that bet against the Cboe Volatility Index were blamed for a price spike in volatility futures contracts. Last year, a flood of cash into funds that invest in small mining companies was linked to price gyrations in gold stocks from Sydney to Toronto.

“They attract investors that want to trade fast,” said Francesco Franzoni, professor of finance at USI Lugano and the Swiss Finance Institute, who co-wrote research showing that stocks included in ETFs become, on average, more volatile.

Mr. Sandberg and his colleagues tried to measure the impact of money pouring into and out of passive strategies, and focused particular attention on ETFs. The research was prompted by S&P clients, mostly large institutional investors, who are increasingly concerned that the rapid growth of index-tracking funds may be distorting stock prices.

“Clients are asking, ‘How big do ETFs have to get before we get concerned?’” said David Pope, a managing director at S&P Global Market Intelligence. “It’s everyone’s underlying fear, that one fund gets so powerful that it starts to move prices in a disruptive manner.”

They found that some stocks are more vulnerable to price moves driven by surges of investor cash. Like many traditional indexes, the S&P 500 is divvied up based on the stock-market value of the underlying companies. But market value has little to do with the availability of the stock, according to the S&P report.

For example, Walmart Inc. accounts for 0.5% of the assets in an S&P 500 index fund, but only 0.1% of the average daily trading volume of S&P 500 stocks in June, according to S&P. By contrast, Netflix Inc. is 0.7% of the benchmark’s assets, but 3.3% of trading.

ETFs may buy more of a stock than is readily available, forcing prices higher to find more willing sellers. Or they may sell more than the market has an appetite for, pushing prices lower to attract buyers.

“There’s not much cause for concern for systemic risk,” Mr. Sandberg said. “But we have been able to quantify that there’s some minimal impact.”