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A volatile love affair with exchange funds and indexes

BY MIKE DOLAN

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(Reuters) - The blossoming love affair with index-based investing and exchange-traded funds is sweeping aside more traditional investment management with its hefty fee premium,



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even if it is stoking market volatility.

The seemingly contradictory combination of cheaper fees and superior performance is proving too attractive for many savers to ignore and appears a win-win for everyone except active managers and hedge funds.

Anyone eyeballing gains of almost 30 percent in the S&P500 index of leading Wall St stocks last year - and double-digit returns in four of the past five calendar years - would certainly ask questions about the higher fees charged by stock picking, value-based or arbitrage funds.

No surprise then that ETFs, funds traded on exchanges just like individual stocks and typically invested in a defined index of securities, have mushroomed in recent years.

Although still less than 10 percent of mutual fund assets worldwide, Deutsche Bank estimates ETFs at over \$2.3 trillion have more than doubled since 2011 and now exceed the \$2.2 trillion pool of funds invested in private equity. They are now just shy of the \$2.6 trillion ploughed in hedge funds.

Net cash flow to U.S. equity ETFs alone last year was almost \$150 billion.

Yet concern about the impact of such broad-sweeping and indiscriminate investment behaviour on constituent stocks and bonds has been brewing.

The latest question mark has come in emerging markets where in a turbulent 12 months investors fled countries badged 'emerging' and baked into emerging indices, regardless of domestic economic and political developments.

Given that assets of emerging ETFs almost tripled over the past six years to a peak of \$300 billion early last year - from virtually nothing in 2004 - the concern is money is being swept in and out of highly diverse assets on a giant tidal wave.

Worries about greater churn of stocks and securities held by ETFs have been a more familiar headache as regulators and others fret about high frequency trading, excessive stock turnover and ultimately the withdrawal of longer-term, more conservative investors from equities.

ARBITRAGE DRIVEN

And some evidence of a link has now been identified.

A paper published this week by economists at Ohio State University, University of Pennsylvania and University of Lugano concluded that U.S. stocks owned by ETFs displayed much higher intraday and daily volatility over the 12 years to 2012.

Train Tragedy



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"We estimate that an increase of one standard deviation in ETF ownership is associated with an increase of 16 percent in daily stock volatility," authors Itzhak Ben-David, Rabih Moussawi and Francesco Franzoni wrote. "The driving channel appears to be arbitrage activity between ETFs and the underlying stocks."

Arbitrageurs are continuously seeking to make money from spotting temporary anomalies in financial pricing and in practise this activity increases whenever there is a significant deviation between the ETF price on the exchange and the net asset value of the underlying stocks.

The study sketches a scenario where there is a large sale of ETF shares by an institution, arbitrageurs buy those ETF shares and hedge their position by selling the underlying stock. And high turnover means that position can reverse quite quickly.

"Due to their popularity among retail and institutional investors for speculative and hedging purposes, ETFs are increasingly exposed to non-fundamental demand shocks," the authors said. "If arbitrage is limited, these shocks can propagate from the ETF market to the underlying securities."

In short, the very existence of the ETF and the pricing anomalies it creates can generate a level of churn and volatility in the larger, more liquid stocks heavily owned by ETFs for no particular reason related to the company's valuation.

The concern then is that higher volatility deters investors who would otherwise be more stable long-term equity investors.

ETF managers reckon the volatility impact is small and overstated and dwarfed by the activity of other fund groups.

"ETFs' selling has on certain days added pressure to the market. But in terms of money going in and out, mutual funds are far more substantial," said Fran Rodilosso, fixed income portfolio manager at Market Vectors ETFs.

NOISE TRADERS

What's more, another study this week by University of Pennsylvania economist Robert Stambaugh said the sharp decline in share of the U.S. equity market owned directly by individuals and households - from about 48 percent in 1980 to some 20 percent almost 30 years later - had sharply reduced related 'noise trading' and resultant 'mispricing'.

By extension, Stambaugh reckons this has led to less mispricing and undermined the performance of active managers who beat the market by exploiting that - and also undermined the fees they charge as investors migrate to more passive vehicles.

While nearly all equity mutual fund assets were actively managed in 1980, that share was down to 83 percent by 2012. The actively managed share of institutionally-owned equity fell to 59 percent in the 20 years to 2006.



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So, whether more volatile or not, the drift to passive investing and ETFs may well just be a function of better-priced markets over time.

(Editing by Ruth Pitchford)

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