New City Initiative

Passive or Aggressive? Why the Growth In Tracking Products Should Concern the Industry and Investors

Prepared for the New City Initiative by Charles Scott-Plummer and Andrew Sykes

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The NCI is a think tank whose members are some of the leading wealth and asset management firms in the City and Continental Europe. Founded in May 2010 at the initiative of Daniel Pinto, Chairman and co-founder of Stanhope Capital, the NCI aims to articulate the views of the many entrepreneurs who have set up businesses whose success rests upon remaining entirely focused on and aligned with the interests of their investors.

We at the NCI have undertaken a series of meetings with senior regulators, government officials and industry participants, with the aim of working together in a dispassionate atmosphere. Our first aim is to develop solutions to make the financial system safer both through better regulation and also by encouraging a greater alignment of interest between decision-makers and their clients. Secondly, we aim to be a source of ideas and initiatives on ways of rebuilding the bridges between the financial sector and society at large. We believe that the financial SME sector benefits the system from the bottom up through better risk management, diversity and innovation.

This paper was prepared on behalf of the New City Initiative by Charles Scott-Plummer and Andrew Sykes of Senhouse Capital.

Introduction

The explosive growth of Exchange Traded Funds (ETF) over the last decade is the latest in a long line of financial innovations to come out of the investment banks who, over the last five years, have seen many of their traditional revenue streams evaporate. Behind these apparently simple, easy and cheap financial vehicles there are armies of traders employed in their ‘construction’. It would not be too far from the truth to say that swaps, futures and stock lending departments now rely for their very existence on the increasing appetite for the ETF.

The purpose of this short note is to point out the downside of this latest of financial innovations. The marketing and lobbying muscle of the investment banking fraternity has been extremely effective at highlighting the advantage to investors of the ETF. The potential downsides of these instruments are less often heard.

Since Jack Bogle launched the *First Index Investment Trust* in 1976, assets in tracking products have grown from just $11 million to over $1.5 trillion today.[1] Whilst these funds initially focused on equity indices such as the S&P 500, there has recently been an explosion of products in more esoteric and illiquid markets, with ETFs accounting for a large proportion of this growth (ETF AUM has increased by 40% p.a. over the last decade).[2] Investors can now buy ETFs in anything ranging from agricultural commodities to one providing leveraged exposure to volatility.

The growth of ETFs has been embraced with relish by the financial services industry and such products now constitute a highly profitable earnings stream. For investment banks, profit margins on ETFs are significantly higher than on traditional actively managed products. Beyond management fees, issuers make extra profits through securities lending, swap origination and futures sales. The high profitability of ETFs creates a powerful incentive for issuers to continue aggressively expanding the number of markets and assets that ETFs purport to track, regardless of whether this is to the benefit of investors and securities’ markets in general.

Good ideas taken too far would be an apt summary of the history of financial innovation. While the ability of investors to gain exposure to a broad array of asset classes at a low cost should be seen as a positive development, the enormous increase in both the scale and scope of ETFs brings with it a number of dangers, which need to be considered by both investors and regulators. Such dangers affect both broader market participants in the form of higher volatility and higher stock correlations, as well as higher valuations of indexed stocks. Investors in ETFs are also exposed to counterparty risk and in certain asset classes, returns far below those of the underlying assets.

[1] ETF Landscape, Global Handbook Q4 2011, BlackRock

[2] Financial Stability Board, “*Potential Financial Stability Issues Arising From Recent Trends in Exchange Traded Funds*”, April 2011

1. Misallocation of Capital

When the indexing industry was small, index funds and ETFs could purchase shares with little price impact. The sheer volume of assets that are now invested in this 'indiscriminate' fashion has meant that an enormous volume of stocks are bought and sold when an index is being rebalanced simply to ensure that a financial instrument is not mismatched with a benchmark, and with no consideration to the price being paid for an asset. There is evidence that this is having a distortionary impact on stock values, with stocks that are heavily owned by index trackers selling at an increasing premium to those that are not. For example, from 1990 to 2005, new additions to the S&P 500 rose by almost 9% around the time of their inclusion.[3] Other studies suggest that the price premium on index stocks may be as high as 40% and has been growing over time.[4]

Beyond the effect that indexation has on simple price premiums paid for index stocks, correlations of assets have increased. While the blame for the greater correlation of assets can be laid mostly at the feet of developed country central banks, the tracking industry is by no means blameless. Jeffery Wurgler from the NYU Stern School of Business finds that: "*The return pattern of the newly-included S&P 500 members changes magically and quickly. As if it has joined a new school of fish*." The problem with the increased correlation of assets is that mixed and confusing signals are communicated to capital. The results are twofold, and to a certain extent competing: firstly, 'inertia' because finance directors and investors cannot be sure of the true cost of capital to input into their financial return models and thereby opt to sit on their cash. Secondly, 'misallocation of capital' as investors are forced to speculate, creating asset bubbles and destroying wealth.

Finally, for the investment management industry to be relevant to society it must fulfil a dual role: increase the size of its customers' savings for retirement by ensuring that the capital for which it is a steward is allocated diligently. The tracking industry has a direct and pernicious side effect which, over the long term, will reduce the long term ability of the investment industry to fulfil its proper function. The tracking fraternity have swung the perception of risk to being short-term performance relative to randomly selected benchmarks or indices. As the old cliché runs, "*One cannot eat relative returns*", so is it logical that CIOs of Life Companies now make investment decisions informed by whether or not a company is included (or not) in an index? In a saner world, such a decision would be made taking into account a company's prospects and the price its shares trade at. On the basis that fundamentals will always reassert themselves, this is the only way to ensure risk is managed properly and capital allocated correctly. By favouring the growth of the passive industry over its active counterparts, regulators and tax authorities play a significant role in distorting markets

[3] Petajisto, A, "*The Index Premium and Its Hidden Costs for Index Funds*", NYU Stern School of Business, 2010
[4] Morck, R and Yang, F, "*The Mysterious Growing Value of S&P Index Membership*", 2001

which will only be detrimental to savers in the long term. There is a strong case to be made that in the long-term, genuinely active investment managers who are allowed to allocate their capital unencumbered by ‘career risk’ or tightly-focused investment mandates will deliver returns superior to the average.

2. Market Volatility and Increased Speculative Activity

The advantage that an ETF tracking the FTSE has over a simple ‘tracker’ or mutual fund is that it can be traded minute by minute, as opposed to once a day. ETF ‘investors’ can change their view on the general direction of UK stocks a hundred times a day and trade accordingly through a FTSE ETF. Along with High Frequency Traders, these investor-traders bring to bear a vast amount of capital in stock markets that may never have interviewed a finance director or opened the annual report of the companies in whose stocks they trade. For example, “SPY”, the world’s largest ETF trades approximately 33% of its shares each day, suggesting an average holding period of only three days. This is an extreme example of the broader global trend toward shrinking investment horizons; average holding periods across international markets have fallen dramatically in the past thirty years, plummeting in some markets to as low as six months.[5]

When the number of buyers and sellers in an ETF are closely matched, they can be netted off, meaning the “Authorised Participant” or AP (in charge of creating and redeeming ETF shares), needs to do little buying and selling in the underlying securities. However, when there are many more buyers or sellers of a particular ETF, then the AP, not wanting to take market risk, will buy or sell the underlying securities. As ETFs make it much easier to make short-term speculative bets on hundreds of underlying securities, such imbalances are likely to be a source of increased market volatility. Indeed, large sell orders on SPY were cited as a contributory factor in the joint report by the US Securities and Exchange Commission and the Commodities Futures Trading Commission into May 2010’s “Flash Crash” in which the Dow Jones plunged 9 per cent.[6]

Although ETF’s represent only a small portion of US market capitalisation, they account for roughly half the trading volumes on US markets today.[7] The main point here is that the growth in the ETF industry has gone hand-in-hand with the increased proportion of trading volume, by percentage of the total, that could be deemed more opportunistic than long term. In other words, the day-to-day turnover of the markets are, at present, in the hands of those who do not see themselves as owners in the businesses of the stocks they trade. This fact alone should be enough to have regulators looking more at the distortions this creates to the governance and long-term cost of capital for all businesses.

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[5] Haldane, A, “*Patience and Finance*”, Bank of England 2010

[6] “*Findings Regarding The Market Events of May 6, 2010*”, SEC and CFTC Joint Report, September 2010

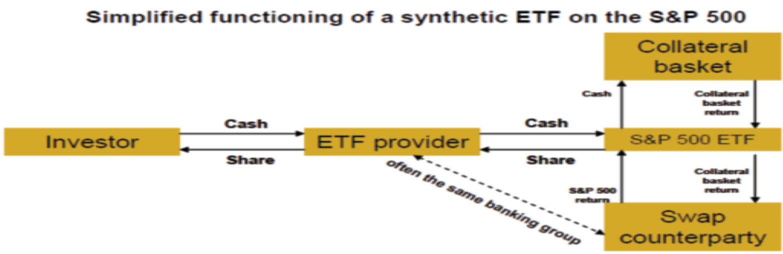
[7] “*ETFs and the Present Danger to Capital Formation*” – Prepared Testimony by Harold Bradley and Robert E. Litan Before the United States Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance and Investments, October 2011

1. Counterparty Risk

Broadly speaking, there are two main structures for ETFs: physical and synthetic. Physical ETFs replicate the index by simply holding a basket of securities that mirrors the underlying index. Until recently physical ETFs constituted the vast majority of industry assets. While this is still the case in the US, more liberal regulation in Europe has meant that synthetic ETFs now constitute just under half the market (with a growing share in Asia).

Synthetic ETFs attempt to mirror the underlying market return by entering into an asset swap. Investors exchange cash for ETF shares, which are then invested in a collateral basket (where the underlying assets often bear little relation to the index being tracked), whose return is then swapped for the return of the market. Such a structure is attractive for ETF providers as it adds additional revenue streams through the sale of swaps and futures to the ETF. Although sold as a lower cost alternative to physical ETFs (because of reduced trading costs), such an arrangement is likely to benefit the issuing bank, rather than the underlying investor and is prone to a number of principal-agent problems.

Figure 1[8]



Given the mismatch between the collateral basket and the underlying index, such a structure opens investors up to counterparty risk in the event of the failure of the issuing bank. Although one would expect the failure of an ETF issuer to be extremely rare, it is still a risk borne by investors. It could be considered equivalent to owning the underlying index, whilst writing a CDS on the issuing bank. To paraphrase a much used analogy, investors are picking pennies up in front of a steamroller, but then handing them over to the bank standing alongside them.

[8] Page 3, "*Potential Financial Stability Issues Arising From Recent Trends in Exchange Traded Funds*", Financial Stability Board, April 2011. Reproduced by kind permission

The potential for investor losses in the event of issuer failure can be reduced by policies such as over-collateralisation. However, there is an incentive for issuing banks to use lower-quality and/or illiquid securities in the collateral basket (using the ETF as a low cost source of funding). Such assets would be likely to face large haircuts in stressed financial conditions, making it difficult to quantify the risks being borne by investors. Recent attention to the risks of synthetic ETFs has led a number of providers to supply more detailed disclosure on this front. However, the lack of regulatory oversight on industry standards is still behind the curve.

When looking at the risks of synthetic ETFs, it should be remembered that physical ETFs (as well as other investment vehicles) are also exposed to counter-party risk through securities lending. This practice is widespread in the investment community, but is another issue that has not been systematically addressed by regulators.

2. Poor Tracking Performance

ETFs of the main global equity indices generally have a low tracking error, whether they are synthetic or physical. However, this is often not the case with those that attempt to replicate the performance of other asset classes. For example, the average high-yield bond ETF has underperformed its index by an average of 5.5% per annum over the last five years.[9] Such underperformance is most likely explained by high transaction costs resulting from high index-turnover and wide bid-ask spreads on the underlying bonds. At the very least, investors in ETFs should not automatically assume that their future returns will be the same as the return on the underlying index, especially in more illiquid assets such as high-yield bonds.

Even more disappointing has been the plethora of commodity ETFs, which in aggregate have lagged significantly behind spot prices. For example, since January 2007, the PowerShares DB agriculture fund has returned 3%, as opposed to the 19% increase in the underlying commodities. Similarly, the biggest oil ETF, the US Oil Fund, has dropped 50% since it started in April 2007, even as crude oil has risen by 11%. The main reason for such poor performance is that the majority of commodities have consistently been in contango (where future prices are above spot prices). This means that when funds have to roll their futures forward, they suffer an immediate loss. There is evidence that the massive amount of investment that has flown into commodity ETFs is one of the chief causes of the current contango, suggesting that the rise in commodity ETFs has been key factor in their poor performance. Whilst such risks are at least mentioned in their prospectuses, there is definitely a case to be made that commodity ETFs have been miss-sold, especially to retail investors.[10]

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[9] "*Warning on high-yield ETF Returns*", Steve Johnson, FT Online, March 11, 2012

[10] "*Amber waves of pain*", Peter Robison, Asjylyn Loder and Alan Bjerga, Businessweek, July 22, 2010

Conclusion

As the recent past demonstrates, financial innovation should not go hand in hand with self-regulation. Although regulators are beginning to look more closely at the dangers posed by ETFs, the burden of proof should be placed on the issuers themselves, who need to convincingly demonstrate that ETFs do not present a hazard both to the orderly functioning of financial markets and to the underlying investors in ETFs.

The recent consultation by the European Securities and Market Authority (ESMA) begins to address some of the issues mentioned above, such as collateral standards and the suitability of certain products for retail investors, although the final details have yet to be released. It does not however, look at the broader market implications discussed above, such as higher levels of volatility and correlations that ETFs may be causing. Investors need to bear in mind the potential problems that these developments create, but also be open to the increased opportunity set that such distortions are creating for long-term, active managers, such as:

1. Increased correlations. It is frequently asserted that this development may lead to the death of active management, the argument being that the value of stock picking is reduced once stocks move increasingly together. Such a viewpoint exemplifies the short-term mindset that is endemic in the financial industry. In reality, higher correlations should benefit active managers. If all stocks move in concert, regardless of developments in the underlying companies, this will increase the frequency of valuation discrepancies, leading to greater opportunities for long term, active stock-pickers. Benjamin Graham characterised the stock market as a voting mechanism in the short-run, but a weighing one in the long run. To be sure, increased correlations have made markets more of a herding mechanism in the short run; in the long run one would expect stocks to revert to their intrinsic value.

2. Overvaluation of heavily indexed stocks. As mentioned above, valuation anomalies caused by indexing may, when combined with short-term performance pressure, create incentives for active managers to more closely track their indices. Those with a more long-term, genuinely active approach however, should benefit from such valuation discrepancies, by investing in areas that are less heavily indexed.

Endnote

This short paper has emphasised that as the financial industry has become dominated by a short-term mindset, complex products which potentially destroy value for investors and in some cases, expose them to hidden risk, have emerged as a powerful market force. The concepts of ownership and responsibility have become disconnected from one another, as the "ownership" of assets has become increasingly fluid and shareholders have become increasingly distant from corporations whose assets they hold.

This disconnect presents a real danger to investors, markets and society as whole, which, as is painfully evident from the events of the past three years, remains highly vulnerable to turbulence in the financial world. As investment horizons continue to shrink, volatile markets and value-destruction seem inevitable side-effects, a situation which policymakers, regulators and especially those in the industry should take seriously.

The New City Initiative believes that encouraging responsible behaviour is as important to the health of our financial system and society as careful, proportionate regulation by authorities. One of the principles on which the New City Initiative was founded was that a greater alignment of interest between investors and the firms that serve them necessarily serves to restore the trust and stability that has gradually ebbed out of the finance industry. The independent firms which make up the NCI's membership practice this alignment, to varying extents, but it is a principle which remains sadly under-subscribed in the broader financial community, a situation which exacerbates the "responsibility" deficit present in today's markets. Restoring a culture of "responsible ownership" and accountability is a challenge to which the industry must rise and soon.

Previous NCI Position Papers

"*Alignment of Interest: Fixing a Broken City*" – August, 2010

"*Start-Up Britain is here in London: Why it is vital to protect Financial SMEs*" – October 2011

For copies of these and other publications, please see www.newcityinitiative.org

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Patron: The Rt. Hon. The Lord Mayor Of London

Contact: Derek Laud

35 Portman Square, London W1H 6LR
Telephone: 020 7725 1888 email: secretariat@newcityinitiative.org
www.newcityinitiative.org

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