

FTfm Exchange Traded Funds

ETF growth is 'in danger of devouring capitalism'

The rise of passive investment vehicles is reshaping the finance industry



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Robin Wigglesworth YESTERDAY

Last spring something odd happened to a host of small US gold miners. Their stocks declined unexpectedly, despite the price of the lustrous metal hitting a five-month high at the time.

The dips were not caused by any of the usual reasons such as poor earnings statements, or signs of a waning appetite for gold among New York socialites, Indian brides or Chinese hoarders. Rather, they fell because of the swelling importance of exchange traded funds.

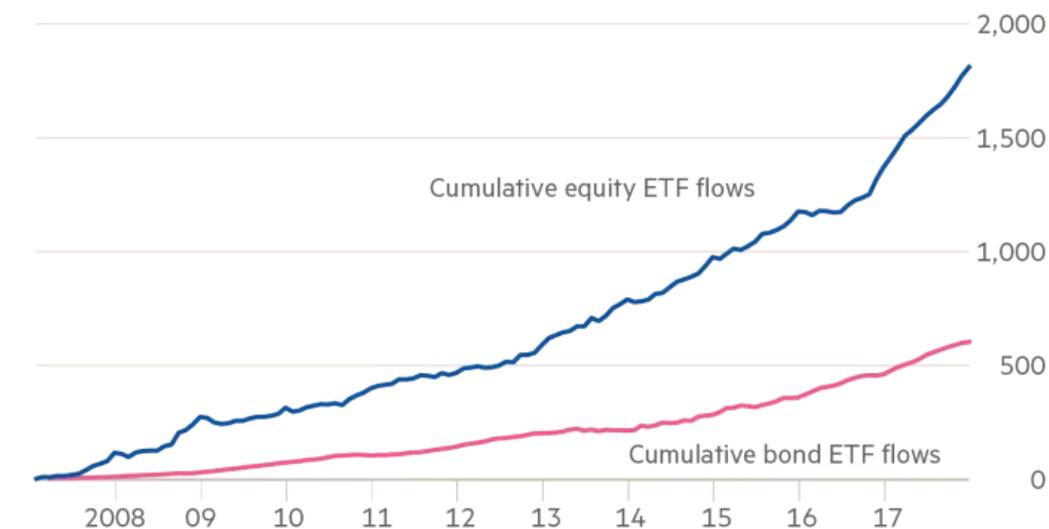
These odd ructions in the stock price of a few gold miners is an under-appreciated but potent example of how ETFs are having a mounting and sometimes unintended impact on markets, even as they save investors around the world billions of dollars worth of fees that would otherwise go to traditional fund managers.

ETFs are passive investment vehicles that combine the cheapness of index trackers, which merely attempt to mimic the returns of an underlying benchmark, with the trading ease and convenience of a normal stock.

Last year ETFs saw record growth and took in over \$460bn globally. That amounts to nearly \$1.8bn of new money every working day of the year. In 2018, the global ETF industry will almost certainly cross the \$5tn mark for the total value of funds invested.

Investors plow billions of dollars into ETFs

\$bn



Source: EPFR
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This shift out of traditional, “active” money management is one of the most profound changes to the global financial system in history and is now powerful enough to rewire how [markets function](#). Many big investors are worried about the implications.

“Passive investing is in danger of devouring capitalism,” Paul Singer, the founder of Elliott Management, one of the world's biggest hedge funds, said in a [letter to investors](#) last year. “What may have been a clever idea in its infancy has grown into a blob which is destructive to the growth-creating and consensus-building prospects of free-market capitalism.”

In the case of the gold miners, a single fund, the VanEck Vectors Junior Gold Miners ETF, was causing the mysterious movements.

Its popularity meant that it had grown too big for the index it tracked, butting up against [regulatory ceilings](#) on how much of a company it can own. So in April last year, MVIS, Van Eck’s index business, decided to change the benchmark — nearly doubling the market value of gold miners it was allowed to invest in. That led other traders to anticipate that some companies would subsequently drop out of the index, pushing their shares lower.

Although it only affected a small corner of financial markets, and went largely unnoticed at the time, the event is a potent example of how the rise of ETFs is not just challenging traditional asset managers but starting to reshape markets in small but profound ways. The US equity market is the furthest ahead in this march towards passive investing, but nearly every market is now undergoing a quiet revolution.

“We can no longer be the fundamental investors we want to be,” complains Federico Kaune, head of emerging markets fixed income at UBS Global Asset Management. In addition to the usual array

of macroeconomic data, he now makes daily checks on the inflows and outflows of ETFs — an absolute necessity in the age of passive investing. “It has dramatically changed the fabric of markets, no question,” he argues.

These concerns have been growing for a while. But over the past year the debate has expanded in tandem with the record-breaking ETF inflows.

Regulators are also exploring some of the challenges raised by this growth more closely. In September the US Securities and Exchange Commission hosted a [one-day conference on ETFs](#), where various academics, analysts, regulators, lawyers and investors pored over their effects on financial markets.

For example, Itzhak Ben-David, a finance professor at Ohio State University, [presented a paper](#) that showed that when a company joins a major index both its ETF ownership and volatility goes up, and when it leaves its ETF ownership and volatility goes down. “No one doubts this [the ETF] is a great innovation, but at the same time it could have some unintended consequences,” Prof Ben-David said at the conference.

We can no longer be the fundamental investors we want to be

Federico Kaune, head of emerging markets fixed income at UBS Global Asset Management

In perhaps the most high-profile attack on passive investing, Inigo Fraser-Jenkins, a senior analyst at research house Bernstein, sent out an note to clients in 2016 arguing that it was “worse than Marxism”, given that communists at least tried to allocate capital efficiently. The reactions in the passive investment industry were predictably scornful.

“I'd say consumers choosing better products at a cheaper price is the very essence of capitalism,” says Jim Rowley, senior investment strategist at Vanguard.

Mr Rowley says he and his colleagues have exhaustively examined whether ETFs are affecting the structure of markets, influencing correlations and volatility, and have concluded that there is nothing untoward going on. “Any changes have more to do with business trends rather than capital markets trends,” he argues.

There have been times when ETFs have been at the centre of some turbulence. On [August 24 2015](#), markets were thrown in a tailspin by fears over China's economy, with the turmoil exacerbated by chaotic trading in many ETFs. “That was a pretty bad day, no question about it,” admits Jim Ross, chairman of State Street's SPDR exchange traded funds business.

The industry has banded together with market-makers and exchanges to resolve most of the technical issues thrown up by the tumult but Mr Ross remains concerned that some kind of rerun

is likely. “We’ve got a lot of stuff done since then, but we’ll eventually have another event like that,” he says.

However, while the ETF industry is resigned to being blamed for future market mishaps, there is little evidence of it being the core cause of turbulence and there are few examples of ETFs significantly worsening a sell-off.

Indeed, the experience of correlation within share indices is a good example of how one major criticism of passive investing has recently proved to be misguided.

In the era following the financial crisis, individual stocks started moving increasingly in tandem, frustrating fund managers that depend on idiosyncratic movements to beat their benchmarks. Blame was apportioned to central banks’ aggressive monetary easing and the rise of ETFs. However, [correlations have reversed](#) over the past year — despite the money still rolling in to these funds.

That traditional hedge fund or mutual fund managers — and analysts that depend on their business — find faults with ETFs and passive investing is understandable and natural. Much of the money pouring into the industry has seeped out of active funds, leading to [tightening pressure on their fees](#).

The average net expense ratio of US equity mutual funds fell to 1.13 per cent last year, compared with 1.44 per cent in 2000, according to Morningstar, a data provider. Competition from ETFs has been less intense in fixed income field, but is now on the increase, pushing down the average cost of administering US bond funds to 0.91 per cent in 2017, from 1.14 per cent over the same period.

ETFs have, therefore, saved investors many billions of dollars both directly and indirectly, through the price pressures they have put on traditional asset managers.

That is not to say that the ETF industry itself is in a universally comfortable position. A mounting price war is biting margins and, with most of the money flowing into the “big three” — BlackRock, Vanguard and State Street — many providers are having to shut funds that fail to gather enough assets.

Active managers have also enjoyed an [upswing in performance](#), and lower fees make many mutual funds more attractive to investors keen on trying to do better than their benchmarks.

Nonetheless, few would be foolhardy enough to bet against the ETF industry enjoying another banner year.