ETFs – Ride the Wave or Has the Bubble Burst?

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What are They?

Exchange Traded Funds (ETFs) are baskets of securities that track a particular index or market segment. ETFs are akin to mutual funds in that they provide a diversified portfolio of securities versus holding and purchasing them individually. They trade like a common stock on an exchange and similar to stocks they trade throughout the day, thus allowing real-time market access. In contrast a mutual fund trades only at the end of the day based on the net asset value. This is calculated using the value of the closing prices of all of the stocks held by the mutual fund. That total value is then divided by the number of shares outstanding to compute the net asset value or NAV per share of the fund.

Are ETFs Popular?

ETFs have exploded in popularity over the last ten years due to their diversification benefits, low fees and the additional liquidity that comes with all day trading access. With the surge in online investing, consumers expect real-time data on their individual stocks and funds. As an added benefit, ETFs are more tax efficient because there is little turnover in the underlying positions, thus reducing trades that trigger capital gains. The value of all ETFs has grown to nearly $2 trillion, up from a little over $300 billion 10 years ago, and they comprise nearly one-quarter of all trading activity. BlackRock, one of the largest providers of ETFs, generated approximately 29% of its revenue from ETFs last year.

Sounds Great. What's the Catch?

Like most investment alternatives, especially those that see a sharp rise in popularity, ETFs have increased in complexity and diversity. Some newer ETFs do use an active management style. Individual investors therefore need to be educated and diligent in determining the best fit for their investment portfolio.

Last month, market volatility exposed an anomaly in some ways tied to ETFs meteoric rise in popularity. On August 24th, ETFs fell short of their promise of added liquidity. They saw a sharp decline in share price that was not aligned with the drop in the stock prices of the underlying securities. On this day, the DJIA dropped over 1,000 points minutes after the market open. Trading halts were instituted for individual stocks and subsequently for ETFs. During this volatile period, some ETF prices dropped far more than the real value of the securities that comprise the fund. As one example, Blackrock's iShares ETF (DVY) was down over 30% while its top three holdings were down less than 3%. This brought to light concerns as to how liquid ETFs actually are in times of market stress. During more volatile times, stodgy mutual funds don't look too bad, as they are not vulnerable to real-time volatility given their end of day pricing.

What is the Explanation?

While the causes are still being investigated, the lack of pricing transparency is at the heart of the problem. Many stocks were halted that Monday morning, thereby making it difficult for market makers to price ETFs accurately. A trading halt in an individual stock interrupts the process whereby ETFs track the underlying equities, and hampers a trader's ability to make proper markets. Market makers are a key component in providing a liquid market for ETF trading and without price clarity on stocks that make up an ETF, they are unable to facilitate normal trading.

As a result, the market was reliant on market orders to dictate prices at which ETFs traded. Compounding matters, many sellers had automated stop-loss orders in place. Stop-loss orders stipulate that when a stock hits a certain price, the security must be sold at any price, no matter how low or unclear that price may be. On August 24th, an inordinate number of ETF sell orders were filled. If the ETF price had truly tracked the market, many of those orders would not have been triggered.

Selling at such an extremely discounted value to the underlying investments is not likely what sellers intended. They simply had orders in place to sell if the ETF fell by a certain percentage, not expecting that the price would move so far from true value. A better strategy for investors would be to submit a limit order, which would only fill at a specific price or better. There is speculation that these types of orders were also the result of large automated computer driven trading, yet another factor in what is being dubbed a "flash crash".

What Next?

Although trading that day returned to normal within about 30 minutes, there may now be more caution around ETFs resulting from what we saw on August 24th. This lapse in liquidity is of great concern to ETF providers because the product is so popular with retail investors. Market participants are examining ways to maintain the flow of pricing information and trading for all securities; this may mean taking a second look at regulations governing trading procedures. This incident also highlights concerns about how bond ETFs will trade if investors are anxious to sell amid interest rate rises. It is a complex problem as the issue has more to do with the market's actions than the structure of the ETF product itself.

Should Investors Buy ETFs?

How does an investor decide between mutual funds, ETFs and individual securities? The answer depends on personal objectives and the size of the portfolio. For larger portfolios, individual securities will give you the most control and eliminate fund and management expenses. When structured properly, a portfolio can also be well diversified when using individual securities. However, even in a portfolio holding mostly individual stocks, a few funds are beneficial to allow for added liquidity or to provide flexibility when rebalancing. For smaller nest eggs, the use of a fund is more practical to achieve diversification and for those that do not have the time or desire to do stock research. Both ETFs and mutual funds are viable options for investors. Investors need to understands the differences and weigh the benefits of each. Time horizon, objectives, risk tolerance and investment style dictate whether the ETF or a mutual is the better fit. Even with the recent misstep in trading, ETFs can be an attractive investment option in some portfolios.