ETFs, ETPs, and Passive Management: Unmitigated risks?

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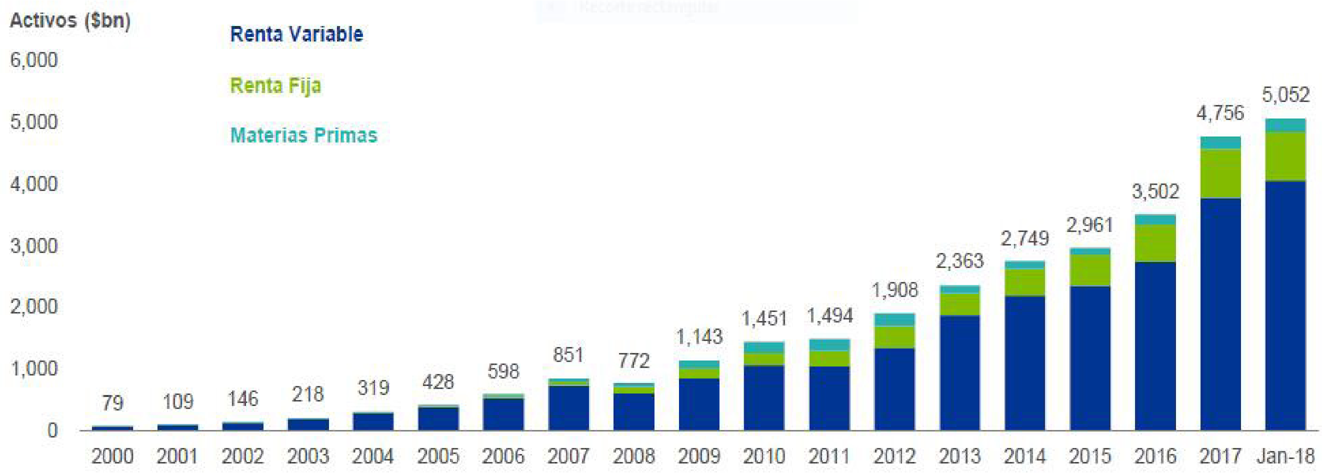
Recent regulatory changes coupled with the constant pursuit of lower management costs has led to a sharp increase in passive management and ETPs (Exchange Traded Products) which, in the last four years, have double in investment volume. Last year alone, ETPs grew by USD 1.2 billion (+36%), 97% of which are ETFs (Exchange Traded Funds).

Graph 1: Global ETP Market.



Source: ETP Landscape, BlackRock.

These types of products, which trade on security exchanges, aim to replicate the composition of a given index in order to gain exposure to a particular index or market quickly, efficiently, and inexpensively. Twenty-five years have passed since the first ETF was launched in 1993, and over time, the degree of sophistication and complexity has advanced significantly. These days it is possible to buy ETFs that simply replicate indices, like the IBEX 35, or leveraged structures in derivatives that multiply the behaviour of the underlying index several times, or indices of commodities, bonds, volatility, and even active investment strategies or investment strategies by factors.

This situation is transforming the foundations of investment, affecting everything from the decision-making process to the composition of many indices and markets. Some investors, like famed philanthropist Carl Icahn (known for the hostile takeover of TWA in the mid-1980s, among other operations), have warned of the dangers of these types of instruments. They argue that when investors channel their bets through indices, without examining the fundamentals of each company or the components of the market in which they are investing, they help divert the share price from the fundamental value of the assets, leaving their positioning exposed to greater vulnerability vis-à-vis any unforeseen change in expectations. They also caution against the formation of "price bubbles" in certain assets, as well as a lack of liquidity in some markets totally influenced by "new trends" that often decouple the share price from the fundamental value of the asset.

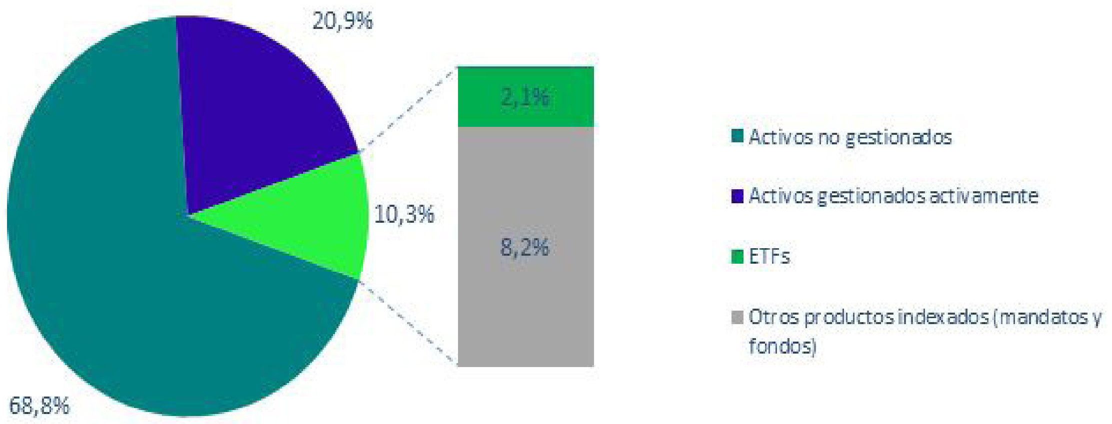
In fact, in early February alarms sounded upon learning of Credit Suisse's decision to liquidate its ETN XIV Velocity Inverse VIX Short-Term, after plummeting more than 80% and volatising nearly USD 3 billion. The publication of a US wage figure that exceeded estimates, caused the VIX volatility index on the S&P 500 (the inverse reference of this product on which the price variation multiplied three-fold) to experience the highest one-day spike of all time by triggering massive volatility purchases and precipitating the collapse of the product, in addition to sharp declines on the stock indices.

The occurrence of these events gives us a good opportunity to put the facts in perspective and argue our view that, despite strong growth in passive management and ETFs, they still only represent a limited portion of the overall market and we believe that they are not to blame for all the evils of the market.

It is important to note that one of the main reasons for the emergence of this type of product are certain regulatory changes that have taken place in recent years. While Basel III and the Volker Rule (approved in the US) aim to increase the capital requirements of financial institutions and reduce the ability of banks to maintain direct bond inventories, the US Department of Labor (DOL) rule, the RDR and MiFID II in Europe have increased the fiduciary responsibility of advisors and forced an increasing reduction in the cost of the instruments used to invest in many portfolios, thus boosting the appeal of ETFs.

Despite the strong growth reported, total assets in indexed products currently account for 10.3% of investable products overall, a figure that underscores the alarmist supposition about the prevalence of passive management.

Graph 2: Proportion of indexed products vs. total assets.



Source: Bank of International Settlements, Strategic Insight Simfund, BlackRock, Bloomberg (8/2016).

Moreover, it is interesting to note that active management strategies continue to have higher turnover ratios. Using as an example the US equity market (which has the highest ETF use rate—7.6% vs. 1.5% in Europe), at present 22 dollars are traded by active managers for every one dollar traded through indexed management.

At Banca March, where we have always been characterised as active management investors, picking and managing products based on a rigorous analysis process and our market forecasts, we believe that in some circumstances (ie: for tactical positioning, niche markets, or remarkably efficient indices), it makes sense to complement the management process by channelling investment ideas through indices. One must be especially meticulous in the selection process because not all products are the same, and although ETFs currently comprise 97% of the global ETP market, determining the counterparty risk of each product is essential to avoid issues like those that arose earlier in the month.

ETP	Exchange Traded Products	Features	Counterparty Risk
ETF	Exchange Traded Funds	Account for 97% of the ETP market. Important to determine if the structure is one of physical replication (where the structure buys each of the securities on the index) or synthetic replication (where various SWAPs are traded to receive the index yield).	Minimum risk for those of physical replication, only through securities lending. Those of synthetic replication assume the counterparty risk diversified between each of the component SWAPs.
ETN	Exchange Traded Notes	Debt instrument in which the issuer receives the index yield synthetically.	Both the credit risk of the issuer and the risk of the included derivatives are assumed.
ETC	Exchange Traded Commodities	Backed by physical metals.	Guarantee of the physical asset.
ETI	Exchange Traded Instruments	Any other type of traded structure apart from the above, such as SVPs. They account for less than 0.1% of all products issued.	TBD in each case.

As the table illustrates, it is very important to analyse whether the structure is one of physical or synthetic replication in order to mitigate counterparty risk.

Surely, despite the strong growth reported, passive management will continue on the upswing before posing a formidable threat to the market.