Emerging Threat Funds?

ETFs promise cheap diversification, liquidity, and perhaps unintended consequences for systemic risk

BY JOHN RUBINO

IT'S BEEN A QUIET REVOLUTION BUT A REAL ONE. Exchange-traded funds (ETFs) have colonized pretty much every available niche in the investment world—frequently at the expense of traditional vehicles, such as mutual funds and hedge funds. And the land grab has apparently just begun.

Which means it's time to start thinking about unintended consequences. One of history's clearest lessons is that when financial innovation really gets going it tends to race ahead of regulators, who only catch up after an idea has revealed its dark side in some painful, sometimes system-threatening fashion. And while ETFs haven't reached the rarified heights of, say, mortgage-backed securities, they are raising a few red flags.

Extraordinary Growth

The ETF concept was born in 1993 with the introduction of the SPDR (pronounced "spider"), which contained a portfolio of stocks designed to replicate the performance of the S&P 500 Index. But unlike the index funds already popular at the time, SPDR traded like a stock. Where a mutual fund could only be bought or sold at the end of a day's trading, SPDR could be traded whenever the market was open. It could also be shorted and bought on margin, and its expense ratio was even lower than that of similar index funds. The result was a combination of cheap diversification and liquidity that caught the imagination of individual and institutional investors alike.

Since then, ETFs and their many cousins (more about these later) have attracted about US$1.3 trillion worldwide. And this was just the warm-up. Pension funds, for instance, seem to be discovering that ETFs facilitate some of their core functions, like moving in and out of cash, transitioning between managers, and stock lending. A recent Greenwich Associates survey found that 61 percent of pension fund respondents expected to increase their ETF holdings in the year ahead.

Fund management companies are rushing to tap this flow of capital by creating a slew of new ETFs. Sector funds are growing ever more precise, with virtually every market and niche either having or soon to have its own tracking fund. HSBC, for instance, recently launched four equity ETFs covering various stock markets in China, while Van Eck will soon launch an ETF tracking Mongolian equities (perhaps a sign that this trend is nearing completion).

The concept has also spread far beyond passive equity portfolios. Commodity ETFs tracking industrial metals, energy, and food are booming in Europe and the U.S. exchange-traded notes (ETNs) now apply the ETF structure to fixed-income instruments. Active ETFs, which manage assets rather than just composing representative baskets, are being introduced by a wide range of financial institutions (the term "non-transparent trading" will soon be on many lips).

And derivatives, of course, are being tossed into the mix, via leveraged funds in the U.S. that magnify the price action of underlying indices and synthetic funds—increasingly popular in Europe—that seek to replicate indices cheaply and accurately with total-return swaps.

It should come as no surprise that in a financial ecosystem this dynamic some problems might arise. Two in particular are worth watching: commodities volatility and synthetic ETFs.

Commodities Volatility

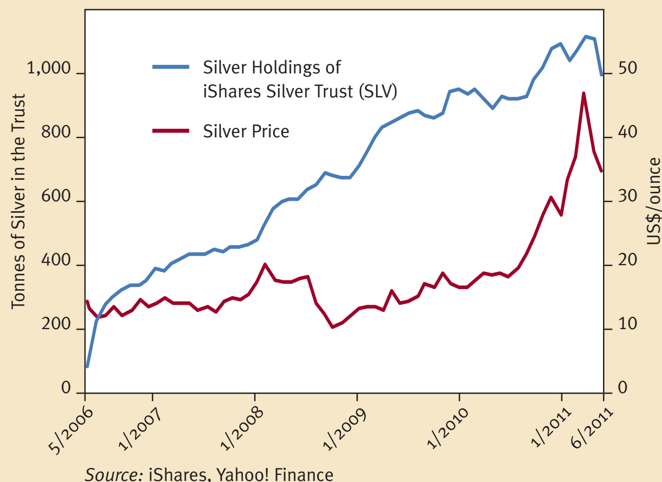
Not so long ago, investors who wanted to own oil, gold, or other commodities directly rather than through the common stock of producers had only a meager set of choices: Buy gold coins and figure out how to store them, or build a portfolio of oil or wheat futures. Neither was simple or easy for the typical investor, and many institutions are barred from owning physical commodities and are limited in their use of futures and other derivatives.

So ETFs that bought and held commodities or related futures contracts were an instant hit. The largest gold ETF—SPDR Gold Shares ETF (GLD)—now controls 40 million ounces, putting it in a class with the world's larger central banks. ETFs owning a vast array of other commodities have seen similar success both in Europe and the U.S., with total fund inflows of about US$6 billion worldwide in 2010.

This is where it gets problematic. The commodity ETFs that buy and hold are, in effect, consumers of their target commodities, which means they have an effect on price. "Commodity ETFs are certainly exacerbating volatility," says Tim Parker, a portfolio manager specializing in natural resources at Baltimore fund manager T. Rowe Price. "The original metals ETF, GLD, was not a problem. Gold has some industrial uses, but mostly it's just an investment. But now there are ETFs for copper, aluminum, iron—things that have an impact on the day-to-day economy. Why are we letting this product sit on the sidelines in an investing vehicle when it could help to continue economic growth?"

It's not clear how much of the recent surge in commodity price volatility is attributable to the emergence of ETFs. But the timing is interesting to say the least. Silver, for example, has more than tripled since the introduction of SLV, the first silver ETF. "You can't say there's causality there, but the volume certainly correlates very well," says Parker.

Silver ETF and the Price of Silver



Source: iShares, Yahoo! Finance

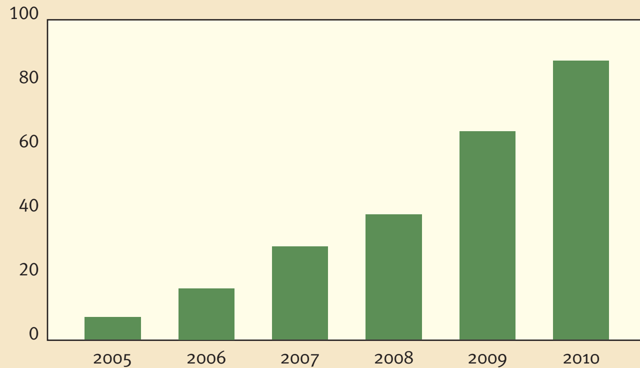
The resulting impact on the economy, at a time when the rising cost of living is causing riots around the world, might bring increased scrutiny—and criticism—to this sector in the future. "You could say that [physical commodity ETFs] just take productive assets out of the system for no other reason than speculation," says Christopher Aldous, CEO of London investment firm Evercore Pan Asset. "Recently, something like 80 percent of U.K. copper stocks was stuck in London Metal Exchange warehouses. I think it's bad for the economy and for the reputation of the whole market." [*Editor's Note: For more on the impact of commodity ETFs and the risks of ETF-driven speculation,* *see the interview with Prem Watsa, CFA, on p. 34.*]

Synthetic ETFs, Real Risks

A more complicated and potentially more serious question involves synthetic ETFs. Where a traditional ETF buys and holds a basket of stocks, synthetic ETFs aspire to achieve more accurate results at lower cost via total-return swaps. It works like this: A fund's creator produces collateral of some sort and then executes a swap with a counterparty in which the fund gets the future return on its target index (say, the FTSE 100), and the counterparty gets the return on the collateral or some other agreed-upon cash stream. If done right, a synthetic ETF tracks the underlying index more accurately (that is, it eliminates tracking error) and cheaply (because there's no need to buy and

maintain a representative list of stocks) than a physical ETF. Swaps also make it possible to track indices that are difficult to replicate physically because of illiquidity or an excessive number of securities.

European regulations are relatively friendly to derivatives, and as a result, synthetics are thriving there, with about 45 percent of the market.



Source: BlackRock, Bloomberg, Financial Stability Board

But with fast growth has come rising anxiety. In a recent report titled "Potential Financial Stability Issues Arising From Recent Trends in Exchange-Traded Funds," the Financial Stability Board (FSB, the G–20 body that coordinates financial regulators) raised several concerns, which have since been echoed by the IMF, Bank for International Settlements (BIS), and several prominent industry players. "While ETFs bring a number of benefits to investors and market participants," noted the FSB, "they may also generate new types of risks, linked to the complexity and relative opacity of the newest breed of ETFs. The impact of such innovations on market liquidity and on financial institutions servicing the management of the fund is not yet fully understood by market participants, especially during episodes of acute market stress."

Among the potential problems, three cause the greatest concern: conflicts of interest, investor confusion, and regulatory compliance.

CONFLICTS OF INTEREST. In theory, a synthetic-ETF investor has two guarantees that the fund will perform as advertised: the counterparty, which is contractually obligated to match the return of the underlying index, and the collateral, which can be sold to satisfy the claims of shareholders. But one possible synthetic-ETF configuration has an investment bank using its own assets for collateral and its own trading desk as the swap counterparty. This arrangement raises a couple of obvious potential conflicts.

First, the ability to choose the collateral creates an incentive for an investment bank to use balance sheet assets for which it otherwise has little use. "In return, they get an investor's cash, which can count as Tier 1 capital" (in effect, converting lower-quality equity collateral into high-quality capital), says Aldous.

Low-quality paper is hard to move in a crisis. An ETF forced to sell its collateral because of the failure of a counterparty might discover that the collateral is worth only a fraction of its face value.

Second, using the in-house trading desk as counterparty means that the same firm owns the collateral and is on the hook for the total-return swap. In effect, an investor becomes an unsecured creditor of the investment bank, not a position that most would voluntarily choose after the events of 2009.

INVESTOR CONFUSION. An individual investor may view an ETF as a straightforward, perhaps even boring, fund that buys shares of stock or physical commodities and holds onto them. Buying one is like acquiring actual shares or barrels of oil, except that someone else handles the paperwork and storage. Alas, this attitude is woefully outdated and potentially dangerous in a world of ETNs, leverage, and swaps.

"Since the complexity of ETFs has changed quite quickly and materially it is not clear that retail investors fully understand their underlying risks," states the FSB report. The report also notes that other types of vehicles listed on U.K. exchanges, such as ETNs and exchange-traded commodities (ETCs), are sometimes "marketed and perceived by investors as being equivalent to" exchange-traded funds, when in fact they work very differently and offer wildly varying risk profiles.

At the core of the debate is the "F" in ETF, says Julie Patterson, director of authorized funds and tax of the U.K. Investment Management Association, the trade group representing mutual funds and investment management. "If it's a fund, the assets—securities, derivatives, or whatever—are held by a custodian. They're not sitting on the management company's balance sheet."

But with some of the new synthetic ETFs, the assets are indeed held in-house. As a result, the ETF acronym is being used to cover things that are actually bank and insurance products, with assets that reside on the provider's balance sheet, according to Patterson. "We should refer to these as exchange-traded *products*," she says. "You're actually a creditor of the bank or insurance company."

This opacity and risk concentration harkens back to Wall Street's securitization debacle. "With Lehman and the other banks, the structured products just disappeared. It wasn't that their value fell like a mutual fund with the market. It's that they had no value," says Patterson.

REGULATORY COMPLIANCE. Under the European Undertakings for Collective Investment in Transferable Securities (UCITS) regulatory regime, the kind of one-stop ETF shop described above isn't allowed. "UCITS rules require not only that the fund's assets be held separately, but that an independent depositary oversees the operation of the management company. Also, the rules require that collateral be

liquid, of adequate quality, and held by a third-party custodian," says Patterson. So the above concerns aren't relevant for a UCITS compliant synthetic ETF.

But a number of synthetic ETFs are not UCITS compliant, and once a non-compliant fund is listed it can be bought by individual investors who don't have a team of analysts to tell which is which. "The customer is entirely in the hands of the ETF provider to give as much or as little information as it wants," says Aldous. "No ordinary consumer is going to understand that they need to ask about collateral, and may not understand the answer if they did."

Table 1 illustrates the difference between two otherwise similar-sounding ETFs. Both track the VIX index of stock market volatility, but "Barclay's VIX index is uncollateralized, except by the Barclays counterparty guarantee," says Aldous.

TABLE 1

	iPath S&P 500 VIX Short-Term Futures ETN (senior, unsecured, unsubordinated debt securities issued by Barclays Bank PLC)	**Source S&P 500 VIX Futures ETF** (UCITS III open-ended fund)
Expense Ratio	0.89%	0.60%
Swap Costs	—	0.15% to 0.20%
AUM	£1,324.5m	US$22.1m
UCITs III Compliant	—	Yes
Domicile	US	Ireland
Collateral	No	Yes
U.K. Reporting Status	No	Yes

Source: Evercore Pan Asset

Systemic Risks?

As leverage and concentration spread through the ETF universe, the entire financial system may become more fragile, with "significant implications for the normal functioning of financial markets," concludes a recent report by the BIS.

To understand how such a scenario might play out, assume that an investment bank is both an ETF provider and the fund's swap counterparty. The bank runs into trouble over unrelated activities, and the bad press causes a spike in redemptions at its ETF. This requires cash, which in turn requires that the collateral be liquidated. But that's not easy because the collateral—in this example, a portfolio of U.S. junk bonds and Japanese small-cap equities—is worth just a bit less than what the bank has estimated.

The resulting cash squeeze puts greater stress on the already-impaired bank, causing its creditors to withdraw funding. If it fails, the total-return swap will become worthless and the ETF's shareholders will be left with whatever the collateral brings during bankruptcy proceedings—if that. Then everyone else panics. As the BIS puts it, "The collapse of funding for individual financial intermediaries could then reinforce funding stresses for the financial system as a whole."

Or the investment bank might choose simply to suspend redemptions at its ETF, which would lead investors at every other ETF on the planet to demand their money back, causing wholesale collateral liquidations. You get the picture.

This isn't likely at the moment because the vast majority of synthetic ETFs are compliant with regulations that prevent the most extreme abuses. "ETFs conform with the highest standards of fund regulation, whether they are swap based or physical replication products," said Manooj Mistry, U.K. head of ETF manager db x-trackers, Deutsche Bank's ETF arm, in a recent *Financial Times* interview. "They are subject to robust and stringent UCITS regulations and they are no different [from] thousands of other funds already being sold in Europe." Mistry went on to point out that non-synthetic funds have conflicts of their own, including securities lending, that might be just as systemically destabilizing.

Meanwhile, the best-run synthetic ETFs are raising the amount and quality of collateral and providing transparent documentation, notes Aldous, who considers these products very useful. "You put US$100 in and you've got US$120 in collateral in many cases. You're not having to buy and deal and settle in thinly traded markets, and they usually track better [than their physical ETF competitors]."

So it's wrong, he argues, to paint all synthetics with the same brush. Instead, the distinction should be between synthetics that are fully collateralized and those that aren't.

Far more likely than an ETF-led systemic meltdown is a reassessment of the ETF concept by investors. Today, "ETF" is a high-quality brand name, and the proliferation of new products under the old acronym risks damaging that brand. "ETFs are such fantastic low-cost simple liquid products for tracking the big asset classes," says Aldous. "It's a pity their reputation is being eroded by a few questionable products on the periphery."

John Rubino, a former financial analyst, is the author of Clean Money: Picking Winners in the Green Tech Boom *and* The Collapse of the Dollar and How to Profit From It.