Should You Fear the ETF?

ETFs are scaring regulators and investors. Here are the dangers—real and perceived.

ILLUSTRATION: BILL MAYER

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Updated Dec. 6, 2015 10:13 p.m. ET

Exchange-traded funds have suddenly become scary—at least to some in the investment community.

“It may be time to re-examine the entire ETF ecosystem,” Securities and Exchange Commissioner Luis Aguilar said at the opening of the SEC’s Investor Advisory Committee meeting in October.

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“Now is the time to be asking the hard questions about ETFs,” his fellow commissioner Kara Stein told an audience at Harvard Law School in November, adding that in stressed markets ETFs “break down in ways that we do not completely understand.”

After 23 years and $2 trillion invested, regulators and advisers are raising the rhetoric on this fast-growing financial product, a cousin to traditional mutual funds (which still dominate with nearly $13 trillion in assets). The SEC is chewing on a list of questions about the products' trading and marketing in the wake of the Aug. 24 "flash crash," when the price of many ETFs appeared to come unhinged from their underlying value, and some financial advisers say they are now wary about recommending the products to clients.

The SEC's Luis A. Aguilar wonders if the 'entire ETF ecosystem' should be re-examined.

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It isn't as if ETFs haven't faced questions before, from both regulators and financial-industry insiders. However, the recent questions have taken this scrutiny to a new level.

"No one sits around debating the merits of the mutual fund," says Matt Tucker, director of fixed-income strategy for the iShares unit of ETF giant BlackRock Inc. But ETFs, he adds, still aren't "mainstream enough."

So what's an investor to think? Are the concerns legitimate? For those looking to practice "safe ETF," here are five questions to consider:

1. Do ETF investors have enough safeguards?

There are plenty of consumer-protection regulations surrounding ETFs, but that doesn't mean the rules are airtight.

Initially created to track indexes, ETFs are similar to mutual funds in that they mostly consist of baskets of stocks and bonds, but they are different in that they trade on exchanges all day like stocks.

Because of ETFs' hybrid nature—and because there is no separate "ETF law"—they are governed partly by the Investment Company Act of 1940, which sets rules for mutual funds, and partly by the Securities Exchange Act of 1934, which sets rules for brokers and exchange oversight.

The problem is, neither law was designed to account for a product that relies on second-by-second pricing of both itself and a collection of other securities. As Aug. 24 showed, ETFs in rough markets can fall harder than the prices of their underlying assets. In normal markets, ETF traders who profit from zooming in and out of the ETFs and their underlying holdings keep the values in line, but investors have been startled to see that balance can be disrupted at times.

ETFs are a “digital-age technology” governed by “Depression-era legislation,” analysts at fund-tracker Morningstar have said.

Exchanges, as well as some fund providers, are examining how to prevent these rare trading anomalies. Meanwhile, the risk that ETFs may not always trade or price as expected is one that investors need to consider.

2. Everyone is doing it. Do I need to be invested in ETFs?

You don’t need ETFs any more than you need to buy the latest iPhone. One reason investors have poured money into ETFs is their tax efficiency and typically low fees (which is possible because 93% of the products track indexes with low turnover, according to researcher XTF Inc., which is what keeps down transaction costs and realized capital gains).

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However, ETFs aren’t the only game in town when it comes to low-cost investing. In certain asset classes, index-tracking mutual funds can be just as cheap as comparable ETFs. What’s more, while ETFs are known for their tax efficiency, that may not be of great importance to everyone, especially those who don’t plan to hold the funds in taxable accounts.

What matters most—and what investors should focus on—is whether a fund’s underlying portfolio fits with their goals, says Rick Ferri, the founder of Portfolio Solutions and long a proponent of index investing. “Look under the hood,” he advises, because many funds that seem similar really aren’t and will produce very different results. From there, investors can assess the product’s structure and whether the costs involved in holding or trading it are a good fit for them.

For some people, ETFs’ intraday tradability is a strong selling point. Unlike mutual funds, which can be bought or sold only at each day’s closing net asset value (NAV), ETFs can be traded all day on exchanges, which usually makes it easier for investors to get into or out of positions at a market price quickly (except, of course, on days like Aug. 24). “How important is that to you?” Mr. Ferri asks.

Others like ETFs because they offer a way to get low-cost exposure to corners of the market that used to be inaccessible to most individual investors.

“ETFs have democratized access to a broad array of asset classes,” says Onur Erzan, director of McKinsey & Co.’s North American asset-management practice. “This has improved the ability of investors and advisers to construct more granular and efficient portfolios,” he says. These include specific segments of the government and corporate debt markets, including high-yield securities (junk bonds) and bank loans, as well as hard-to-reach economies such as China, India and other developing markets, domestic and international sectors and industries, and socially responsible themes. On top of these, some asset managers offer currency hedging within the ETF and leveraged or short daily exposure geared more toward professional traders.

3. What happened in August and could it happen again?

Critics say stock-market swings on Aug. 24 exposed the flaws in ETFs they have been warning about for years. Proponents say ETFs mostly were caught in the crossfire of marketwide trading issues that had little to do with them. One thing is for sure: It wasn’t the first time ETFs have surprised investors.

ETFs were in focus during the flash crash of 2010, in which bids on dozens of ETFs (and other stocks) fell as low as a penny a share, and again in 2013, when municipal-bond ETFs traded at a discount to their net asset values during the “taper tantrum,” when bond yields jumped.

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And then came Aug. 24. The debacle was a test for the labyrinth of new regulations put in place after the 2010 flash crash, and it wasn’t pretty. As the Dow Jones Industrial Average plunged 1,000 points, triggers went off for mandated halts in many stocks held by ETFs, as well as the ETFs themselves. Then, a number of ETFs stunned investors by trading at prices far below their NAV, highlighting concerns that ETFs might not be as easy to move in and out of at “fair” prices when markets are in disarray.

In response to the Aug. 24 debacle, the three U.S. listing exchanges—the New York Stock Exchange, Nasdaq Stock Market and BATS Global Markets Inc.—indicated they will no longer accept stop-loss orders on any traded securities. Such orders seem to protect investors by triggering a sale when a target price is met, but at a certain point in a falling market they become “market orders” that are completed at any price. The NYSE is considering a way to flag “aberrant” ETF trades.

Meanwhile, it may be more advisable than ever for investors to use limit orders—orders to buy or sell a security at a specific price or better, literally putting a limit on how low the price can go.

“Have good trading hygiene,” says Dave Nadig, director of ETFs for FactSet. “The vast majority of ETFs deliver on their core promise to investors. But if you trade them poorly, that’s probably on you.”

4. What parts of the ETF market should I be most wary of?

Investors should be wary of “any area where there’s a lot of product development,” Mr. Nadig says.

Regulatory issues aside, the “safety” of any financial product largely depends on how well an investor understands it, and in this regard, the ETF ecosystem has grown more complicated in recent years.

The idea behind the earliest index-tracking ETFs was pretty simple: provide investors with market-cap-weighted exposure to entire markets or giant chunks of markets at the lowest possible cost.

Since then, ETF offerings have proliferated. Anyone with a brokerage account can now choose from among more than 1,800 different exchange-traded products, covering almost every conceivable market sector, niche and trading strategy. While some advisers love that—it gives them an easy, low-cost way to provide clients with exposure to certain market segments—the concern is that some less-sophisticated investors may be buying complex, heavily marketed funds without fully understanding what they are getting.

“ ‘Smart beta,’ in particular, creates real due-diligence problems,” Mr. Nadig says, referring to the growth in index products that shun traditional market-cap weightings and instead weight holdings according to an investment factor such as volatility, value, quality or momentum.

“With some new factor-based ETFs, it can be very hard to really understand what you are getting and why,” says Mr. Nadig. It requires understanding how the fund is segmenting securities based on a factor such as value, how it is weighting stocks in the portfolio, how often its index is rebalanced, and whether there are stock or sector limitations or weights.

If you don’t have the knowledge or time to build and manage a complex portfolio, it may be best to stick with broad-based index ETFs with significant assets and trading volume, experts say, and leave the niches to the pros.

5. Where do ETFs go from here?

Even as ETFs continue to surge in popularity, gobbling up $200 billion in investors’ dollars so far this year, their emerging dominance in the passive-investing world is already being challenged.

Online broker Motif Investing, for example, offers low-cost direct investing in baskets of up to 30 stocks tied to investment themes, industries and sectors. It charges only $9.95 per “motif” trade or rebalance order.

Among “robo advisers,” which are automated investing services, Wealthfront now offers direct indexing for clients with more than $100,000. Instead of using an ETF, Wealthfront will buy anywhere from 100 to 1,000 individual stocks, proportional to their share in Standard & Poor’s market-cap-weighted U.S. indexes, and harvest tax losses at the individual security level. The company charges 0.25% of assets annually manages the first $10,000 free.

A NYSE trader on Aug. 24, when the ‘flash crash’ raised questions about ETF pricing.

A NYSE trader on Aug. 24, when the ‘flash crash’ raised questions about ETF pricing. PHOTO: BRENDAN MCDERMID/REUTERS

Traditional mutual-fund managers, meanwhile, are looking to ride a new investment vehicle developed by a unit of Eaton Vance—an exchange-traded managed fund that will trade all day like a stock but won’t have to fully disclose its portfolio like other actively managed ETFs—to sustain interest in their investment strategies. Similarly, other issuers of index ETFs, including BlackRock, State Street Corp.’s State Street Global Advisors and Vanguard Group, are looking at ways to reintroduce ETF-inclined investors to active strategies.

“Investors will ultimately embrace them only if they are convinced of the incremental value versus some of the technicalities,” says McKinsey’s Mr. Erzan.

So far, it has all been a tough sell.

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OldestReader RecommendedMilton Rodriguez

Milton Rodriguez 2 hours ago

Just finished the article and it seems that ETFs seem to be properly balanced. Obviously the need to understand what is going on behind your investments is important but ETFs do provide the ability to diversify into a lot of different sectors. There are definitely dangers with flash markets when prices are all over the place. Those dangers lie in all exchange traded securities as well as they will move when then market moves.

I use ETFs and I enjoy them but I also understand the disadvantages they pose. I wouldn't necessarily say they're "dangerous".

Tony Pondel

Tony Pondel 3 hours ago

On Aug 24th when the ETF was apparently mis-priced "too cheaply" I bought.

Problem solved. Don't panic sell.

Gordon Laird

Gordon Laird 5 hours ago

One huge trap that I didn't see explicitly written about in this article is a common psychological phenomena in investor's mentality. Most every investor sees the world through rose colored glasses, me included. i.e. overall, over time, all markets will rise in value. Or, all ships rise with the tide.

Well, when one is paying for active managed fees and the manager is lazy in a traditional mutual fund, during a rising tide, it is natural to ask; "Why am I paying these expenses, for no added value to my portfolio?". The downside, assuming one can and does find diligent active managers, when we enter market periods such as the last ~2 years, the tide is not rising at all. In fact, it is tending to slowly descend. Well, a passive ETF, like all ships, will settle in a outgoing tide. There is a hope, not always realized, that in a actively managed fund, the manager is diligent enough to pick contrary stocks or go to cash.