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Volatility, Thy Name Is E.T.F.

By ANDREW ROSS SORKIN

Did you watch the markets on Monday? In the last 18 minutes of trading, the Standard & Poor's 500-stock index jumped more than 10 points with no news to account for the rally. If you were left scratching your head, you were not alone.

Douglas A. Kass, founder and president of Seabreeze Partners Management.

Almost every day there is an article in the newspaper trying to explain the stock market's wild swings, or volatility, and often the explanation is inconclusive, involving everything from Europe's banking problems to new fears of recessions.

Through the summer and into the fall, I, too, have been pondering the gyrations in trading, especially the late-day sell-offs and rallies that seem always timed perfectly to coincide with the closing bell. Rarely do the rallies or sell-offs, which invariably start after 3 p.m., justify 3 to 4 percent moves in the indexes. The swings have a deleterious effect on the markets because they undermine confidence and investors start sitting on the sidelines.

And then I started talking with investors like Douglas A. Kass, a longtime Wall Street denizen who is the founder and president of Seabreeze Partners Management.

He says he knows the culprit behind the late-day market swings: leveraged exchange-traded funds or E.T.F.'s.

These funds, which allow investors to bet on a certain basket of stocks, commodities or an index, are perhaps the hottest rage in investing, with some $1 trillion invested. E.T.F.'s are particularly attractive to some investors because you can bet long or short — and you can leverage your bet. And you can hop in and out within the trading day to lock in gains, just as with stocks.

If you bet $100 that the ProShares Ultra S&P500 would rise by 1 percent on a given day, and it did so, say by 3 p.m., you could settle the bet and receive double the return — in this case 2 percent (excluding fees). Of course, if the market goes in the opposite direction, you could lose 2 percent. There are also what are called inverse leveraged E.T.F.'s that go up when the price of the basket of goods goes down, and vice versa.

To Mr. Kass, these E.T.F.'s are the "new weapons of mass destruction." (His description is an homage to Warren Buffett's widely quoted line that derivatives are "weapons of mass destruction.")

"They've have turned the market into a casino on steroids," Mr. Kass said. "They accentuate the moves in every direction — the upside and the downside."

Mr. Kass, who has written about this topic for TheStreet.com, may be right: at the end of every day, leveraged E.T.F.'s have to rebalance themselves by buying and selling millions of

shares within minutes to remain properly weighted. If the E.T.F. made money that day, to remain balanced it has to reinvest the proceeds and leverage them again. In many cases, leveraged E.T.F.'s use options, swaps and index futures to keep themselves in balance.

You might consider the E.T.F. the new derivative.

"It is these derivatives and not the phenomenon known as high-frequency trading (H.F.T.) — commonly critiqued as contributing to the 'flash crash' of May 6, 2010 — that pose serious threats to market stability in the future," Harold Bradley and Robert E. Litan of the Kauffman Foundation wrote in a controversial white paper last year. "The S.E.C., the Fed and other members of the new Financial Stability Oversight Council, other policy makers, investors and the media should pay far more attention to the proliferation of E.T.F.'s and derivatives of E.T.F.'s."

Mr. Bradley and Mr. Litan contend that it is the "rebalancing risk" of E.T.F.'s that makes them particularly dangerous.

Back in 2009, Barclays Global's research department studied the growing leveraged E.T.F. market — before the flash crash — and concluded that the funds created systemic risk because they "amplify the market impact of all flows, irrespective of source."

The view that leveraged E.T.F.'s are responsible for the market's volatility has not gone unchallenged.

William J. Trainor Jr., a professor at East Tennessee State University, conducted an extensive study of market volatility at the beginning and the end of the market day and concluded that E.T.F. rebalancing had nothing to do with it.

"Intra-daily volatility in time periods not associated with rebalancing saw the same spikes in volatility as the last 30 minutes did," he said in his report.

Mr. Kass, who has been trading since the 1970s, scoffs at this notion.

"Ask any hedge fund manager what their gut says," he protested.

I took an informal poll of a half dozen brand-name fund managers and virtually all of them agreed with Mr. Kass. But some of them said that high-frequency traders, which themselves trade E.T.F.'s, could be magnifying the problem.

"We know E.T.F.'s are the dominant factor in the marketplace," Mr. Kass said. "In the '70s and '80s it was the mutual funds, in early 2000s it was the hedge funds. Now it's the algorithms running the E.T.F.'s."

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