Exchange Traded Funds

Exchange Traded Funds (ETFs) have developed into a very big and fast growing market in the US. ETFs have been available on the ASX for some time and have grown steadily over several years after a slow start. We are still a long way behind the US market in total traded volume and in the number and complexity of these funds. However, this is bound to change and it is useful to be aware of what has happened in the US and elsewhere as a guide to what may be in our future. A recent article headed *Explosive* in *The Economist* 26 June 2010 highlights some of the features in ETFs in the US market that are beginning to attract attention from regulators.

ETFs have been marketed in Australia as being simply an index fund that can be traded on the ASX. As such, they would seem to be nothing new, other than the ease of trading in and out of them, though that convenience comes with a transaction cost.

In the US, ETFs have grown into an enormous industry and its size alone has become a cause for concern. To give an idea of their magnitude, at end May 2010 US ETFs managed approximately US$793 billion. At the end of 2009, the worldwide market in ETFs controlled over US$1 trillion of assets. With estimates of growth in 2010 of up to 30%, this is now a huge sector in the financial markets.

Another concern centres on the spread of ETFs into specialised asset types such as commodities, where the size and growth of ETFs could begin to affect the prices of the commodities themselves.

One thing that makes ETFs popular is not just the ease of trading in and out of them, but that this can be done all through the day, so that they become day trading vehicles. Traditional index fund prices are determined at the close of each day, so day trading is not possible because they can only be traded at the beginning and end of the day. This day trading facility introduces potential liquidity risks. The promoters of ETFs tell us that there are market makers who will provide liquidity at all times. However, as the market in ETFs grows, panic situations could arise where many people want to get out at the same time and the volume of sell orders overwhelms the market makers. The 1,000 point meltdown on the US stock market on 6 May 2010 saw US ETF liquidity vanish, with many ETFs traded down to near zero. This could have been a dress rehearsal for a major future event.

Even though 6 May 2010 might be dismissed as a rare event, we have seen many periods in the past when there has been extreme volatility in the underlying stocks or commodities. Volatility can be correctly seen as opportunity for short term traders. The bigger the price swings the bigger the potential profits in a short period. However, when volatility is combined with leverage, things could turn very nasty.

Firstly, there is the existing situation where some ETFs have sought to put a rocket under returns by leveraging their fund. This is a way of multiplying the gains from small price movements in the underlying stocks or commodities. However, as any experienced trader will tell us, leverage also multiplies the losses when prices move against our position. It is important for those readers who are interested in ETFs to make sure that they understand whether the underlying fund is leveraged and by how much.

Secondly, there are now ETFs that use derivatives to boost returns. They therefore construct a “synthetic” fund, where, instead of buying a commodity as a base for the funds, they buy swaps or other derivatives. Where the derivatives are traded on a public exchange (e.g. futures or options), there is unlikely to be much counterparty risk. However, with swaps, which are transacted in the over the counter (OTC) market, if the counterparty were to go bankrupt, the profit made on such an ETF would not be realisable. This would be very galling: we get the direction of the commodity right, but because the counterparty to our ETF’s investments fails, we lose all our bet.

The US Securities and Exchange Commission (SEC) have now issued a moratorium on new ETFs using derivatives. The thinking is that by the last quarter of calendar 2010, the SEC will have developed a policy that limits the use of derivatives in ETFs and a full disclosure policy. Then derivative-based ETFs may be off and running again, albeit with a speed limiter in place. This alerts us to the need to check carefully that we understand how a specific ETF is set up before buying it.

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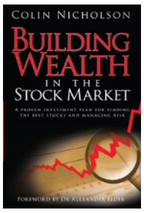

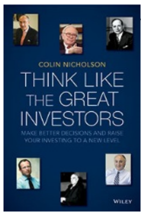

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