Markets

Authers' Note: Excessively Traded Funds

Premium

The FT's daily newsletter on the world of investment

John Authers

6 HOURS AGO by: **John Authers**

How bad an idea are ETFs? As we near the end of our series (https://www.ft.com/age-of-etf?emailid=56cef8b842182003007144814&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2), the FT leader column has taken an official position (https://www.ft.com/content/88efd6be-c2e7-11e6-81c2-f57d90f6741a?emailid=56cef8b842182003007144814&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2). Very broadly, the FT line is that it has not been proven that ETFs create a fresh systemic risk through liquidity mismatches, but it is

clear that ETFs can exacerbate existing systemic risks by giving the appearance of high liquidity, and by encouraging excessive trading. There is also a need to buttress consumer protection. ETFs are being made needlessly complicated, while ETF providers are finding an excuse to raise fees.

This is unhealthy. For a parallel, think of the world of hi-fi before the iPod. The way to sell more stereos for more money was to add ever more buttons, many of which were never used, and more flashing displays on the front (It's brilliantly satirised by a young Rowan Atkinson here) (https://www.youtube.com/watch?v=TxQqWSnsHoA). As a sales strategy it worked until Apple tried offering consumers one white pod with one button in the middle of it. Such a fate might yet befall ETFs if the ETF industry is not careful. The FT is right to warn about this, and the leader draws a parallel with Paul Volcker's scornful judgment that the only financial innovation that had benefited the world during his career was the ATM (https://www.ft.com/content/55e3103e-d4bc-11e5-829b-8564e7528e54?emailid=56cef8b842182003007144 81&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2) — usually, the financial services industry takes good new ideas and stretches them until they crack under the strain.

For now, the FT says — and I agree — that the onus is on the industry to rein in added complexities and added costs, and on regulators to publicise all transgressions. ETFs still have many advantages (https

://www.ft.com/content/c06a0488-c5db-11e6-9043-7e34c07b46ef?emailid=56cef8b842182003007144 81&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2); let's hope that straightforward transparency will deal with the problems in the sector, without the need for more intrusive regulation.

And on the subject of excessive trading — Jack Bogle, the founder of Vanguard, was kind enough to write a guest column on the subject earlier in our series. One paragraph confused some.

Vanguard's patented structure for ETFs — in which both its Tifs and ETFs are shares of the same underlying portfolio — presents a unique test case for evaluating investor outcomes in the two types of index funds. Over the past months, Tif investor returns were a few basis points higher than fund returns in each of the five largest Vanguard broad-market index funds. In contrast, returns earned by the firm's ETF investors — owning the identical underlying portfolios — trailed the returns of the funds by an average of 1.6 per cent during the same period. This anecdotal evidence seems to confirm the consensus that higher trading activity takes its toll on investor wealth.

Authers' Note

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A number of readers were confused by what he meant by

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this, so I asked Mr Bogle for clarification. This is his reply:

While the math is a bit complicated, some of your respondents got the right answer and some didn't. Let's start with the data that I presented. During the 12 months ended 10/31/16, the return on both the Admiral shares of our basic Total Stock Market Index Fund (0.05 per cent expense ratio) and the ETF shares of the same portfolio (same expense ratio) were identical—4.15 per cent. But the investors in TSM Adm earned a return of 4.41 per cent, 0.26 percentage points higher. And the investors in the ETF earned 2.58 per cent, 1.57 percentage points lower.

In my article, I was referring to the distinction between investor returns and fund returns. The former are pretty much ironclad, the latter often muddy. This link provides a detailed explanation of the concept from Morningstar (http://investors.morningstar.com/news/cmsAcontent.html?t=EISMX&src=Morningstar&date=05-06-2015&nav=no®ion=USA&cu

lture=en-US&ProductCode=mle&resourceId=673129). To summarise, the standard return calculation in the mutual fund industry is the time-weighted return. This is the return on some investment with each period of time weighted equally. This measure is often considered an appropriate way to evaluate a manager's performance as it treats all units of time (eg, months, quarters, years, etc) equally, regardless of cash flow from investors.

The investor return is the dollar-weighted return, which takes into account how much money is invested in the fund in a given period of time. This measure is the IRR of the investment given its cash flow over some period of time. This measure is typically seen as a good way to evaluate performance from the investor's point of view.

To illustrate with an example, say a fund returned 10 per cent in year 1 and 5 per cent in year 2. The annual return the fund would report (time-weighted return) for those two years is 7.5 per cent.

Say I invested $10 at the beginning of year 1. Impressed with the 10 per cent return, I then invested $100 at the beginning of year two. So I had much more capital at risk in year 2 relative to year 1, and the investor return calculation places much more weight on the return earned in year 2. My annual investor return (IRR) over those two years is only 5.4 per cent,

about 2 percentage points less per year than the fund's return. If investors add money to an investment after it outperforms and redeem money after underperformance (as is too often the case), their investor return will lag the return of the investment itself.

It is not unusual for investor returns to lag fund returns, simply because investor behaviour tends to emphasise buying when optimism is rife and prices high, and selling when pessimism is in the air and prices low. For the fund industry, according to Morningstar, investors on average earn annual returns of 1.5 per cent lower than fund returns.

I hope this is now clear. Mr Bogle was trying to give a strong indicator that ETFs' great advantage over mutual funds — the ease with which they can be traded — had translated into investors earning lower returns than would have been gained by those who operated a pure "buy and hold" strategy. This is not surprising, but does suggest that ETFs should not, as both the FT and Mr Bogle suggest, be offered too aggressively to individuals. They must not be allowed to become yet another tool to allow unscrupulous brokers to persuade people to churn their account too much.

There is an alternative view to this: *caveat emptor*. Continuing the glorious tradition that the Lex column can sometimes directly contradict the official FT

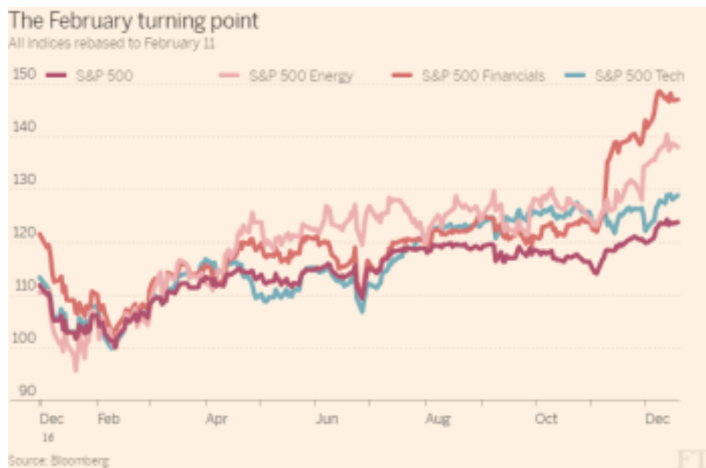
line, Lex suggested (https://www.ft.com/content/ecb62dc2-c08c-11e6-9bca-2b93a6856354?emailid=56cef8b8421820030071448 1&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2) that "pragmatism leans towards a more relaxed attitude".

That active investment is on average poor for your wealth is increasingly well understood. For the 5 per cent of ETF investors who think they know better, hard experience is the best teacher around.

That was the year that was . . .

Don't look back in anger, look back instead with the FT markets team. Here you can watch our latest Facebook Live chat, in which Katie Martin interrogated Roger Blitz and Mike Mackenzie about the shocks of the year. Both name Brexit as the greatest, but it was a year of at least three salient turning points — mid-February (probably driven by the reaction to the Bank of Japan), the first week of July (Brexit), and the second week of November (Trump). Here they are to talk about it:

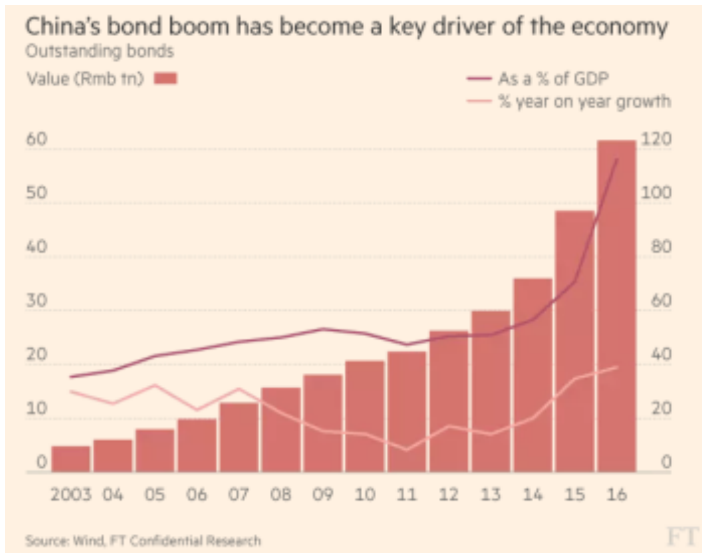
What were the most important turning points? For the US stock market, the moment that counted came in February, when risk appetite suddenly returned after the Bank of Japan's disastrous attempt to push interest rates into negative territory. I suspect this was taken as a sign that ever cheaper money had finally reached its limit, and something else would now be needed to boost growth. The turn in the oil market also came at about this point — and the returns in the most cyclical sectors since then have been extraordinary:



Then again, the moment the world embraced an "America first" ideology, at least when it came to market returns, came with Donald Trump's election in November. For example, it completely reversed the growing recovering trend for emerging markets:

But there are still plenty of arguments for Brexit as a turning point, particularly as bond yields hit a new record low and then started to climb only a matter of days after the referendum. Many charts, in many asset classes and geographies, show a year of two halves, although I suspect Britain's vote was not the only reason behind that turning point. Look for example at the way that cyclicals began at last to outperform defensives at mid-year (and then gained extra turbocharges after the US election):

Whether this was a year of two halves or three inflection points, it was an unusually interesting one, and a difficult one to trade. For another fascinating take on it, read this piece by Mike Mackenzie and Joe Murtagh, which reviews the year's biggest shocks (https://www.ft.com/content/6d24125c-c066-11e6-9bca-2b93a6856354?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2). Mike chose to end the piece with a forward-looking chart on the critical player in the world's economy that people have decided is in acceptable health of late. China's bond issuance boom has become critical to its economy, and this should arguably be a source of concern, as the bull market now appears to be facing a serious test (https://www.ft.com/content/beda8c28-c5bd-11e6-8f29-9445cac8966f?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2):



And finally . . .

There have rightly been other concerns today. Somehow volatility continues to fall amid appalling news from Turkey and Germany. But one clear avenue for volatility to increase lies in the possibility of conflict between the President-elect Trump and Janet Yellen. Clive Crook, writing for Bloomberg View (https://www.bloomberg.com/view/articles/2016-12-19/coming-soon-trump-vs-yellen), suggests we should brace for quite a fight and points out that Mr Trump has so far accused the Fed chair of acting in bad faith, rather than of making mistakes.

His final pay-off deserves repeating: "To repeat, the case in principle for central-bank independence may be weak, but the practical case has never looked better. Today, you can sum it up in just two words: President Trump."

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