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Things to Note when Trading ETFs

Anyone keeping tabs of the asset management industry will know that the exchange traded fund (ETF) sector has been on explosive growth trajectory for the past decade at an annual growth rate of 25.1%. ETFs now hold a total of $2.99tn in assets as of December 2015 – a figure consultancy firm PwC expects to hit $5tn by 2020 compared to the broader industry growth of 6%. The benefits of using ETFs are straightforward – low cost, transparency, tax-efficient etc., hence gaining popularity among investors.

Nevertheless, like any investment structure created, ETFs are bound to have their flaws and the events during the flash crash of 24 August 2015 shined light on issues inherent in ETFs. That morning the Dow Jones Industrial Average had dropped nearly 1,100 points in the first few minutes of trading before rebounding by almost 600 points just moments later. During then, we saw some significant moves in the ETF market, almost to be described as crazy.

The two charts below speak volumes. The white lines represent intraday prices of two ETFs – the iShares Core S&P500 ETF (IVV) and the Powershares S&P500 Low Volatility Portfolio (SPLV); while in red we have the indices they are tracking. We can see most of the time during the day; the ETF tracks the NAV quite closely. However, during the market opening on 24th, the S&P500 Index declined 5.3%, but IVV dropped 26% for a few minutes. Even worse for the low volatility ETF, it declined more than 45% and only recovered after a full hour - volatility not very low here. Sufficient to say investors who sold shares then or got stop-losses kicked in will be shell-shocked until today.

Plausible reasons to this will be the market stress that day which caused more than 1,000 trading halts combined with computerized trading. Stoppages on the ETF's underlying stocks inhibited the calculation of intraday NAV (iNAV) and the ETF creation/redemption process which ensures prices trade near its NAV. Additionally, markets are no longer manual, especially ETF markets. They are electronic and driven by computer models with rules and assumptions about when to participate, how much liquidity to offer, and how to wide to make the bid/ask spread. When a large percentage of underlying stocks are halted, the model loses confidence in its fair-value number; the result is to widen out the spread and thin out the depth. Add in higher than normal trading volumes (3.5x and 6.4x average 30-day trading volume for IVV and SPLV respectively), you get some results seen as insane.

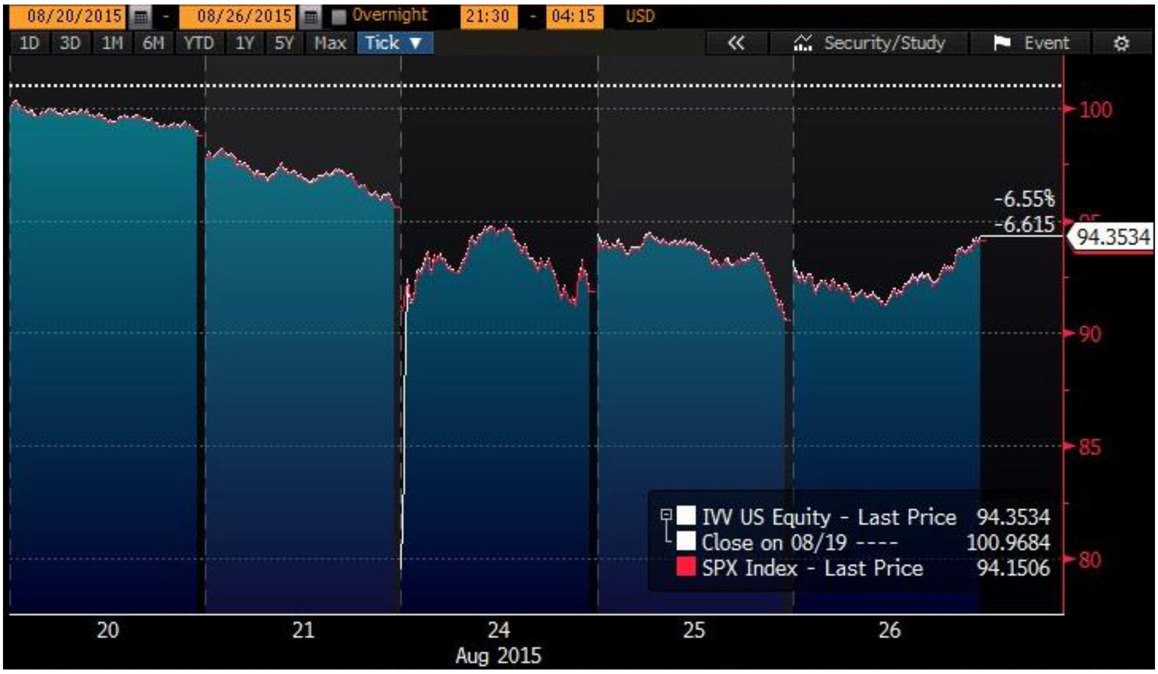

Chart 1 iShares Core S&P500 ETF (IVV) vs iNAV (Source: Bloomberg)

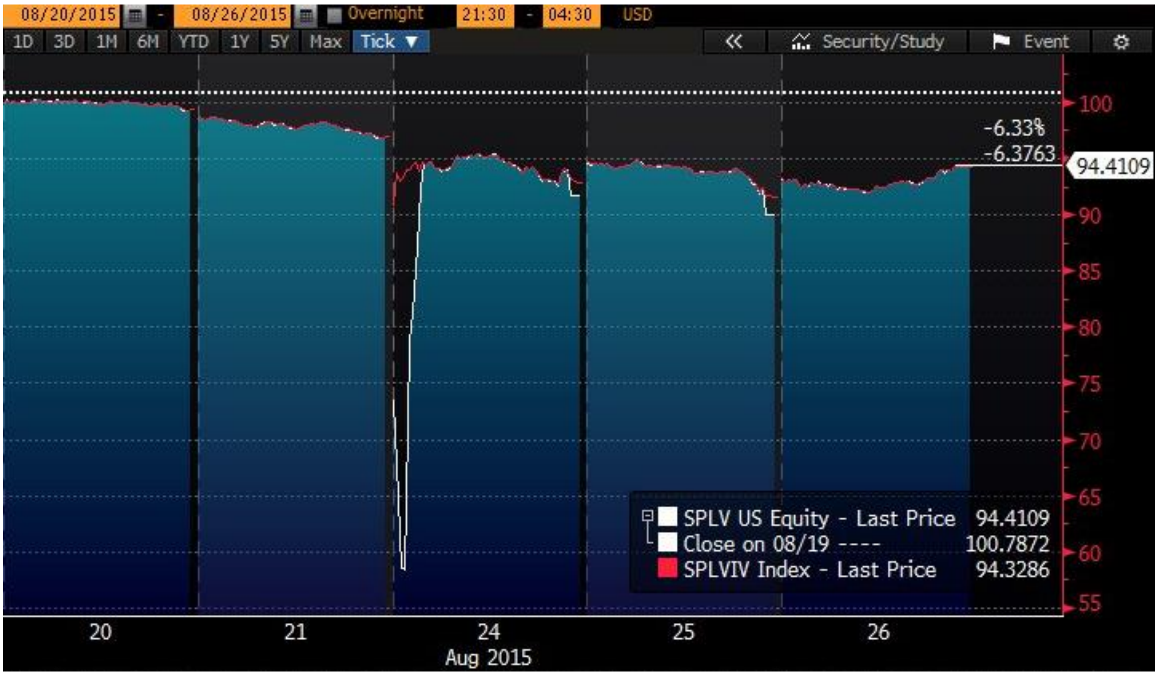

Chart 2 Powershares S&P500 Low Volatility Portfolio (SPLV) vs iNAV (Source: Bloomberg)

The purpose of this article is not to scare readers and ask them to swear off using ETFs. In fact, we ourselves use ETFs for portfolio construction and risk management for clients. Investors have to recognize certain limitations of the ETF structure to be able to use it in an efficient and optimal way. There are some important things to note when trading ETFs:

1. Check iNAV before placing orders
2. Have limit prices on orders
3. Never have stop-loss orders in force

Investors are able to check iNAV through sites like Yahoo! Finance by prepending a ticker with “^” and appending “-IV”. Eg. “^IVV-IV” will give you the iNAV for the iShares Core S&P500 ETF (IVV). iNAV ticker is easily obtainable for investors having a Bloomberg terminal using the function FLDI Q1980. If iNAV is unavailable, try to check a proxy (index/similar ETF/futures).

In the ETF market, ensuring prices are staying near NAV is largely dependent on market makers’ arbitraging the disparities between them. They are not charities and will exit the market in times of uncertainty. Specifying a limit is a small price to pay to insure against the proverbial when things hit the fan. Investors with large orders should work with liquidity providers and authorized participants to facilitate the trade.

Live stop-loss orders are largely geared for traders who normally have highly-levered positions; using them to close out losing positions systematically when trades go wrong. As investors who have longer time horizons, using market closing prices to stop losses is a perfectly acceptable method. Alternative is to use stop-limit orders whereby a limit order is activated instead of a market order when the stop-loss price is hit.

Ultimately, like mutual funds and hedge funds, ETFs are structures that provide investors access to a certain asset class, geographical region, industry sector, strategy etc. but with relative better liquidity as an exchange-listed vehicle. However, they should not be traded blindly and may not be suitable for all investments. The liquidity of the underlying assets must be commensurable to ensure efficient trading and creation/redemption process. Liquidity cannot be manufactured from thin air; putting an ETF wrapper on illiquid or restricted assets (China A-shares and special situation cases such as distressed lending) does not make them more liquid. For such strategies, a managed approach makes more sense.

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Sources:
1. ETFGI, 2016. ETFGI Monthly Newsletter December 2015.
2. PwC, 2015. ETF 2020 – Preparing for a new horizon.
3. FT, 2016. FTfm Special Report – Exchange traded funds.

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