SEVEN Investment Management

7IM's Peter Sleep ETF Blog: Emotion, Acronyms and ETFs

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Peter Sleep, Senior Investment Manager, Seven Investment Management (7IM) explores some criticisms of ETFs that have recently been levelled by some commentators in the media.

What is it about ETFs that generates so much emotion whereas their close cousins, tracker funds, go comparatively unscathed? Could it be the three letter acronym, inspiring a Pavlovian response much like the fully loaded, three letter 'CDO' (Collaterised Debt Obligations), LSD (Lysergic Acid Diethylamide) or WTF? (I won't spell that out). Whatever the cause, doomsters have been known to predict that the next crash is going to be caused by ETFs.

I'm not brave or clever enough to predict where the next crash will stem from. But I will pick my way through the key points that have been raised, and give my two pennies worth, as I see them.

The transparency debate

A complaint against ETFs is that investors do not know what they are buying. This is an odd comment as ETFs disclose daily their index methodology and their holdings on their websites. Even the rapidly diminishing synthetic ETFs will disclose the index they track and any collateral that they hold. This is much greater transparency than can be found in many other collective investment vehicles.

Are ETF investors really any more prone to irrationality than others?

Another line of attack is that the buyers of ETFs are more likely to sell up and run at the first sign of trouble. I think this insults the intelligence of investors. Say an investor held a FTSE 100 ETF and the Woodford High Income Fund and needs to raise money. Why wouldn't an investor weigh the relative merits of each investment before making a sell decision? She might look at Woodford's good track record playing defence and sell the FTSE 100, or she might decide to take profits on Woodford for CGT purposes. Either way, I am not sure ETF investors are particularly prone to irrationality more than any other investors.

Does 'cheap' really encourage churn?

Naysayers point out that ETFs are cheap to trade and this encourages churn. This is the first time I have heard a complaint against cheap trading, but I guess there is no requirement to be rational. Many of the platforms offer low cost trading on listed securities like ETFs and investment trusts, so I am not sure this complaint against ETFs holds much water.

ETFs and the madness of crowds

I have also read that ETFs are encouraging overvaluation in the equity markets particularly the FAANGs. This seems to suggest that ETFs are responsible for the madness of crowds and that ETFs have a sentient ability to pick stocks. Given the vast majority of ETFs are market cap weighted I really cannot see how ETFs can contribute to the hype in a small group of stocks or the overvaluation of the market. Surely QE and low interest rates have more of a role to play in valuation than the investment vehicle?

Not about the structure

I do think that any market weakness will arise not due to the ETF structure, but from within us as fallible and emotional investors. I believe that an ETF is like a cross between an open-ended mutual fund and an investment trust. We have always had volatility and investment bubbles, and we will always have volatility and investment bubbles in the future, regardless of the chosen investment route. The criticisms of ETFs are really, at heart, criticisms of investors as being human.

A lot of the predictions about ETFs seem to be complaints about how the market is driven by human fear and greed, and the big weakness of ETFs is that they cannot insulate us from that. Perhaps the tongue-in-cheek answer to the predictions is to rebrand ETFs without using a three letter acronym. Life would be simpler then, but less fun.

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