Problems with ETFs are down to the driver

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By Chuck Jaffe 4/15/2017

Your Funds

Investors have fallen in love with exchange-traded funds, but a new study suggests that too many ETFs as holdings in a traditional fund could be bad for your wealth.

Three professors published research — and are continuing a study released earlier this year — which found that actively managed funds holding an average of 12.8 percent of their assets in passive investments wind up underperforming peers that stick to stocks and bonds by between 0.41 percent and 1.63 percent.

The academics — Sara Shirley of Roger William University, D. Eli Sherrill of Illinois State University and Jeffrey Stark of Bridgewater (Mass.) State University — drew the obvious, logical conclusion from the numbers, which they summed up this way: “Large ETF positions are associated with large underperformance.”

Everyone reading and reporting on the study seemed to think that this was some sort of an indictment on ETFs and passive management.

As a general rule, fund managers who trade in ETFs are doing it to achieve diversification at a reasonable cost, or to take tactical advantage of market swings and sectors that are heating up or fading fast.

A manager, for example, who wants to play the infrastructure boost promised by the policies of the Trump administration could buy a bunch of individual companies or could opt for an ETF like Global X US Infrastructure [PAVE], taking a broad brush to cover the sector.

Fund managers also use ETFs as a place to park money if their charter limits how much cash they can have in the portfolio, or while they are waiting for their next investment idea.

The problem with the research is that it’s not clear that there is a true cause and effect here, that the problem is too much dependence on ETFs rather than simple unmistakable bad decision-making on the part of the fund manager.

The professors are still studying why ETF-holding funds underperform, though they posited that the problem was misguided sector bets and over-trading/market-timing.

If that’s the case, then the issue is less with ETFs than it is with active management; the mistakes that are reducing portfolio aren’t occurring because of the investment type being used, but rather result from the investment strategy the manager is pursuing.

Think of it in a different way: If you substituted the words “precious metals funds” for ETFs and found that every portfolio with a certain concentration of assets in gold and silver was underperforming, you could blame the performance on the metals, or you could place the blame with the guy who decided to put that much of the portfolio into that one volatile sector.

Ultimately, the fault isn't with the vehicle but with the driver.

"ETFs have a job to do, and they are doing it, by giving you the exposure to a market or an asset class, but if performance is bad it's not because you held ETFs in the portfolio, it's because of what the manager was allocating to," said Tom Lydon, editor of ETFTrends.com. "

Active managers have a hard time outperforming, and that was the case long before ETFs were invented. Now you have managers who actively manage portfolios by using ETFs; you can't really assume that the problem is with the ETF rather than the active management, can you?"

This is an important point for consumers, because while the research was focusing on funds that hold ETFs, the truth is that many financial advisers and money managers now build client portfolios where they are actively managing money using ETFs.

If the conclusion you draw from the study is that ETFs, by themselves, could lead to underperformance, you effectively are allowing the carpenter to blame his tools when your portfolio-construction project goes wrong.

If the portfolio doesn't hold together, blame the stone mason who built it, not the bricks he used in construction.

Sure, there are ETFs that are weird, poorly conceived and executed and downright dangerous. But those leveraged and/or high-powered tools aren't the ones being held in large chunks by ordinary funds making sector plays.

If a fund holds big slugs in ETFs, it may be a sign that the manager is trying to gain a tactical edge on the market, ramping up trading — and therefore trading costs — and managing more actively, producing less-desirable results.

"If you're not very good at picking stocks — or timing the market — you probably won't be great picking or timing with ETFs," said David Trainer, president of New Constructs Inc., a Nashville research firm that evaluates funds and ETFs based on their holdings.

"Diversification, by law, is not a substitute for diligence. People may think they're safer because they don't have one or two stocks but instead have an ETF with a lot of stocks in it, but there's not much difference between buying a bunch of bad securities or one bad-but-diversified security.

"Sure, there could be a connection between ETFs and bad performance, but the problem isn't that someone is using ETFs, it's that they are buying and selling the wrong ones at the wrong times."