ETF's - A safe Way To Invest?

Well Maybe! - Let's see if it's worth smashing the piggy bank open for...

We have seen investors' enthusiasm for cheaper, passive ways to invest rapidly increase over the last 15 years, as the growth in the global exchange-traded fund (ETF) industry has shown. ETF holdings have increased by almost 2,300% since 2003, so it is little wonder that global press articles are starting to ask if ETFs are really as safe as many suggest.

The size of the industry, its predominantly passive investment approach, lack of liquidity in underlying assets, uncertainty about how ETFs could perform in a market downturn, and the potential of financial system risk have all been listed as reasons for concern, so it is important for investors to understand what these issues are.

Individuals are understandably starting to become nervous, and the obvious question is "Are ETFs safe investments?"

The answer really depends on what type of ETF you own.

What Is an ETF?

The original Exchange-Traded Fund structure is really simple. An investment vehicle is set up to hold a basket of securities designed to track an index, just like an index-tracker unit trust or mutual fund. Shares of this ETF are then created and traded in the same way as an individual stock. The ETF can hold each stock in the index it is tracking in the same proportion as the index, or it can purchase a representative mix to reflect the index movement. Either way, the ETF holds shares in the actual stocks that make up the index being tracked.

An example is S&P SPDR, the oldest ETF, launched in early 1993. This ETF is designed to track the performance of the S&P 500. This index comprises 505 stocks, listed by the 500 biggest US listed companies, and represents about 80% of the American equity market by capitalisation.

ETF Benefits

A benefit of the traditional ETF structure is that it can be bought and sold easily via the market, with typically low trading cost, and nominal spread as dictated by the market, not the fund manager. Also, ongoing ETF costs tend to be lower than those of mutual funds, though it is worth noting their passive nature - an ETF manager will not sell the poorer quality assets in the index or hold more cash in a market downturn.

The ETF simply provides investors, even small investors with the ability to easily construct diversified portfolios at low cost, and with the risks to the investor of this structure being pretty much the same as holding an index mutual fund.

Synthetic ETF's, or ETN's

The "ETFs" that have prompted so much debate recently are not structured in the same way as a traditional ETF and expose investors to a greater level of risk.

Although often called ETFs, they should more accurately be called "Exchange-Traded Notes" (ETNs). Far from holding actual shares in the underlying stocks of the tracked index, these ETNs are essentially synthetic. They are in effect, a promise by the ETN provider, usually a financial institution, to replicate the return of a particular index. To do this, they use derivatives and may in some cases employ leverage.

Typically, an ETN provider will enter into a swap agreement with another financial institution, usually an investment bank. The investment bank agrees to pay an amount equal to the return of the benchmark tracked by the ETN, and the ETN provider gives the cash raised to the investment bank. In return for the cash, the ETN provider also demands collateral from the investment bank that may or may not be related to the index the ETN is supposed to track.

Often, the collateral is of lower quality and less liquid than the real assets of the index being tracked. The investment bank is now obliged to provide the return on the index.

So, instead of holding a fund that owns the actual shares of stocks that are in an index, with these types of ETNs, you are holding one backed by the promise of a financial institution.

Risks of Synthetic ETN's

One major risk to investors is counterparty risk, or the risk that the ETN provider and investment bank fail to deliver the return on the index the ETN tracks.

If the investment bank were to fail, the ETN provider would be left with the lower-quality, less liquid collateral that may have no relation to the index tracked. In extreme market conditions, this collateral could be hard to sell, exposing ETN investors to significant losses.

As well as counter-party risks, there are other risks associated with some types of commodity ETN's.

Rather than buy the underlying commodity, the ETN purchases a futures contract. This is the promise of delivery of a commodity at a certain date and price in the future. When the contract is about to expire, instead of actually buying the underlying commodity, the ETN rolls its assets over to another futures contract. Because of market inefficiency and gaming within this process, there is risk that the price of the ETN may fall, even when the price of the underlying commodity rises.

Another risk area includes the use of leveraged and inverse ETNs. These are a fast-growing segment of the overall ETF industry, but they do not necessarily produce the results expected, and they contain risks of their own.

Leveraged ETNs use derivatives to magnify the single-day return of an underlying index, often by 2 or 3 times.

Leveraged and inverse ETNs contain counterparty risks inherent in the use of derivative products as noted above, and since the counterparties may be using leverage and potentially selling short, the risks are multiplied.

Finally, because the derivative contracts are for single-day returns only, the underlying contracts are repurchased every day. This means that in the longer-term, returns may bear little resemblance to the underlying market, since they simply consist of stringing together a number of single-day returns along with each days inherent inefficiencies. I would argue these types of ETNs are not for long-term investors building diversified portfolios for long-term goals, but rather, they have a place for more speculative day-traders.

Why Regulators Are Worried?

What has regulators concerned is the potential for systemic risk presented by the rapid growth of the newer, synthetic ETNs.

The interconnected chain of counterparties involved in building these synthetic ETN's puts other financial institutions and the investor at risk should one counterparty fail. This creates the potential for risk to cascade through the financial system as it did with the subprime crisis of 2008.

The current risk presented by synthetic ETN's may not be near the levels of 2008 subprime debt, but regulators are starting to sit up and take notice.

Additionally, regulators have taken steps to reduce risk by limiting the amount of exposure a synthetic ETN can have to any one counterparty, issuing standards for collateral quality and liquidity, and attempting to limit conflicts of interest between counterparties and ETF investors.

The problem for the average investor is that due to aggressive marketing, they may not be aware of whether they have invested in a traditional ETF or a synthetic ETN.

Of course, all the required information is provided in the prospectus, but often, individual investors do not read all the small print.

Are ETFs Safe Investments?

So back to the original question, "Are ETFs a safe way to invest?"

Traditional ETFs that hold shares in the underlying index they track present pretty much the same risks as any index mutual fund. With synthetic ETNs, you must accept counterparty risk beyond the normal risk associated with traditional ETFs and mutual funds.

Still, in some cases, there may be a role for some types of synthetic ETNs.

For example, you do not need a synthetic ETN to gain exposure to the S&P 500 – The SPDR does the job. But if you want to access, say agricultural commodities, ETN's could provide the vehicle to do so (unless you can find a place to store pork bellies, soybeans and a few tonnes of wheat!).

You just have to decide whether the benefits of including the particular asset tracked by the synthetic ETP in your portfolio is worth the additional risks.

To protect yourself, make sure you know which type of ETF you are holding. If you do not know, ask your financial advisor and have them explain the risks inherent in each type of structure.

For more information on ETFs or ETNs, please contact me