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# "ETFs: Are they too big to fail?"

By Jim Pratt-Heaney

**Our experience on Wall Street has taught us to be wary of new financial vehicles hailed as the answer to modern investing.** In the last 20 years, no investment product has grown in assets more than the exchange traded fund (ETF). This impressive growth might suggest that ETFs add tremendous value for investors, but we'd suggest taking a closer look.

In 1993, when State Street Global Advisors introduced the SPDR ETF to track the S&P 500 index, the issue size was $6.5 million. Today, the ETF market has over 1,600 ETFs, representing over $2.7 trillion. This sort of growth is not without market consequences. Consider:

- $18.2 trillion worth of ETF shares were traded over a 12-month period from July 2014 to July 2015.[1]
- Over the same 12 months, ETF annual turnover was 870 percent, versus 200 percent for the average stock, and 35 percent for mutual funds.[1]
- 75 percent of ETFs are held by institutions for hedge or portfolio construction purposes, not long-term investment.[2]

Most investors know an ETF is a "basket" of stocks, bonds, commodities or other asset classes. In fact, this range has ballooned to include leveraged and synthetic varieties.

Among other reasons, ETFs vary from their mutual fund cousins due to their ability to be traded throughout the day. While this provides theoretical liquidity, it also introduces risk in attempting to price an aggregation of securities on a real-time basis based upon buy-sell order flow.

**So, what can go wrong?** An analogy is a movie theater with clearly marked exits. Yet, in stressful situations, those same exits cannot handle the flow of traffic in an efficient, safe manner.

Looking back at the market volatility of August 2015, we saw ETFs trading as much as 30 percent lower than the true value of their holdings; there were even temporary trading stoppages because market makers could not follow the rules to maintain an acceptable price. As part of LLBH's financial review, we evaluate prospective clients' investments to discover potential portfolio concerns. We often find portfolios loaded with ETFs and have identified important questions to consider:

- **Diversification:** We advise a diversified portfolio, not a basket within a certain asset class.
- **Position overlap:** Oftentimes, different ETFs hold the same underlying securities, exposing investors to potential company or sector risk.
- **Fees:** While popular due to their discounted pricing, many ETFs' fees have risen.
- **Performance relative to benchmarks:** Difficulty with replication has resulted in fixed income ETF underperformance versus benchmarks, some by more than 5 percent.[3]
- **Are benchmarks appropriate?** Some actively managed ETFs don't have a real index or benchmark to follow, making them difficult to evaluate.[4]
- **Is there potential for trading issues?** The bond market sell-off of 2013 highlighted the impact of rapid movement of money in and out of fixed income ETFs.[5]

Our aim is not to deride ETFs as a poor investment vehicle; ETFs can play a role in a well-formed portfolio. But, as an investor, you should be aware of their underlying issues and recognize that while there may be a lot of assets committed to the category, ETFs are not too big to fail. Ⓦ

*[1]Eric Balchunas. Bloomberg.com, http://www.bloomberg.com/news/articles/2015-07-30/the-amount-of-etf-shares-being-traded-has-eclipsed-u-s-gdp: paragraph 3, July 30, 2015; [2]Jane Wollman Rusoff.* Research *magazine: "How John Bogle Really Sees ETFs," October 2012; [3]Bloomberg Data, cumulative performance versus benchmark, January 1, 2009, to June 1, 2015; [4]Investor.gov,* Investor Bulletin: SEC Exchange Traded Funds, *August 2012; [5]Massoudi, Arash, Braithwaite, Tom and Foley, Stephen. Financial Times, "Bond market sell-off caused stress in $2tn ETF industry," June 21, 2013.*

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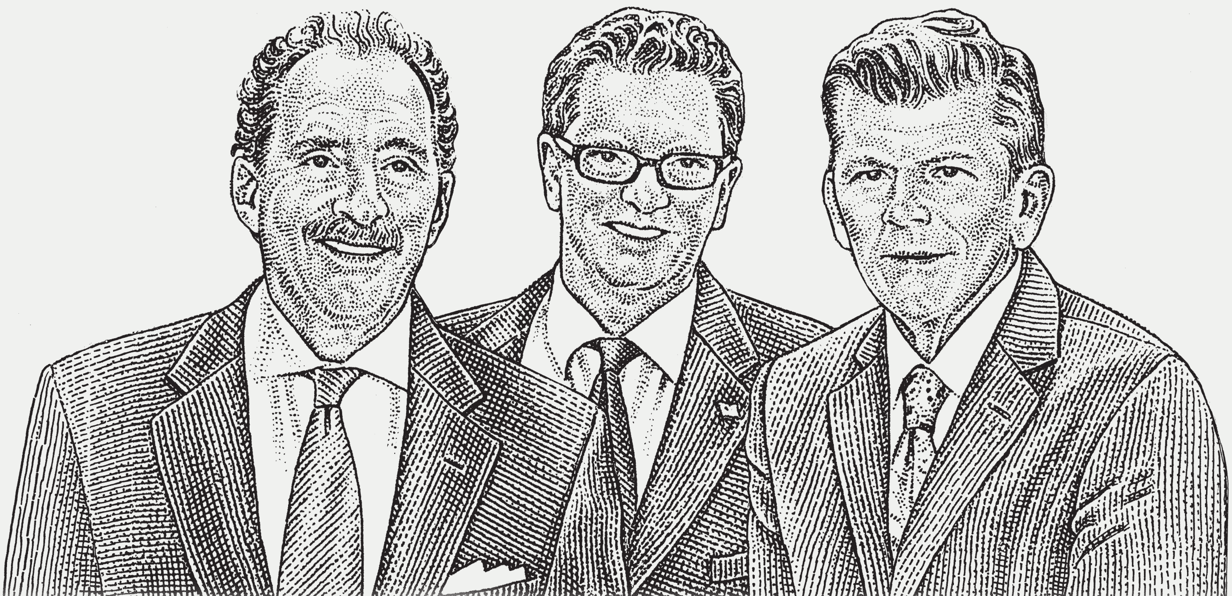
>
> —Jim Pratt-Heaney

### How to reach Jim Pratt-Heaney

*I look forward to discussing how LLBH can help you reach your financial goals and can be reached at* 800.700.5524.



*Left to right:*
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Bill Loftus

ILLUSTRATION BY NANCY JANUZZI

## About LLBH Private Wealth Management LLC

LLBH Private Wealth Management is an independent registered investment advisor offering a full range of wealth-management services. Often referred to as a "virtual family office," LLBH strives to bring clarity and control to the financial lives of its clientele by delivering customized personal and business solutions. From its offices in Westport, Conn., and Los Angeles, Calif., LLBH services high net worth individuals, families and foundations on both coasts and nationwide.

Assets Under Care $1.7 billion (approximately, as of 10/31/2015)

Minimum Fee for Initial Meeting
None required

Minimum Net Worth Requirement
$10 million (investment services)

Financial Services Experience
200 years (combined)

Compensation Method Asset-based

Primary Custodian for Investor Assets
Pershing, A BNY Mellon Company

Professional Services Provided Financial planning, asset management, concentrated stock hedging, lending, cash management, alternative investment due diligence and family office services

Association Memberships Financial Planning Association, Investment Management Consultants Association

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