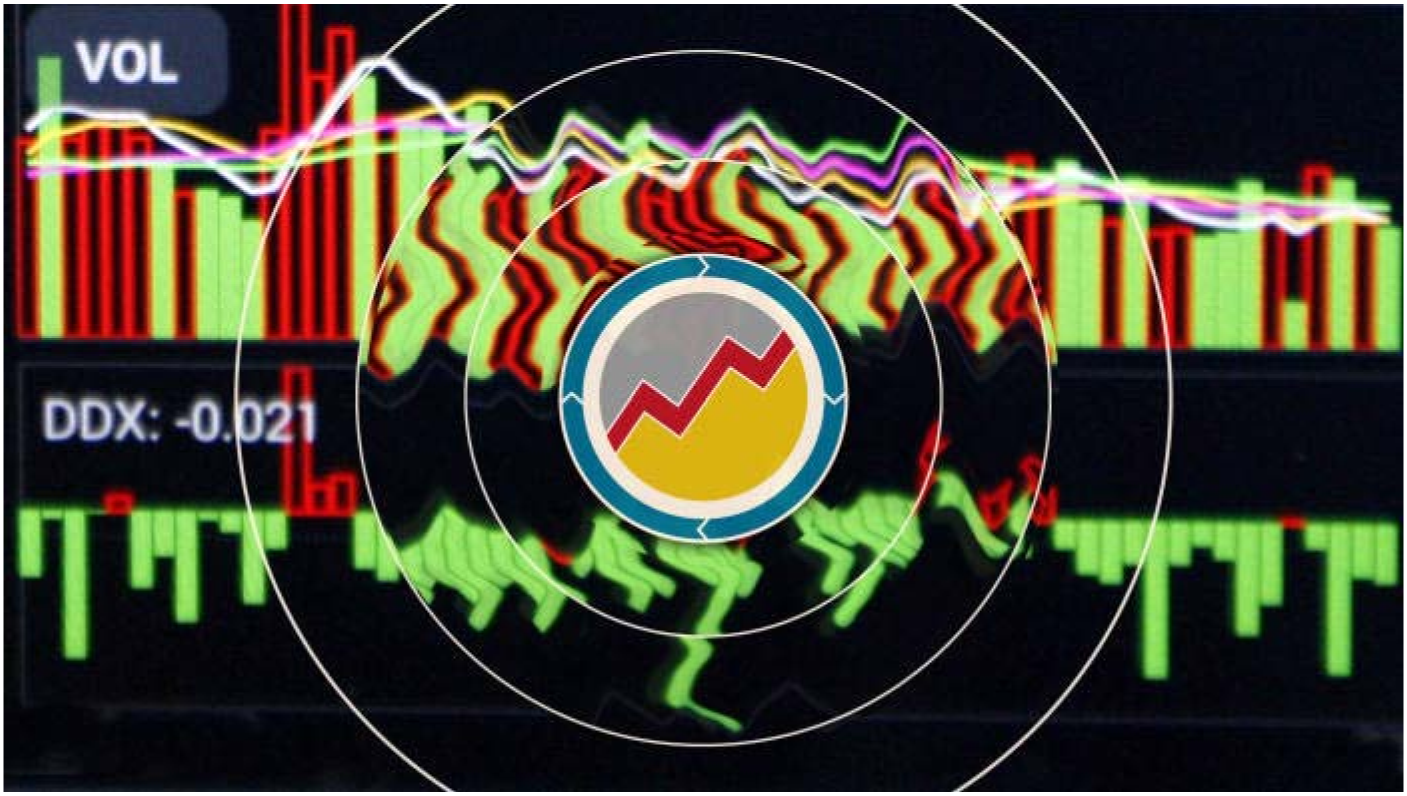
Age of the ETF

ETFs: everywhere but not yet a systemic risk

Odd conduct of funds focused on gold mining highlight case for regulatory review



Some have started to wonder if ETFs are distorting markets rather than mirroring them © FT montage; Getty Images

DECEMBER 8, 2016 by: **Chris Newlands** and **Miles Johnson**

This is part of a series (http://www.ft.com/etfage) on the global rise of exchange traded funds

The morning after the US election (https://www.ft.com/donald-trump) Steven Bregman, a New York-based hedge fund manager, began to notice something strange going on in a corner of the stock market.

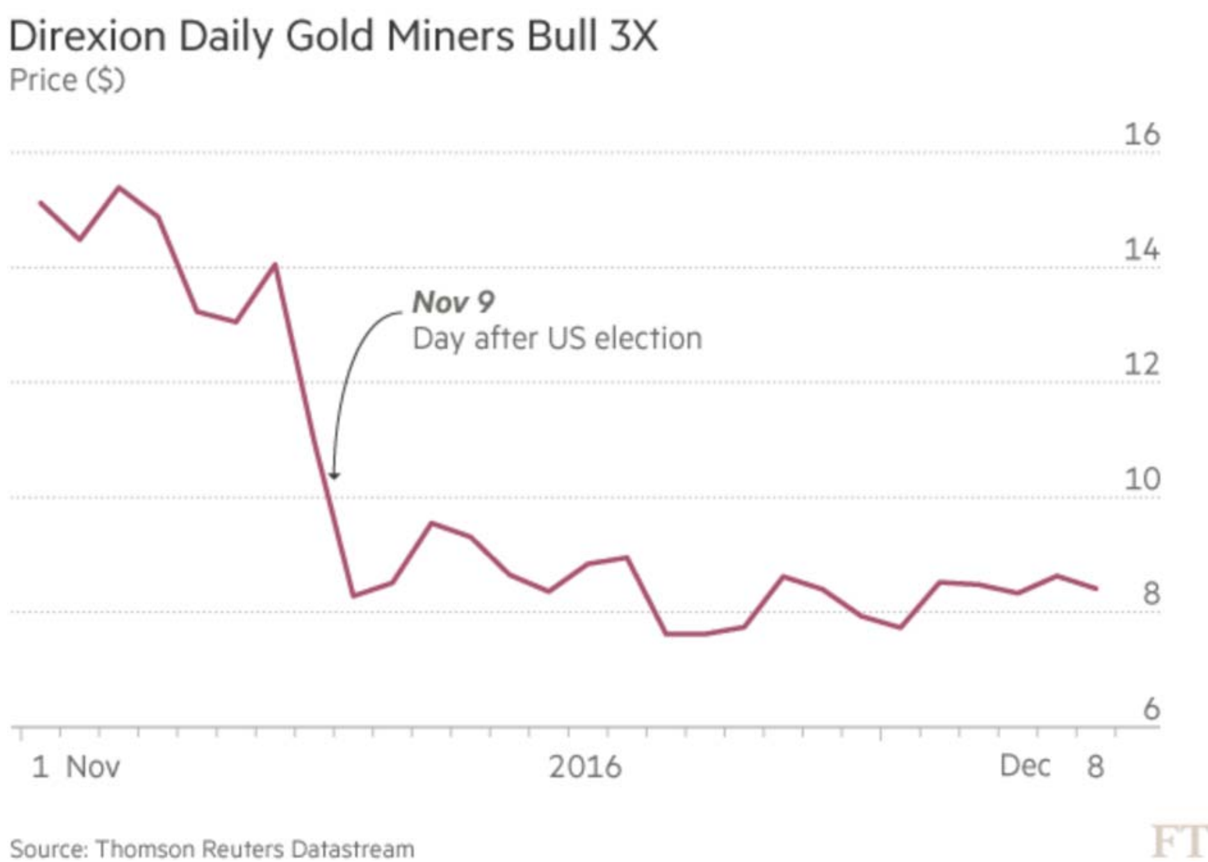
His screen showed that shares of gold mining companies were being sold indiscriminately, falling by double digits, even though the price of gold itself had dropped only a small amount. His first instinct was that the size of the falls did not make sense.

Sitting in the Manhattan offices of his $6bn hedge fund company Horizon Kinetics, Mr

Bregman then started looking at what was happening to the prices of the leading US gold mining exchange traded funds.

One of the largest, the Direxion Daily Gold Miners Bull 3X ETF, known by its ticker NUGT, had started to crash. Its shares tumbled 41 per cent over the three days following the US election, wiping out $493m of paper value.

What stood out to Mr Bregman even more than the sizeable plunge in the ETF's value was the frenetic trading activity taking place in NUGT shares. Even though data showed investors in NUGT had pulled out only $25m of assets — a tiny fraction of its $1.2bn total — the number of its shares traded totalled nearly 200m, almost 12 times the amount in issue.



"No normal listed security trades more than 11 times its shares in three days," Mr Bregman said. "Investors were not pulling out their money, but something else was happening. The ETF had become a forced seller in a big way."

Rather than invest directly in gold mining companies, NUGT invests its assets in the largest gold mining ETF, the $10bn Vectors Gold Miner ETF. This makes the fund akin to an ETF squared, or an ETF of ETFs.

Due to its leveraged structure, the NUGT had been forced to offload twice the amount of assets than the losses it had first suffered.

Over the three days, Mr Bregman watched as shares in the gold mining companies included in the Vectors ETF were pummelled, even as the price of gold itself dropped only 3.5 per cent.

One company held by the ETF, Silver Wheaton, is not a miner at all but a provider of financing to miners in which Horizon Kinetics owns shares. “Silver Wheaton doesn’t own a single shovel or a hard hat,” said Mr Bregman. This did not stop shares in the company tumbling by more than a quarter.

Mr Bregman is not the only worried onlooker. Others with more influence than the hedge fund manager have also started to wonder if ETFs are distorting markets rather than mirroring them.

A few weeks after more than a fifth of all US-listed ETFs were forced to stop trading on August 24 last year, Luis Aguilar, commissioner of the Securities and Exchange Commission, posed this question to fellow regulators during a speech in Washington: “Should we consider curtailing the growth of ETFs?”

The SEC has since begun preparations for a root-and-branch review (http://next.ft.com/content/00196dd0-967a-11e6-a1dc-bdf38d484582) of the industry amid concerns that massive flows into ETFs may be exacerbating volatility in financial markets.

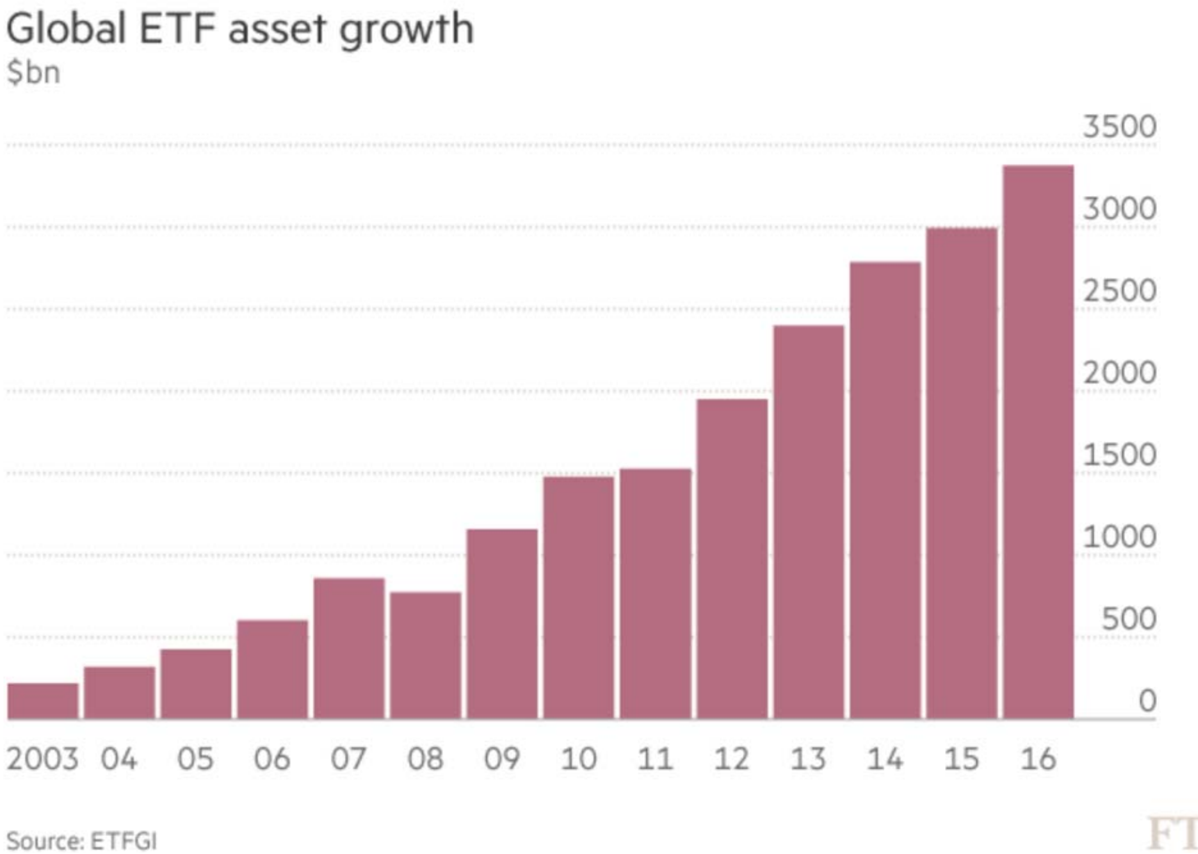
Jack Bogle, who founded low-cost fund giant Vanguard and created the first ever index fund, said: “Yes, it is high time both the ETF industry and policymakers re-examine the entire ETF ecosystem. Why? Because of its sheer size and fragility in times of market stress.”

Trading on that day in August was the most volatile in the US for four years, and was littered with more than 1,000 trading halts (http://next.ft.com/content/cc76fcea-4dc8-11e5-b558-8a9722977189)— stoppages that inhibited the essential arbitrage mechanism of ETFs and prompted their prices to fall well below the indices they are designed to track.

The wild price swings prompted Mr Aguilar to pose six more questions about the credibility and suitability of ETFs, including whether the time was right to “re-examine the entire ETF ecosystem”.

Most believe the time has come for a review but few think the sector has reached the critical mass needed to pose a systemic problem. Amin Rajan, chief executive of Create Research, the asset management consultancy, said: “ETFs are often portrayed as a financial innovation out of control but the reality is more nuanced. First, ETFs account for less than 5 per cent of the total investment universe: below the tipping point at which a systemic threat becomes all too real.

“Second, not all ETFs are created equal. The plain vanilla ones emerged unscathed after being severely stress tested by the emerging market rout in 2013 and the contagion effect from the Chinese market crash in August last year.”



But Mr Rajan does concede there are certain types of ETFs that "keep investors awake at night", such as leveraged loans and high-yield bond ETFs. At a conference in the summer of 2015 Carl Icahn, the billionaire activist investor, claimed high-yield bond ETFs could create severe liquidity problems (http://next.ft.com/content/cf8aecc0-badc-11e6-8b45-b8b81dd5d080)and described BlackRock — the world's largest provider of ETFs — as "an extremely dangerous company". Mr Icahn was sitting next to Larry Fink, BlackRock's founder at the time.

Michael Clements, head of European equities at Syz Asset Management in Switzerland, said: "While regulators need to ensure they are aware of how and where risks are building, it is probably not necessary to curtail growth at this stage. Where there are liquidity risks, regulators and asset managers alike need to ensure there are measures in place to protect clients, themselves and the broader system. This could include capping the outflow of funds — something that mutual funds are used to but not ETF providers."

In the meantime providers will have to sit and wait for the results of the SEC's review and hope that the regulator, like Mr Bregman, fixes its gaze on the corners of the market rather than the market itself.

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