HORIZON RESEARCH GROUP

The ETF Tide and Stock Selection

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THE ETF TIDE AND STOCK SELECTION

Why does stock selection seem to not work? To answer that question, one need only look at the historical data on the growth of assets under management (AUM) in equity ETFs that BlackRock compiles. The table below reproduces those figures from 1993, when there were $800 million AUM in equity ETFs, to the end of 2010, when there were over $1 trillion. No stock selector could stand before such a trend in which stocks are either purchased in enormous quantities, or are not purchased based on whether or not they're included in ETFs. The reason for an ETF to purchase or not purchase a company's stock depends on the decision rules for each ETF, which also determine the position size. Those reasons might have nothing to do with the fundamentals of the company in question.

	ETF AUM *($ in billions)*		ETF AUM *($ in billions)*
1993	$0.8	2002	$137.5
1994	1.1	2003	205.9
1995	2.3	2004	286.3
1996	5.3	2005	389.6
1997	8.2	2006	526.5
1998	17.6	2007	730.2
1999	39.6	2008	596.8
2000	74.3	2009	841.6
2001	104.7	2010	1,053.8

Source: http://www.blackrockinternational.com/content/groups/internationalsite/documents/literature/etfl_industryhilight_ye10.pdf,

It's hard to imagine any individual investor or any professional manager standing before this growing tide. According to the National Stock Exchange, during the month of October 2011, $23.6 billion flowed into ETFs. Of that $23.6 billion, $22.8 billion went into the four leading providers, which include Vanguard, Blackrock, State Street, and PowerShares. [1] As a matter of practice, the ETFs have the effect of concentrating the assets in the hands of four firms.

Note that the $23.6 billion represents one month of cash flow. If that amount of money went to one active manager in one month, people would be appalled; however, when it goes to a passive manager, people find it normal and they continue the practice. Year-to-date cash flow for the ETF business is $99 billion as of the end of October 2011, which is up roughly 19% from last year.

If this trend were to be reversed, meaning that people would revert to individual management, clearly the indices would have to be sold, but who exists to buy the index? If X dollars had to be removed from a given index, each individual security would have to be proportionately sold. What instrumentality exists to purchase those shares when and if they come into the marketplace? I think people should consider that question. The answer is that there is no such instrumentality.

[1] Source: http://www.nsx.com/content/etf-net-flows-list