



Under the Hood: What's in *Your* Index?

(An Ongoing Series - November 2015)

How Liquid is YOUR ETF, or What Does This Have to Do With Me?

So far in this series we've reviewed:

- How the standard asset allocation model typically assigns 30% to 40% of a portfolio's stock investments to international ETFs, to diversify a core position in the S&P 500 Index – *even though the S&P 500 companies already earn that much in foreign revenues.*
- How the enormity of U.S. investors' ETF buying power applied to an emerging market like India (\$14 billion from just 4 ETFs¹) restricts them to the largest few percent of those companies, companies that either derive most of their earnings from outside India or are bid to very high valuations – that is, *exposure that is not emerging, not even Indian, nor even promising.* These ETFs returned, essentially, nil since 2007².
- How, with their strict rule-set for investing new funds, which do not include a criterion for valuation, for instance, or even for the likelihood of solvency, the amount of index-based buying power for international high yield bonds can end up altering the cost of borrowing for an entire nation: so much so that a Russian Federation 15-year bond can sell for 3.66%, essentially the same price as a 10-year IBM bond, or that the Republic of Lebanon can sell a 6-year note for 5.6%, about the same as Wendy's.

These are examples of how mechanistic indexation cleanses the investment process of the most basic fundamental evaluation or judgement, and can result in topsy-turvy choices and unintended consequences. The sheer volume of money flowing into these baskets of securities can overwhelm the available supply and dangerously distort prices. In that sense, they are no longer indexes in the traditional performance measurement and passive participation sense – since they change the pricing of that which they purport to measure and participate in. Indexes have become just another investment. A trillion dollars-plus of money flows since 2008 is going to have an impact.

What does this have to do with me, if I simply buy a plain-vanilla ETF of large-cap, creditworthy, U.S. companies? No esoterica, just plain old investing. Unfortunately, even bystanders are now at risk. An event occurred this past August 24th. We'll describe it further in a bit, but it involved 30%+ price drops in a variety of ETFs. It was reminiscent of an event in October 1987 when the S&P 500 dropped by 27% in 2 days. That was a shocking decline, neither preceded by, nor followed by, a recession. Neither were stocks particularly expensive, nor was there any funny business with interest rates or declarations of war. What did happen, for the first time in history, was computer-driven trading, called portfolio insurance – which was supposed to reduce volatility: it was safer, see.

Portfolio insurance involved selling stock futures as the market declined. So a 0.5% decline in the S&P 500 would initiate the sale, within a stock portfolio, of an equivalent amount of stock futures. This was intended to reduce exposure to equities in a declining market, so that by the bottom, the portfolio will

1 The four ETFs mentioned above include: Wisdom Tree India Earnings Fund, iShares MSCI India ETF, Vanguard FTSE Emerging Markets ETF and, iShares MSCI Emerging Markets ETF.

2 The iShares MSCI India ETF was not inception until 2012.



have outperformed, since it would have been reducing its exposure. It worked just fine with the first pension plan to adopt it. That is the way of the market – you and a few friends can do exceedingly well with a secret formula, but once too many others share the secret, it simply will not work anymore; if enough people know the secret, it will eventually work in reverse. Supply and demand and pricing.

By the time that a minor bit of political news caused the stock market to open down sharply on October 20th, 1987, portfolio insurance had become quite popular with institutional investors, such as pension funds and endowments. They employed a sufficient amount of capital in this manner such that their automated sales of futures contracts caused the market makers, challenged by the volume, to hedge their own exposure to those futures contracts by selling short the underlying stocks. This further depressed share prices, which caused the computers to engage in a new round of futures selling, and so the cascade began.

In today's investment world, a standard method to reduce risk is to invest in an index rather than individual securities, and the indexes have focused the net buying into a relatively narrow set of companies: the largest and most liquid, in order to accommodate the demand. This buying power, in turn, assisted in producing strong returns and lower volatility. Which has attracted more capital. A (temporarily) virtuous circle. There's both a lot of assets and a lot of volume. Perhaps too much. ETFs rose from 3% of public stock market value in the U.S. in 2007 to 7.5% in 2014 and, more importantly – and startlingly – from about 23% of daily trading volume to almost 27% – hugely more than in October 1987.

Where does this trading take place? Take the most benign of ETFs, the very first: the SPDR S&P 500 ETF (SPY). Established in 1993, it has \$168 billion of AUM. It is a basic asset allocation building block, the idea being that if long-term participation in the economic returns of the larger U.S. companies is appropriate in someone's portfolio, that position should be held for a long period of time. One needn't try to second-guess interest rates, economic cycles, or presidential cycles. Absent changes in planning assumptions (such as retirement age), this position might be rebalanced periodically, say quarterly or annually, if it rises or falls too much. That's the proposition of indexation – participating, not exceeding, not trading.

So, how much trading takes place in the S&P 500 companies? The annual share turnover rate of the largest 10 companies averages 115%; that's about 0.45% per day. Armed with that information, what do you think is the daily turnover of SPY itself, the index product that one neither intends to trade frequently, nor needs to?

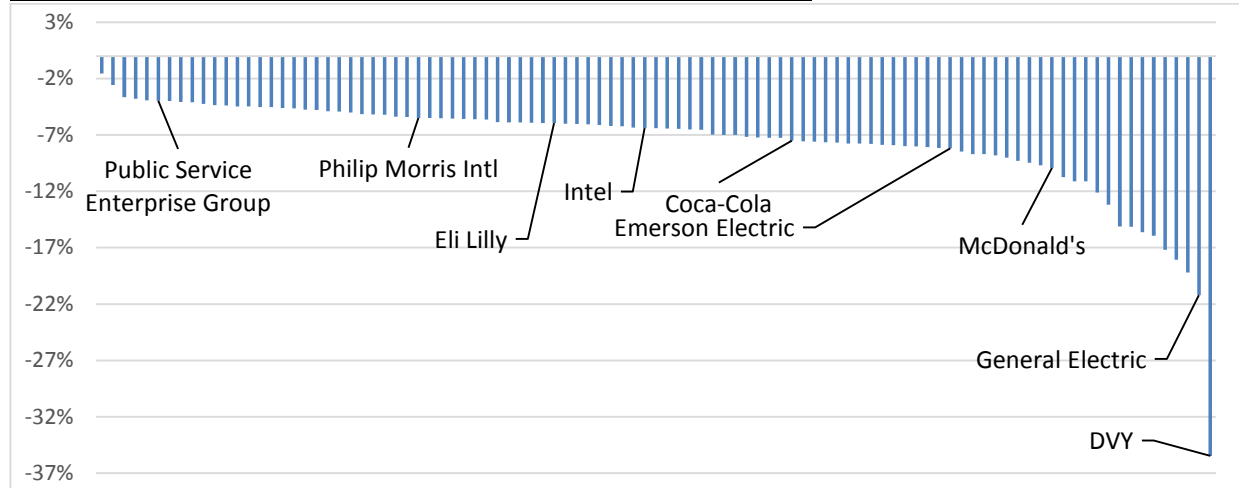
The daily turnover of SPY is 16.7%. Just to be clear, that means that 100% of its shares are traded every 6 days, and each year that's 4,200%. Investors seem to have liquidity demands for the index instrument that are 35x the daily trading volume of its largest constituents. What if instead of trading the shares of SPY back and forth between each other, which they can because more money is constantly coming into the index, there is, on balance, net selling of SPY? Is there enough underlying liquidity?

Which brings us back to August 24th which, among other interesting features, set the all-time record share of ETF trading volume of 37%. That morning, prices of more than a few ETFs departed markedly from their net asset values. This is not supposed to happen. Example: shares of DVY, the iShares Select Dividend ETF, dropped 35%. Yet, the NAV of the fund declined by no more than 2.5%, and only 8 of its 99 holdings declined by more than 15%. DVY is no marginal fund; it has \$13 billion of assets under management, and



McDonald's and General Electric are typical holdings. We believe that's a sign. The safety of indexation doesn't feel so safe anymore; or perhaps the excesses of indexation have created this sense of danger.

Largest Intra-Day Drop in DVY Constituent Prices: August 24, 2015



Source: iShares, Bloomberg

Why all of this buying and selling, which has nothing to do with indexation as conceived? It might have something to do with the *business* of selling indexation products. It has been estimated that the various ETF providers collect about \$6 billion per year from management fees. But roughly \$9 billion is collected from the market-making spread on all of that trading. So let's compare the profit proposition for Wall Street as between ETFs and mutual funds.

Not so many years ago, before the mass market use of ETFs, mutual funds were the instrument for indexation. The Vanguard S&P 500 Index mutual fund was established in 1976, and now has \$150 billion of AUM. The annualized turnover of its units is only about 30%, or 0.12% per day. Now that makes intuitive sense; while that's more turnover than any individual would need, there are thousands or millions of investors who might own units. Certainly, it makes more sense than 4,200%. The major selling point of ETFs is that whereas a mutual fund is priced and can be bought or sold only once a day, at the end of the day, an ETF's holdings are priced every 15 seconds. And an ETF can be traded – and is – every millisecond of the day. That tradeability helps all sorts of players in the financial markets – although it's not obvious what the value of 15-second pricing is for someone with a multi-year or multi-decade allocation to large U.S. companies.



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