Did ETFs Trigger October Selloff?

BI ETF Research, Global Dashboard


Eric Balchunas
Team: Strategy
BI Senior ETF Analyst


James Seyffart
Team: Strategy
BI Associate Analyst

Evidence Again Counters Claims ETFs Are Tail Wagging Market Dog

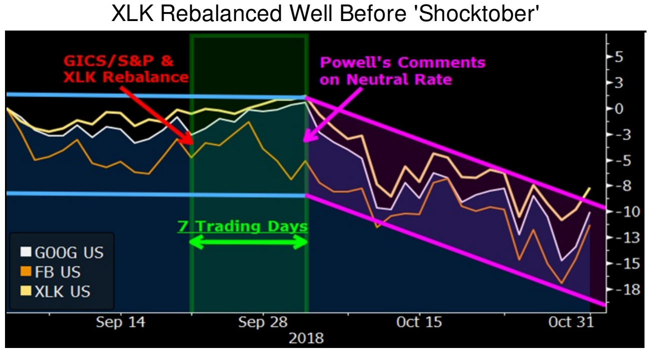
(Bloomberg Intelligence) -- ETFs are often wrongly blamed for market selloffs, and there's no evidence that a technology fund's rebalancing during the GICS classification triggered the latest one. The rebalancing occurred more than a week before the start of the worst decline for stocks since 2011, which was more likely sparked by Federal Reserve comments. (11/14/18)

1. Google, Facebook Rose After XLK Sold Them

During the recent GICS reclassification, the Technology Select Sector SPDR Fund (XLK) was forced to sell about $1.2 billion worth of Facebook shares and $2.3 billion of Google as they moved to the new communications sector. The selling wasn't matched by inflows, fueling claims that it helped trigger the market's October decline. Yet the rebalancing took place on Sept. 21, more than a week before the selloff began, and both stocks rose more than 1% in the following days. In addition, XLK's selling amounted to only 0.3% of each company's shares outstanding.

Professional investors who used XLK likely bought a sampling of the tech stocks on their own instead of using the new and relatively illiquid Communication Services Select Sector SPDR Fund (XLC). (11/14/18)

XLK Rebalanced Well Before 'Shocktober'

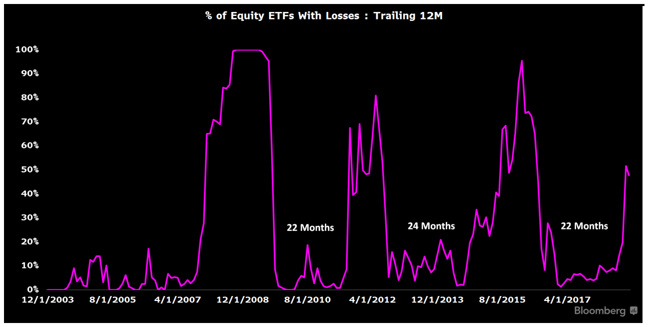


2. Blame 'Powell Panic' and 'Two-Year Itch'

The stock selloff that began a week after the historic -- and orderly -- GICS reclassification was more likely sparked by comments by Federal Reserve Chairman Jerome Powell indicating further rate-tightening. In addition, selloffs have come every two years or so during this bull market as investors take profits after a run-up. This pattern can be seen in the percentage of equity ETFs with a negative 12-month return over the past 15 years -- a figure that's spiked at regular intervals.

While ETFs play a role in market swings, they act more to reflect the mood of active investors. Passive funds in general don't trigger selloffs, but they can amplify them as they react and recalibrate to the prices set by active investors. (11/14/18)

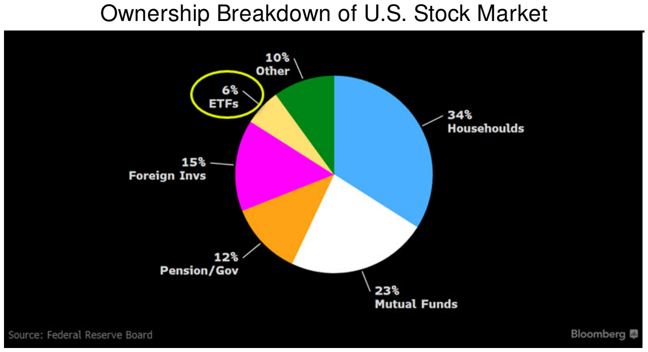
% of Equity ETFs with Negative 12-Month Returns



3. Small Stock Stakes Should Ease System Risk

Despite claims that ETFs could cause the next financial crisis or distort fundamentals, they own a relatively small slice of the market. While their assets are growing quickly, only 6-7% of an average company's shares outstanding are owned by ETFs, though there are pockets where that percentage is higher. If ETFs maintain their asset trajectory, they may own about 20% of some stocks in 10-20 years. But even at that level, majority ownership by active investors would help to properly price the shares. (11/14/18)

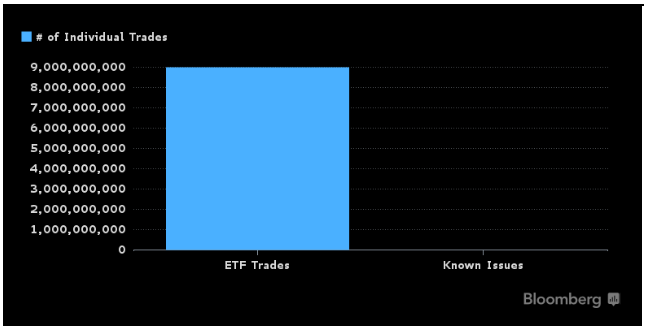
Ownership Breakdown of U.S. Stock Market



4. Handful of Issues in 9 Billion Trades

While ETFs have executed about 9 billion successful trades in the past 25 years, the reliability of market plumbing and exchange connectivity remains a concern for issuers and investors. The few issues that have arisen have sprung from elsewhere in the market. For example, many ETFs were unable to complete closing auctions on March 20, 2017, when the New York Stock Exchange had a problem with a software update on its Arca trading platform. Ultimately, the ETFs got their closing prices, but the glitch highlighted their reliance on exchanges and computers. (11/14/18)

Total ETF Trades vs. Known Trading Issues

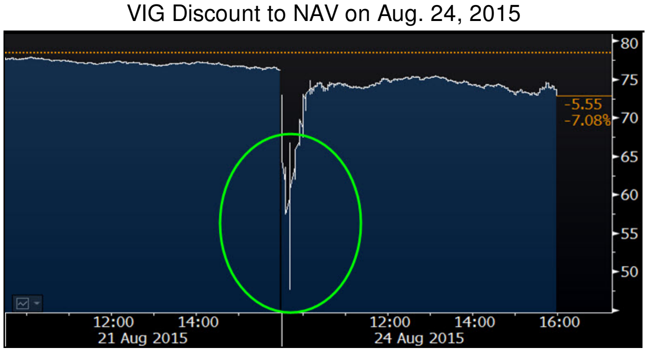


5. Education Needed as ETF Use Attracts Critics

ETFs were blamed in the past year for creating a stock-market bubble, holding shares "hostage," causing an exchange's software glitch and -- most recently -- sparking the worst month for the S&P 500 Index in seven years. Such criticisms may reflect a lack of understanding of the size and scale of ETFs and their mechanics, such as how the creation and redemption process works, or what market makers do. As a result, issuers must better educate users about the way ETFs function.

When the market fell at the open on Aug. 24, 2015, NYSE rules resulted in some stocks being halted, prompting market makers to widen their bid/ask spreads on ETFs. Though ETFs were downstream from the cause, they were characterized as "broken" in news reports. (11/14/18)

VIG Discount to NAV on Aug. 24, 2015



6. Worried About Index Funds for 40 Years

ETFs and index funds have been around for decades, and so have concerns about them. Well before assets in ETFs and index funds grew to about $7 trillion, they were targeted over their potential impact on trading efficiency. In a 1975 letter to the Wall Street Journal, the director of research for the former Chase Investment Management warned that index funds would create market distortions.

Even in parts of the stock market where ETFs have above-average ownership, such as REITs, there's scant evidence they dictate the market. (11/14/18)

Website

"A proliferation of index funds, though accounting for ever-increasing amounts of investment monies, would lead to an inefficient market. A stock's price would become more a function of the monies flowing into index funds than a reflection of its investment merits. The efficient market hypothesis would be dead."

Mary Onie Holland - Director of Research, Chase Investors Management Corporation
Wall Street Journal, Letters to the Editor, Dec. 8, 1975

Click to view website

Passive Funds Near Majority Owner of Some Stocks, and That's OK

Passive funds' growing stock-market ownership hasn't had any unusual effects on share prices so far, and their focus on ESG issues could be viewed as complementary to active managers that mostly chase profits. About 16% of the market is passively owned, with pockets exceeding 30% and Tanger Outlets approaching a majority. (10/25/18)

7. Tanger Close to Majority Passive Ownership

Tanger Factory Outlet Centers is on the brink of becoming the first stock with most of its shares outstanding held by passive funds. Tanger is an outlier, given the Russell 3000 Index as a whole is only 16%-owned by passive funds, but it offers a glimpse of what the broader market may look like in 10 years if the shift to passive investing from active management sustains its current pace. Tanger has 31% of its shares held by just ETFs, the highest among stocks.

While inflows and outflows of ETFs directly involve the buying and selling of Tanger's stock, there's virtually no correlation between the shares outstanding of its biggest ETF owner, the SPDR S&P Dividend ETF (SDY), and its stock price. This indicates that active funds' buying and selling is determining the price more than passive flows. (10/25/18)

Top 10 Companies with Highest Passive Ownership

Ticker	Name	ETF Ownership %	Passive Ownership %	GICS Sector
SKT	Tanger Factory Outlet Centers Inc	31.5	46.85	Real Estate
MDP	Meredith Corp	29.56	40.49	Comm Serv
WPG	Washington Prime Group Inc	23.62	39.16	Real Estate
RPT	Ramco-Gershenson Properties Trust	22.64	38.18	Real Estate
PEI	Pennsylvania Real Estate Investment	22.57	37.9	Real Estate
CBL	CBL & Associates Properties Inc	21.77	37.65	Real Estate
ABM	ABM Industries Inc	25.86	37.54	Industrials
KRG	Kite Realty Group Trust	21.19	37.26	Real Estate
UBA	Urstadt Biddle Properties Inc	21.38	37.01	Real Estate
CHSP	Chesapeake Lodging Trust	21.08	36.84	Real Estate

Note: Russell 3000 Index

Bloomberg

8. Diverse Traits Appeal to Variety of ETFs

Contributing Analysts Lindsay Dutch (REITs)

Tanger is among several small REITs that match the filters for different types of passive funds, resulting in a high level of passive ownership, with ETFs leading the charge. Tanger's sector puts it into REIT funds, while dividend funds like its high yield. The REIT also meets thresholds for both mid- and small-cap funds with its borderline market value of less than $3 billion. Tanger also makes it into growth and value ETFs. All of these categories are increasingly popular with passive investors, attracting about $400 billion in combined inflows during the past eight years.

If interest rates were to fall, Tanger's passive ownership could top 50% within a year. Should rates continue to rise, the figure will likely drop to about 40%. (10/25/18)

Tanger Held by Several Kinds of Passive Funds

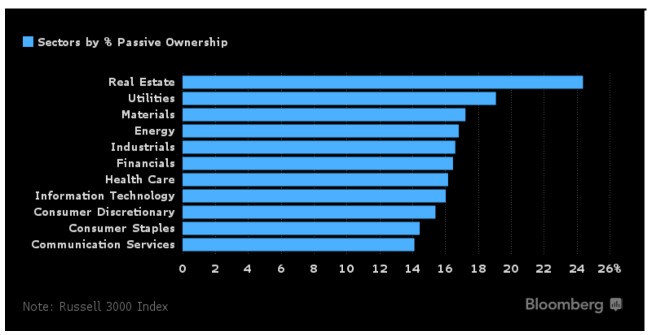
	Portfolio Name	Ticker	% Portfolio	% Out	Holder Name
1.	SPDR S&P Dividend ETF	SDY US	1.556	11.99	State Street Global Advisors Inc
2.	iShares Core S&P Mid-Cap ETF	IJH US	0.120	2.76	BLACKROCK FUND ADVISORS
3.	Vanguard Real Estate ETF	VNQ US	0.182	2.68	VANGUARD GROUP INC
4.	Vanguard Real Estate Index Fund	VGSIX US	0.182	2.34	Vanguard Group Inc/Wayne
5.	Vanguard Total Stock Market Index Fund	VTSMX US	0.007	2.23	Vanguard Group Inc/Wayne
6.	iShares Russell 2000 ETF	IWM US	0.095	2.15	BLACKROCK FUND ADVISORS
7.	Vanguard Small-Cap Index Fund	NAESX US	0.057	1.88	Vanguard Group Inc/Wayne
8.	Principal Investors Fund Inc - Real Esta...	PRENX US	0.796	1.44	Principal Management Corp
9.	Principal Small-MidCap Dividend Income...	PMDAX US	0.964	1.24	Principal Management Corp
10.	Vanguard Extended Market Index Fund	VEXMX US	0.041	1.22	Vanguard Group Inc/Wayne
11.	SPDR S&P MidCap 400 ETF Trust	MDY US	0.117	1.15	State Street Global Advisors Inc
12.	DFA Real Estate Securities Portfolio	DFREX US	0.248	1.02	DIMENSIONAL FUND ADVISORS LP
13.	iShares Russell 2000 Growth ETF	IWO US	0.191	0.88	BLACKROCK FUND ADVISORS
14.	Vanguard Small-Cap Value Index Fund	VISVX US	0.106	0.88	Vanguard Group Inc/Wayne
15.	Virtus Ceredex Small Cap Value Equity F...	SCETX US	2.646	0.87	Virtus Fund Advisers LLC
16.	Principal Global Diversified Income Fund	PGBAX US	0.154	0.73	Principal Management Corp
17.	Schwab U.S. REIT ETF	SCHH US	0.321	0.72	Charles Schwab Investment Man...
18.	Vanguard Small-Cap Value ETF	VBR US	0.106	0.70	VANGUARD GROUP INC

9. Real-Estate Stocks Most-Held by Yield-Seekers

About a quarter of all real-estate stocks are owned by passive funds -- the biggest share by far for any sector. The high yields offered by the stocks, many of which are pass-through securities, make them attractive in a low-yield environment. As a result, any prolonged increase in interest rates would likely drag ownership levels closer to the market average. Yield-thirsty investors have made utilities the second-most-owned sector among passive funds.

The rise of passive investing has led to concerns about corporate governance. Yet the biggest passive asset managers all have corporate-governance teams who engage with boards, usually over creating an environment for long-term growth, rather than short-term business issues. (10/25/18)

Real Estate Is Passive Funds' Most-Owned Sector



10. Passive Won't Be Pushover for CEOs, Activists

The increase in passive-fund assets to about $7 trillion has raised concerns that CEOs and activist investors will have an easier time using these shareholder votes to their advantage. Yet passive-fund issuers such as Vanguard and BlackRock have indicated they won't be pushovers, insisting they'll maintain an independent outlook that focuses on long-term performance. For example, Vanguard voted in about 13 proxy contests during the 2017-18 season and sided with activists 38% of the time. Each time, Vanguard officials met with activist investors and the company's management team, then researched the issue before making a decision. (10/25/18)

Company Website

"As a fiduciary acting on behalf of these clients, BlackRock takes corporate governance particularly seriously and engages with our voice, and with our vote, on matters that can influence the long-term value of firms. With the continued growth of index investing, including the use of ETFs by active managers, advocacy and engagement have become even more important for protecting the long-term interests of investors."

Larry Fink - Chairman and CEO, BlackRock
Letter to CEOs, Jan. 24, 2017

Click to view website

11. Passive Vanguard Promises Engaged Role

The rise of passive investing doesn't necessarily mean CEOs will face less pressure over corporate governance. Vanguard and BlackRock, which rank among the top three owners of about 95% of S&P 500 stocks, say they will promote good governance to boost shareholder returns over time, regardless of whether funds that own the shares are active or passively managed. As Vanguard CEO Bill McNabb wrote in a 2015 letter to boards: "We have no interest in telling companies how to run their business, but we have valuable governance insights to share with the board of directors."

Passive owners, who focus mostly on ESG concerns, could be viewed as complementary to active owners, who focus on profits. (10/25/18)

Vanguard's Principles for Corporate Governance

Independent oversight	Board should be substantially independent of management and have independent leadership (i.e., chair or lead director).
Accountability	Management should be accountable to the board and directors should be accountable to shareholders.
Shareholder voting rights consistent with economic interests	This means one share, one vote. No special share classes for added voting power.
Annual director elections and minimal anti-takeover devices	Minimize use of anti-takeover devices such as classified boards or poison pills.
Sensible compensation tied to performance	Executive pay should be tied to the creation of long-term shareholder value.
Shareholder engagement	We encourage boards to have a thoughtful process to communicate with shareholders.

To contact the analyst for this research:
Eric Balchunas at ebalchunas@bloomberg.net