Financial services industry has habit of spoiling its best inventions

Save the ETF!

Olivier Zucker

Once again, the financial industry needs to be saved from itself. Over the past 25 years, time after time, perfectly good financial instruments have been turned into hazardous tools of wealth destruction. My fear is this destructive tendency is about to grip exchange-traded funds (ETFs), one of the most compelling and useful products ever launched. It is therefore time to launch a campaign - 'Save the ETF!'

Olivier Zucker is managing director of Zucker & Co Investment Advisors

ETFs allow everyone from private retail investors to hedge fund traders to build efficient and well-diversified portfolios and to implement investment ideas quickly and cheaply. With a very low tracking error and low expenses, ETFs enable investors to get the exact exposure they want, in the most efficient way, without forfeiting liquidity and flexibility.

Structures examined

Yet these simple and successful instruments are being turned into something altogether more complicated and opaque. In part, this is a result of genuine investor demand to cover new and different markets. But it is also being driven by product providers seeking to increase profits

Crucially, not all ETFs are equal. As an investor who exclusively uses index trackers to implement asset allocation in portfolios, I am very comfortable with some structures, and tend to steer clear of others.

An ETF that fully replicates an index – physically buying the securities it is tracking – is the best and safest structure. While this is straightforward for major equity indices such as the FTSE 100, not all benchmarks lend themselves to this method: in smaller and less liquid markets, the smaller constituents cannot be traded in sufficient quantities to allow the ETF to work efficiently. ETF providers thus often resort to 'portfolio sampling', creating a basket that tracks the underlying index as closely as possible, without holding all the stocks in the index.

Swap shop

Unfortunately, a growing number of ETFs are not built physically but are synthetic and based on derivatives known as swap contracts. In this structure, the ETF does not hold the underlying securities at all, but enters into a swap agreement with an investment bank. The ETF receives the total return of the underlying index and, in exchange, the ETF pays the investment bank the performance of the collateral portfolio in which it has invested on the advice of the swap provider (see 'How ETF swap agreements work' below). Collateral portfolios are usually a combination of cash, fixed income and a surprising amount of equities – in most cases more than 50%.

I am still wary of these synthetic ETFs and use them only when and where there are no alternative ways to access to a market. They expose the investor to a 'counterparty risk' which does not exist with physical ETFs. For example, if Lehman Brothers had acted as a swap provider to an ETF at the time it went bankrupt, the investor would have faced a great deal of uncertainty and would have been dependent on the collateral portfolio for preservation of capital and future returns.

Providers of synthetic ETFs often dismiss these concerns by pointing out ETFs are 'over-collateralised' (in other words if the ETF invests £100, the swap counterparty will provide a collateral portfolio which is worth £110 or £120). Yet there is still relatively little transparency about how the collateral portfolio is managed, who takes the decisions and what guidelines they follow. Stress tests are needed to show how these collateral portfolios might perform in a crisis, and to provide clarity on what would happen if a swap counterparty goes into default.

The emergence of leveraged ETFs and short ETFs has created an additional set of potential problems. These structures combine counterparty risk with liquidity risk, which can be explosive and lethal.

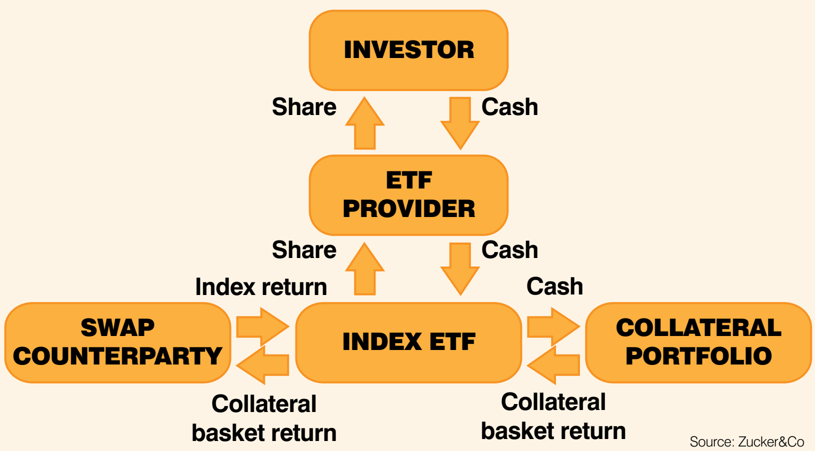
Investors should never forget the liquidity of a derivative is limited by the liquidity of the underlying market. In these structures, investors are dependent in part on the ability of the counterparty to manage its swap exposure, which in turn is dependent on its credit standing.

Call to action

As the ETF industry has evolved, regulatory bodies have begun focusing on ETFs as a source of future systemic risk to the entire financial system. This seems far-fetched, particularly while fully-replicated physical ETFs still represent the majority of assets.

Nevertheless, I believe now is the right time to focus on saving the ETF from the financial world's destructive tendency to over-innovate. Any future crisis involving more opaque and complex structures risks bringing down the weight of a regulatory clampdown on all ETFs. Regulatory measures could suddenly make it difficult to access even the most basic and transparent ETFs, imposing huge constraints and endangering a valuable product that offers a wide range of benefits to private investors.

How ETF swap agreements work



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