

What Every Investor Should Know About Exchange Traded Funds (ETFs)

Exchange traded funds are mutual fund-like baskets of securities that trade like stocks. The earlier exchange traded funds provided investors with a low-cost way to achieve exposure to a broadly diversified stock index like the S&P 500 Stock index and the Russell 2000 stock index. Over the past several years, however, Wall Street created numerous exchange traded funds that focus on ever-narrower market sectors and slices of sectors (niche funds), as well as leveraged, inverse leveraged and synthetic exchange traded funds. These extreme and exotic funds have many hidden risks that are dangerous for investors.

The risks and problems associated with ETFs may include one or more of the following:

- **Leverage** – Leveraged and inverse leveraged funds use leverage to multiply returns two or three times. They are far more sensitive to market movements than non-leveraged exchange traded funds because of the multiplier effect of leverage. Leveraged and inverse leveraged exchange traded funds can lose many times their value in a single day.
- **Derivatives** – Use of derivatives and daily compounding of returns makes these funds unsuitable as long-term investments. For example, a leveraged exchange traded fund that is supposed to return 200% of an index's return can decline in value, even though the index rises. Derivatives also introduce the risk of tracking errors and counterparty risks (the other side of a derivatives transaction is an unsecured obligation of the counterparty, which may default on it).
- **Volatility** – As exchange traded funds have increased in popularity, so have overall market volatility and portfolio risk for many unsuspecting investors. Exchange traded funds now generate 35% to 40% of exchange trading volume, according to Morningstar. High-frequency trading involving exchange traded funds was implicated in the flash crash that occurred in May 2011, which sent equity prices to impossible highs and lows in a matter of minutes. Exchange traded funds that track broadly diversified indexes like the S&P 500 stock index contribute to the current extreme market volatility by the sheer volume of trading in such funds, especially by high-frequency computer-based traders. With regard to extreme and exotic exchange traded funds, niche exchange traded funds are thinly traded slices of narrow sectors of the market, which can cause them to exhibit sudden and large changes in market prices. Synthetic and highly leveraged exchange traded funds are also extremely volatile.
- **Illiquidity** – Niche exchange traded funds are thinly traded and illiquid. As a result, they are subject to greater price volatility and market manipulation.
- **Fees** – These funds may have hidden costs, including a differential between the purchase price and the sell price, as well as transaction-based commissions.
- **Lack of transparency** – Hidden costs, use of leverage and complex derivatives, and illiquidity combine to render niche, leveraged, inverse leveraged, and synthetic exchange traded funds opaque to most financial advisors and investors. The quality of the underlying assets in synthetic exchange traded funds is often unclear. In addition, bond exchange-traded funds have problems associated with pricing and lack of transparency.
- **Overconcentration** – Sellers of niche exchange traded funds invite investors to speculate on supposedly hot trends. Speculation often leads to a concentrated rather than a balanced and diversified portfolio. Most investors should limit exchange traded fund holdings to broadly diversified funds, which may include the niche that interests them, but as an appropriate proportion of their overall portfolio.
- **Closure** – Niche exchange traded funds often do not attract enough capital to make it profitable for the managers, who then close the fund. When an exchange traded fund closes, shareholders may incur losses or owe taxes on any gains.
- **Premium/Discount** – Exchange traded funds trade like stocks with the result that they may be priced at a premium or a discount relative to the net asset value of the underlying holdings. Several corporate bond exchange-traded funds had discounts to their net asset value of 5 percent or more in the 2008 crisis.



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(877) 673.0047