



Exchange Traded Funds Impact on Active Managers

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April 2007

Exchange Traded Funds (ETF) have grown in popularity among investors in recent years, as a method of getting immediate market exposure. The total index segment has grown from \$5.6 billion of the market in 1988 to more than \$1 trillion today, and is 17% of the total equity fund market. The ETF share is \$430 billion. These index securities trade like stocks, enabling small and large investors to structure liquid portfolios with the diversification of large institutions, but at a lower cost. The rapid growth in ETF trading volume is affecting the stock portfolios of active managers.

Mutual funds are priced at the end of the day, taking in account subscriptions, redemptions, and the underlying securities closing prices. Market volatility is reduced by this method. Unlike mutual funds, ETF's are traded on the open market which allows hedge funds and investors to short, buy on margin, trade intraday, and write or buy options on the securities; increasing market volatility.

According to Gordon Johnson - Senior Portfolio Manager at Allegiant Asset Management, "an ETF magnifies sector volatility, shortens the investment horizon, and makes macroeconomic events more important." An investor may gain immediate exposure to an asset class at a low cost and get out immediately after reaching an expected return.

Hedge fund traders are able to gain broad market exposure at a low cost, and in turn short underlying stocks in the ETF index to create a modified or enhanced index portfolio. Margin trading and short selling increases short-term market volatility. On February 27, 2007 the emerging market iShares ETF lost 8.1%, compared to the underlying index, which fell 3.1%. This was due to the enormous volume of short selling in a single day. Unlike individual stocks, ETF's are not restricted by the uptick rule, and as prices are plummeting traders can still sell short.

Capital flows to and from ETF's have increased the correlation of differing asset styles, growth and value stocks tend to move together when the ETF holds both. Style specific managers are being impacted by core ETF capital flows. Good stocks may decline in an active portfolio for no fundamental reason, other than the result of ETF forces. This adversely affects manager performance, and makes the stock selection process more difficult.

Finally, the ETF industry has created immediate access to global capital markets for all investors. Active managers must contend with increased volatility and under-performance. The lower costs of ETF platforms have placed downward pressure on management fees. As ETF's change the structure of capital flows, there will be temporary volatilities, or arbitrage opportunities. But in the end, a more efficient market will prevail.

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