How ETFs Foster Cycles and Volatility in Your Stock

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Outline

Exchange Traded Funds are 50% of daily market volume and the biggest investment phenomenon of our long bull market.

We're the Market Structure Experts.

Did You Know?

When investors buy iShares Exchange Traded Funds (ETFs), do those investment dollars go to Blackrock? The answer is no.

Who gets the money? You'll see as we unfold this story that understanding the MOTIVATION of the two parties to ETF transactions fosters market cycles, volatility, and periodic divergence among peer stocks.

Exchange Traded Funds are 50% of daily market volume and the biggest investment phenomenon of our long bull market. We're told ETFs are mutual funds that trade like stocks. Mutual funds are pooled investments under the Investment Company Act of 1940 in which investors can buy or sell shares representing proportionate claims on the asset pool directly from the fund.

From Vanguard ETF FAQs: ETF Shares of the Fund *cannot be directly purchased from or redeemed with the Fund, except by certain authorized broker-dealers.* Your ownership of ETF Shares will be shown on the records of the broker through which you hold the shares. *Vanguard will not have any record of your ownership. (Bolding ours.)*

When investors buy ETFs, "certain authorized broker-dealers" get the cash. These so-called Authorized Participants (APs) are linchpins to how ETFs work – and key to the effects ETFs can have on trading in your shares. We'll come to it soon.

The fine print of ETF prospectuses reveals ETF shares are created via tax-free, commission-free, "in-kind" exchanges of collateral between APs and ETF creators. *In 2017 according to the Investment Company Institute (ICI), there were nearly $3 TRILLION of ETF shares created and redeemed.* As of May 2018, we can extrapolate from ICI data that nearly $2 trillion of ETF transactions have occurred already. Real net investment inflows are less than 5% of this figure.

The Fictional Whitetree Capital Management

To understand the impact of ETFs on your shares, let's create a fictitious ETF that lets people trade houses. Let's name our ETF company after a color and something from nature. How about WhiteTree? We at Denver-based Whitetree (get our subtle play on words?) make Big Broker Inc., our Authorized Participant (AP) responsible for creating ETF shares, and we advertise: "Want to own residential real estate but trade it like stocks? Buy PADS!"

There's demand (editorial note: ETFs like STWD offer this exposure) and we tell our AP, Big Broker Inc., to provide a "Creation Basket" of titles to Denver homes as collateral, and in exchange BBI can create ETF shares to sell to the public.

We get deeds to real estate tax-free. Cool! Why? It's an "in-kind" exchange under IRS rules and SEC exemptive orders. One thing of equal value is exchanged for another. No fund turnover, no commissions (and we can charge BBI to boot!).

We don't manage any money, just the collateral, the houses. Demand is great for PADS and analysts say, "It's a boom in residential real estate." We need more PADS to sell. So we ask BBI for more collateral and BBI says, "We're out of Denver homes. Will you take some in Minot, ND?" Sure. It's collateral. More PADS shares, investor demand is strong, and The Housing Index, the benchmark PADS tracks, rises.

We can't keep up with PADS demand. We tell BBI the Creation Basket will take any housing deeds they've got. "We're out," BBI says. "How about a check for the amount of a thousand houses in Minot?"

Done! More ETF shares created. The media says WhiteTree is managing billions of investments in housing. No, we manage collateral. And we're now writing futures on The Housing Index to boost reported ETF returns. Home prices in Minot soar. Pundits are saying, "Minot is an economic model for the nation. Everybody wants to live in Minot!"

But at WhiteTree, we've got a problem. Home values nationwide are rising and those capital gains taxes will be imputed to PADS shares, hurting our performance versus the benchmark. We need to get rid of capital gains, something ETF Redemption permits.

So we survey the collateral and Minot deeds have risen most. We offer a Redemption Basket to BBI: PADS shares for equal value in Minot deeds (or a cash substitute). BBI shorts The Housing Index, borrows PADS shares from another broker, gives them to WhiteTree, which delivers Minot deeds, and BBI dumps them.

Real Estate in Minot implodes. Pundits are saying, "The economy turned. Everybody is leaving Minot!"

ETFs in the Real World

Replace housing with stocks. This is how ETFs work. They permit greatly more money to chase a finite asset class (stocks) because they are substitutes, not additional stocks. And the MOTIVATION for the parties creating and redeeming ETF shares – the only ones pricing ETFs – is arbitrage.

ETF creators make money by baking a small fee into every created ETF share, charging brokers to create ETF shares, and eliminating tax and commission costs. They can use the collateral received from APs for stock loans (Blackrock earns hundreds of millions annually this way), to back derivatives trades, to sell and keep the profits, and more. This is how ETF managers outperform stock-pickers while merely tracking the benchmarks.

APs profit by selling ETF shares at higher values than the "in-kind" exchange that created them, and offsetting risk as ETF market-makers by hedging directionally.

For instance, an AP will know Blackrock wants to remove Facebook shares from its portfolios to slough off capital gains because Blackrock will trade it for ETF shares brokers want to redeem. Armed with that information, a broker can short Facebook and buy futures on a part of the market expected to move opposite Facebook, and then sell the Facebook shares it receives.

How often do you suppose stocks are driven by this process?

The two parties driving the creation and redemption of ETF shares are motivated by profit opportunity in the short run, not investment. The real shocker is that the trillions of dollars of ETF creations and redemptions aren't counted as fund turnover, so ETF creators tell the public they "don't trade." Were these transactions counted, ETF turnover would be far higher than conventional investment.

One example: In 2016, State Street reported that its S&P 500 ETF, SPY, had turnover of just 3%, or $7 billion. But that figure reflected only changes to the S&P 500 index. Creations and redemptions totaled more than $500 billion, turnover of 200%. SPY trading volume was $6.8 trillion, so over 90% of SPY trading was a form of arbitrage.

How ETFs Affect Your Shares

There are two big ways this process affects your shares. First, ETFs need not use all the securities of the indexes the ETFs ostensibly track. They can sample some, use as few as one, or even in many cases substitute cash. So if your shares are not in the creation or redemption basket and a peer's are, your stock will move differently and yet the cause is still "passive" investment.

Second, ETFs promote short-term cycles because the two parties in the primary ETF market – ETF creators and APs – must continually create and redeem shares to make money on how prices change.

While we have theorized with PADS, our fictional ETF, what I've described about stocks is what we see in the analytics we invented to track Passive Investment. Everything in the theoretical PADS scenario describes what we've found in ETF regulatory documents – including the bit about getting rid of taxes. Again from Vanguard ETF FAQs: *"Vanguard ETFs can also use in-kind redemptions to remove stocks that have greatly increased in value (which trigger large capital gains) from their holdings."*

ETFs are substitutes for stocks that unsuspecting investors buy from brokers, not knowing ETFs have no claim on a pool of assets and that the shares were created by brokers with motivation to change prices.

The central problem is motivation. If the parties continuously roiling markets and changing the direction of stocks are doing it to profit on price-changes, then fundamentals are not driving these moves.

As with anything from watching football to practicing medicine, if you want to understand what's going on you must first understand the rules. Football has rules and objectives. Medicine turns on science. And stock markets move according to the motivation of the money.

So, having learned that ETFs are not at all what you supposed, and they're 50% of market volume, driving trillions of dollars of transactions, and dwarfing every other investment vehicle today, do you suppose much of what occurs in your stock is driven by ETFs too rather than fundamentals?

See How ETFs Affect Your Own Shares

Let us show you. **Ask us for an introduction to Market Structure Analytics,** our market-leading predictive analytics that quantify what all the money behind your shares is doing – including when ETF creations and redemptions are the primary price-driver.

For a free Market Structure Report and demo on how to read our analytics, contact Mike Machado at mikemachado@modernir.com. It may change forever the way you think about the Investor Relations role today.

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