Are ETFs “Weapons of Mass Destruction”?

A Bloomberg **article** quoted a money manager as saying that exchange-traded funds (ETFs) are “‘weapons of mass destruction’ that have distorted stock prices and created the potential for a market selloff.” According to the managers of the FPA Capital Fund (FPPTX), ETFs (and index funds) allow investors to invest in equities without needing to rely on fundamental research or paying attention to valuation. This, in turn, has led to the market no longer being driven by underlying fundamentals. The managers worry that the market has not gone through a major downturn with so much money invested in passive funds (according to Bloomberg the U.S. ETF market now has about $2.7 trillion in assets) and a massive sell-off by these funds could exacerbate a market decline.

It is worth pointing out that the FPA Capital Fund was one of the top performing funds in the U.S., returning an average of 14.% from 1986 to 2010, according to Bloomberg, while the Russell 2000 index averaged an 8.5% annual return. Over the last five years, as the fund has struggled to find attractive stocks to buy, its average annual return has been 4%, according to Bloomberg, which trails 99% of its peers over that period.

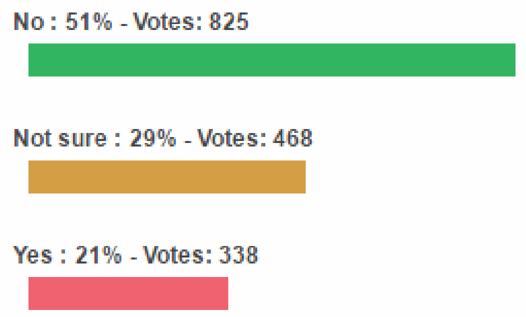
AAII Weekly Survey Question

With so many of our members and readers investing in ETFs and index funds, we were curious to get their take on these managers’ claims. So last week’s survey question asked:

> ***A recent Bloomberg article quotes the managers of the FPS Capital Fund as saying that echange-traded funds are “weapons of mass destruction” that have removed the consideration of underlying company fundamentals and valuation and have created the potential for a market sell-ff. Do you agree with their assessment?***

Here are the results:

A recent Bloomberg article quotes the managers of the FPA Capital Fund as saying that exchange-traded funds are "weapons of mass destruction" that have removed the consideration of underlying company fundamentals and valuation and have created the potential for a market sell-off. Do you agree with their assessment?



In all, 1,631 readers voted as of Monday morning, May 8.

Just over half–51%–of the respondents disagree with the managers of the FPA Capital Fund. Not an overwhelming indictment, however. Twenty-nine percent of voters aren't sure about the claims made by the FPA Capital managers while only 21% agree that ETFs do pose a problem for the market.

Weekly Special Question

A common misunderstanding is that a closed-end fund (CEF) is a traditional mutual fund or an exchange-traded fund (ETF). A closed-end fund is not a traditional mutual fund that is closed to new investors. And even though CEF shares trade on an exchange, they are not exchange-traded funds (ETFs). Closed-end funds share characteristics of both traditional open-end mutual funds and exchange-traded funds.

CEFs do share some traits with traditional open-end mutual funds:

- Both have an underlying portfolio of investments with a net asset value
- Both are run by a professional management team
- Both have expense ratios and, typically, fee schedules
- Both may offer distributions of income and capital gains to investors

However, traditional mutual funds issue and redeem shares daily, at the end of business, at the fund's net asset value. CEFs do not issue or redeem shares daily. Instead, CEF shares trade on an exchange intraday, like stocks. The share price for a CEF is set by the market. The share price only rarely, and by sheer coincidence, equals the CEF's net asset value. Also unlike traditional mutual funds, CEFs may issue debt and/or preferred shares to leverage their net assets. That leverage can increase distributions (income) but also increases volatility of the net asset value.

CEFs also share some traits with ETFs:

- Both have an underlying portfolio of investments with a net asset value
- Both trade during the day on exchanges
- CEF and ETF shares can be treated very much like a stock, in that you can set limit orders, short the shares, and buy on margin
- The portfolios may be leveraged
- Both have expense ratios and, typically, fee schedules
- Both may offer distributions of income and capital gains to investors

ETFs have a redemption/creation feature, which typically ensures the share price doesn't stray significantly from the net asset value. As a result, an ETF's capital structure is not closed. CEFs do not have such a feature. CEFs are actively managed, whereas most ETFs are designed to track an index's performance. CEFs achieve leverage through the issuance of debt and preferred shares, as well as through financial engineering. ETFs are precluded from issuing debt or preferred shares. ETFs are structured to shield investors from capital gains better than CEFs or open-end funds are.

To get an idea of whether our readers prefer closed-end funds over exchange-traded funds, last week's special question asked:

> ***If you prefer closed-end mutual funds over exchange-traded funds (ETFs), or vice versa, what factors drive your preference?***

In all, 100 readers replied to the question.

The answers they provided favored ETFs over closed-end funds nearly three to one.

The biggest advantage ETFs have over closed-end funds, according to our readers, is lower costs, followed by the ability to trade an ETFs throughout the day.

The main reason why readers prefer closed-end funds over ETFs is that they can trade at a discount to their net asset value (ETF).

Here is a sample of the responses:

- “With a CEF you can easily identify which are are selling at a discount, along with earnings ability to cover dividends on a monthly basis.”
- “Timing periods of CEF’s price lower than NAV and higher than NAV.”
- “Prefer ETFs because of factors mentioned in ‘**Level 3 Investing**‘.”
- “Prefer ETFs because they are easily traded on the open market and are not subject to wide value swings for tax purposes at year-end like mutual funds.”
- “Lower expense and liquidity of ETFs.”
- “I like the fact that CEFs are actively managed, and given that CEFs are an “inefficient market,” it is possible to pick up some CEF bargains that have strong historic performance at a discount if market sentiment has shifted away from a particular asset class.”
- “I prefer ETFs for lower cost and ease of purchase/sale.”
- “ETFs. No leverage risk.”
- “CEFs do not have to worry about massive redemptions when the overall market falls.”

Everybody has an opinion! Why not give us yours? Participate in our weekly member poll, updated every Monday, and see the results online at http://www.aaii.com/memberquestion.