

This study is to analyze the risk that is involved in using ETFs for long term wealth generation

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ABSTRACT

Exchange Traded Funds (ETFs) may be lauded as a cheap and simple alternative to opaque actively managed funds. ETF as an investment vehicle is –at least on the surface is rather simple. It allows individual investors who might have only Rs500 to invest in a wide range of asset classes previously available to much larger investors. This study is to analyze the risk that is involved in using ETFs for long term wealth generation.

Keyword: *ETF, investing, index*

INTRODUCTION

One of the biggest investment trends of recent years has been the growth of exchange-traded funds, or ETFs, which allow investors a cheap and convenient way of buying into a particular stock market index or a particular region or commodity or some other kind of investment theme. In India as well ETFs are gaining popularity with government of India promoted CPSE ETF, Bharat 22 ETF and several other Gold ETF etc. Globally there's now \$4 trillion invested in them around the world, but the very popularity has led to worries that we might be looking at a bubble of some kind.

The first exchange traded fund, created in 1992 by Nathan Most, was named “Standard & Poor’s Depository Receipts” (SPDRs), and quickly dubbed “Spider.” The original idea was to allow investors to “buy the market” — to give them a diversified exposure to an index of stocks, so protecting them from the idiosyncratic risks of any one company going south. Rather than trying to buy every equity in the index, the

investor could buy units in one fund that would take positions in each of the constituent stocks. The advantage over traditional funds would be that the fund is traded throughout the day, with prices quoted like equities on the exchange, allowing investors quickly to enter and exit positions. Today, ETFs give the private investor access to a wide range of asset classes and themes, from high-yield bonds and small-cap equities to the more esoteric.

From that single fund, Global ETFs have grown to be one of the largest asset class from \$800bn 10 years ago to \$4.2tn at the end of August, according to industry data provider ETFGI, with a 41 percent share, up from just 9 percent as 2000 began and only 3 percent a decade ago. Led by index portfolios whose shares are rapidly traded in narrow market segments (despite their stark contradiction of each of the five concepts underlying the original index fund), ETFs have become a force to be reckoned with in the financial markets. Their amazing growth certainly says something about the energy of Wall Street’s financial entrepreneurs, the focus of money managers on gathering assets, the marketing power of brokerage firms, and the willingness—nay, eagerness—of investors to favor complexity over simplicity, continuing to believe, against all odds, that they can beat the market.



Literature Review

Markus Stadlmann, chief investment officer of Lloyds Private Bank, agrees that this automatic buying activity is a problem. “[It’s] obviously wrong because it takes the valuation of the companies to a level that is not appropriate, and it also opens up the stocks to arbitrage.”

Steven Bregman, the co-founder of US-based investment adviser Horizon Kinetics, is critical of the distortions being created by the rise of ETFs. “There is a law of supply and demand, and if something gets overdone, and too much money flows into one place, you get distortions,” he says. “This particular distortion, and there are numbers to show it, is probably the largest in history.”

Statement of the problem

This study is to analyze the risk that is involved in using ETFs for long term wealth generation.

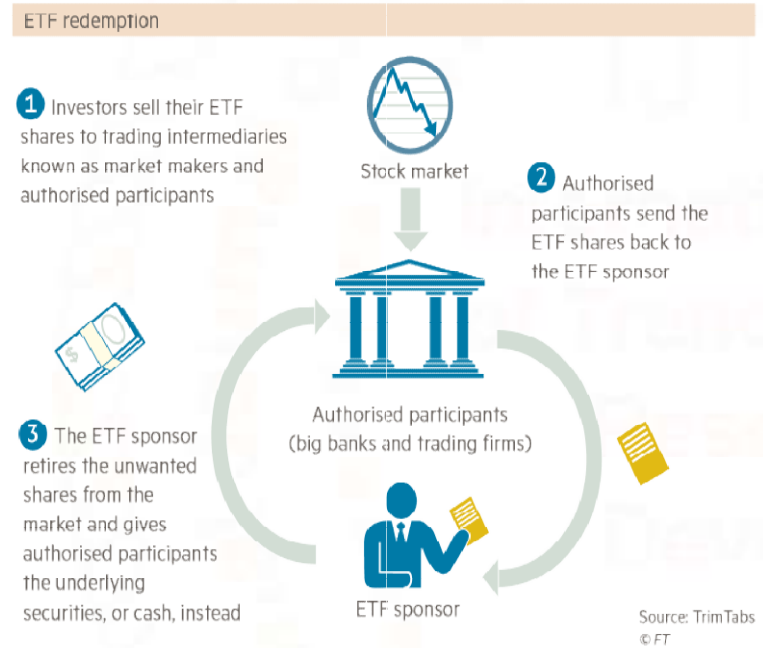
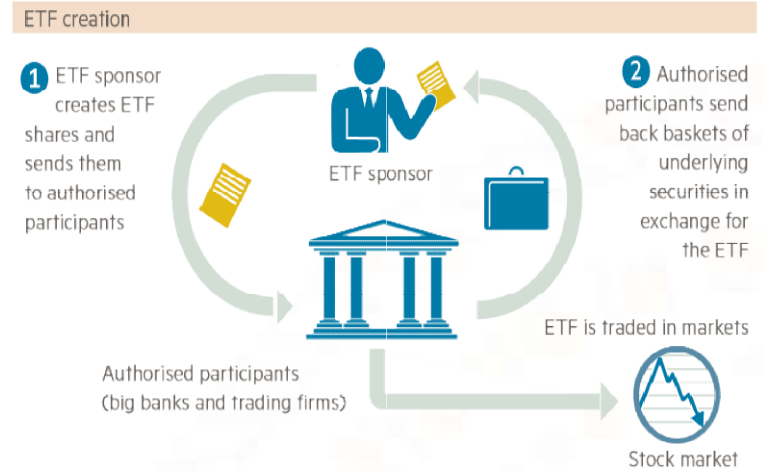
Objectives

- To analyze the risk that is involved in using ETFs for long term wealth generation.

Research Methodology

- A descriptive research is used in the study which analyze the risk that may is involved in using ETFs for long term wealth generation.

How exchange traded funds work



The Risks of ETFs

When the dotcom bubble burst, ETFs were still the new kids on the block and even by the time of the financial crisis they were nowhere near their current scale. But some believe they have yet to be tested as a model. The end of the current bull market will partly play out through ETFs, and there is uncertainty about how they will withstand sudden shocks.

Rise of passive management also inflating asset prices. Years of large net inflows into indexed-tracking products has encouraged a momentum effect. “Winners keep on winning and losers keep on losing,” FT columnist John Authers. Whereas active managers might buy or sell equities based on fundamental factors such as value, much passive money is effectively “blind” in that it buys assets according to the rules of the index or theme.

Trading Risks

One of the most advantageous aspects of investing in an ETF is the fact that you can buy it like a stock. However this also creates many risks that can hurt your investment return.

First it can change your mindset from investor to active trader. Once you start trying to time the market or pick the next hot sector it is easy to get caught up in regular trading. Regular trading adds cost to your portfolio thus eliminating one of the benefits of ETFs, low fees.

Additionally, regular trading to try and time the market is really hard to do successfully. Even paid fund managers struggle to do this every year, with most not beating the indexes. While you may make money you would be further ahead to stick with an index ETF and not trade it.

Finally, adding on to those excess trading negatives you subject yourself to more liquidity risk. Not all ETFs have a large asset base or high trading volume. If you find yourself in a fund that has a large bid-ask spread and low volume you could run into problems with closing out your position. That pricing inefficiency could cost you even more money and even incur greater losses if you can't get out of the fund in a timely fashion.

Increased Portfolio Risk

There are many types of risk that come with a portfolio, everything from market risk to political risk to business risk. With the wide availability of specialty ETFs it's easy to increase your risk across all areas and thus increase the overall riskiness of your portfolio.

Every time you add a single country fund you add political and liquidity risk. If you buy into a leveraged ETF you are amplifying how much you will lose if the investment goes down. You can also quickly mess up your asset allocation with each additional trade that you make, thus increasing your overall market risk.

By being able to trade in and out of ETFs with many niche offerings it can be easy to forget to take the time to ensure you are not too making your portfolio too risky. Finding this out would happen when the market is going down and there is not much you can do to fix it then

Counterparty risk

“Synthetic” ETFs bear the risk of failure of the counterparty, such as an investment bank, on the other side of the investment swap from the fund manager. The collapses of US banks Lehman Brothers and Bear Stearns during the financial crisis show that this worst-case scenario can happen. Investors should examine what collateral is being held against the swap by asking the provider or reading the fund prospectus.

Tracking error

This is the extent to which any ETF deviates from the index that it is set up to mimic. Managing this is a key job for the manager of the fund, and how they have performed is something for the private investor to look at: they can compare the fund's record with the selected index in the fund documents or on the manager's website. Some asset classes, such as emerging markets, are likely to demonstrate more tracking error than others. Liquidity risk: Ultimately, the ETF is as liquid as the market it is tracking. In times of market stress, investors will be able to get their money out more easily from a highly liquid, diversified market.

Conclusion

ETFs have become so popular because of the many advantages they offer. Still, investors must keep in mind that they aren't without risks. Robustness of ETFs as an investment vehicle has yet to be tested by a sustained market sell-off, there have been other signs to unsettle investors. ETFs played a role in the flash crashes of May 2010 and August 2015, as the market-making activity that underlies even the most straightforward fund broke down. The US Securities and Exchange Commission's review into the 2015 episode makes sober reading.

According to the SEC, exchange traded products (including ETFs and more) “experienced more substantial increases in volume and more severe volatility” than standard stocks. Perhaps more concerning was its finding that extreme swings in price “seemed to occur idiosyncratically among otherwise seemingly similar ETPs”.

Strict rule system for ETFs allows more active market participants to take advantage of an ETF while the ETF manager's response comes only after the damage has been done. For example if a company breaks a rule for inclusion short sellers can pounce on it knowing it will be sold off by the index at the next rebalancing.

Communicating what your actual follow through will be to an event ahead of time, and following through without fail, can only result in a an asymmetric disadvantage.

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