Most ETF Trading Doesn’t Affect Underlying Markets

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## ICI Series to Address Market, Policy Issues Raised by ETFs

**Washington, DC, September 22, 2014** - Investors seeking to invest in or sell exchange-traded funds (ETFs) overwhelmingly use the secondary market to buy or sell ETF shares, rather than turning to authorized participants (APs) to create new shares or redeem existing shares, according to new research from the Investment Company Institute (ICI).

On average, daily aggregate creations and redemptions for all ETFs amount to 10 percent of their total trading activity and comprise less than 0.5 percent of aggregate ETF assets. Instead, the vast majority of trading activity involves buying and selling existing ETF shares. Investors involved in many of these transactions do not interact with the ETF and do not directly create transactions in the underlying securities held by the ETF, because only the ETF shares are trading hands.

This initial finding helps put into perspective questions regarding the roles that ETF creation and redemption activity and ETF secondary market trading may play in the markets for equities and bonds that ETFs hold in their portfolios. This and other findings are presented in “Understanding Exchange-Traded Funds: How ETFs Work,” the first of a series of ICI papers that will address policy and research issues raised by the emergence of ETFs.

“The size and scope of the ETF industry has grown and the use of ETFs has become more widespread. As a result, regulators, academics, and the media have taken more interest in how these products are structured, how they affect the markets for various asset classes, and how they behave under stressed market conditions,” says Shelly Antoniewicz, ICI senior economist and coauthor of the paper. “Before we can analyze questions—such as whether secondary market trading in ETFs amplifies general market volatility or transmits financial stress, or whether there is a link between ETF arbitrage and volatility in the underlying securities held by an ETF—we must first clearly understand how ETFs are structured."

## Several Factors Contribute to the Growth and Popularity of ETFs

In the past decade alone, total net assets of ETFs have increased twelvefold, from $151 billion at year-end 2003 to $1.8 trillion as of June 2014. Although the $13.1 trillion in total assets managed by equity, bond, and hybrid mutual funds are significantly larger than those of ETFs, ETFs' percentage of their combined assets has increased considerably, from less than 3 percent at year-end 2003 to more than 12 percent by June 2014.

There were 1,364 U.S.-registered ETFs as of June 2014, up from 119 at year-end 2003, and with the increase in demand, sponsors have offered more ETFs with a greater variety of investment objectives. The ICI study shows that some factors are related to specific features of ETFs that investors find attractive, while others correspond to more recent general trends in investing and money management.

"Intraday tradability, transparency, tax efficiency, and access to specific markets or asset classes are features that appeal to institutional and retail investors alike," says Jane Heinrichs, senior associate counsel at ICI and coauthor of the paper. "Demand for ETFs by institutional and retail investors has been spurred by the ability to gain exposure to specific markets or asset classes that would otherwise be difficult or impossible for them to attain."

ETFs have also gained favor due to the rising popularity of passive investments. Investor demand for index-oriented products, particularly in the domestic equity space, has been strong for the past several years. From 2007 through June 2014, index domestic equity mutual funds and ETFs received $855 billion in cumulative net new cash and reinvested dividends, while actively managed domestic equity mutual funds experienced an outflow of $595 billion over the same period.

Other general trends that have contributed to the popularity of ETFs include financial advisers' increasing use of asset allocation models and external fee-based models of compensation.

## ETFs Must Comply with Provisions of the Investment Company Act of 1940

The study reports that the vast majority of ETFs are regulated by the Securities and Exchange Commission as investment companies under the Investment Company Act and are subject to the same regulatory requirements as other registered funds. Unlike other types of registered funds, however, these ETFs must first receive exemptive relief from certain provisions of the Investment Company Act before they can commence operations.

## ICI Will Explore More Complex ETF Topics

Future papers in this series will examine whether secondary market trading in ETFs amplifies general market volatility or transmits financial stress; explore whether there is a link between the arbitrage mechanism used by APs and other ETF investors and volatility in the underlying securities held by an

ETF; and provide information on fees and expenses of ETFs.

For more information on ETFs, please visit our resource page at www.ici.org/etf.

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