Are ETFs Safe for Expat Investors?

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In recent years, investors' appetite for cheaper, passive ways to diversify has accelerated growth in the global exchange-traded fund (ETF) industry. According to industry data-provider ETFGI, total assets in ETF products surpassed $4 trillion as of May 2017 globally. Growth in ETF assets combined with frothy global markets has spawned an increasing amount of alarming press emerging over the safety of ETFs. The size of the industry, its largely passive investment style, lack of liquidity in underlying assets, uncertainty regarding how ETFs may perform in a market downturn, and even the potentiality of systemic risk have all been listed as reasons for concern. Investors are understandably nervous, and the obvious question is "Are ETFs safe investments?" The answer really depends on what type of ETF you own.

What Is an ETF?

The original ETF structure was and is pretty simple. An investment vehicle is created to hold a basket of securities designed to track an index, just like an index mutual fund. Shares of this vehicle, called an ETF, are then created and traded throughout the day in the market. The investment vehicle or ETF can hold each stock in the index it is tracking in the same proportion as the index, or it can purchase a representative sampling. In both cases, the ETF is holding shares in the actual stocks that make up the index the ETF tracks.

An example is the Vanguard Large Cap ETF (VV). This ETF is designed to track the performance of the MSCI US Prime Market 750 Index, which is essentially a broadly diversified index made up of large-cap U.S. companies. As stated in the ETF's prospectus: "The Fund attempts to replicate the target index by investing all, or substantially all, of its assets in the stocks that make up the Index, holding each stock in approximately the same proportion as its weighting in the Index."

The risks to the investor of this structure are pretty much the same as holding an index mutual fund: market risk and tracking error. Market risk is the risk that the value of the underlying stocks in the index that are held by the ETF will go down. Tracking error is the amount by which the ETF fails to track exactly the performance of the index. For most ETFs, this amount is typically very small.

ETF Benefits

A benefit of the traditional ETF structure is that, unlike a mutual fund, it can be bought and sold easily throughout the day. In addition, ETF costs tend to be lower than mutual fund costs. The ETF essentially provides investors, even small investors, the ability to easily construct diversified portfolios at low cost.

The benefits to expat investors in the offshore markets may be even greater. By using ETFs, expats are able to build globally diversified portfolios with average costs ranging from 0.15% to 0.40%. Compare this with paying a 2% annual fee and a 5% sales charge on the mutual funds available offshore or the 4% to 5% in annual fees (not including sales charges) of the typical insurance-linked investment products that have been heavily marketed to expats.

Synthetic ETFs, or ETPs

The “ETFs” that have prompted so much recent concern are not structured in the same way as the traditional ETFs outlined above, and they do expose investors to a greater level of risk. Although they are often called ETFs, they more accurately could be referred to as “exchange-traded products” (ETPs) or “exchange-traded notes” (ETNs). Instead of holding actual shares in the underlying stock of the index the ETF tracks, these types of ETPs are synthetic in nature. They are essentially a promise by the ETP provider, typically a financial institution, to replicate the return of a particular index. They make use of derivatives and may in some cases employ leverage.

Typically, an ETP provider will enter into a swap agreement with another financial institution, usually an investment bank. The investment bank agrees to pay an amount equal to the return of the benchmark tracked by the ETP, and the ETP provider gives the cash raised to the investment bank. In return for the cash, the ETP provider also demands collateral from the investment bank that may or may not be related to the index the ETP is supposed to track. Typically, the collateral is of lower quality and is less liquid than the assets of the tracked index. The investment bank is now on the hook to provide the return on the index.

So, instead of holding a fund that owns the actual shares of stocks that are in an index, with these types of ETPs, you are holding one backed by the promise of a financial institution.

What Are the Risks of Synthetic ETPs?

One major risk to investors is counterparty risk, or the risk that the ETP provider and investment bank fail to deliver the return on the index the ETP tracks. If the investment bank were to fail, the ETP provider would be left with the lower-quality, less liquid collateral that may have no relation to the index tracked. In extreme market conditions, this collateral could be hard to sell, exposing synthetic ETP investors to significant loss.

There are further risks related to some types of commodity futures ETPs, or ETNs. Rather than buy the underlying commodity, the commodity futures ETN purchases a futures contract, or the promise to get a delivery of a commodity at a certain date and price in the future. When the contract is about to expire, instead of actually buying the underlying commodity, the ETN rolls its assets over to another futures contract. Because of market inefficiency and gaming of this process, there is risk that the price of the ETN may fall, even if the price of the underlying commodity is rising.

Another risk area includes the use of leveraged and inverse ETPs. These are fast-growing segments of the overall ETF industry, but they do not necessarily produce the results an investor may have anticipated, and they contain risks all of their own. Leveraged ETPs use derivatives to magnify the single-day return of an underlying index. In some ways, they are a bit like margin investing, albeit for a single day. They can be either “bear” or “short” ETPs (using derivatives to offer the opposite of the return of the underlying index) or “bull” or “long” ETPs (which attempt to amplify the returns of the underlying index, or amplify the profits of shorting the underlying index).

Leveraged and inverse ETPs contain counterparty risks related to the use of derivative products highlighted above, and since the counterparties may be using leverage and potentially selling short, the risks are greater. Finally, because the derivative contracts are for single-day returns only, the underlying contracts are repurchased every day. This means their long-term returns may differ considerably from what the investor expected, since they simply consist of stringing together a number of single-day returns. At best, these types of ETPs are speculative and have no place in a diversified portfolio intended for retirement or other long-term goals.

Why Regulators Are Concerned

What has regulators concerned is the potential for contagion and systemic risk presented by the rapid growth of the newer, synthetic ETPs, particularly in Europe and Asia. The interconnected chain of counterparties involved in the construction of these synthetic ETFs puts both other financial institutions and the investor at risk should one counterparty fail. This creates the potential for risk to cascade through the financial system as it did with the subprime crisis. The current risk presented by synthetic ETPs may not be near the levels of subprime debt prior to the 2008 crisis, but regulators should be paying close attention.

Additionally, regulators have taken steps to reduce risk by limiting the amount of exposure a synthetic ETF can have to any one counterparty, issuing standards for collateral quality and liquidity, and attempting to limit conflicts of interest between counterparties and ETF investors.

The problem for the average investor is that due to aggressive marketing and mislabeling, they may not be aware of whether they have invested in a traditional ETF or a synthetic ETP. Of course, all the required information is provided in the ETP prospectus, but, too often, individual investors do not read the prospectus.

Are ETFs Safe Investments?

So we return to the original question, “Are ETFs safe investments?” Traditional ETFs that hold shares in the underlying index they track present pretty much the same risks as any index mutual fund. With synthetic ETPs, you are taking on counterparty risk beyond the normal risk associated with traditional ETFs and mutual funds.

Still, in some cases, there may be a role for some types of synthetic ETPs. For example, you do not need a synthetic ETP to gain exposure to the S&P 500, but they may be useful in gaining exposure to typically illiquid or hard-to-access assets such as a broad basket of commodities or even gold. You just have to decide whether the benefits of including the particular asset tracked by the synthetic ETP in your portfolio are worth the additional risks.

To protect yourself, make sure you know which type of ETF you are holding. If you do not know, ask your financial advisor and have them explain the risks inherent in each type of structure.

This article is a revised and updated version of one that had appeared previously on www.crevelingandcreveling.com.

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