FINANCIAL

ETF Market Shows Little Sign of Slowing Down

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Double-digit growth in assets held in exchange-traded funds (ETFs) over the past year indicates the ETF market shows little sign of slowing down. This growth is occurring as investors crave the funds for their flexibility, liquidity and convenience.

Fueled by the passive investing boom, ETFs now make up a big subset of the indexing market — and its fastest-growing one at that. ETFs are here to stay, whether advisors like it or not.

ETFs do have their place in an investment portfolio. This is especially true in a market notching all-time highs, as the market has recently in the wake of the Nov. 8 election, said Alexander G. Koury, an advisor in Scottsdale, Ariz.

But beware, he cautioned. Some ETFs pose significant risks to investors, and too many investors have no clue how ETFs work.

“Most people believe you can ‘set it and forget it,’ but that can’t be further from the truth,” Koury said.

Even the indexing industry’s elder statesman John Bogle, founder of indexing leader Vanguard Group, has expressed reservations about the growth of ETFs, which are geared to trading instead of buying and holding.

What draws investors to ETFs like bees to honey?

ETFs are diversified. They come in all shapes, sizes and asset classes. They are also liquid. Like individual stocks, they trade on exchanges during market hours.

Most of all, they are convenient. The financial barrier to entry is much lower than for mutual funds, many of which require a minimum $3,000 investment.

ETFs aren’t sold directly by mutual fund companies but are instead listed on an exchange, where they can be bought and sold through a brokerage account.

Along with index mutual funds and indexed separate accounts, ETFs are a subset of the index investing products market segment, said Chip Roame, managing partner of Tiburon Strategic Advisors in Tiburon, Calif.

ETFs Notch 12.1 Percent Growth

Howard Erman, a financial planner in Seal Beach, California, calls ETFs a blessing and a curse.

ETFs are inexpensive, which is important to a middle market investor. But ETFs also are unmanaged and don’t offer protection in falling markets, which fade farther from view as the bull market approaches its eighth anniversary in March.

As investors turn away from active management and toward passive management and indexing, ETFs are expected to grow, analysts said.

In 2008, the year the financial crisis almost dragged the nation into depression, ETFs in the U.S. held an estimated $531 billion in assets, according to data from the Investment Company Institute.

But by October, assets had grown to more than $2.3 trillion, an increase of 12.1 percent over the 12-month period ended October 2015.

There were more than 1,700 ETFs in the U.S. this year, more than double the 728 ETFs in 2008 and 29 ETFs in 1998, Roame estimated.

A Rainbow of Flavors

Investors are clamoring for more, not fewer, ETFs. That's according to a survey of 175 financial advisors by Brown Brothers Harriman & Co., a New York-based company handling ETF custody, and ETF.com, an ETF news and analysis website.

Among the new flavors of ETFs the industry has come up with to manage volatility: international fixed income ETFs, commodity ETFs and even something called "smart beta."

Smart beta is a "catchall for any quantitative investment strategy that is mechanized into an index and sold through mutual funds, ETFs and separate accounts," wrote Rick Ferri in a January 2014 article in Forbes. But smart beta isn't as smart as it sounds.

"In this mad 'me too' dash, there is now plenty of junk out there, especially of the so-called 'smart beta' variety," said Kashif A. Ahmed, president of American Private Wealth in Woburn, Mass. "The term itself is quite dumb."

For the moment, though, the money — if not the smart money — is on smart beta. The Brown Brothers-ETF.com survey found 97 percent of investors plan to maintain or add to their smart beta investment positions next year.

Among survey respondents, 59 percent indicated they had purchased a smart beta ETF in the past year, a 10 percentage point jump from 2014.

"Smart beta products are going to grow," Roame said. "They will proliferate."

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