SIGMA
INVESTMENT MANAGEMENT COMPANY

THE SUM
Knowledge + care + discipline bring you peace of mind

December 2017 Vol. 4

Sell? To Whom?

The availability of indexed investments, particularly in the form of exchange-traded funds, has had a strangely perverse effect in the markets widely varying from the original conception of the uses of index funds. The academics that have pushed the concept of index investing generally assumed that since you no longer were trying to beat the market or consider the relative merits of individual stocks, there is no incentive to sell your index holding until you need the money for spending.

Investors, however, taking advantage of the intra-day liquidity of ETFs, are sharply reducing their average holding period.

For many, ETFs are the preferred instrument for day trading. Hyper-kinetic hedge funds have been heavy users of ETFs as well.

For ETFs focused on highly liquid U.S. large capitalization stocks, the underlying stock holdings are highly liquid, allowing for rapid-fire trading without unduly moving market prices.

There may be a danger, though, if investors think that all ETFs are infinitely liquid, even if the underlying asset is not. Consider ETFs based upon indexes of emerging market bonds or thinly held micro-capitalization stocks.

As long as there is a rough match of buyers and sellers for the ETF, even at high trading volumes, there need be little required trading in the underlying assets.

What if there is a panic, though, and suddenly there seem to be only sellers of the ETF?

In that environment, there will be few market makers active in emerging market bonds or micro-cap stocks and an inability to use the

underlying securities to match the ETF trade flow. The result could be a substantial gap between the ETF price and the value of the underlying security, or sudden, unexpected huge downdrafts in the price of the underlying security.

Another pervasive issue with ETF investors is that many do not seem to look under the hood to know what they own.

Investors may assume that they are diversified just by virtue of owning one or more index ETFs.

The eighth largest ETF traded in the U.S., PowerShares QQQ, currently has over 43 percent of its value concentrated in its holdings of just five companies, four of which are in the technology sector. It would be easy to criticize the fiduciary standards of a manager putting clients into such an undiversified portfolio.

A related problem is that even investors holding multiple ETFs may not realize that the same names or sectors can show up in many different ETF guises.

Utility stocks, for example, can be large percentages of the portfolios of utility, defensive, low volatility and high dividend ETFs.

Google could be a large percentage of large cap, high quality, momentum, growth and technology ETFs. Just because you hold several ETFs does not mean you can ignore the composition of the overall portfolio.

"And what you do not know is the only thing you know

And what you own is what you do not own

And where you are is where you are not."

– T.S. Eliot, 'East Coker', *The Four Quartets*

The propagation of cheap index instruments broadens the palette of choices we can make for our portfolio management clients. So far, ETFs and other index investments have been of tremendous benefit to investors in the long bull market.

The extreme popularity of indexing among investors, though, makes it worthwhile to consider questions such as these.

There seldom are huge changes in investor behavior without some surprising, and often negative, consequences.

We would worry less if we believed investors as a whole were worried more.