Financial Planning

Fine Young Cannibals Municipal Aid

By Lawrence Carrel

March 1, 2009

So much for not selling at the bottom. October 2008, unequivocally Wall Street's worst month of the financial crisis thus far, saw more cash pulled out of long-term mutual funds—stocks, bonds and hybrids—than any other month in history: $127.55 billion. It was twice the $63.82 billion outflow seen in September, the second worst month ever, according to the Investment Company Institute (ICI).

Of October's total, 57%—or $72.44 billion-came out of equity funds, reports ICI. In September 2008, the month that saw the bankruptcy of Lehman Brothers and the bailouts of Freddie Mac, Fannie Mae and AIG, 88% of the outflows-that is, $56.36 billion—came out of stock funds. Although outflows began to slow in the final months of the year, the trend continued.

That's a lot of money to be swirling around. Yet while asset values fell, and cash poured out of mutual funds like water from a broken main, ETFs experienced net cash inflows. In 2008, $245 billion poured out of equity mutual funds alone, while $140 billion net cash entered equity ETFs, according to TrimTabs Investment Research. Much of those equity fund outflows went into money market funds. Still, for every two dollars that exited equity mutual funds, equity ETFs took in more than $1.

Are ETFs really cannibalizing 50% of mutual funds' assets? That may be doubtful, but the number could be as high as 25%, say analysts. ETFs' distribution crosses various markets, thus making it difficult to establish a correspondence among the money flows. State Street Global Advisors, the firm with the largest ETF in the world, the SPDR S&P 500 ETF (SPY), estimates that half of all ETF assets reside with traditional institutional firms, 35% to 40% come from the retail clients of investment advisors and the rest from self-directed investors.

A Mixed-Use Product

"The thing with ETFs is that they're not a retail-only product," says TrimTabs analyst Vincent Deluard. Mutual funds began seeing net redemptions in the middle of 2007, he says, while ETF inflows didn't pick up until the end of 2008. Deluard, who believes that a lot of the mutual fund money is going into ETFs, notes that the sectors that saw the most cash inflows were the short ETFs that capture the inverse of the market's move, the high-yield bond group and ETFs with moderate allocations.

"We finished the year with $64 billion in net cash inflows, about $15 billion of that in December alone," says Anthony Rochte, senior managing director of State Street Global Advisors. The SPDR ETF family finished the year up $1.7 billion over a year earlier. "Advisors are in a very difficult environment and are using ETFs to tax-loss harvest," Rochte says. "This past year we only had 10 ETFs that were net negative in terms of cash flows." Those were mainly among international ETFs, especially emerging markets and China-based ETFs.

Tricky to Track

One problem with tracking ETF inflows is that there's no definitive way to identify individual shareholders. Mutual funds have transfer agents who track the entry and exit of every dollar in the fund. Few institutions use mutual funds; most investors are individuals. ETFs, on the other hand, only sell or redeem shares with a broker or specialist, known as the authorized participant. After creating new shares, the authorized participant then sells them on the secondary market. Thus, the ETF has no knowledge of who holds its shares.

No doubt, some money entering ETFs isn't coming from mutual funds. ETFs that match futures, such as the SPDR S&P 500, and the Dow Diamonds (DIA), which tracks the Dow Jones Industrial Average, are traded heavily by institutions such as pension and hedge funds.

Why ETFs

However, ETFs with specialized portfolios receive money mostly from retail investors. While small, those inflows have remained steady over the past year. Gary Hager, the president of Integrated Wealth Management, an Edison, N.J.-based financial services company, says this is especially true for alternative assets not correlated to stocks and bonds, such as commodities and currencies. ETFs—or in some cases, exchange-traded notes (ETNs)—act as a proxy for investors wishing to invest in these hard-to-access areas that just a few years ago were unavailable or required a lot of money to diversify.

"There's something else people are missing: what's not happening with ETFs," says Scott Burns, Morningstar's director of ETF analysis. "People aren't selling. Not only are people leaving stocks and mutual funds to buy ETFs, the people who own ETFs are also not selling them."

Burns acknowledges similar behavior among investors of index mutual funds, the few long-term mutual funds still seeing positive fund flows right now. These investors are sticking to their guns, he says, since index funds typically pick up market share during downturns.

Since most ETFs are index funds, this offers one explanation for the rapid inflows. In an environment where most investments lose value, the benefits of indexing's passive strategy come into sharp focus. Actively managed mutual funds have one purpose: to beat their benchmark index. True alpha represents the value the portfolio manager's skill adds to the fund's return. However, the elusive nature of true alpha has been made abundantly clear in the wake of the financial crisis.

Investors are asking themselves why they pay high management fees for mutual fund managers who fail to beat the index-and don't protect them from losses, either. Funds that post annual losses of 34% in a year when the index falls 37% aren't making any friends, either.

The average actively managed domestic equity fund charges 1.45% a year, according to Morgan Stanley. Meanwhile, the average expense ratio for domestic equity index funds is 0.70%. The average equity ETF, however, charges just 0.53%.

ETFs also offer features not available in actively managed mutual funds, but which could heal many of the wounds recently inflicted upon investors through lack of transparency and liquidity. Transparency has become a crisis buzzword as investors struggle to assess the value of toxic assets that remain on the books of financial institutions.

Hedge fund investors are suffering greatly due to their inability to know what their funds own, but mutual fund investors are not much better off.

Because mutual funds only have to report their holdings four times a year, investors don't have much insight into what these funds are doing. Add a considerable amount of window dressing by fund managers during the last weeks of the quarter, and investors receive a portfolio description with little resemblance to the fund's actual holdings during the previous three months.

In addition, the market's dramatic, volatile moves have given liquidity—in particular, the ability to get out of an investment—greater significance. Hedge fund investors have suffered mightily with the rule requiring them to give 90 days' notice to cash out. Mutual fund investors suffered too. Unable to get a final price for shares they sold until the market closed for the day, many watched in horror on days when the market plunged.

By contrast, ETFs can be traded by the minute. After the bucking-bronco markets last fall, ETFs' trading flexibility became a major selling point for advisors.

This year, the ETF's famed tax efficiency may prove to be its biggest selling point. Despite the drops in mutual funds' net asset values, many of these funds incurred huge capital gains because they were forced to sell securities to raise cash. By law, these gains must be passed on to the remaining shareholders, rubbing salt in their portfolio wounds. Investment advisors facing irate clients may recommend ETFs as a good alternative.

Tony Corrao, a financial advisor and vice president with Oppenheimer & Co. in New York City, has been transitioning clients into an ETF strategy for three years now, and is warning clients with mutual funds to be prepared for a huge capital gains bill. "Every new client I meet, I mention an ETF allocation strategy rather than a mutual fund strategy," he says. "I think it's more efficient for the client. The fees are lower and more transparent for what the ETF owns."

Money managers are also gravitating toward ETFs in order to implement sector-oriented strategies, says Kevin Mahn, chief investment officer at Hennion & Walsh Asset Management in Parsipanny, N.J., and the portfolio manager of Smart Growth Funds, mutual funds that hold ETFs. It's too difficult to determine, for example, which financial stock will rise the quickest or go under next. But if you buy the ETF, you get the financials as a group, so no single stock sabotages the portfolio. "Individual investors will take the lead from their advisors," Mahn continues. "People are past the point of cutting losses and are now looking for ways to constructively take advantage of the correction."

The ICI reported that the mutual fund industry ended 2008 with 8,029 funds, five more than 2007. But that number hides the 38 funds that closed in December alone. Meanwhile, the ETF industry grew 15.8% year-over-year to 728 funds. With mutual funds holding $9.6 trillion in assets at the end of 2008 (down 20% year-over-year) vs. $531.3 billion in ETFs (down 12.7%), mutual funds aren't going away any time soon. Still, only the tone deaf won't see this as a wake up call from investors and advisors who are growing disenchanted with mutual funds' limitations.

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