Risks Involved When Investing in Exchange Traded Funds
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The asset under management (AUM) of the Exchange Traded Fund (ETF) industry has grown substantially in the recent years. From 2007 to the end of 2016, AUM increased from $851 billion to $3.546 trillion. Investors have been enjoying many benefits, especially the low cost, offered by ETFs as a result of this explosive growth. However, there are risks that they are not often aware of. In this post, we are going to present some of the risks embedded in the illiquid and leveraged ETFs. An exhaustive list of all the risk factors will follow.
Investing through Exchange Traded Funds is a good way to access illiquid markets, for example high-yield corporate or emerging market debts. Also, investors can short sell or employ leverage by using inverse or leveraged ETFs. However, besides market risks, there are structural risks embedded in these ETFs that investors should be aware of. They are:

1. Liquidity risk*: exotic ETFs are characterised by liquidity mismatches, leverage or both – and it is on these products that concerns tend to focus. In the event of a sell-off in a high-yield ETF, for example, where liquidity in the underlying bonds has all but disappeared, gaps may emerge between the price of the ETF and that of the index it is trying to replicate*.
2. Counterparty credit risk: *Synthetic ETFs, which are backed derivatives not physical securities, with investment banks as counterparties, also present some issues. In many cases, the collateral the counterparties post to the derivative arrangement bears no relation to the assets of the underlying index being tracked. At times of stress, this mismatch exposes the ETF to credit risk from its counterparties*.
3. Operational risks: *Leveraged ETFs present other difficulties. Due to the requirement to rebalance leverage daily, investors using such ETFs to match their exposure to an index may find that after three days of market volatility they have not had the gains or losses they expected based on the performance of the index*. *Read more*

In addition to these (more or less) apparent risks, there exist other ones which are less obvious and are caused by the herd mentality. For example, as investors have flocked into smart-beta funds, they increase these funds correlations. When the FED stops providing a “protective put” and market volatility increases, the smart-beta funds will likely underperform, and investors will pull their money out of these funds. This can cause a flash crash, or at least a deterioration of the ETFs' performance. In a long term, these smart-beta funds can lead to other problems, for example:

1. *Companies will adjust their accounting to become attractive to these publicly-known factor models.*
2. *A small number of securities favored by the same academic models will receive large inflows.*
3. *Prices will rise beyond their fair value, not because these theories are right but because the academic marketing machine keeps inflating their prices in a predictable manner.*
4. *Quant funds will prey on pseudo-quant funds. Read more*

Investing in smart-beta ETFs does not necessarily mean we make a smart decision. “Smart” investing requires careful evaluation of the risks involved and decide whether we can afford to take them.

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