MARKETWATCH

The new spot-bitcoin ETFs are likely to disappoint

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Narrowly-defined and specialty ETFs have underperformed more-broad based ETFs

The highly-anticipated spot bitcoin ETFs are likely to be disappointing performers for a considerable time after they are launched.

That's the implication of recently published research into the post-launch performance of ETFs that focus on specialized niches of the market. The study found that these narrowly focused ETFs, on average, lag the broad stock market on a risk-adjusted basis for five years after they came to market.

The study, "Competition for Attention in the ETF Space," was conducted by Itzhak Ben-David and Byungwook Kim of The Ohio State University, Francesco Franzoni of the University of Lugano in Switzerland, and Rabih Moussawi of Villanova. It was published earlier this year in the Review of Financial Studies.

Though no spot bitcoin ETFs have yet been able to launch, many are ready at a moment's notice as soon as the Securities and Exchange Commission gives regulatory approval--which could come any day now. Reuters estimates that as many as eight to 10 firms have filed registration paperwork to create their own such ETF, including BlackRock, the world's largest fund manager. Up until now, the only bitcoin ETFs that the SEC has approved are those that invest in bitcoin futures; spot bitcoin ETFs would enjoy several advantages over these futures-based funds.

The new study didn't focus on a possible bitcoin ETF in particular, and the authors are not making any prediction about bitcoin's future performance. The reason that just-launched narrowly focused ETFs tend in general to underperform is that they invariably come to market when investor enthusiasm for a particular investment theme has reached a fever pitch. That in turn means that the securities in which these ETFs invest will tend to be overvalued.

A related reason why these narrowly focused ETFs tend to underperform is their high expense ratios. Ben-David, in an email, said that the issuers of narrowly defined ETFs exploit investor enthusiasm "and often charge high expense ratios on these new ETFs."

The proposed expense ratios of the new spot-bitcoin ETFs are averaging close to 1%, for example. In contrast, the Vanguard Total Stock Market Index Fund ETF VTI, which is benchmarked to the entire U.S. stock market, has an expense ratio of just 0.03%.

Though fund management firms have been trying for years to create a spot-bitcoin ETF, there also is little doubt that investor enthusiasm for such ETFs is running extremely high right now. A week ago, when BlackRock's planned bitcoin ETF was assigned a ticker symbol, bitcoin's price jumped to its highest level in 18 months. The very next day, when the ticker symbol was removed from the Depository Trust & Clearing Corporation's (DTCC) website, bitcoin's price fell by more than $1,000.

To appreciate just how poor the odds are for a new spot-bitcoin ETF, consider what the authors of this new study found when analyzing all specialized and narrowly focused U.S. equity ETFs from 1993 through 2020. Over the first five years of their lives, these ETFs lagged behind the broad market by an average of 5.4% per year on a risk-adjusted basis.

It's worth noting in this regard that a separate bitcoin valuation model also finds that bitcoin's future performance is likely to be mediocre. That model in mid-October estimated bitcoin's long-term expected future return to be just 1.1% annualized. I think it fair to say that the investors who are so excited about a possible new spot-bitcoin ETF are hoping for long-term returns far greater than that.

The bottom line? On the one hand, it wouldn't be surprising if bitcoin's price surges if and when SEC approval for a spot-bitcoin ETF is granted. On the other hand, it also wouldn't be surprising if bitcoin's performance subsequent to that surge is disappointing.

Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at mark@hulbertratings.com.

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