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Opinion **Markets Insight**

From marijuana to the metaverse: specialised ETFs underperform

New research shows investors should be wary of funds focused on specific themes or one industry

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From the legalisation of marijuana to the rise of working from home, if there is a trend or theme in markets, there will be an exchange traded fund for it.

As the cost of issuance of new ETFs is low and the competition between fund issuers intense, financial innovation has flourished. Thousands of new ETFs have been launched over the past three decades. The range of recent specialised ETFs seemingly stretches as far as the imagination of investors.

But does financial innovation in the ETF space create value for investors? A study to be published in the Review of Financial Studies that I co-authored with Itzhak Ben-David, Byungwook Kim and Rabih Moussawi suggests otherwise. Our results show that, on average, new equity ETFs are poor investments on a risk-adjusted basis. The study points the finger at specialised equity ETFs that focus on specific industries and themes.

Over the past two decades, industry and thematic ETFs have underperformed broad-based benchmarks by about 30 per cent in the first five years since their inception. Out of these, only about 3 percentage points is due to their fees and 27 percentage points is due to the underperformance of the base assets.

The need to attract investors' attention has led ETF providers to ride the latest trends, turning a passive product into an active bet on the theme du jour. After the success of the first wave of ETFs tracking broad-based indices such as the S&P 500 index, competition intensified and fees declined. To counteract this development, issuers came up with new types of products which charged higher fees and tracked smaller segments of the market. Smart beta ETFs — which are constructed to reflect investment approach rather than straight market capitalisation — were introduced. Then came ETFs based on industries and, thematic versions. Single-stock ETFs are but the latest step in the evolution of the species.

Newly launched ETFs focus on the flavour-of-the-month topics that investors are excited about. In 2020, new ETFs held portfolios related to areas such as Covid-19 vaccines, telemedicine and gaming/sports betting. In 2021, investors' dreams included bitcoin, electric cars and the metaverse.

Naturally, ETF issuers design new products with one consideration in mind: to maximise their revenues. Revenues are greater when the fee rate and the assets that investors pour in are higher. With thousands of ETFs already on the market, new ETFs need to be unique and catch investors' attention.

And if the idea behind the ETF provides investors with the excitement to bet on their preferred theme, they will be less sensitive to the price they pay for the product. So amid the forced restructuring imposed by falling markets, the industry is renewing its bet on specialised ETFs.

Despite managing only 18 per cent of the assets in equity-focused ETFs in the US, these products are true blockbusters as they collect about 35 per cent of the revenues, due to the higher fees that they charge.

Academic literature has shown that investors chase assets that have recently experienced good returns. Possibly aware of these results, ETF issuers introduce products that track “hot” industries and themes. As a result, the stocks in the baskets of specialised ETFs start from relatively high valuations. In particular, new ETFs hold firms that, before the fund launch, had unusually high past returns (outperforming benchmarks by 5 per cent a year, on average) and received very favourable media coverage. The high fees that specialised ETFs charge contribute to their poor performance — overall about 0.60 percentage points.

But fees are not the main reason for the gross underperformance. That is driven simply by the assets that specialised ETFs choose to hold. They are overvalued at the time of launch and underperform in the following years.

To conclude, investors should beware when considering investing in specialised ETFs. They risk losing along three dimensions: they sacrifice portfolio diversification, they are likely to invest in overvalued assets and they pay higher fees. Our research shows that recent episodes of protracted and deep drawdowns for specialised ETFs are a widespread phenomenon.

Jack Bogle, the founder of the index fund industry and an advocate of passive investing, was very critical of ETFs. His view was that ETFs are the greatest marketing innovation of the 21st century, but one that does not serve investors well. Our study buttresses this view, as far as specialised ETFs are concerned.

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