ETFS: SAVIORS IN CRISES, TREATED LIKE PARIAHS

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This is the final post in a four-part blog series addressing the attacks on smart beta and exchange-traded funds (ETFs). Today we touch on the argument that asset classes such as emerging markets, which typically have a liquidity fear hanging over them in crises, will see exacerbated downside in the next crisis because of the presence of ETFs in the system.

Always Remember: ETFs Saved Hides as Lehman Buckled

We often say that attacking ETFs for causing crises is like saying that online travel websites are the cause of hotel and airplane bookings. The argument that ETFs exacerbate crises is particularly preposterous because it comes after one of the few corners of the market in which many people seek out and find liquidity during panics, then spins the story around into one in which the very presence of the investment vehicle (like a junk bond ETF, etc.) somehow exacerbates illiquidity.

When making their argument, attackers usually focus on riskier assets classes, including just about everything in the emerging world, plus any kind of credit that is below investment grade, but we have seen the argument applied to all marketable securities.

As we look back at the global financial crisis and forward to inevitable future crises, we need to remember that every transaction has a seller *and* a buyer. In a crisis, ETFs can foster price discovery at the broad market level and allow botto m-up investors to have a point of reference for when they engage in classic individual security analysis. ETFs can provide the gift of reliable price transparency[1] because of their intraday trading. They offer a real-time window into the true degree of panic or euphoria that may be occurring as a crisis unfolds.

DEM During Lehman's Collapse

Perhaps the experience of the WisdomTree Emerging Markets High Dividend Fund (DEM) during the global financial crisis can provide a glimpse into what an ETF investor in a volatile asset class would have confronted during those dark days.

The intraday trading action in DEM on September 15, 2008, the day Lehman Brothers went bankrupt, is shown in figure 1. Optically, it appears that the largest drop-off in price from one trade to the next occurred between 11:42 a.m. and 11:47 a.m., in a move that took DEM from $44.6599 to $44.36. However, it is tough to see with the naked eye, but there actually were two other trades in that window, one that also came at 11:42 a.m. and another at 11:46 a.m. Investors who were using limit orders and were looking for trade execution were finding a market for their trades with frequency throughout the trading session. Keep in mind too that this was occurring in an ETF that was brand new at the time, in an environment in which many investors were not yet using ETFs, in an asset class that could have theoretically frozen up completely as the system imploded.

Figure 1: The WisdomTree Emerging Markets High Dividend Fund, 9/15/08

Source: Bloomberg. Past performance is not indicative of future results.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at www.wisdomtree.com.

WisdomTree shares are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Total returns are calculated using the daily 4:00 p.m. EST net asset value (NAV). Market price returns reflect the midpoint of the bid/ask spread as of the close of trading on the exchange where Fund shares are listed. Market price returns do not represent the returns you would receive if you traded shares at other times.

Please click here for DEM standardized performance.

Also, when we compare DEM's ostensibly volatile moves that day, that wasn't something that was unique to the WisdomTree Emerging Markets High Dividend Index or to DEM, which tracks it. The MSCI Emerging Markets Index that the WisdomTree index is often compared to was moving to and fro in a similar manner that day (figure 2).

Figure 2: MSCI Emerging Markets Index, Day of Lehman Bankruptcy (9/15/08)

Source: Bloomberg. Past performance is not indicative of future results. You cannot invest directly in an index.

Many investors were able to turn to ETFs during Lehman's collapse because they were finding bids and offers when they needed them most. In Figure 3, we see that DEM's average daily volume rose from 51,357 shares in August 2008 to 97,915 shares in September. In the week after the Lehman news, an average 143,598 shares were changing hands every day. For small investors, they could enter the market and have limit orders filled in the teeth of a crisis, every day, while creation/redemption was, of course, available for larger players and institutions.

Figure 3: WisdomTree Emerging Markets High Dividend Fund, August/September 2008

Notable Crisis Events	Dates
Fannie Mae & Freddie Mac Nationalized	9/7/2008
Lehman Bankruptcy	9/15/2008
BofA Buys Merrill	9/15/2008
AIG Bailout	9/16/2008
JPM Buys WaMu	9/25/2008

Average Daily Volume	
August	**51,357**
September	**97,915**
Lehman Week	**143,598**

Source: Bloomberg, WisdomTree. "Lehman Week" is from 9/15/08 to 9/19/08. Past performance is not indicative of future results.

In short, one could say ETFs clear the market. We know their net asset value at a moment in time, and they provide a real-time glimpse at broad pricing, especially if they trade every second or two. Such action on the tape provides critical information to the individual buyer of riskier or more esoteric asset classes.

In turn, the availability of that information allows the transaction of individual bank loans, individual high-yield bonds, individual emerging market stocks and bonds, individual everything, to be exchanged with more confidence. Both buyer and seller are armed with knowledge—and that knowledge comes from ETF activity.

This breeds confidence and brings forth a critical mass of players on both the buy and sell sides of a market, much more so than before the advent of ETFs, when many securities would change hands "by appointment." Those days are fewer now.

ETFs provided this information to all of us. They allowed individuals and money managers to buy (or short) individual securities with more confidence, knowing that on a moment's notice they can go into the market and hedge their position by taking the other side of a trade across a broad market basket. Mutual funds did not give us this transparency, a reality that is all too evident to anyone who has been caught on the wrong side of a volatile market while they sweat the clock in anticipation of 4 p.m. EST. In the meantime, mutual fund owners have to count down as they are impotent to protect themselves intraday. Those days are fewer now.

It's high time for this industry to ask the mutual fund complex why exactly it wishes in vain for this critical source of liquidity and valuable market information to disappear. Read about the differences between ETFs and mutual funds here.

[1]Holdings are displayed daily.

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DEFINITIONS

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Junk Bond : A high-yield or non-investment grade bond. Junk bonds are fixed-income instruments that carry a rating of 'BB' or lower by Standard & Poor's, or 'Ba' or below by Moody's. Junk bonds are so called because of their higher default risk in relation to investment-grade bonds.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Bottom-up : An investment approach that de-emphasizes the significance of economic and market cycles. This approach focuses on the analysis of individual securities.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Limit Orders : An order placed with a brokerage to buy or sell a set number of shares at a specified price or better.

MSCI Emerging Market Index : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.

Bids : What investors are willing to pay.

Clear the Market : When something "clears a market," it means that it brings buyers and sellers together by solving for some other rigidity. A market can only be cleared when a price is agreed upon between the buyer and seller. ETFs allow the market to be cleared because they give us price discovery that you may not have in illiquid securities during a panic.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.