NIRI Virtual Chapter

Program Wrap-Up

Program Title: Are ETFs Driving Your Stock and the Market?

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The expansion of passive investment has confounded both novice and experienced IROs since the recovery from the financial crisis. With many companies seeing their shareholder bases moving to 20%, 25%, 30% or more of shares held by "passive" investment and consistent inflows to passive and outflows from active, IROs would be forgiven for paying little attention to the changing dynamics of the buy-side given that the rising tide of passive appears to have lifted most corporate boats throughout the recovery.

But what if that assumption is too simplistic? What if market structure and shareholder relations as a whole have been *negatively* impacted by the rise of passive, especially the ETF vehicle? Those answers reach far beyond "ETF 101" – and in the webinar "*Are ETFs Driving Your Stock and the Market?*", NIRI Virtual presented the graduate-level, "ETF 501"-style course in understanding the impact of ETFs in the US market. NIRI Virtual invited Tim Quast of *ModernIR*, well known for his focus on market structure, as well as Rene Casis, ETF Portfolio Manager at *American Century Investments*, with a deep background managing ETF portfolios at Blackrock in addition to his current employer, to the table to help IROs sort out the impact. The conclusion? ETFs may be a Rorshach test – there may be no true answer available for whether "ETF X is moving the share price of Stock Y at 9:41:16.44534 AM" – but knowing how ETFs operate is important in understanding whether there is evidence of that impact. Some takeaways:

ETF liquidity trading is *not* just the volume quoted on the exchanges… ETFs are unique vehicles in that they have a creation / redemption mechanism available to them, similar to open-ended funds but on an ongoing basis, not just buying & selling at the close. In a creation transaction, an Authorized Participant (AP) is allowed to create a unit of an ETF in exchange for a "creation basket" of securities comprising the holdings of that ETF in appropriate weights. Therefore, if an investor buys the set of securities in the creation basket in the open market in order to exchange for the ETF unit, there could be increased demand for the underlying securities.

…and some volume on individual equities is sourced directly from this creation / redemption process. Liquidity in the ETF – the ability to be able to buy and sell any ETF easily – is created by the arbitrage process available by this structure. The NAV of an ETF is made available to the market every 15 seconds – so in theory, if the NAV of the ETF is worth more than the value of the underlying securities' creation basket, you could buy the creation basket, exchange it for an ETF, then sell the ETF and profit instantly. Obviously only the largest investors have the ability to algorithmically buy a creation basket, but it does offer some short-term opportunity for profit while creating liquidity.

The ETF structure requires liquidity in the underlying securities for this process to work – so most ETF assets are concentrated in the larger and more liquid securities. This can mean over the long term, companies able to grow sufficiently in float cap to be able to, for example, reach the bottom of the Russell 1000, may see a virtuous cycle of increasing ownership from passive funds. However, the reverse may be true as well, and might be an interesting issue for those companies engaged in aggressive stock buybacks that are *reducing* their float caps.

Rebalancing and reconstruction of indices is becoming increasingly important to individual securities – with greater passive assets, weighting adjustments, often conducted at the end of the month or at the same time as index options expirations, become even more important liquidity events. Since most indices' construction methodology is well known, it's often possible for companies to predict the net impact of weightings changes in terms of net flows to or from passives. One corollary: *don't* call an index provider or passive fund portfolio manager suggesting that you should be in a particular index. Usually these index construction methodologies are quite rigid, and need to be in order to be used as an effective benchmark for a manager.

ETF holdings are the most transparent of any reporting regime. All ETF providers in the US are required to post their exact security holdings on a daily basis; most ownership providers will collect this data and make it available as part of their products. Therefore, the *net share impact* of ETF buying and selling on your company, or any company, is fully transparent, and further it should be a simple exercise for IROs to find out if large inflows / outflows to any fund are likely to be putting *net pricing pressure* on your shares.