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SOUNDBITE

Wednesday November 23rd, 2011

Good morning,

As our client, we want to share with you our concerns about aspects of market activity that suggest that exposure to securities lending may be imprudent for the next several months.

Over the last decade, ETFs (and ETPs) have grown over 40% per annum and there are now over 2,700 such funds managing approximately $1,500 billion of assets. Although they represent approximately 11% of securities in the US, they execute over 50% of daily stock exchange trades and, in the May 2010 Flash Crash, they were responsible for 70% of cancelled trades. Through their use of securities lending (to help keep fees low and competitive) and of collateral embedded in synthetic and structured ETFs, they also have exposure to counterparty risks.

New products take some time to begin to be regulated. The first stage of regulation for ETFs began this spring when the International Monetary Fund, Bank of International Settlement, and Financial Stability Board all published “Working Papers” that pondered whether and how to regulate this new and growing product. They collectively concluded that ETFs could lead to greater levels of market instability and were particularly concerned about the more complex ETFs (synthetic, structured, levered). The next step is for these bodies to publish proposed legislation regulating ETFs “For Comment”, which could take up to a year from now, followed by a delay for comments to be submitted and reviewed before the final regulations are imposed (possibly one to two years from now).

ETFs are considered to be very liquid and can be traded throughout the trading day; however, we have not seen them in this magnitude in all market environments. We know that “creation units” can be made very rapidly as investor demand has grown, but we do not yet know if units can be redeemed rapidly during periods of major market volatility. We are also uncertain what the impact of heavy ETF redemptions may have on the prices and liquidity of the underlying assets.

Regulators are concerned that the underlying collateral securities in synthetic ETFs are not required to match the markets they are trying to replicate and there are numerous examples of entirely different securities held as collateral. They also worry that some collateral may well be quite illiquid. The Financial Stability Board was concerned that Synthetic ETFs’ “creation process may be driven by the possibility to raise funding against an illiquid portfolio that can’t otherwise be financed”.

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Synthetic ETFs are very popular in Europe and represent half the issuance. New synthetics have been suspended in the US since March 2010. We have found that most investors are unaware of these differences and suspect that if synthetic European ETFs experience difficulties, North American investors may well panic on “plain vanilla” ETFs here.

In September, the Financial Times reported “in a sell-off, OTC market makers are under no obligation to offer a floor price to institutions, or indeed to buy ETF shares at all, meaning anyone with a large position could potentially be locked into an ETF”. One witty comment we recently heard that sums this issue up well: “an ETF really means you are an unsecured creditor to an investment bank”.

We are in the midst of a volatile market that faces significant macroeconomic challenges that suggest to us greater vulnerability to financial accidents. Simultaneously, there has been significant growth in passive investment strategies, which may be the cause of the extreme levels of correlation of securities to broad indexes.

ETFs are a large fast growing passive strategy that remains untested in all market conditions and has widespread influence via counterparty exposure through securities lending and collateral held, contributing to market risk.

We claim no expertise in the evolving intricacies of global financial plumbing but our experience creates a concern that any lack of liquidity in ETFs will be quickly translated into challenges in delivering underlying securities lent out. Perhaps it might be prudent to step back and learn from the safety of the sidelines whether securities lending suffers an impact or not.

The Sionna Team

For further information, please email Kelly Battle at kelly_battle@sionna.ca or call (416) 203-2732
8 King Street East, Suite 1600 Toronto, Ontario M5C 1B5

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