



May 11, 2015

ETF Fund Flows

ETFs have been a tremendously popular tool for investors of all types. For long-term investors, these securities provide a lower-fee alternative to mutual funds, the ability to hone in on a sector, commodity or asset class, combined with intraday liquidity. For traders, they provide similar benefits, though with an emphasis on the intraday liquidity. Both assets and trading volumes have surged across the ETF complex. Many have talked about the role ETFs have played in changing investor allocations and market structure, including us. In our November commentary, we focused on “the oil investors who don’t even know it,” and the role their buying of high yield bond ETFs based on a search for income has played as a source for cheap capital to the energy sector.¹

We did an analysis of fund flows into (and out of) important and popular ETFs relative to market prices since the March '09 bottom. As one would expect, the price of most asset classes and securities have risen in this time period—after all, that was part of the point in selecting the March 09 as the starting point for this analysis. The second reason behind picking the '09 bottom to start was its status as an inflection point in the most pivotal market dislocation of our time. Such inflection points tend to change the way people think about asset management, and this is something we know did in fact happen.

“More Buyers than Sellers” – or not.

Before getting to the heart of our findings, a slight digression is necessary. An oft-repeated market cliché to explain why a stock rises is that “there are more buyers than sellers.” As with many clichés, this is mostly true, but does not tell the full story. In fact, securities can and often do move higher with more sellers than buyers—if by ‘more sellers’ one means the flow of funds out of the security as opposed to transaction volume or the net number of buyers bidding in the market. Securities can also move up with absolutely no transactions at all. A simple illustration can help illicit why: imagine a market where the bidder (Bidder A) is offering \$1.00 for a widget, but the seller (Seller A) is asking for \$2.00 and the last transaction occurred at \$1.50. The spread for this widget is thus \$1.00 x \$2.00.

A new buyer (Buyer B) comes in and offers \$1.25 for the widget, making the new spread \$1.25 x \$2.00. Upon seeing Buyer B enter the fray, Seller A thinks “maybe \$2.00 is too low, I should ask for \$2.50.” Meanwhile, seller B, the patient seller has been asking for \$2.25 all along. Buyer A really needs this widget and is kicking himself because he could have comfortably owned it already had he just paid what

¹ <http://www.rgaia.com/the-oil-investors-who-dont-even-know-it/>



Seller A was asking from the start. Buyer A is intent on not paying up to \$2.00, so he places a bid at \$1.75, making the new spread \$1.75 x \$2.25. Given our last quote was \$1.50, it's clear that the market price today has "gapped" above this level and is at lowest \$1.75, or more fairly were we to take the midpoint of the spread, it is \$2.00. This price increase happened without a single actual buyer transacting and with an equal number of buyers and sellers on each side.

Let's take this one step further: Seller C, who has been watching from the sidelines, sees there is a buyer for the widget at \$1.75 whereas before the buyer was at \$1.00. He gets excited and jumps in to sell on the bid, for \$1.75. Seller A now has his widget, but in the process we learned that there were really 3 sellers in this market compared to 2 buyers. Yet, the price did ultimately rise.

We can draw out further illustrations on how the bid / ask process works, but now we can jump to the point: George Soros calls this a "price-mediated feedback loop" between market participants and market prices. This is a form of a positive feedback loop (in contrast to the negative feedback loop we covered last month).² Movements in bids and asks alone, or movements in price, do in fact change the behavior of market participants and can elicit further changes in price. It is no coincidence that we keep citing feedback loops in these commentaries, for we feel they are at the very heart of how markets operate. This idea of a price-mediated feedback in one way or another belies all transactions and is a necessary precursor for the explanation of some of our findings in the ETF space.

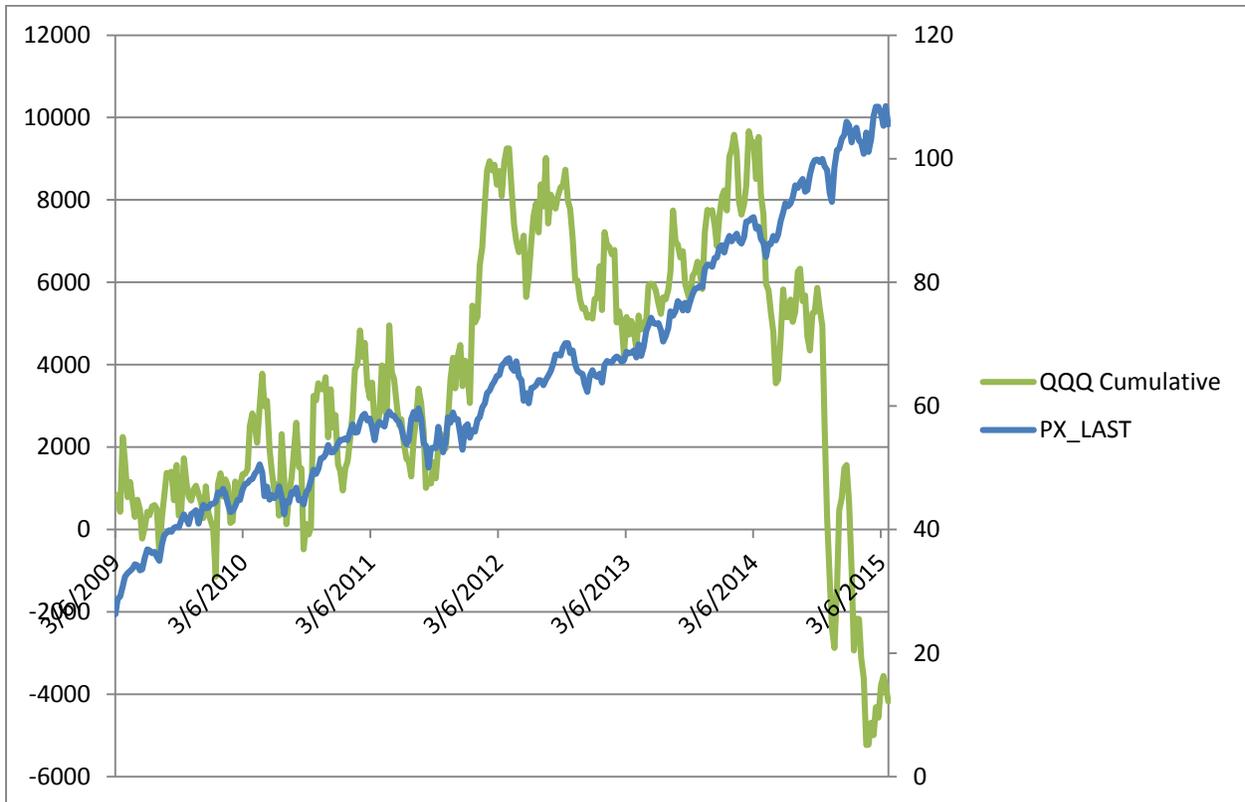
When we talk about fund flows in ETFs, we are referring to the net addition of new money to an ETF rather than the appreciation (or depreciation) in net value of the ETF itself. In our opinion, this is the cleanest metric for whether there are more buyers or sellers. If funds go out, there are more sellers, if funds go in, there are more buyers. By and large there was nothing remarkable with the relationship between fund flows and price performance. In fact, overall, there has been little correlation between the two in the main ETFs. Price and flow were somewhat correlated in the short-run but random over medium and longer timeframe. The general trend saw more money flow into the core ETFs over time thus putting upward pressure on prices. This is not surprising given it was the case in most markets. However, three ETFs stood out to us as particularly anomalous: QQQ (the Nasdaq-100 proxy index), IBB (the most widely traded biotech ETF) and USO (the oil commodity tracking ETF). What follows are the charts and a brief discussion of what confounds us in each:³

² <http://www.rgaia.com/negative-feedback-loops/>

³ All charts use Bloomberg for cumulative fund flows and last price, with data as of March 10, 2015.



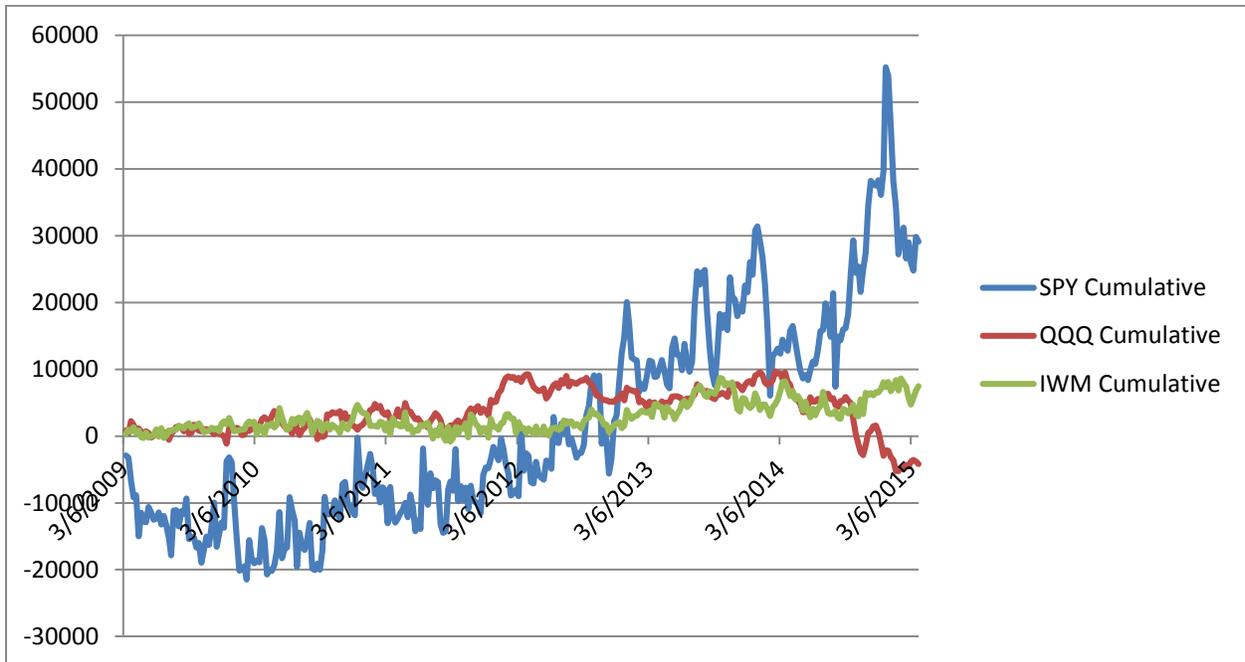
The QQQs:



The blue line is price, while the green is flow. Of the major index ETFs (SPY/S&P 500, IWM/Russell 2000—sorry Dow, you are a mere after-thought to us), the QQQ is the only one to experience net fund outflows.



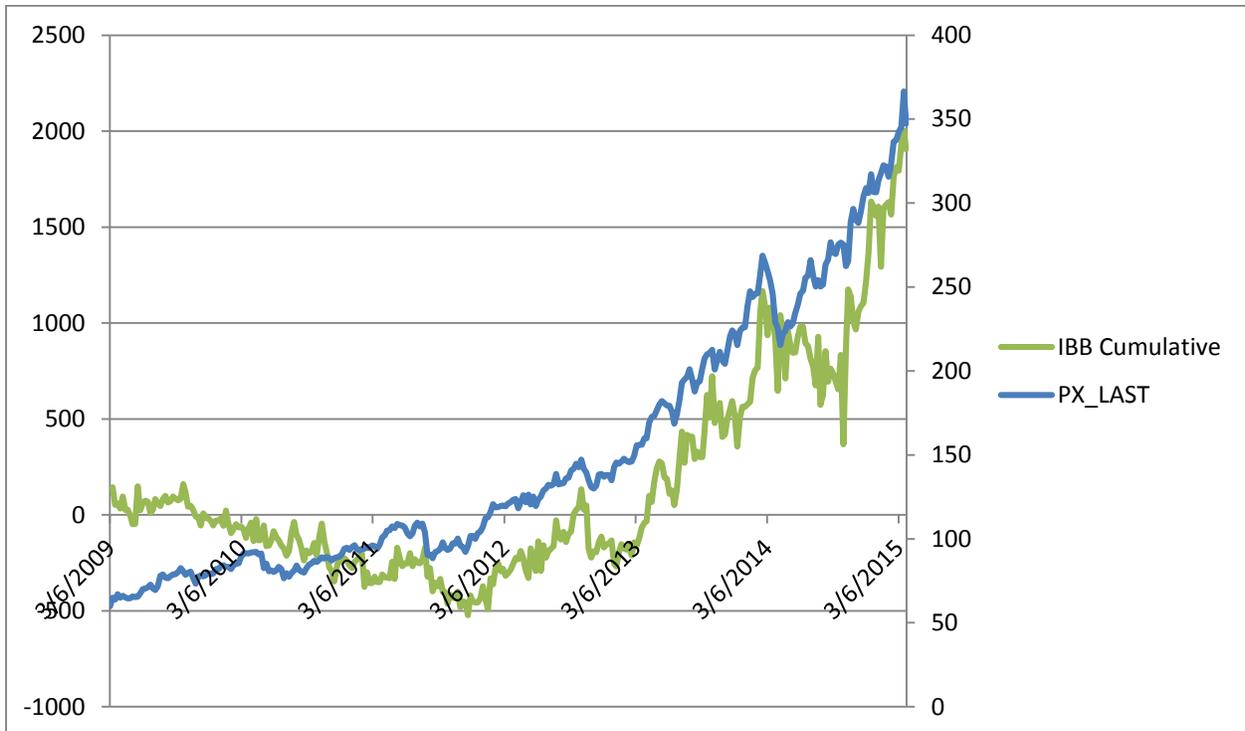
Here's the QQQ flows alongside the SPY and IWM:



We have no particularly robust explanation for why the QQQ might be experiencing such significant outflows compared to its brethren, though we do find it noteworthy. This is especially so at a time when conventional wisdom holds that increasing amounts of money are going into tech stocks. The NASDAQ is known as the tech corner of the market. Were money flying into tech the primary cause of the advance in stock prices, one would expect to at least see positive flows. Many claim that the market is being driven by momentum-seeking hot money, but if you look at the NASDAQ, that seems to be the converse of reality. The NASDAQ has been a far better performer than the SPY and IWM since the bottom and investors have seemingly been prudent in taking some chips off the table from the hottest of areas. Note that there were negative net fund flows for the first three years of the S&Ps rally off of the March '09 bottom. *The market en masse went up with more sellers than buyers.*



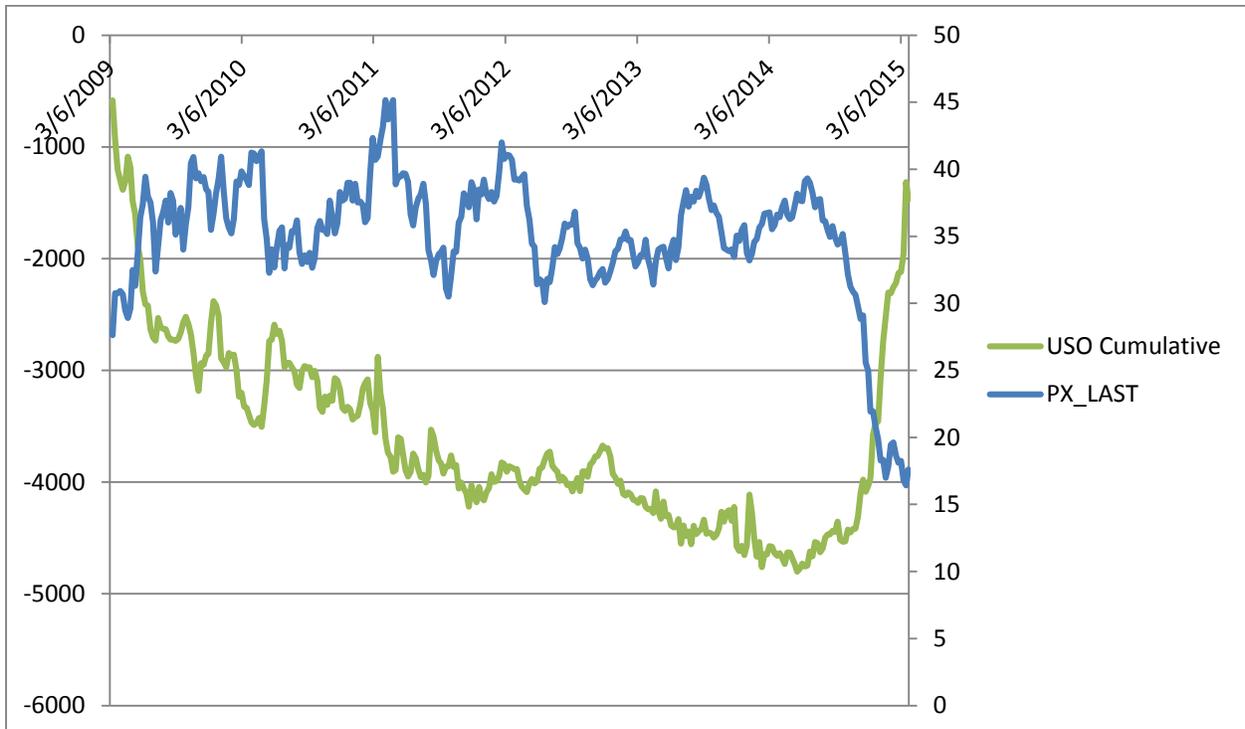
The IBB:



Of the dozen plus ETFs we looked at, this is the only one where price and flow moved upwards in tandem. This is exactly what a price-mediated feedback looks like. *The rise in price brings more flow, which drives price higher, thus attracting yet more flow.* This is also the explanation for how momentum works and what it looks like in action. While in the past we asserted biotech was not in a bubble based on valuation metrics and the fundamental outlook, this right here is a very concerning development. The longer this persists, the more troubling it will be. While price and flow can keep driving each other higher, when one breaks down, the other too will follow. One of the foremost points we learned from Soros is that when price-mediated feedback loops break, they do not simply find a new equilibrium at the price's present plateau. Rather, the feedback loop reverses and works in the opposite direction. Note that the move up and down in price and flow are both positive feedback loops—the disequilibrium-seeking forces in markets. As such, these relationships are inherently unstable.



The USO:



The cumulative flow since the '09 bottom remains below the X axis here—in other words, the flow of funds has been net negative. During much of the period when USO/oil prices trended sideways, investors were pulling money from this key ETF. Once the price of oil started its rapid descent, rather than withdrawing money, traders started piling it in. Clearly traders were eager to buy this dip, with the buying commencing early in the oil decline. This action in USO was not enough to stem the price decline in oil and this makes sense, for in this ETF alone we do not get a clean sense of where the true supply/demand equilibrium shakes out.

To sum this all up, while there is no one overarching point, it merely goes to show that “more buyers than sellers” doesn’t necessarily have any one meaning anywhere. It does however show that certain ETFs can and do have a very real influence on the sectors that belie them (IBB is the extreme example of this), while the flow in others lends skepticism to the prevailing narrative (QQQ and momentum seeking hot money).



Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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