A Bird's Eye View
Sparrows Newsletter
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When panic selling hits a market, or even worse when a market is shut down for a long period of time to deal with a crisis or market dislocation events, we should always be monitoring the situation closely.

This is all the more important if your investments are not made directly by buying the securities but through an investment vehicle which replicates the performance of the underlying securities. This is the case for ETFs (Exchange Traded Funds). One can for good reasons fear that trading in ETFs is vulnerable to disruption or mispricing when market conditions become highly volatile, or underlying securities are suspended.

In Greece, equity trading in the debt-ridden country was suspended on June 29 after the government closed banks and imposed capital controls. Then Greece's stock market reopened on August 3rd after five weeks to the most savage wave of selling in decades, underlining a crisis that's crippled the economy and pushed the country's euro membership to the brink.

During the closure, investors used an exchange-traded fund listed in the U.S. as a proxy for Greek stocks. It turned out that their expectations were quite close to what actually happened when markets reopened: the Global X FTSE Greece 20 ETF fell 17 percent during the suspension (20% for the index, still a meaningful spread though). Another provider however, Lyxor, decided to suspend their ETF on Greek stocks. With no underlying market trading, Lyxor said "there was a risk the price of the ETF could have been manipulated in the absence of activity in the underlying market".

In China, we have been keeping a close eye on the situation where markets have been under severe selling pressure despite moves by regulators to restore confidence. Chinese markets, which had risen as much as 110 percent from November to a peak in June, have tumbled 30 percent since June 12 in jaw-dropping volatility as money surges in and out of the market. Credit had expanded more rapidly in recent years than in any other major economy in history. This credit expansion in conjunction with the use of leveraged accounts by retail investors is one of the most likely causes of the current volatility.

During the last two months crash, 1400 companies saw their stock suspended (more than half of all listings) and this has caused great concerns for ETFs tracking the Chinese markets. Indeed ETFs were not suspended: CSOP ChiNext ETF for instance traded every day while two third of the stocks in this ETF were suspended. This has caused the ETF to jump up 20% while the underlying index moved by only 4.1% on Friday 10th July. In that week, Blackrock's iShares FTSE A50 ETF traded at a 15% discount to its net asset value.

For an investor in an ETF who has been told that buying an ETF is a passive investment which gives you (almost) exactly the performance of the market (the index), these numbers are raising a lot of eyebrows! In fact one could argue from these examples that the risks of investing in an ETF could be greater than the risks of directly investing in the underlying securities.

However, one could also argue that liquidity was still available for ETF investors thanks to the ETFs market participants, while your investments and your money would be encumbered if invested in the suspended underlying securities. Traded volumes on Chinese ETFs doubled during the crash.

The risks of investing in ETFs may primarily be on liquidity and redemption, particularly during periods of market stress. Incentives to redeem funds may also increase the risk of fire sales during those periods. It is reassuring that the Greek and Chinese situations have not lead to a complete meltdown of the ETF markets in these regions, or in ETFs which include these regions.

The short term price differences between the ETF and its underlying market are indeed discomforting. The relative access to ETF liquidity in the current crisis is reassuring. So as a long term investor, one should carefully monitor the situation and balance those risks, while avoiding panic fire sale.

Fahd Rachidy

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For more information:

+44 (0)20 3714 4624 | www.sparrowscapital.com | info@sparrowscapital.com