Did ETFs Cause the Q418 Sell-Off?

Ryan O. Issakainen, CFA • Senior Vice President • ETF Strategist

When equity markets have sold off over the past decade, many have been quick to point at exchange-traded funds (ETFs) as the possible culprit (remember the "flash crash"!?). Plenty of active mutual fund managers have ample incentives to characterize ETFs as problematic, especially while facing consistent outflows, as ETFs continue to gobble up market share. Thus, it's not uncommon for investment advisors to encounter clients that have had seeds of doubt planted about whether or not ETFs really are to blame when volatility picks up, or equities sell off.

Among such investors, these concerns may have been further stoked by an unexpected spike in volatility and equity market sell-off in Q418. Surely, ETFs were to blame as nervous investors exacerbated the downturn by selling their ETFs into a declining market, right!? Nope. If anything, the data points in the opposite direction (see Chart 1). In Q4, US equity and sector ETFs had over $31 billion of net inflows. Even in December, as the S&P 500 Index had its steepest decline, US equity and sector ETFs had over $13 billion of net inflows. Meanwhile, traditional US equity and sector mutual funds had nearly $38 billion of net outflows in Q4. If anyone was selling into a falling market, it was mutual fund investors! However, before anyone starts blaming the Q4 market decline on traditional mutual funds, keep in mind that this is nothing new. In fact, traditional equity mutual funds had net outflows for 8 of the prior 9 months in 2018, averaging over $11 billion per month.

But what about a category like bank loans!? Surely ETF investors were to blame for that decline, right? Doubtful. During the months of November and December, as bank loans sold off, ETFs had roughly $2.4 billion of net redemptions, compared to $17.6 billion of net redemptions from traditional bank loan mutual funds (see Chart 2). That's right, the volume of traditional mutual fund redemptions was more than 7 times as great as ETF redemptions for the bank loan category.

The bottom line: the evidence does not support the idea that ETFs meaningfully increased market volatility in Q4, nor that they steepened market declines. On the contrary, in many cases, ETF investors were net buyers as the market declined, taking advantage of cheapening valuations.

Chart 1: Mutual Fund Flows: US Equity and Sector

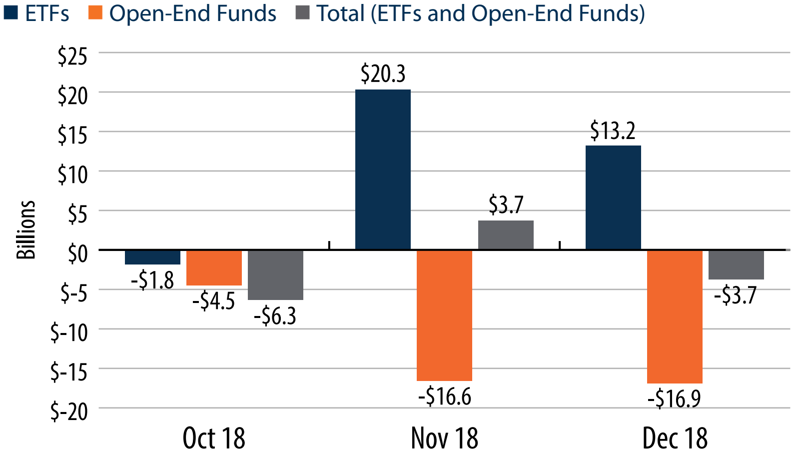
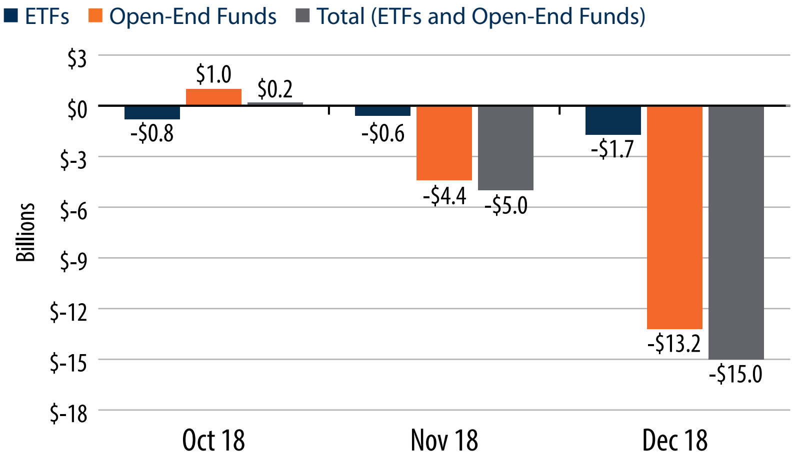


Chart 2: Monthly Fund Flows: Bank Loans



Source for charts: Morningstar Direct.