QUARTZ MEMBERSHIP

How the ETF explosion transformed global markets

Member exclusive by  Dasia Moore

The rise of ETFs

Exchange-traded funds (ETFs)—which didn't exist 30 years ago—now account for 10% of global assets held in funds. Their rapid rise has impacted global markets in three key ways:

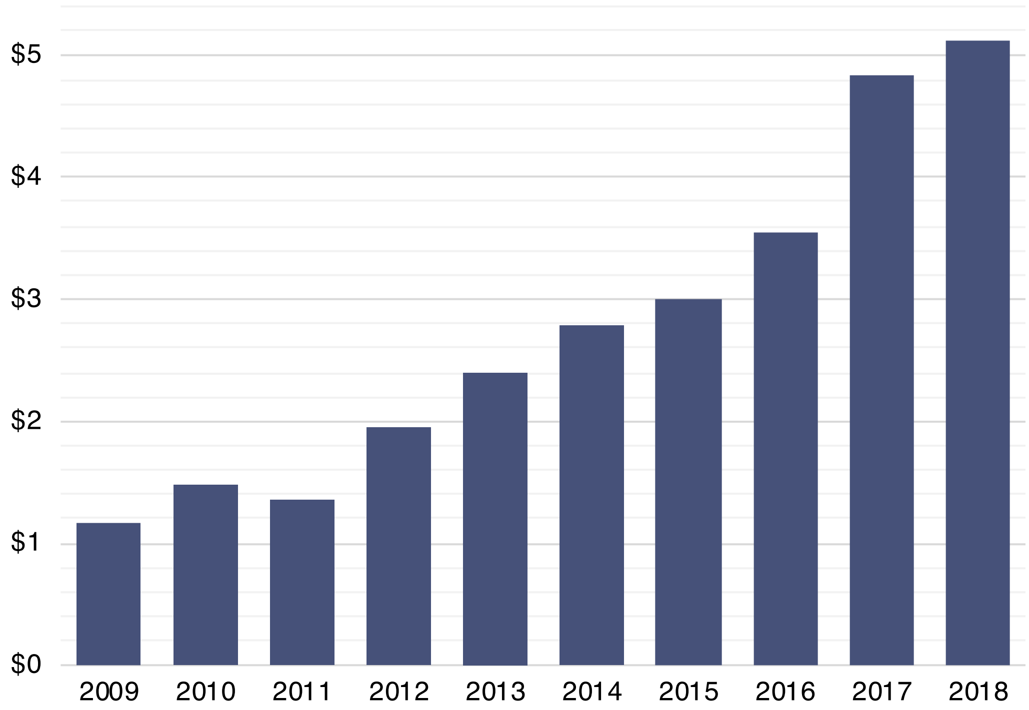
1. ETFs have **attracted a different profile of investing households**. Lower costs of entry and products built for the digital age appeal to younger investors.

2. At the same time, ETFs have **contributed to a widening gap between public and private markets**, where startups and small companies raise money from private equity, and the rewards of innovation mostly go to the wealthy.

3. Critics worry that ETFs **could cause or exacerbate the next market crash**. There's evidence they make flash crashes worse, and the funds remain untested in a major financial crisis.

Global ETF assets

Trillions



A fund that trades like a stock

ETFs are traded on exchanges just like individual stocks, but they combine a basket of securities into one fund to offer diversification and low costs. Traditional ETFs have stocks as their underlying assets. These market ETFs track an index: The oldest and best-known of these tracks the S&P 500, for example. But the proliferation of ETFs has introduced funds with a range of underlying assets including bonds, currencies, and commodities. Stock ETFs can also be focused on certain sectors, investment styles, or foreign markets.

	Management	Cost of entry	Taxes	Risk & trading
How are ETFs different from mutual funds and individual stocks?	Usually passively managed, which allows fund managers to charge low (and sometimes no) commission. Assets are pre-selected by managers.	Lower investment minimums than mutual funds. Exposure to a range of stocks at a fraction of the cost of purchasing each individually.	Lower capital gains taxes since funds do not have to sell stock (and thus capture capital gains) each time an investor redeems.	As with mutual funds, diversification reduces losses. As with stocks, real-time pricing allows investors more control over the price of a trade.

The road to the ETF explosion

Despite what their current explosive popularity might suggest, ETFs had several false starts before taking hold in the stock market for good. The oldest ETF still in existence was founded in 1993, but ETF history begins a couple of decades earlier, with the popularization of passive investing.

1957 Standard & Poor creates its S&P 500, a computer-generated index of the US market that is the first of its kind.

1973 The first index mutual funds are created in response to research touting the benefits of passive investing.

1990 The first ETFs are created—one to track the Toronto Stock Exchange and one to track the S&P 500 (1992). Neither survives into the present day.

1993 State Street Global Investors launch S&P 500 SPDR (Spider), now the oldest ETF in existence.

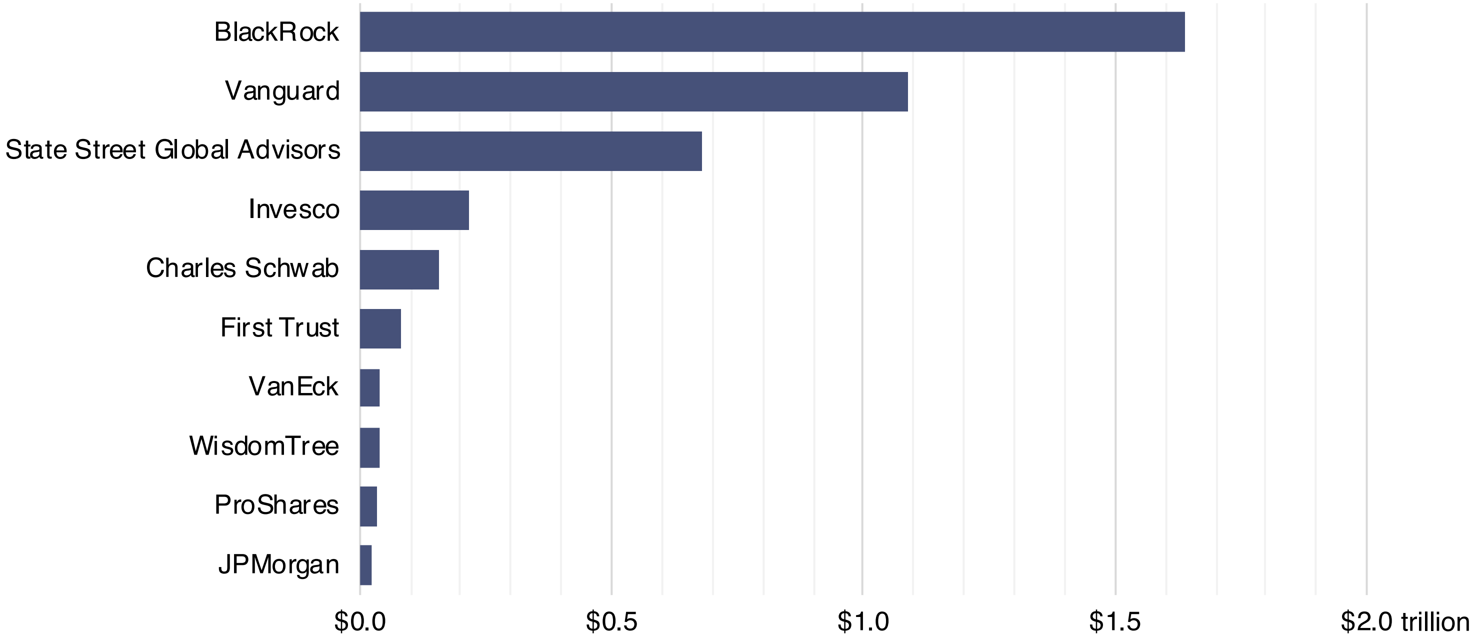
2008 The global financial crisis reveals mutual funds' weakness in the face of major downturns and fuels a desire for passively managed, index-based funds.

2009 The ETF market breaks $1 trillion in assets—nearly a 100% increase over 2008.

How big is the ETF explosion?

There are a few ways to measure how big the market for ETFs has become. More than 400 investment management companies issue ETFs. Together, those issuers offer more than 2,000 products (ETPs) on nearly 7,000 ETFs. About 70% of the $5.3 trillion in global ETF assets are held in the US. The market is dominated by a handful of issuers—led by BlackRock, Vanguard, and State Street Global Advisors.

Top 10 ETF issuers
Ranked by ETF assets under management (AUM)



ETFs have attracted a different set of investors…

Compared to mutual fund investors, ETF investors are younger. Lower fees and initial investing minimums could explain part of ETFs' appeal to a younger demographic. At the same time, ETF investors are more educated, slightly wealthier, and much more confident relying on their personal knowledge and digital research to make financial decisions.

7%
of US households own ETFs. Households headed by someone in their 40s are most likely to be invested in ETFs, at 9% ownership.

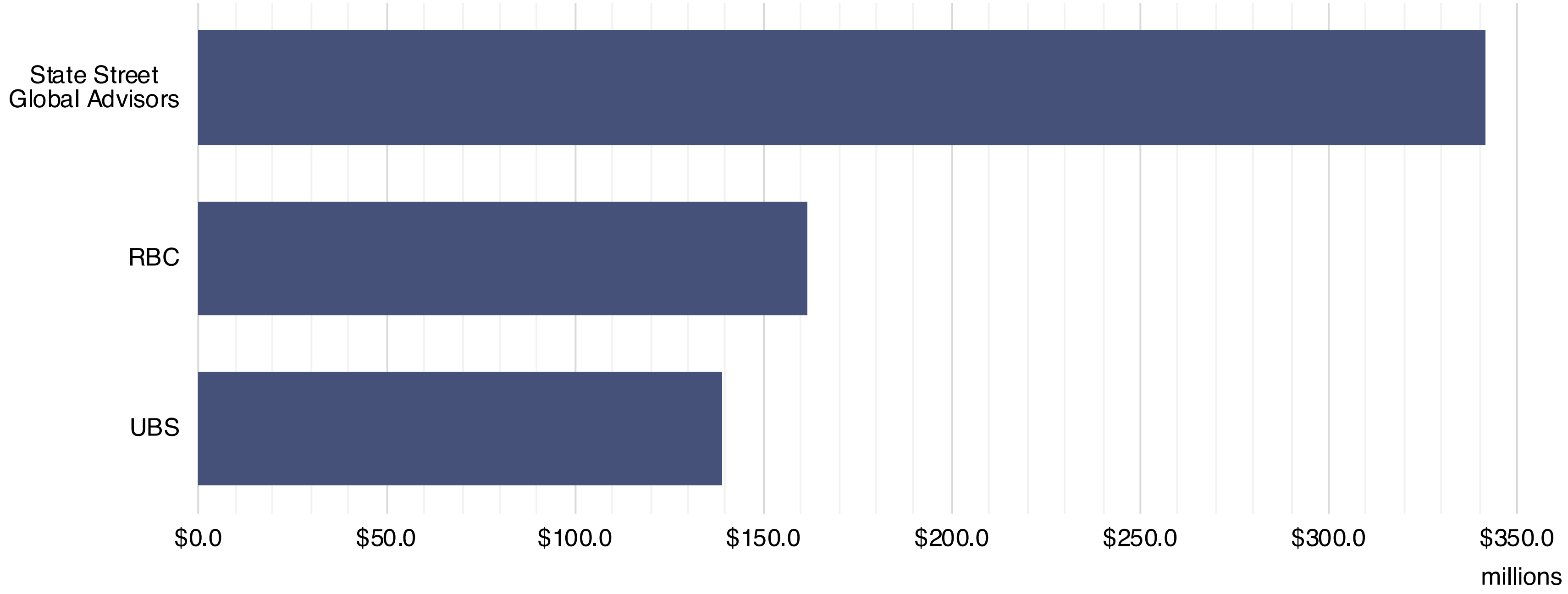
36%
of US ETF heads of household are 60+, versus more than half (52%) for mutual funds. 21% of ETF investors are under 40.

57%
of US ETF households have incomes of $100,000+, versus 45% for mutual funds. 66% are headed by a degree holder.

…and changed what they invest in

The flexible nature of ETFs has allowed the proliferation of funds focused on encouraging certain corporate behaviors, including environmental consciousness, equal pay and gender parity, socially responsible product sourcing, diversity, and more.

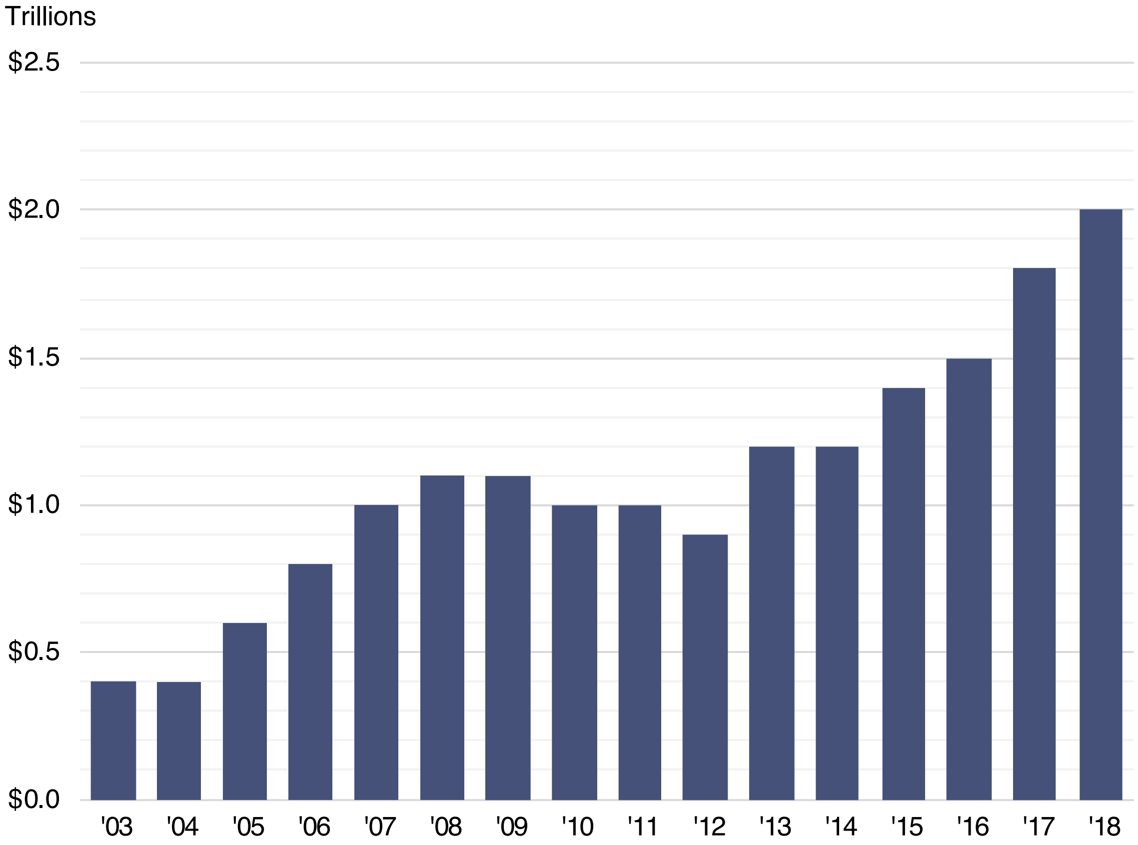
Top gender lens investing (GLI) ETFs
Ranked by GLI ETF assets under management (AUM), out of seven total GLI ETFs



ETFs have contributed to a widening gap between public and private markets

ETFs are one piece of a major shift in investing. On one end of the markets, passive investing (led by ETFs) provides an affordable way to bet on large, proven companies via indexes like the S&P 500 and Nikkei 225. On the other end, active investors carefully select small companies to provide with large investments. In turn, startups looking to raise capital have turned away from the public market and towards private equity. The result is that returns generated by innovation are reserved for the wealthiest individuals, professional investors, and large institutions that can afford to play in the private market.

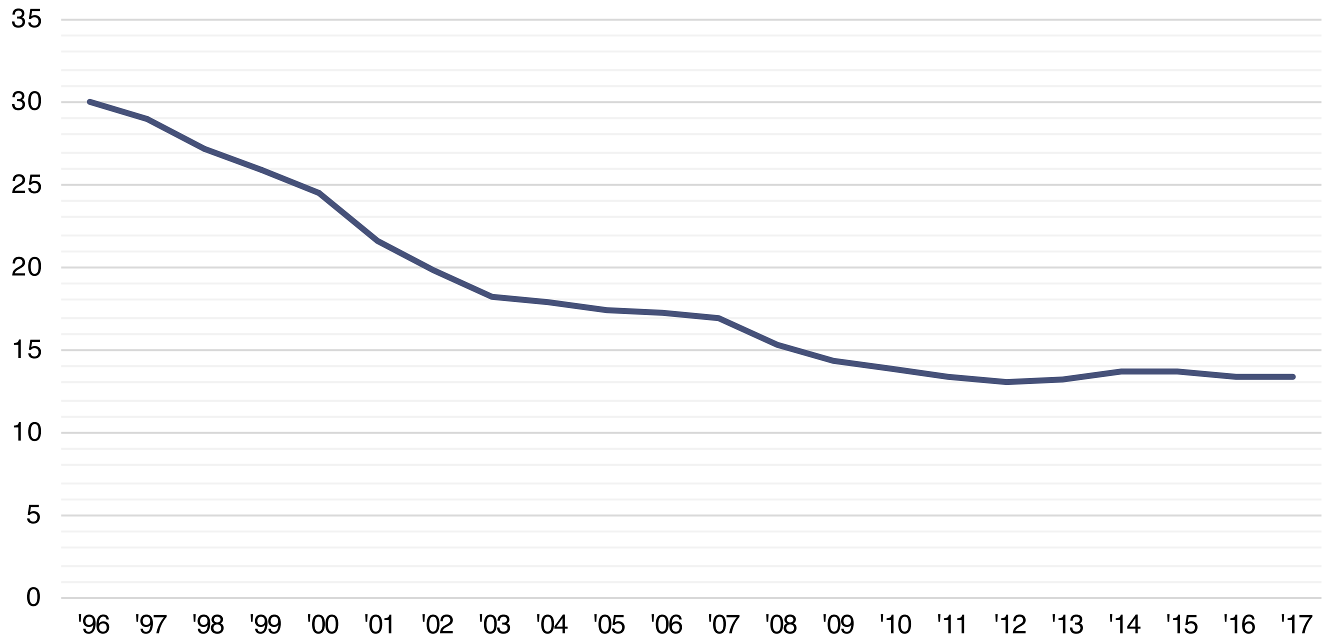
Global private equity dry powder



Go big or go home

It’s difficult to overstate the overwhelming shift in how companies raise money. Traditionally, startups would go public to make money on the public stock exchange. Now, the number of publicly traded US companies is more than 50% lower than in the late 1990s.

Number of publicly listed US companies
Per million people, annually



ETFs have introduced new risks

On average, ETF trading accounts for 20-30% of daily market activity in the US. But when the market shows signs of volatility, they can account for even more.

40%
The highest share of US daily market activity that ETFs have accounted for

2:45pm
The time at which many ETF market makers paused their work during the flash crash of May 6, 2010

50%
The drop some top ETFs experienced in a matter of minutes on August 24, 2015, when the S&P 500 fell 5.3%

Will ETFs be behind the next recession?

There is no evidence that the ETF explosion will trigger a financial crisis, but concern about what the funds could mean for global markets usually stems from two questions about ETFs:

- **Do ETFs weaken corporate governance?** One concern is that passive investing leads to more passive governance and that index-based investing lowers incentives for individual companies to be well-governed.

- **Do ETFs make downturns worse?** ETF trading activity certainly spikes during flash crashes, which suggests they increase short-term volatility in the markets. At the same time, some ETFs are designed to profit from market declines, and in 2008, many ETFs performed well throughout the crisis.

Even if ETFs don't trigger a crash, one concern remains: we don't know how ETFs will respond to the next crash. Since ETF assets have grown rapidly since 2008, a large portion of the global markets is untested under crisis.

Want to know more? Read more Quartz coverage of ETFs.

- There's a new S&P 500 index without all the bad stuff – For more on ETFs and environmental, social, and governance (ESG) investing.
- There almost as many equity funds as there are stocks for them to invest in – If you want to understand the rise of funds in the context of the decline in publicly listed companies.
- Charles Schwab is cutting brokerage fees to zero, but that doesn't mean it's free – To know how low ETF fees can go.
- A new fund will pay investors to buy it. What's the catch? – If you want to understand the pressure on smaller ETF issuers to recruit new investors at all costs.

You'll also enjoy our upcoming member-exclusive field guide on how ETFs ate the market, which will be available starting on Monday, November 18.

Have questions about this presentation, or suggestions for us?
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