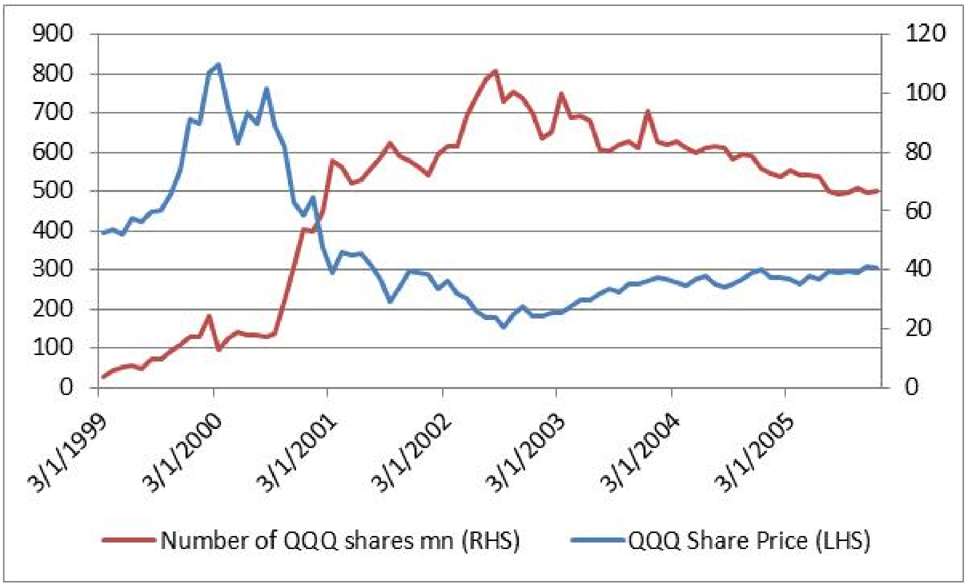
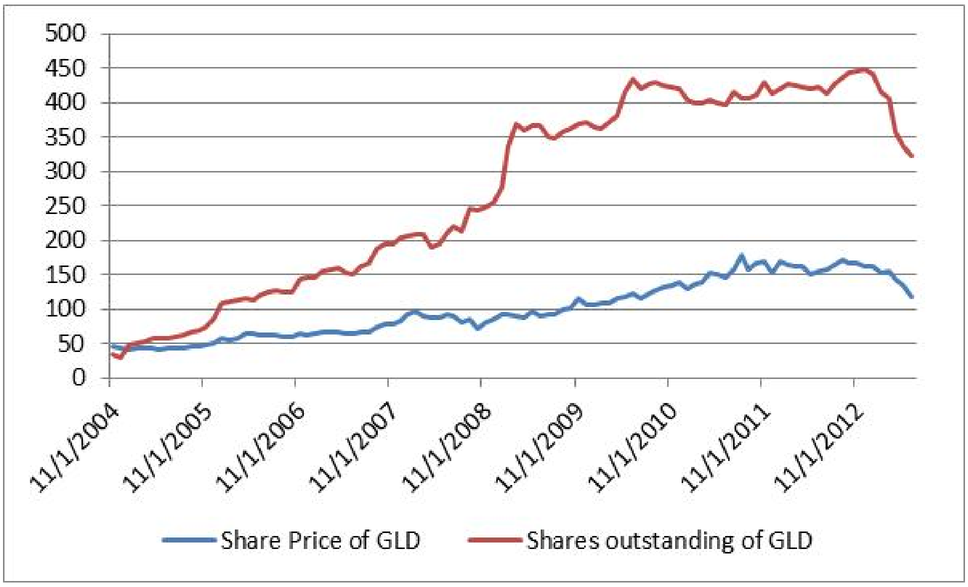
I started working in the financial markets as a graduate trainee at the height of the dot com bubble in early 2000. Among the many new names of companies and stocks I was hearing, one kept popping up consistently – QQQ. QQQ was an ETF (exchange traded fund) that had been launched in 1999 to track the tech-heavy Nasdaq. It was extremely popular with investors. What was very curious about QQQ is that investors continued to buy this ETF even after it started to fall rapidly in value. We can see that by looking at the number of shares issued by the ETF. When an investor buys the ETF – the ETF issues more shares, and buys more of the underlying stocks.



As can be seen from above, investors continued to buy QQQ as it fell, and only began to sell QQQ once it began to rally in 2002. We can work out how much of that market cap has come from issuing shares, and how much from capital appreciation. At the end of 2002, QQQ had raised some USD 35bn in market cap through issuing shares, but had lost USD 18bn in capital destruction, to give a market cap of USD 17bn. In this case the ETF buying was not enough to influence the bear market in tech stocks – and in fact investors began redeeming at the low.

Recent years have seen the rise of more and more ETFs into differing investment areas. They have in particular focused on areas that were traditionally hard for retail investors to gain access to: the rise of GLD ETF for gold, and EEM and VWO ETFs for emerging markets.



Unlike QQQ, investors have not increased their holdings of GLD as the gold price has fallen. This raises the intriguing question that ETFs are no longer passive investors, but have become the driver of prices for some assets. If this is true, then keeping an eye on the share counts of large ETFs could be an important signal for changes in market dynamics.

It is with this experience in mind, I was recently amazed to learn that two emerging market ETFs are among the largest ETFs by assets in the world, EEM and VWO. VWO and EEM have very similar share prices. Intriguingly, investors in EEM and VWO acted like investors in QQQ during the large sell off in 2008 and in 2011, but in this current sell off they have been sellers too. Again the implication is that ETFs are no longer passive investors – but the driver of asset prices.

For the first time in many years, ETF buyers are not natural supporters of emerging market equities. This has two consequences in my mind. Firstly, portfolio flows to emerging markets are likely to reverse, and countries with current account deficits are likely to feel devaluation bias. This is already apparent, with the South African rand, Indian rupee and the Brazilian real all having depreciating trends.

Secondly, many emerging market fund managers have developed fund flow indicators to help them time their market buying and selling. Typically when a certain threshold of redemption is reached (either % of AUM, or number of consecutive weeks of outflows) it is time to increase net longs for at least a bounce. If large ETFs have moved from being secular buyers to secular sellers then these market timing tools are probably of less use.

While VWO and EEM are the two largest emerging market equity ETFs, there have been a proliferation of very successful emerging market ETFs in recent years. In equities there is VEIEX (Vanguard EM Stock Index – USD 15bn), DEM (Wisdomtree EM Income – USD 5bn), EWZ (ishares MSCI Brazil ETF USD 6bn) and the FXI (ishares China Large Cap – USD 5 bn). All of these funds are showing signs of client redemptions for the first time in years.

To my mind this implies further depreciation in the currencies for countries with current account problems, and also means that large common holdings in these funds are likely to see structural selling of their stock. That large ETFs are holders of this stock explains one conundrum. ETF funds are big lenders of stock to short sellers as the fees made on this can be substantial. Typically when the outlook for a stock is poor, short sellers quickly bid up the cost of borrow. Despite the poor outlook for many EM stocks, the cost of borrow for short selling has stayed very low. When cost of borrow starts to increase I suspect we will know that that the influence of ETFs will be on the ebb in emerging markets.

Information

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