Beware the 'Specialized' ETFs

By Kerry Pechter *Thu, Feb 25, 2021*

In this month's Research Roundup, RIJ shares four recent academic papers on the proliferation of ETFs, the danger (or not) of national debt, rational inflation expectations, and the impact of recent changes in RMD rules.

When exchange-traded index funds (ETFs) first appeared, Vanguard employees heard through the office grapevine that Jack Bogle didn't see the point. He didn't object to index mutual funds—they were his passion. He didn't see the sense of trading index funds throughout the day.

Maybe Bogle foresaw the complications described in the recent research paper, "Competition for Attention in the ETF Space." In it, four economists assert that the first ETFs were solid; but too many new ones are faddish, opaque, expensive and a trap for investment duffers.

That's the first of four papers in our latest Research Roundup. The others try to answer, respectively, these questions: Does the national debt matter? Does the average person expect deficit spending to cause inflation? And, will changes in the RMD (required minimum distribution) rules change how Americans use tax-deferred savings accounts?

Beware the 'Specialized' ETFs

Exchange-traded funds (ETFs) came to market in two distinct waves. First there were the ultra-low-cost index funds that revolutionized the fund industry. More recently there's been a wave of bright, shiny, higher-fee "specialized ETFs" designed to exploit passing investment fads, a new academic paper asserts.

"The original ETFs, which are broad-based products, are beneficial investment platforms, as they reduce transaction costs and provide diversification," write Itzhak Ben-David and Byungwook Kim of Ohio State University, Francesco Franzoni of the Swiss Finance Institute, and Rabih Moussawi of Villanova University in "Competition for Attention in the ETF Space" (**NBER WP No. 28369**).

"Specialized ETFs ride the same wave of financial innovation," they add. "However, these products compete for the attention of unsophisticated investors who chase past performance and neglect the risks arising from the under-diversified portfolios. Specialized ETFs, on average, have generated disappointing performance for their investors.”

The authors suggest that “the most important financial innovation of the last three decades, originally designed to promote cost-efficiency and diversification, has also provided a platform to cater to investors’ irrational expectations.

“The investor clientele of specialized ETFs has a greater fraction of retail investors, who are typically considered less sophisticated. Relatedly, specialized ETFs are very popular among sentiment-driven investors, i.e., those that trade through the online platform Robinhood, which has become famous in recent years for hosting investment frenzies.”

With a market value of more than $5 trillion, ETFs now account for about 17% of the total assets in US investment companies, according to the paper. More than 3,400 ETFs have been launched, covering broad-based indexes like the S&P 500 to niche investment themes, such as a trade war, cannabis, vegan products, work from home, and COVID-19 vaccines.

“Specialized ETFs fail to create value for investors,” the authors conclude. “These ETFs tend to hold attention-grabbing and overvalued stocks and therefore underperform significantly: They deliver a negative alpha of about −4% a year. This underperformance persists for at least five years following launch.”

Does The National Debt Matter?

Stocks climb a wall of worry, they say. So does the national debt. It grew steadily after the US left the gold standard in 1971, and the federal bailouts of 2008 and 2020 have pushed it into the nose-bleed zone. If you try to forget it for a minute, somebody shows you the National Debt Clock.

In their new paper, “Does the National Debt Matter,” Randall Wray of the Levy Institute at Bard College and Yeva Nersisyan of Franklin and Marshall College propose a different way to look at the debt. It doesn’t come from out-of-control government spending, they say. Instead it reflects the enormous US trade deficit and debt remaining from fiscal responses to past recessions.

When Americans buy electronics from Asia or cars from Germany, dollars pile up overseas. A chunk of that money necessarily comes back to the US through purchases of US debt by foreign banks. [Technically, no physical dollars “pile up.” Digits change in foreign accounts at the Fed.] When the US suffers recessions, tax receipts fall, social welfare payments rise, and/or the Treasury engages in debt-financed spending.

Wray and Nersisyan are both proponents of Modern Monetary Theory. MMT reveals the integration and interdependency of the public, private, and foreign sectors of the US economy. Given that a sovereign country is never short of its own currency, MMT holds that no level of federal debt or deficit stops the US Treasury from paying its bills or prevents the Federal Reserve from supplying the private banking system with enough reserves to ensure that all good checks clear (including Treasury checks). In MMT, the public sector serves as a risk-free counter-party to the private sector, not its competitor for limited finances. "Mainstream economists look at government debt as a liability of the government, forgetting that it represents an asset for the holder," they write.

In a country issuing its own currency, economic growth never has to stall for lack of money or credit per se. It stalls when there aren't enough real resources to mobilize with money. In the current COVID-19 pandemic, they write, "The problem has not been lack of finance, but lack of the real output we need: hospital beds, masks, testing kits, safe places to quarantine those who are infected, and maybe even food, shelter, and clothing to support the population. Focusing on resource availability and resource distribution… rather than government budgetary impacts would have been a good first step."

Do Most People Expect Deficit Spending to be Inflationary?

How does the average person, living in his or her tiny microeconomic universe, respond to macroeconomic trends? When the media reports that government debt has soared to a record high, or that it will reach a stratospheric level in 10 or 20 years, how does an individual's expectations of future inflation change?

In their recent research paper, "Fiscal Policy and Household Inflation Expectations: Evidence from a Randomized Trial" (NBER Working Paper No. **28485**), three economists report their analysis of the responses to the questionnaires they sent in December 2018 to about 92,000 American households covered by the famed AC Nielsen. About 30,000 people responded.

Most people respond to predictions of towering *future* national debt levels with increased expectations about inflation, but not to reports of current levels of debt, according to authors Olivier Coibion of the University of Texas at Austin, Yuriy Gorodnichenko of University of California–Berkeley, and Michael Weber of the Chicago Booth School of Business at the University of Chicago.

“Our results suggest that most households do not perceive current high deficits or current debt as inflationary nor as being indicative of significant changes in the fiscal outlook. In that sense, our results are not out of line with Dick Cheney’s famous quip that ‘deficits don’t matter,’” they write.

“Telling households that the US budget balance will deteriorate so that the national debt will increase by ten trillion dollars by 2028 leads to an increase in short-run inflation expectations of 25 basis points and a rise in the cumulative inflation expectations of about one percentage-point over ten years.”

The economist Robert Barro suggested in the 1970s that government borrowing today to boost the economy would be self-defeating, because rational investors would foresee higher taxes in the future and make offsetting preparations for them. (Barro’s idea was based on the Ricardian Equivalence, which holds that it doesn’t matter in the long run whether a government funds itself through borrowing or taxes.) This new paper didn’t support that idea.

How Will Changes in RMD Rules Change Behavior?

Taking required minimum distributions (RMD) from tax-deferred accounts like IRAs and 401(k) plans can be painful for retirees, especially if they don’t need the money for current expenses or if they planned to leave the assets to their beneficiaries. The withdrawal doesn’t add much to their enjoyment of life; it just triggers a tax bill.

New legislation has begun to shake up the sleepy RMD world. The age at which Americans must start taking annual required minimum distributions (“RMDs”) from their pre-tax IRA, 401(k), or 403(b) savings accounts was lifted to 72 from 70-1/2 by the SECURE Act of 2019. Proposals are also afoot to raise the age to 75, to exempt accounts of less than $100,000 from RMDs, or even to eliminate the RMD altogether.

What would be the consequences of any or all of those changes? Economic researchers looked into that question and concluded that none of them would have much affect on retirees who use their tax-deferred accounts for current income, but it might affect the behavior of retirees who intend to bestow those pre-tax assets on their heirs.

“If RMD rules were applied only to retirement assets in excess of $100,000… or were completely suspended, this would result in notably lower lifetime tax payments by high-income individuals having a bequest motive,” write Olivia Mitchell of the Wharton School and Vanya Horneff and Raimond Maurer of Goethe University in Frankfurt, Germany, in “Do

Required Minimum Distribution 401(k) Rules Matter, And For Whom? Insights from a Lifecycle Model” (NBER Working Paper **28490**).

“Financial institutions such as insurance companies and mutual funds offering retirement plans and investment advice would benefit from ascertaining their clients’ bequest intentions, before advising them about RMD strategies,” the authors point out. “Our conclusions will also interest professional financial planners guiding clients as they make retirement payout choices.”