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The (Dis)Connection Between ETFs and Market Volatility

By Rochelle Antoniewicz

In the past year, many commentators have charged that exchange-traded funds (ETFs) are responsible for driving stock market volatility to unprecedented extremes. That charge, however, breaks down under an examination of the data. Our analysis shows that:

- Recent levels of volatility aren't unprecedented.
- Episodes of heightened volatility predate the rapid growth of ETFs.
- Volatility is a global phenomenon and occurs in markets where ETFs play a much smaller role than they do in the United States.
- Macroeconomic events—not particular market instruments—offer far more plausible explanations for episodes of volatility, including those experienced in the past three years.

As this chart shows, over the past 25 years, equity market volatility has experienced several spikes. Those levels have been at least as high as the volatility experienced since 2008. Indeed, the peak volatility for this period was during the Black Monday Crash of 1987.

Recent Market Volatility Is Not Unprecedented

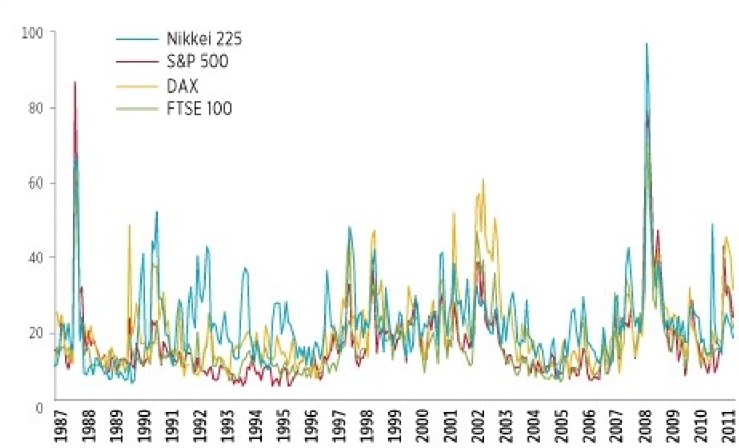
Source: Investment Company Institute and Bloomberg

The chart also shows the level of ETF assets at particular times over this period. ETFs were not available as an investment product in 1987. Their assets were negligible when volatility spiked during the Asian currency crisis in 1997 and Russia's default in 1998. ETF assets were still relatively small compared to current levels in 2000–2001, when volatility spiked frequently due to the September 11 terror attacks and the bursting of the dot-com bubble.

What's more, from 2004 through 2006—while ETF assets and demand for ETFs were growing rapidly—equity market volatility remained subdued.

From mid-2007 to today, the equity market has been volatile. At the same time, the popularity of ETFs has soared, with assets reaching just over $1 trillion by the end of 2011. But creating a causal relationship requires a case of selective amnesia. Don't forget there was also a prolonged global financial crisis that threatened to take down the international banking system and threw financial markets worldwide into turmoil. Recession ensued and many national economies are still operating below full capacity.

Equity Market Volatility Is Global



Source: Investment Company Institute and Bloomberg

Just as equity market volatility isn't a recent phenomenon, it's also not unique to the United States. The second chart plots volatility in the stock markets of Japan (the Nikkei 225 index), Germany (the DAX), and the United Kingdom (the FTSE 100) against volatility in the Standard & Poor's 500 index. As the chart shows, volatility follows a very similar pattern in all of these markets—and each market has its share of episodes when its volatility exceeds the others'.

ETFs, however, play different roles in each of these markets. ETFs in Japan and the United Kingdom account for a much smaller share of their domestic equity market capitalization (1 percent for Japan and 2 percent for the United Kingdom) than do ETFs in the United States (7 percent) and Germany (8 percent).[1] Yet stock prices have been equally volatile in all of these countries.

If neither historic patterns of U.S. stock market volatility nor international comparisons of stock market volatility appear to be related to ETF growth, what does account for volatility? The answer is obvious in Figure 1: stock market volatility is driven by macroeconomic events—the Crash of 1987, the Asian currency crisis, the Russian default. And since 2007, markets have been pummeled by macroeconomic events in the fallout from the financial crisis. Anemic economic growth, high unemployment, the still-unresolved European debt crisis, and the United States' own debt showdown and ongoing fiscal difficulties—the road to recovery has been difficult and riddled with potholes, each of which has jarred investors and raised uncertainty.

Commentators who overlook the effects of these macro developments on recent market volatility in their rush to focus on ETFs fail to meet the test of reason.

[1] Sources: Investment Company Institute, BlackRock, and World Federation of Exchanges. Data for Japan, Germany, and the United Kingdom are as of October 2011. Data for the United States are as of December 2011.

Rochelle Antoniewicz is Senior Director of Industry and Financial Analysis at ICI.