EXAMINING THE IMPACT OF ETF INVESTMENTS ON DIFFERENT CHARACTERISTICS OF THE UNDERLYING STOCKS IN THE US

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ABSTRACT

Exchange Traded Funds (ETFs) have been one of the most important innovations in the financial industry over last the three decades. Their popularity stems from the diversification benefits offered similar to that of mutual funds, while exhibiting higher liquidity and flexibility of trading like that of a stock. However, these advantage comes at a cost, as ETFs are also marred with controversies of exhibiting significant risk of increasing volatility and mis-pricing in the underlying stocks. With the total assets of ETFs surpassing that of active stock funds recently (Gittelsohn, 2019), their significance has now become greater than ever before. Thus, this article aims to assess the effect of ETF investments by examining the impact of their flow and turnover on different characteristics of the underlying such as returns, liquidity and risk. 192 stocks belonging to Information Technology (IT) and Energy sectors in the US stock market between 2016 and 2019 has been used for this purpose. After controlling for other firm specific factors, the results indicate that returns decreased with both ETF flow and ETF turnover (trading) for IT and Energy sector stocks. However, ETFs have been beneficial to the underlying stocks in case of both liquidity and risk, by improving liquidity and reducing risk for both IT and Energy sector stocks[1].

Keywords*: ETF, arbitrage, flows, trading volume, Arbitrage Pricing Theory, Quantile Regression, ARFIMA*

1. INTRODUCTION

The last three decades has seen a tremendous increase in the investments into the ETF. As of 2018, they account for nearly 25% of the daily trading volume in the U.S. stock market (Evans and Wilson, 2018). Their popularity largely stems from the fact that ETFs offer a convenient and cost effective tool for diversification, apart from providing liquidity of that of a stock. They enable investors attain desired levels of exposure to multiple systematic factors, themes, and businesses from different geographies. Demand for ETF has not only seen a drastic increase from institutional investors but also from retail clients. As of year-end 2018, the total net asset of ETF in the US is $3.4 trillion, of which $2.3 trillion was contribution from last 10 years alone (Collins, 2019).

Unlike Mutual funds, ETFs issue securities offering an opportunity to trade continuously in a regular stock exchange. Similarly, ETFs also enable investors to liquidate their position by trading their shares during

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