DAS INVESTMENT

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Hans Peter Schupp, 16.05.2023

Hidden risks with ETFs

When skyrocketing valuations no longer matter

ETFs are more popular than ever. But active funds also have their justification, says Hans Peter Schupp. He shows which advantages actively managed investment funds have over passive ones and which are the hidden risks - especially with regard to exaggerated valuations – that may be lurking in ETFs.

The argument about whether an ETF or a managed fund is the better investment vehicle is as old as the first ETF. This saw the light of day on March 9, 1990, as the "Toronto 35 Index Participation Fund", known as TIPs, which was listed on the stock exchange in Toronto, Canada. Since then, the discussions for and against exchange traded funds have not ceased.

There are many reasons why investors invest in ETFs. They offer a variety of benefits that are worth taking a closer look at.

One of the most important advantages of ETFs is their broad diversification. By investing in ETFs, investors can invest in a range of assets, including different companies, industries and countries. This reduces the risk associated with investing in individual stocks and allows investors to benefit from diversification without having to manage multiple stocks.

Another advantage of ETFs is their cost efficiency. ETFs have lower fees than actively managed funds because they do not require the input from analysts and fund managers. ETFs are also highly liquid. They can be traded on exchanges at any time, which allows investors to change their positions in ETFs quickly and easily. Finally, transparency is another attractive feature of ETFs. Investors can get an overview of the portfolio's composition and the ETF's investment strategy at any time.

Danger of bubbles forming

Investing in ETFs seems like a straightforward, transparent and low-cost option, but it also carries some hidden dangers.

The approximately $10 trillion in ETF assets under management worldwide has become a powerful force causing market fluctuations. ETFs follow the composition of indexes and blindly invest in the stocks that make up the index. This means that when investors buy ETFs, they invest a large portion of their money in influential giants within the index. In the DAX index, for example, heavyweights like SAP, Deutsche Telekom and Siemens make up a whopping 25 percent, and even the MSCI World index is made up of 15 percent Apple, Amazon and Microsoft.

This may seem harmless at first glance, but it can lead to a dangerous scenario. Due to good performance in the past, these companies have a high index weighting, and this is the only reason why more money is flowing into these stocks - regardless of their fundamentals or valuations. This can cause the prices of these companies to rise to unsustainable levels, setting the stage for a bubble to form. The danger, of course, is not in the inflow of money, but particularly in the potential outflow. If investors withdraw from exchange-traded funds, this can trigger a chain reaction that leads to a rapid decline in prices.

Market concentration on a small number of stocks facilitates the search for undervalued stocks

As an active fundamentally oriented fund manager, we see this with one laughing eye and one crying eye. The crying eye bemoans the fact that we are not there when prices explode. The laughing eye, however, sees exactly: Away from the mainstream which concentrates on the big players, you find plenty of buying opportunities that are not affected by this effect and that hardly anyone cares about. Our fund investments in coffee machine manufacturer De Longhi or in Italian automotive supplier Sogefi can be cited as examples here. Sogefi has a patent on large-surface radiators, which are used above all in many electric cars. KSB from Germany, one of the largest pump manufacturers in the world, also fits into this category.

And finally, a word on counterparty risk: investors who avoid bank shares because of their risk should consider should think hard whether swap ETFs are the right form of investment for them. It is true that these ETFs can replicate an index as closely as possible, as the reference index is replicated via a synthetic swap transaction with a financial institution. However, the bank only guarantees the potential gains of the index, and this swap transaction leads to a so-called counterparty risk, as the portfolio is not backed by a real equity portfolio, i.e. physical shares.

In summary, ETFs offer numerous advantages such as broad diversification, cost efficiency, liquidity and transparency. However, investors must also be aware of the potential dangers. ETF assets under management globally are significant and invest rigidly. This poses the risk of bubble formation - a market concentration in a few stocks. Active fund managers, on the other hand, can also find buying opportunities in undervalued stocks because they have more options in stock selection and flexibility in portfolio composition.

About the author:
Hans-Peter Schupp has worked as a portfolio manager at Fidecum, a financial services provider he co-founded, since 2008. Previously, he was head of asset management at Mainfirst Bank.

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