ETF sticker-shocked? Don't be.

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Vineet Budhraja: Thank you for joining this audiocast. My name is Mike McManus and I'm an investment strategist within Bank of America's Global Wealth and Investment Management Division. I will be discussing a new paper in our Chief Investment Office Educational Series called "Are you ETF sticker-shocked? Don't Be. Why ETF prices may not necessarily reflect their true value."

Many investment periodicals and media news outlets will have you believe that exchange-traded funds or ETFs are designed for the everyday investor and that there are next-to-no complexities when understanding their mechanics and design. Unfortunately, this can be further from the truth. ETFs, although often providing ample transparency into holdings and intraday price information, come with their own subtle nuances. Today, we're going to discuss one nuance in particular - price discrepancies of the ETF itself versus its underlying securities. In particular, we will discuss how this is most prevalent in foreign markets traded on U.S. exchanges.

Envision this for a moment. You go grocery shopping and buy ten items, each priced at $1.00 and then place them into your shopping cart. The total cost of your purchase should be $10.00, ignoring tax for a moment. What if I told you that the total cost, once placed in your shopping cart, amounted to $11.00 or even $9.00? How could the cost of the individual items not sum up the total cost of the shopping experience? This is the discrepancy we're describing here. In that shopping example, paying $11.00 for that basket of goods would be called "paying a premium." Conversely, paying $9.00 would be considered buying at a discount.

In the world of ETFs, these price discrepancies are often short-lived but can be fairly sizable at times. There are several common causes or situations where these anomalies arise, the first of which is via time zone differences. If an ETF-owned foreign securities but the ETF itself trades on U.S. exchanges, there will be a significant gap from when U.S. investors may trade the actual ETF itself versus when the local or foreign securities are actually being traded on their own exchanges. As you can imagine, strong buying or selling of the ETF, when the underlying are not actively trading, could drive the price of the ETF forcefully in one direction or another, dislocating from the individual stocks or bonds which make up the fund.

Another way to think about this phenomenon is to imagine significant positive news being announced during U.S. trading hours which impacts equities across the globe. As expected, U.S. domiciled stocks rally on the news, understanding that this news could likely impact non-U.S. companies in a similar manner, and that will bid up the price of ETFs with foreign exposure despite the underlying foreign securities not being available to trade. This would result in those ETFs appearing to trade at a significant premium to the underlying basket of securities.

However, the ETFs actually represent the most up-to-date and fair market price for the underlying securities. This is a process called "price discovery" and it occurs on a daily basis in markets with time zone differences. While time zone differences can be a major contributor of ETF and underlying security price discrepancies, they are certainly not the only cause. Liquidity, or lack thereof, infrequent trading, and significant fund flows are also leading contributors to this phenomenon. Knowing all of this, we should be able to identify areas of the marketplace where this is likely to be most noticeable. A few asset classes which stand out in this regard would be foreign markets such as international developed, emerging, and the frontier markets.

We would also expect to observe this disconnect in less-liquid asset classes such as small and microcap equities, as well as many fixed income sectors and maturities where supply may be less prevalent. You may be saying to yourself, "This sounds terrible, and what can I do to ensure I don't get a bad deal?" The good news is that the majority of these price discrepancies are extremely short-lived. Many are actually eliminated from the close of business one day to the open the next.

However, what should you be on the lookout for? If you are someone who scrutinizes performance of your portfolio and/or securities regularly, consider taking performance snapshots on multiple days. Do not base any buying or selling decisions solely on the performance of one-time period alone. These dislocations in price could cause drastic differences in your performance from one day to the next if not examined properly and evaluated with this information in mind. Think long-term and also consider working with an investment professional to aid you in your investing journey.

Finally, if you find yourself ETF sticker-shocked, don't be. For more information on this topic, please read the full paper titled "Are you ETF sticker-shocked? Don't be. Why ETF prices may not necessarily reflect their true value."

Thank you again for listening.

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