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Pointing Fingers at Index Funds Won't Explain Market Volatility

With all the recent volatility in the US stock market, two questions are frequently being asked:

- Are fund investors fleeing the stock market?
- Are index funds causing market turbulence?

The short answer to both questions is no.

Experience and research show that investor flows to and from mutual funds and exchange-traded funds (ETFs) tend to track market returns. Historically, those flows have tended to constitute a small share of fund assets. Recent activity is no exception.

Yesterday, ICI published data showing that investors redeemed, on net, $21.8 billion in domestic equity ETF shares for the week ended Wednesday, February 7—a week that includes the sharp market drop of February 5. (Domestic equity ETFs are those that invest primarily in the stocks of companies listed on US stock exchanges.)

Figure 1

Last Week's Net Redemptions of Domestic Equity ETFs Were Not Abnormally High
Percentage of previous month's assets, weekly*

* Flow for the week ended February 7, 2018, is a percentage of December 2017 assets.

Source: Investment Company Institute

Though sizable in dollar terms, the $21.8 billion that investors redeemed from domestic equity ETFs is not large as a percentage of fund assets—in fact, it amounted to just 1.1 percent of the assets of domestic equity ETFs, as shown in Figure 1, above. That drop is not out of line with several other, far less memorable weeks in the past five years. In fact, the gold medal for the largest outflow on record goes to the $23.6 billion outflow recorded almost four years ago exactly, during the week ended February 5, 2014. Then, as now, the Winter Olympics were about to start, and market volatility jumped. But after two weeks of outflows, domestic equity ETFs resumed their growth.

Redemptions Don’t Drive Volatility

Some commentary has suggested that index funds—and ETFs in particular—have fueled market volatility. Once again, the data undermine that contention.

Investors, especially institutional investors, use ETFs to quickly and efficiently transfer and hedge risks. It’s therefore not surprising that during the recent market turbulence, ETF trading volumes rose—but so did the volume of company stocks traded, as Figure 2 shows. For example, on February 6, $266 billion worth of ETF shares exchanged hands, more than double the value traded on February 1.

Figure 2

Investors Use ETFs to Quickly and Efficiently Transfer and Hedge Risks
Total dollar value of shares traded on US equity markets, daily, billions*

Source: ICI calculations based on Bloomberg and CBOE Exchange data

But most of these trades represent investors exchanging shares of ETFs among themselves. Such trades, which occur in the secondary market, don’t “touch” the company stocks that ETFs hold—that only happens when there are net creations or redemptions of ETF shares. As noted earlier, for the week of February 7, redemptions of domestic equity ETFs totaled $21.8 billion, and represented a mere 1.2 percent of the $1.8 trillion in company stock that changed hands that week. In other words, while company stocks traded heavily, only a very small fraction of that volume can be attributed to ETFs.

Economic Developments Drive Volatility

Throughout history, macroeconomic events—not particular market instruments—have driven the direction and volatility of markets. The recent spike in volatility occurred because a higher-than-expected increase in wages stoked concerns that inflation could pick up, which could in turn lead the Federal Reserve to raise interest rates faster and further than previously anticipated.

As Figure 3 shows, volatility spikes when the world turns uncertain—regardless of the level of index fund assets. In contrast, market volatility was notably subdued from 2012 to 2017, even though assets in index funds grew from $2.5 trillion to $6.7 trillion.

Figure 3

Equity Market Volatility Is Driven by Macroeconomic Events
Annualized 30-day realized volatility of S&P 500*

* As measured by the 30-day rolling standard deviation of daily returns on the S&P 500 index; 2018 data are as of February 9.

Note: Index fund asset data include ETFs and index mutual funds.

Sources: Investment Company Institute and Bloomberg

Despite their recent rapid growth, index funds remain a relatively small part of US stock markets, as shown by Figure 4. At year-end 2017, index mutual funds and index ETFs held only 13 percent of US stock market capitalization—far less than the 40 percent figure reported by some sources. Actively managed mutual funds and actively managed ETFs held another 17 percent, while other holders—including hedge funds, pension funds, life insurance companies, individuals, and others—held the remaining 70 percent of US stocks.

Figure 4

Index Fund Share of US Stock Market Is Small
Percentage of US stock market capitalization held by mutual funds, ETFs,* and other holders

* Note: Prior to October 2009, data for index ETFs include a small number of actively managed ETFs.

Sources: Investment Company Institute and World Federation of Exchanges

Market turmoil can be dramatic and unsettling, and it's natural for commentators and the press to look for causes and consequences. But it's wrong to assign responsibility for the market's movements to specific investing vehicles, such as index funds. And it's wrong to assume that fund investors react to market moves with panic. Time and again, history has proven that they don't.
