“Is there a Dark Side to Exchange Traded Funds (ETFs)?
An Information Perspective”

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From
IDC

יומ שני, 12 בינואר 2015, בשעה 14:00
סדנאות הסמינר המתקיימים בתוכם להרצאה בנושאים:

Abstract

In this paper, we hypothesize and find that ETF ownership is accompanied by a decline in the pricing efficiency of the underlying component securities. Consistent with predictions from noisy rational expectation models with costly information, an increase in ETF ownership is associated with an increase in firms’ bid-ask spreads. In addition, we show that increased ETF ownership is also associated with: (1) a decline in the predictive power of current returns for future earnings (“forecasted earnings response coefficients”), (2) an increase in the co-movement of returns to market-wide factors (“price synchronicity”), and (3) a decline in the number of analysts covering the firm. Collectively these results suggest increased ETF ownership can lead to higher information costs and deterioration in firms’ information environment.