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Want a hot stock tip? Avoid this type of investment fund

Specialized ETFs invest in trendy, overvalued areas, study finds

OHIO STATE UNIVERSITY

Research News

COLUMBUS, Ohio - "Buy low and sell high" says the old adage about investing in the stock market.

But a relatively new type of investment fund is luring unsophisticated investors into buying when values are at their highest, resulting in losses almost immediately, a new study has found.

The lure? Buying into trendy investment areas like cannabis, cybersecurity and work-from-home businesses.

"As soon as people buy them, these securities underperform as the hype around them vanishes," said Itzhak Ben-David, co-author of the study and professor of finance at The Ohio State University's Fisher College of Business.

"They appeal to people who are not sophisticated about investing. They may have an extra $500 and decide to try to make what they think is easy money in the stock market."

The research was presented earlier this month at the annual meeting of the American Economic Association and is available on the SSRN preprint server.

These investment funds are a particular type of Exchange Trade Funds, or ETFs, which were first developed in the mid-1990s. ETFs are investment funds that are traded on stock markets and are set up like mutual funds, holding a variety of other stocks in their portfolios.

The popularity of ETFs is growing quickly. By the end of 2019, in excess of $4 trillion was invested in more than 3,200 ETFs. The original ETFs were broad-based products that mimicked index funds, meaning that they invested in large, diversified portfolios, such as the entire S&P 500, Ben-David said.

But more recently, some companies have introduced what Ben-David and his colleagues call "specialized" ETFs, which invest in specific industries or themes - usually ones that have received a lot of recent media attention, like work-from-home opportunities.

"These specialized ETFs are often promoted as the 'next big thing' to investors who are wowed by the past performance of the individual stocks and neglect the risks arising from under-diversified portfolios," said study co-author Byungwook Kim, a graduate student in finance at Ohio State.

For the study, the researchers used Center for Research in Security Prices data on ETFs traded in the U.S. market between 1993 and 2019.

They focused on 1,086 ETFs. Of those, 613 were broad-based, investing in a wide range of stocks. These are the Walmarts of ETFs, appealing to value-conscious consumers, Ben-David said.

The remaining 473 were specialized ETFs, investing in a specific industry, like cannabis, or multiple industries that are tied by a theme. These are the Starbucks of ETFs, appealing to consumers who are willing to pay more for what they see as higher quality, he said.

"The securities that are included in the portfolios of specialized ETFs are 'hot' stocks," said co-author Francesco Franzoni, professor of finance at USI Lugano and senior chair at the Swiss Finance Institute. "We found that these stocks received more media exposure, and more positive exposure, than other stocks in the time leading up to the ETF launch."

In 2019, the new ETFs included products focusing on cannabis, cybersecurity and video games. In 2020, new specialized ETFs covered stocks related to the Black Lives Matter movement, COVID-19 vaccine, and the work-from-home trend.

The performance of broad-based versus specialized ETFs was very different, the researchers found.

Broad-based ETFs had earnings over the study period that were relatively flat, the analysis showed. But specialized ETFs lost about 4 percent of value per year, with underperformance persisting at least five years after launch.

"Specialized ETFs, on average, have generated disappointing performance for their investors," said co-author Rabih Moussawi, assistant professor of finance at Villanova University.

"Specialized ETFs are launched near the peak of the value of their underlying stocks and start underperforming right after launch."

The study found that the types of investors who bought into specialized ETFs were different from those who invested in the broad-based products.

For example, large institutional investors who have professional managers, such as mutual funds, pension funds, banks and endowments, generally avoid specialized ETFs.

The study found that institutional investors own about 43 percent of the market capitalization of broad-based ETFs in their first year, but less than 1 percent of the capitalization of specialized ETFs.

In contrast, data from one online discount brokerage that caters to individual investors showed that its customers are much more likely to invest in specialized than broad-based ETFs.

Other research has suggested that investors using that discount brokerage exhibit "sensation-seeking behavior" and their holdings can be described as "experience and curiosity holdings," Ben-David said.

The results suggest that most people should be wary of investing in specialized ETFs, Ben-David said.

"If you purchase a specialized ETF, you are likely to lose money because their underlying stocks are overvalued," he said.

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