How ETFs Affect Your Stock and the Market



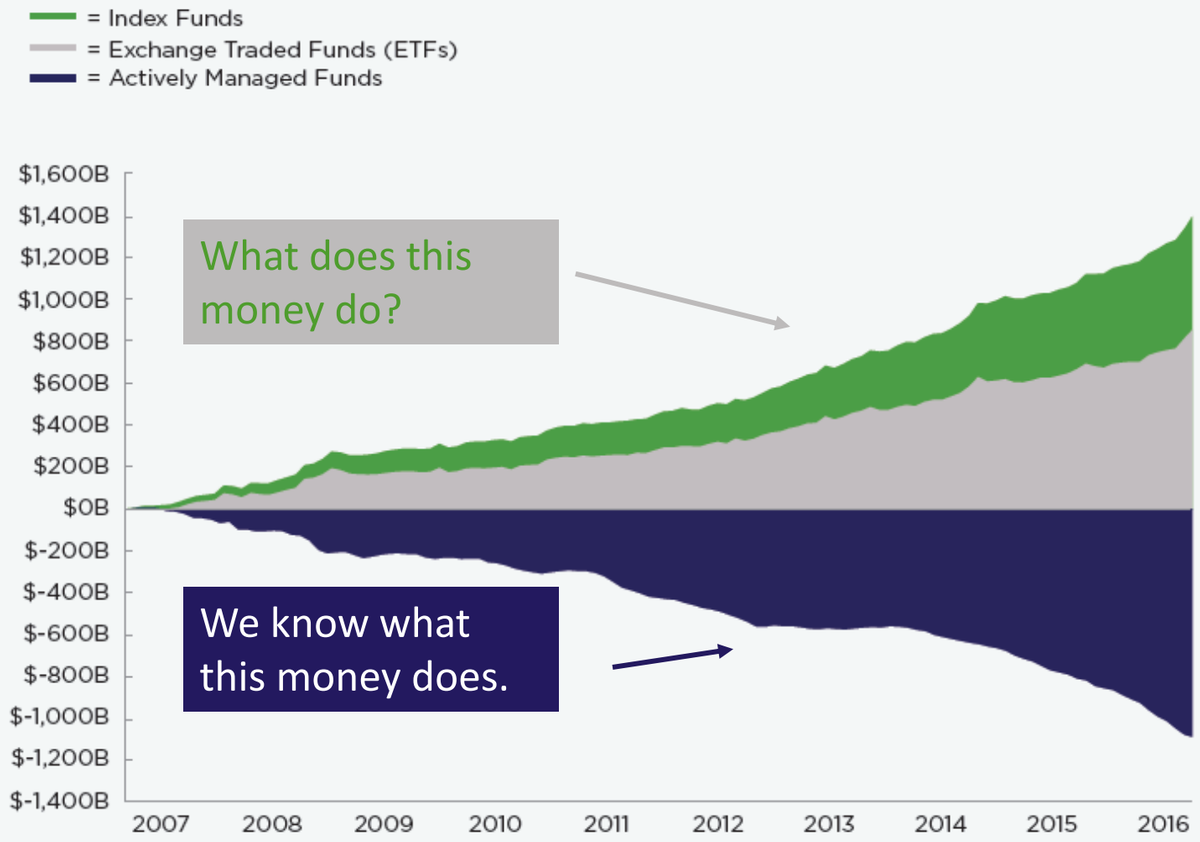
Why Should I Care About ETFs?

WHY MARKET STRUCTURE matters

Price-setting authority has shifted from fundamentals to fund flows as investors flee active management.

Active investors search for ways to beat the index when market rules promoting average prices favor passive investment.

Public companies seek answers for stock movement unrelated to story.



*2017 Investment Company Institute Factbook

Know how today's investment vehicles work.

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ETFs Are Exempt from the “Redeemable” Rule

All Conventional “40 Act” Funds must be redeemable:

The Act defines “redeemable security” as any security that allows the holder to receive his or her proportionate share of the issuer’s current net assets

SEC Exemptions for ETFs:

-ETFs with an arbitrage mechanism (all of them) are *not* redeemable

-Exempted from one price for all rule (instead, primary, secondary markets)

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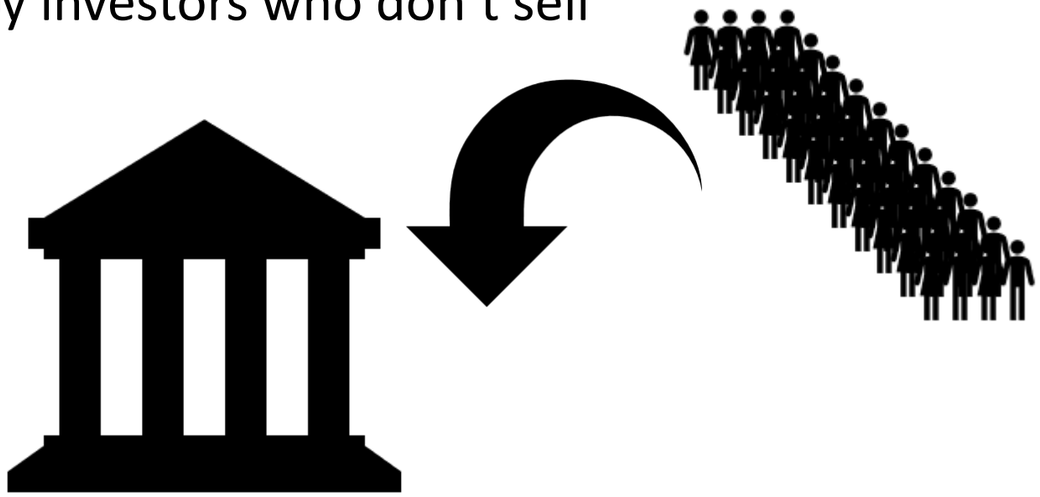
Why ETFs Exist

THE STOCK MARKET…
has limited supply, most shares owned by investors who don't sell



BUT…
A lot more people **want to invest** in US stocks

WHAT TO DO?
Create a **substitute for stocks** of equal, in-kind, value that can be increased or decreased in supply, to trade INSTEAD of stocks

ETFs = **Collateral**

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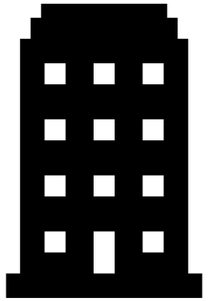
The Primary Market: How ETF Shares are Created



Creation basket: Sponsor lets APs create 50,000 ETF shares in trade for collateral





Broker "Authorized Participants"

- **Off-market BLOCK transaction**, no competition
- **No commission** for Fund Sponsor
- Broker pays $3,000
- **No taxes**, an IRS "in-kind exchange"
- **Set price** determined by ETF Net Asset Value
- **Fund Sponsor gets collateral** – stocks, cash
- Broker gets **50,000 ETF shares to sell**

The process works in REVERSE for ETF share REDEMPTIONS

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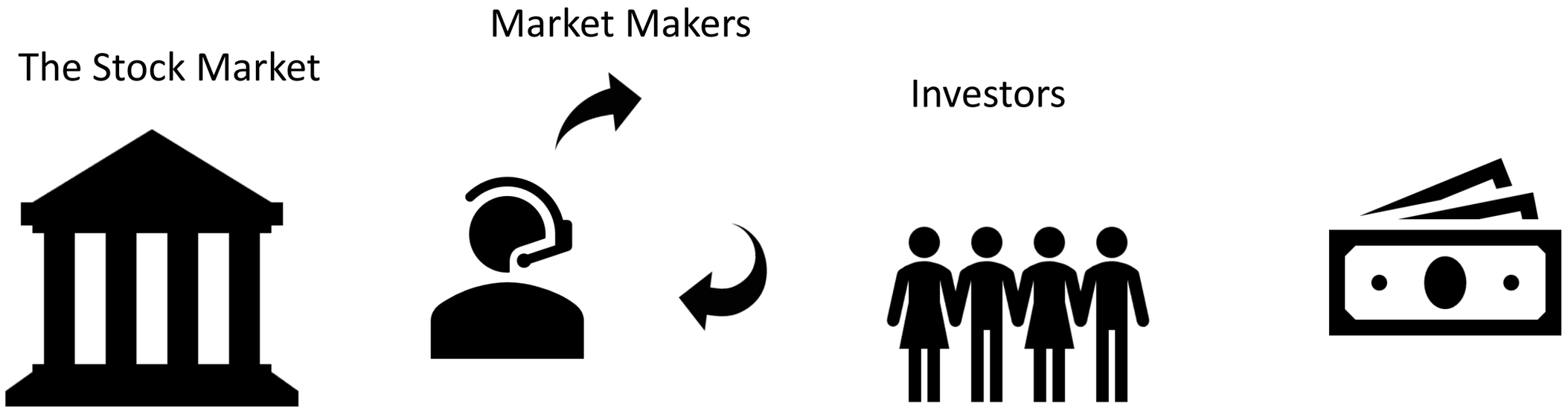
The Secondary Market: ETF Shares Trading Like Stocks



The good: ETFs give investors exposure to the same stocks other investors own, at lower cost and better liquidity.

The bad: ETFs have no intrinsic value, and may be collateralized by stock someone else already owns.

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ETFs Revolve Around Collateral, Not Investment

A sampling of stocks, not the whole index, even one stock

Borrowed stocks

Stocks owned by a single large investor

Stock owned by the ETF sponsor itself

cash

Collateral = ETF Shares

The Stock Market



That you are part of an index, then, does not mean you will behave like the index

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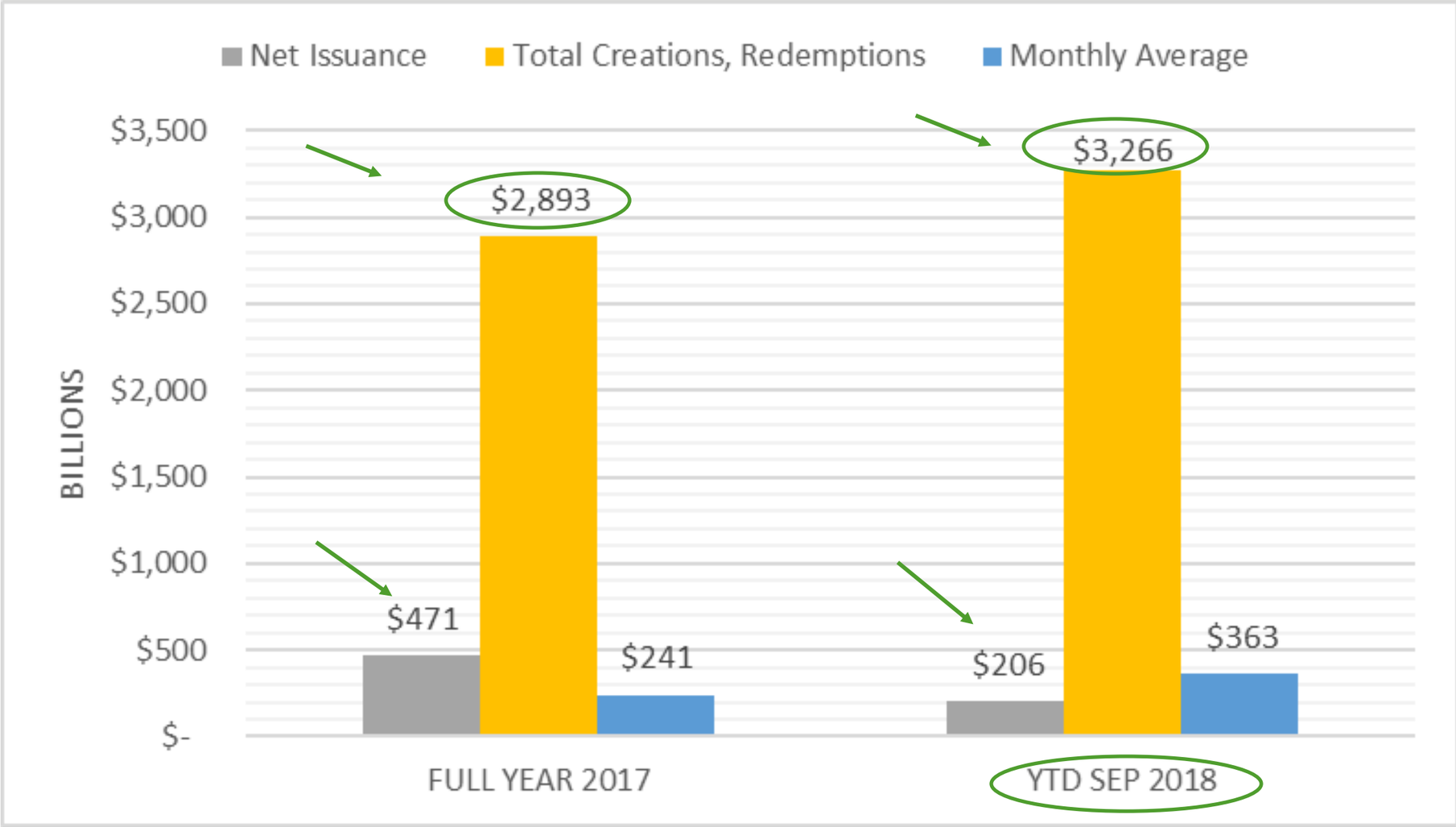
ETF Creations and Redemptions= $Trillions

ETFs permit a cadre of brokers to move, reprice trillions of dollars of collateral like stocks or cash behind ETF shares

Q318 ETF Gross Issuance: Est. $1.1 *trillion*

Comparison: Blackrock Q318 Inflows: $3.1 billion

NET issuance down 56% in 2018, inflows have slowed, markets weaker, volatile



ETF data: Investment Company Institute

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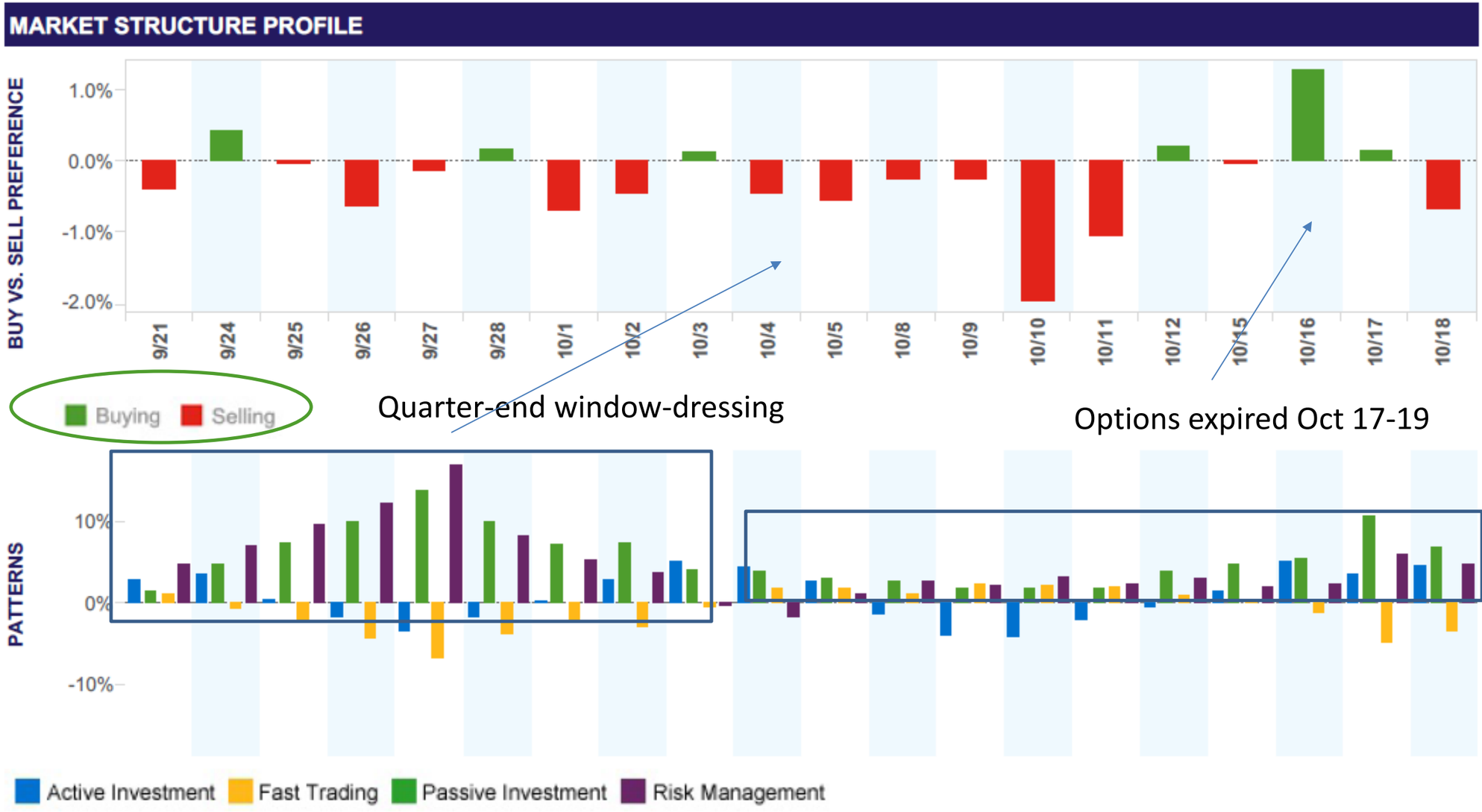
Tech Sector: October 2018 Correction – ETF Patterns

How ETF creations, redemptions, manifest in behavioral patterns

Can dwarf all other factors, especially at month-ends, options-expirations



Source: Proprietary Sector Reports from ModernIR

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Ramifications For You: IR Profession

1. **ETFs foster an *economic incentive for intermediaries to CHANGE PRICES* OF STOCKS (it's not your story -- and intraday volatility is 2.7% daily, 2018)**

2. **ETFs have an <u>insurmountable regulatory advantage</u> (over core IR audience)**

3. **ETFs are <u>stock substitutes, not pooled investments</u>**

4. **IR needs to understand ETFs – because boards, execs, think story sets price**

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