ETF Death Watch: Why Are Funds Closing?

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The financial crisis isn't just shrinking portfolios and profits. It's also putting exchange-traded funds and notes out of business. According to State Street, 58 exchange-traded products closed last year and another 30 or so from companies like SPA, Credit Suisse and Northern Trust have stopped trading the last three months. With more on the way, the liquidation process is shaping up to be a prominent trend for investors to watch in 2009.

The recent spate of closures has a direct correlation to the frenzy of launches that occurred in the industry earlier this decade as competing firms tried to grab a first-mover advantage. According to the Investment Company Institute, there were 80 ETFs on the market in 2000. That number swelled to 737 at the end of 2008. But industry assets and trading volume are dominated by a few funds like the SPDR S&P 500 (SPY) and the PowerShares QQQ (QQQQ), which tracks the 100 largest nonfinancial firms on the Nasdaq. The 17 most active funds account for 74% of the industry's activity. That leaves many ETFs with too little assets or too little trading volume.

The uptick in liquidations is another sign of growing pains in the ETF industry. ETFs are index-fund-like products that trade throughout the session like a share of stock instead of being priced at the close of each day like a traditional mutual fund. These funds can be cheaper than actively-managed mutual funds and have better tax efficiency. However, as they've grown in popularity ETFs have also come under more scrutiny for their pricing, their ability to accurately track the returns of their underlying indexes and, now, their ability to survive one of the most chaotic markets of the last century.

Indeed, the closing trend has become such a problem that Ron Rowland, president of Austin, Texas-based Capital Cities Asset Management, has come out with what he calls the "ETF Death Watch."

To qualify for the list, U.S.-listed ETFs must be at least six months old and have a daily trading volume of $100,000 or less. (Rowland thinks that's the cut-off for a sustainable vs. a nonsustainable fund.) The March list included 171 funds, a 12% increase from the previous month's tally and almost 25% of the funds currently trading. Every major ETF sponsor has funds on the list.

"If they're not getting a volume worth $100,000 a day, there's a good chance they won't succeed," says Rowland. "About midway through last year, I noticed that even though it was my job to keep up with new [ETF] products, I couldn't do it. I thought, 'There's going to be problems here,' because that's my job. And if I can't do it, then the investing public can't."

If you find one of your funds on Rowland's list you should think hard about selling. He says investors aren't usually adversely affected by an ETF closure because the shares have already bottomed out. The liquidation process could take a week or so where that cash is tied up, but Rowland says it's a generally orderly process.

In any case, more investors will soon find out how the liquidation process works. The morning after the market's recent 500-point swing, we counted 175 ETFs on our ETF Tracker that had failed to trade a single share by 11 a.m. Meanwhile, State Street says ETFs experienced a net outflow of $45 billion last month, leaving about $451 billion invested. (By comparison, mutual funds hold $9.5 trillion.)

One potential side effect of this phenomenon is that ETF investors may be reluctant to invest in new funds, regardless of their merits. Ted Feight, head of Creative Financial Design in Lansing, Mich., says he notices new fund launches, but waits for funds to demonstrate a market before committing his clients. "When I look at these new ETFs, I really don't want to use them unless I'm sure they're going to be around a while," he says.

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