THE WALL STREET JOURNAL.

https://www.wsj.com/articles/new-etfs-fight-to-escape-shadow-of-blackrock-vanguard-11578565803

MARKETS

New ETFs Fight to Escape Shadow of BlackRock, Vanguard

Less than half of ETFs experience asset growth; a ranking tool raises managers' ire

By Michael Wursthorn

Jan. 9, 2020 5:30 am ET

It is becoming increasingly hard to break into the $4.3 trillion market for exchange-traded funds.

A rising number of fund closures has deterred financial advisers from backing new entrants, reinforcing a cycle that has allowed bigger funds managed by established players to keep growing. Many other ETFs are shrinking—and potentially on a trajectory to eventual closure—if they can't accrue enough assets to stay in business.

Of 1,662 ETFs tracked by investment-research firm CFRA LLC over a five-year period through August, 24% shut down and an additional 30% experienced a decline in assets. Most of the fastest-growing ETFs were broad, low-cost products managed by industry juggernauts BlackRock Inc., Vanguard Group and State Street Corp., which together control 81% of all ETF assets.

ETFs generally are easy to trade. They change hands on exchanges like a stock and tend to track various stock and bond indexes.

But the raft of closures has sent a chill through the money-management community. Financial advisers worry that if they pick a small fund it might close. Recommendations that don't pan out are awkward to explain to clients, who might also face an unexpected tax hit when a fund closes and returns their money.

Analysts say those concerns have contributed to the money imbalance. Data providers such as FactSet Research Systems Inc. have added fuel to the fire, scoring individual funds based on their risk of closure. That has rankled some money managers who argue such lists perpetuate the industry's bifurcation.

"You need to have deep pockets to keep these funds going," said Scott Sacknoff. In 2017, Mr.

Mr. Sacknoff's fund was an early entrant into the field of socially responsible investing.

When backtested, it beat the broader stock market in three of the previous five years. Electric-car maker Tesla Inc., health-care company DaVita Inc. and Google parent Alphabet Inc. were some of the constituents.

It gathered roughly $6 million in assets at its peak and charged a 0.5% fee, drawing money mostly from small wealth-management firms and other individual investors. But after two years pitching the fund, it remained unprofitable, and Mr. Sacknoff shut it down in March 2019.

The problem wasn't the strategy, he said. Instead, investors largely avoided the fund because it was too small.

"Everyone who looked at our materials and methodology loved it, saying we were solving a problem," Mr. Sacknoff said. "But financial advisers said, 'We can't invest in you.' At the end of the day it came down to our market cap."

Prior to 2008, new funds had an easier time getting off the ground. Many of the offerings launched then were strategies that gave investors an opportunity to match the returns of indexes like the S&P 500, rather than beat them.

There is now a debate within the ETF industry as to whether the market has become oversaturated. More than 2,100 ETFs compete for a slice of the pie, ranging from broad funds such as the iShares Core S&P 500 ETF, which has $201 billion in assets, to more nuanced offerings that hedge currencies, bet on low volatility or focus on investment themes like pets.

Analysts say investors have a preference for the established players. Just 20 ETFs of the 1,662 tracked by CFRA accounted for 44% of the industry's asset growth over the five-year stretch, and 18 of them were low-cost funds managed by BlackRock and Vanguard.

Part of the driving force: Financial advisers use brands as a proxy for quality, Cerulli Associates said in a report on the ETF industry published this week. But that puts money managers at risk of missing out on other opportunities, Cerulli added.

Michael Cornacchioli admits assets under management are his first consideration when choosing ETFs.

Mr. Cornacchioli, a vice president of investment strategy at the $6.7 billion wealth-management firm Clarfeld Citizens Private Wealth, said he screens out funds with less

“Assets in a fund is probably the most important element in determining its viability,” he said, adding he gives a greater preference to firms like BlackRock and Vanguard.

Data providers have tried to help money managers better decipher which funds are headed for an early death. FactSet’s ETF Closure Risk tool, which is available on ETF.com’s fund database, assigns a closing probability rating, from high to low, based on factors including whether a firm has closed other funds, fund flows and assets.

A year before Mr. Sacknoff closed his fund, FactSet’s ETF tool had assigned a high closure risk to the fund, in part because of its low asset level.

Noah Hamman, chief executive of AdvisorShares Investments, has faced a similar threat. His actively managed AdvisorShares Dorsey Wright Micro-Cap ETF has collected $2.4 million in assets since its 2018 launch and charges a relatively hefty fee of more than 1%. That is partly why FactSet’s methodology assigned a high closure risk for the fund.

Mr. Sacknoff’s fund, an early entrant into the field of socially responsible investing, closed in March 2019. **PHOTO:** STEPHEN VOSS FOR THE WALL STREET JOURNAL

Mr. Hamman said the fund has beaten its index, the Russell Microcap benchmark, by 9 percentage points over the past 12 months, proving the strategy works even if inflows have fallen below expectations.

“It doesn’t help to have those types of services out there,” said Mr. Hamman, referring to tools like FactSet’s. “I have no intention of closing that fund.”

Elisabeth Kashner, director of ETF research at FactSet, said the tool is conservative in nature because clients have said they would rather avoid a fund that appears likely to close, even if doesn’t, than invest in one that shuts down.

“We chose to flag closure risk aggressively, in keeping with a duty to warn, because we believe investors dislike surprises,” said Ms. Kashner. “Asset managers aren’t always super happy with that decision. They feel there’s an undeserved shadow hanging over their fund.”

SHARE YOUR THOUGHTS

Are funds with less than $100 million in assets worth investing in? Why or why not? Join the conversation below.

—To receive our Markets newsletter every morning in your inbox, click here.

Write to Michael Wursthorn at Michael.Wursthorn@wsj.com