UNDERSTANDING SECURITIES LENDING IN ETFS

A well-run index fund is typically characterized by its ability to effectively track its index, lagging only by the amount of its expense ratio. In theory, it should not be possible for an index fund to come any closer to its benchmark's return--but some do, including funds that utilize full replication of their index's holdings. A handful of funds even beat their benchmark while perfectly replicating its holdings. How can this be? In many cases, this is an example of securities lending at work.

Here is the inner workings of securities lending, but the highly simplified version: An exchange-traded fund lends out shares of its holdings to another party and charges a rental fee. Running a securities-lending program is another way for an ETF provider to wring more return out of a fund's holdings. Revenue from these programs is used to offset a fund's expenses, which allows the provider to charge a lower expense ratio and/or tighten the performance gap between an ETF and its benchmark. Active managers sometimes balk at the idea of participating in securities lending because they dislike facilitating another party betting against their holdings. Index ETFs, however, are passively managed and have no such qualms. Most large ETF providers run a securities-lending program, because not doing so leaves cash on the table. It's not a risk-free enterprise, however.

VARYING DEGREES OF SUCCESS

Some ETFs are able to bring in a surprisingly large amount of revenue through their lending programs. ETFs that hold less-liquid assets, such small caps, international stocks, and deep-value stocks, have the potential to use securities-lending revenue to help offset the costs of running the fund. Some funds are able to use securities lending to recoup a few percentage points of its expense ratio, whereas other funds are able to recover more than 100% of the fund's operating costs. Let's look at three examples.

Among small-cap ETFs, one example is the Vanguard Small-Cap ETF (VB), which charges a 0.10% expense ratio and uses full replication, meaning that it holds all the stocks in its underlying index. Since its inception, VB's annualized performance has beaten its benchmark because of significant securities-lending revenue. Another example is the iShares Russell 2000 ETF (IWM), which has beaten its index in 2013 and 2012, and has trailed by less than its expense ratio during the last 10 years. In the past year, IWM's securities-lending revenue was greater than its expenses, offsetting its relatively higher 0.24% expense ratio. IWM's 2013 annual report showed that it generated $45.6 million in securities-lending income, which was more than enough to offset the fund's expense ratio.

Funds that track large-cap securities have less opportunity to profit. A recent report shows that last year there was a tremendous supply of large-cap U.S. equities offered for loan, but not significant demand. iShares Core S&P 500 ETF (IVV), which is allowed to engage in securities lending (unlike the SPDR S&P 500 (SPY), which is structured as a unit investment trust), generated enough securities-lending income to offset about 13% of the fund's expense ratio--far less than the small-cap ETFs are able to do, but enough to bring its performance even closer to its benchmark's.

HOW IT ALL WORKS

There are a handful of reasons one may want to borrow a security, but chief among them is to "short" a stock. Securities lending is an integral part of the process of shorting a stock: For the process to take place, there must be stockholders willing to loan out their shares. Many different entities loan out stock, such as insurance companies, broker-dealers, and pension funds. ETFs (and mutual funds, to a lesser extent) also participate. ETFs do not necessarily keep all the proceeds from securities-lending programs. Various fund providers take their cut of the revenue, and the split can vary. Vanguard returns all profit back to its funds after fees. iShares takes 20% to 30% of revenue (recently lowered from 35%), and State Street takes 15%.

NOT WITHOUT ITS RISKS

Securities lending is not risk-free. Loaned shares are also subject to the possibility of counterparty risk, or the risk that the borrower won't follow through with its obligation to return shares. Almost all ETF providers disclose very minimal information about their programs, which means investors could be taking on more risk in their portfolio than meets the eye. There are several cases of fund providers being sued by investors for not sufficiently disclosing risks and then losing money. A notable example was Lehman's bankruptcy, which meant entities that loaned securities to Lehman never saw their holdings again.

CONCLUSION

WT Wealth Management performs due diligence on thousands of ETF's each year looking for the slightest edge in order to maximize tracking correlations and increase shareholder value. While the lending procedures of an ETF provider will never be sole the factor in our ETF selection process it is one small advantage that the professionals at WTWM search for in order to provide unprecedented value to our clients.

DISCLOSURE

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At WT Wealth Management we strongly suggest having a personal financial plan in place before making any investment decisions including understanding your personal risk tolerance and having clearly outlined investment objectives.

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