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Liquidity, style investing and excess comovement of exchange-traded fund returns[☆]



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ABSTRACT

This study shows that exchange-traded fund (ETF) misvaluation – based on return differentials between ETFs and their net asset values (NAV) – comove excessively across ETFs. Excess comovements are positive (negative) and significant across ETFs in similar (distant) investment styles. Further tests based on return reversals suggest that misvaluation stems primarily from the ETF, rather than the NAV price. Excess comovements are greater for funds with high commonality in demand shocks and attractive liquidity characteristics. These findings are consistent with the idea that the high liquidity of ETFs attracts a clientele of short-horizon noise traders with correlated demand for investment styles.

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1. Introduction

In frictionless markets with rational investors, the price of a security will equal its fundamental value, and any comovement in returns must be due to comovement in fundamentals. However, in economies with frictions or with irrational investors, and in which there are limits to arbitrage, comovement in returns may be partially delinked from fundamentals, giving rise to what is known as *excess comovement*. In [Barberis and Shleifer \(2003\)](#), investors allocate money at the style level and engage in short-term style switching – allocating more capital to styles that recently performed well and taking money out of styles that have performed poorly – for reasons unrelated to fundamentals. The resulting price impact can generate excess comovements among security returns in similar styles.¹

Investor demand should go first to the securities for which the purest play exists and liquidity is highest. Exchange-traded funds (ETFs) provide investors with easy access to popular investment styles (e.g., large, small, value, growth, and sector) at a cost that is on average lower relative to their underlying basket of securities ([Broman and Shum, 2015](#)). Moreover, it is easy to move money in and out of two different styles with ETFs and to enter into long-short trading strategies (e.g., value-growth) due to the relatively low short-selling costs of ETFs.

My conjecture is that, due to the ease of investing in investment styles with ETFs and because of their high liquidity, ETFs attract a clientele of short-term investors with correlated non-fundamental demand at the style level. Consequently, the returns of ETFs will be more exposed to a common source of style-based non-fundamental risk *relative* to their underlying securities. This relative, or twin-based, comparison allows me to identify excess comovements by studying common factors in changes in misvaluation, proxied by the return difference between an ETF and its underlying portfolio net asset value (NAV). This approach is in sharp contrast to studies that investigate anomalous return comovements around “exogenous” events, or by relying on a CAPM type model to filter out the fundamental component of returns.² Moreover, by properly controlling for the fundamental drivers of return comovements, I can examine the determinants of the degree of excess comovements to provide a better understanding of the ETF characteristics, particularly liquidity, that facilitate excess comovements.

An alternative mechanism that can generate excess comovements is differences in the speed of information diffusion between ETFs and their underlying portfolios [the information diffusion view of [Barberis, Shleifer, and Wurgler \(2005\)](#)]. In this case, the high liquidity of ETFs is more likely to attract investors with fundamental (long-term) information concerning abstract risk factors.

An important distinction between the non-fundamentals-based and the fundamentals-based view of excess comovement is that the former assumes that style investors have short horizons. Although the liquidity is beneficial to both long- and short-term investors, liquidity is likely to benefit short-term investors the most ([Amihud and Mendelson, 1986](#)). Supporting this conjecture, [Broman and Shum \(2015\)](#) show that ETFs with high liquidity (relative to their underlying securities) have higher short-term fund flows, greater short-term institutional ownership, and shorter institutional holding periods (relative to their underlying baskets). Retail investors are even more likely to be attracted to ETFs for liquidity reasons because the transaction costs that they face when investing in the underlying security basket are likely prohibitive, and because ETFs have lower cost and superior tax efficiency relative to passive index mutual funds.

This paper is closely related to [Lee, Shleifer, and Thaler \(1991\)](#), who argue that changes in the premiums of U.S. closed-end funds (CEFs) relative to their NAVs tend to move together due to unpredictable variations in sentiment that are impounded in CEF prices. The (passively managed) ETF environment is, however, better suited to disentangling the non-fundamentals-based from the fundamentals-based theories of excess comovement. In the (actively managed) CEF setting, there are there are at least two prominent and rational theories that can potentially explain the dynamics of the

¹ Similar predictions arise in the preferred habitat model by [Barberis, Shleifer, and Wurgler \(2005\)](#). I will contrast these theories in the hypothesis section.

² E.g., [Pirinsky and Wang \(2006\)](#); [Green and Hwang \(2009\)](#); and [Kumar, Page, and Spalt \(2013\)](#).

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