A wake-up call for ETF investors

The booming exchange traded funds industry has traps for those who don't do their due diligence, according to a leading academic, who says some 'smart beta' ETFs are based on misleading research.

A leading academic has raised doubts about the efficacy of many exchange-traded funds because they are built on misleading data analysis.

Professor Campbell Harvey from Duke University in North Carolina says there are incentives in academia that have resulted in peer-reviewed research papers being published, which do not hold up under empirical analysis.
Markets are not all plain sailing and nor is the data used to make certain products. David Rowe

Many of these research papers have been used by financial product manufacturers to build ETFs that have not performed for investors.

In an interview before his keynote address to the 10th Behavioural Science and Capital Markets Conference in Melbourne, Harvey says the problem starts with the wrong incentives in the system.

First, academic journals want to publish papers with positive "significant" results that support the hypothesis being proposed. Research papers with negative results are less likely to be cited.
This inbuilt bias in the system tends to encourage researchers to avoid costly data collection because the risk of not obtaining positive results is too high. Also, there is an incentive to leave out variables that might diminish the prospect of a positive result.

Harvey gives two examples of research that delivered misleading results but were presented as ground-breaking.

'Censored' results

The first was a paper by Joseph Amato, the chief investment officer of Neuberger Berman, who argued against comparing the performance of an index against an entire universe of active strategies.

The paper found that if you only included active managers in the top three quartiles of performance, 84 per cent of US equity active managers had beaten the S&P 500, net of fees, over the 20 years to September 2018.
But Harvey says the hypothesis was proven only because the research excluded the "single most important economic episode – the global financial crisis".

He says people outside academia seem to think university research is a binary outcome of either being true or false.

"Within science, it's possible that you get kind of conflicting sort of evidence," he says.

"Traditionally people have looked to the academics as people that are kind of relatively unbiased as they are scientists and want to get close to the truth.

"But now it's different and it all has to do with the incentives. The academic incentive is to get published. You get published. Then you get promoted. You get a higher wage. You're more mobile in terms of going to a better school.

"So it's all about getting published and they get published. It's almost always the case that these scientific journals publish significant results, stuff that's really interesting.

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likely not hold up in the future. So this definitely impacts the products that investors buy."

ETFs have boomed in recent years. Assets invested in active ETFs and exchange-traded products increased 10.5 per cent during September, reaching a record of $US228.41 billion, according to ETFGI, an independent research and consultancy firm.

Harvey says there are some good "smart beta" ETFs on offer but there are some not so good ones.

"I'm not saying everything is false," he says.

"I am just saying a lot of the product out there is going to disappoint investors. And the reason is that people are misled by the historical tests because that data has been tortured."

Harvey's 78-page Powerpoint presentation will be shown at the Behavioural Science and Capital Markets Conference on Wednesday. It is organised by Prof Petko Kalev from the La Trobe Business School at La Trobe University.

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