circumstances, an accurate outcome ends up owing more to chance than good judgment.

I read an interesting paper over the weekend on just this subject. In *Some Lessons from the Financial Crisis for Economic Analysis*, European Central Bank economists Geoff Kenny and Julian Morgan analysed what worked and what direction of any deterioration, but they missed out completely on the scale.

We saw this when the US's Bureau of Economic Analysis first released its estimate of 2008 fourth-quarter gross domestic product. It reported a 3.8 per cent contraction. This was the number the Obama administration used to prepare its industry have assessed the potential impact of bank sector regulatory reform.

On Monday, the Bank for International Settlement released its report, *Assessment of the Macroeconomic Impact of Higher Loss Absorbency for Global Systemically Important Banks*. Given its pedigree, I wasn't

yields the best results.

Compare this to estimates tabled last month from the Institute of International Finance. The IIF is a banking industry body, so I regard its report, *The Cumulative Impact on the Global Economy of Changes in the Financial*

generated by Obama's Council of Economic Advisers. A simple approach is often better than one that is overly complicated.

That's worth remembering when we next anchor our investing fortunes to an output that's long on complexity but short on gut feel or simple logic.

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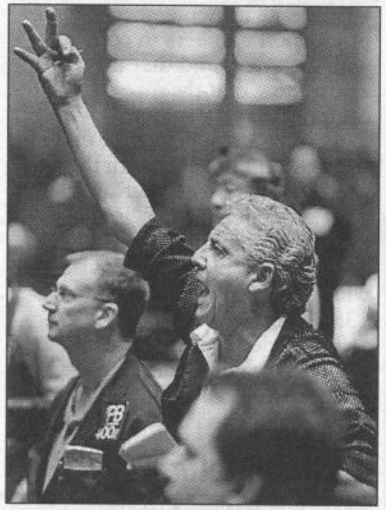
ETFs are 'new weapons of mass destruction'

Long-time investor Douglas Kass says of ETFs: 'They have turned the market into a casino on steroids.' He is not alone in his belief that they are a dangerous tool, writes **Andrew Ross Sorkin**.

Market volatility is causing a lot of head scratching at the moment. On Monday, for example, in the last 18 minutes of trading, the S&P 500 index jumped more than 10 points with no news to account for the rally.

Almost every day there is a newspaper article trying to explain the wild swings, or volatility, and often the explanation is inconclusive, involving everything from Europe's banking problems to new fears of recession.

Through the north American summer and into the autumn, I too have been pondering the gyrations in trading, especially the late-day sell-offs and rallies that seem always timed perfectly to coincide with the closing bell. Rarely do the rallies or sell-offs, which invariably start after 3pm, justify 3 to 4 per cent moves in the indices. The swings have a deleterious effect on the markets



Some blame ETFs for gyrations in trading near the close. Photo: BLOOMBERG

because they undermine confidence and investors start sitting on the sidelines.

And then I started talking to investors such as Douglas Kass, a Wall Street denizen, who is the founder and president of Seabreeze Partners Management. He says he knows the culprit behind the late-day market swings: leveraged exchange-traded funds, or ETFs.

These funds, which allow investors to bet on a certain basket of stocks, commodities, or an index, are perhaps the hottest rage in investing, with some $US1 trillion invested. ETFs are particularly attractive to some investors because you can bet long or short – and you can leverage your bet. And you can hop in and out within the trading day to lock in gains, just as with stocks. If you bet $US100 that the ProShares Ultra S&P500 would rise by 1 per cent on a given day, and it did so, say by 3pm, you could settle the bet and receive double the return – in this case 2 per cent (excluding fees). Of course, if the market goes in the opposite direction, you could lose 2 per cent.

There are also what are called inverse leveraged ETFs that go up when the price of the basket of goods goes down, and vice versa.

To Kass, these ETFs are the "new weapons of mass destruction". (His description is a homage to Warren Buffett's widely quoted line that derivatives are "weapons of mass destruction".)

"They have turned the market into a casino on steroids," Kass says. "They accentuate the moves in every direction – the upside and the downside."

Kass, who has written about this topic for *TheStreet.com*, may be right: at the end of every day, leveraged ETFs have to rebalance themselves by buying and selling millions of shares within minutes to remain properly weighted.

If the ETF made money that day, to remain balanced it has to reinvest the proceeds and leverage them again. In many cases, leveraged ETFs use options, swaps and index futures to keep themselves in balance.

You might consider the ETF the new derivative. "It is these derivatives and not the phenomenon known as high-frequency trading – commonly critiqued as contributing to the flash crash of May 6, 2010 – that pose serious threats to market stability in the future," Harold Bradley and Robert Litan, of the Kauffman Foundation, wrote in a controversial white paper last year.

"The SEC, the Fed and other members of the new Financial Stability Oversight Council, other policymakers, investors and the media should pay far more attention to the proliferation of ETFs and derivatives of ETFs."

Bradley and Litan contend it is the "rebalancing risk" of ETFs that makes them particularly dangerous.

Back in 2009, Barclays Global's research department studied the growing leveraged ETF market – before the flash crash – and concluded that the funds created systemic risk because they "amplify the market impact of all flows, irrespective of source".

The view that leveraged ETFs are responsible for the market's volatility has not gone unchallenged.

William Trainor, a professor at East Tennessee State University, conducted an extensive study of market volatility at the beginning and the end of the market day and concluded that ETF rebalancing had nothing to do with it.

"Intra-daily volatility in time periods not associated with rebalancing saw the same spikes in volatility as the last 30 minutes did," he says in his report.

Kass, who has been trading since the 1970s, scoffs at this notion. "Ask any hedge fund manager what their gut says."

I took an informal poll of six brand-name fund managers and virtually all of them agree with Kass. But some of them say that high-frequency traders, which themselves trade ETFs, could be magnifying the problem.

"We know ETFs are the dominant factor in the marketplace," Kass says. "In the '70s and '80s it was the mutual funds, in early 2000s it was the hedge funds. Now it's the algorithms running the ETFs."

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