# Discussion of "ETFs: Guilty?"

## by Thomas Marta


**Dan Su**

CKGSB


IFMA conference 2025

# This Paper

- **Motivation:** a long-standing debate on whether ETFs distort underlying markets or improve them
- **Key contribution and findings:**
  - propose a novel and more intuitive measure on ETF "crowdedness": ratio of holdings in a stock to its daily trading volume
  - present a new set of empirical evidence on its positive impacts with novel "identification" strategies: lower volatility, higher liquidity, and greater price efficiency
  - explain the underlying mechanism: short selling pressure proxied by fails-to-deliver

# Comment #1: Identification

- Key: the association between ETF crowdedness and stock quality are **causal**
- **Current approaches**: cross-sectional heterogeneity (+ propensity score matching + panel regressions with fixed effects)
    - sort firms monthly into five portfolios based on ETF crowdedness
    - compute the average quality metric within each portfolio
    - calculate the crowdedness spread
- **Endogeneity:** crowdedness may reflect firm *unobserved and time-varying* traits (size, value, etc.) that also affect outcomes, leading to omitted variable bias or reverse causality
- **Suggestion:** use a shift-share design (or GIV approach)
    - *Share:* stock $i$'s exposure to different ETFs at time 0
    - *Shift:* future changes in average crowdedness at the fund level
- **Benefit:** better separates firm-specific changes from broader ETF trends and improves causal interpretation

## Comment #2: Underlying Mechanism

- **Key finding:** higher ETF fails-to-deliver (FTD) are associated with improvements in the market quality of underlying securities
- **Interpretation:** short-selling and arbitrage activities conducted by market makers and authorized participants (APs), i.e., **activities that are not unique to ETFs**
  - the observed improvement in price efficiency may reflect the disciplining role of short-sale-based arbitrage, which could occur in any market with well-functioning short-selling infrastructure, even in the absence of ETFs
  - the role of ETFs is more passive—as a conduit for these arbitrage trades—rather than being an active contributor to market quality
- **Suggestion:** clearly distinguish the effect of ETF structure per se from the broader effects of short-selling mechanisms
  - include a comparison group under different short-selling constraints
  - distinguish between passive and active sources of ETF fails-to-deliver
- or connect with recent trading-volume-timing literature (e.g., Goyenko-Kelly-Moskowitz-Su-Zhang, 2025)

# Comment #3: More Balanced or Focused Framing

- **Concentration and fragility:** a growing literature suggests that concentrated ownership can amplify tail risk, especially during liquidity shocks
- **March 2020 case study:** during the COVID crisis, several bond ETFs (e.g., LQD, HYG) traded at deep discounts to NAV, and this divergence revealed significant liquidity mismatches between ETF shares and their underlying assets
- **Mechanism:** in stressed markets, ETF redemptions and mechanical rebalancing may reinforce downward price spirals, turning ETFs into pro-cyclical amplifiers rather than stabilizers

FINANCIAL TIMES

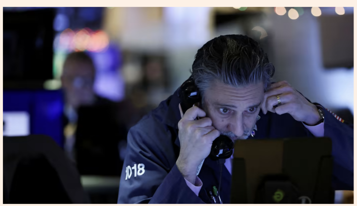
HOME WORLD US COMPANIES TECH MARKETS CLIMATE OPINION LEX WORK & CAREERS LIFE & ARTS HTSI

ETF Hub Exchange traded funds + Add to myFT

The inside story of how ETFs weathered the March 2020 storm

As markets went into meltdown the people who worked in the industry stepped into overdrive

Save




At the New York Stock Exchange, level 1 circuit breakers, triggered when there is a 7 per cent decline in the S&P 500, activated four times in eight trading days between March 9 and March 18 © Andrew Kelly/Reuters

The problem, as Dan Izzo, chief executive of market maker GHCO pointed out, was the potential flaw in how the ETF ecosystem works (see above), particularly for bond ETFs.

"As every AP was trying to redeem at the same time, the ETF providers had to restrict negotiation of the custom bond baskets to make sure they didn't deviate from their index and that they treated everyone fairly. That meant that APs and market makers could get stuck with some bonds, illiquid at the time, that they were unable to trade out of as they redeemed the ETF shares."

# Comment #3: More Balanced or Focused Framing

- **Scope of evidence:** The paper's findings are based on tranquil market periods. It remains unclear whether the same effects hold—or potentially reverse—under crisis conditions.
- A more balanced discussion of both benefits and risks of ETF crowdedness would strengthen the overall message.
- **Alternatively:** consider reframing the title from "ETFs: Guilty?" to a more specific focus on ETF ownership and firm fundamentals, avoiding broad claims not fully supported across all regimes

- While the "Magnificent Seven" example is notable, it could be integrated into the broader analysis as a robustness check rather than presented as a separate section

# Summary

- **A great paper!**
- **Clear contribution:** introduce a new empirical measure and addresses a timely, policy-relevant question
- **Well-executed analysis:** rich dataset, careful empirical design, and novel angle on short-selling channels
- **Thought-provoking message:** offers a constructive revision to the narrative that passive ETFs only distort markets
- **Good luck with the publication!**