Do ETFs ameliorate or exacerbate the mispricing of underlying securities?

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Abstract

The recent few years have seen an explosive rise in exchange traded funds (ETFs). Prior research finds mixed evidence on the impact of ETFs on the pricing of the underlying securities. In this study, we examine this issue using two kinds of tests. First, we examine the impact of ETFs on the magnitude of the post earnings announcement drift, differentiating between sector ETFs and broader ETFs. Second, we examine the impact of the dominant ETF stock (industry leader) on other stocks. We find that while ETFs do reduce the post earnings announcement, the effect is driven almost entirely by sector ETFs. We also find that a lead firm's returns affect the returns of the other firms in the ETF. Finally, using path analysis, we show that the impact of the leading firm on the other firm's returns is driven almost entirely by the ETF effect as opposed to other channels (e.g. macroeconomic or industry news).

Speaker Profile

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