

**ETF Roundtable
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The Genesis of ETFs

Bachelier to Fama: 1900 to 1971

- **Genesis: Modern Portfolio Theory and Efficient Markets Theory**
 - Focus on portfolio structure
 - Active/passive debate?
- **Efficient Markets Theory**
 - Theory and Empirical results
 - Results predated theory: theory fit to results
 - “Beat the Market”?
 - Price = Value?
 - Price = Price?

Fair Game Model

- Market a Fair Game
- Expected ex-ante excess profits are zero
- Best estimate of next period's rate of return is...

$$E\left[r_{jt} / \phi_t\right] = r_{jt} - 1$$



Efficient Market Theory

Early Tests

- **Robust evidence of weak form**
- **Generally robust evidence of semi-strong**
- **Robust evidence of strong form (re fund managers, not insiders)**
 - **Mutual funds in the 60s and 70s**
 - **High fees**
 - **Relatively poor performance**
 - **Focus of active/passive debate**
 - **Theoretical basis for index products**

The Genesis of ETFs: the Visionaries

- **Burton Malkiel " A Random Walk down Wall Street," 1973**
 - " What we need is a no-load, minimum management-fee mutual fund that simply buys the hundreds of stocks making up the broad stock-market averages and does no trading from security to security in an attempt to catch the winners. Whenever below-average performance on the part of any mutual fund is noticed, fund spokesmen are quick to point out "You can't buy the averages." It's time the public could
- **Hakansson , Rubinstein, Leland**
 - Supershares!

The Genesis of ETFs: Indexing Debuts

- **1971**, the first index portfolio: Samsonite pension fund
- **1973**, the Wells Fargo Bank the first large index fund
- **1975**, *Bogle, First Index Investment Trust* Bogle's fund: *Vanguard 500 Index Fund*, (\$125 billion in assets)
- **1978**, Canada's first index fund: National Trust's TSE 300 Index Fund

The Genesis of ETFs: the Jurisdictional battle and product failure

- **March, 1989: SEC approved PHLX, AMEX, CBOE stock basket products**
 - IPU to track S&P 500
 - Cash settled; no physical settlement
 - CIPS, EIPS and VIPS
- **Legality challenged by Chicago Mercantile Exchange; Investment Company Institute**
 - IPU had characteristics similar to futures contracts; should be traded only on CFTC regulated “futures exchange” and not on SEC regulated exchange
 - Chicago Mercantile Exchange v. SEC 883 F.2d 537 (7th cir. 1989), cert.denied, 110 S.Ct.3214 (1990)
 - Courts defined IPU as futures contract and not equities because...
 - No ownership voting rights; future rather than present delivery; not transferable

The Genesis of ETFs: the Jurisdictional battle and product failure

Result was worst possible!

- **Exchanges that wanted IPUs blocked from listing them!**
- **Exchanges that didn't want IPUs allowed to trade them!**

The Genesis of ETFs: the Jurisdictional battle and product failure: **Made in Canada Story?**

- **Canada: TSE introduced TIPS in March 1990**
- **Ability to exchange in-kind at NAV keeps ETFs trading close to NAV**
 - i60s; S&P/TSE
 - Reputation in IPU
- **US: Delayed IPU in US for 4 years!**
 - January 1993: Standard & Poor's Depository Receipts: SPDR

