## Discussion of

# Index Disruption: The Promise and Pitfalls of Self-Indexed ETFs

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*LSU Finance Symposium*

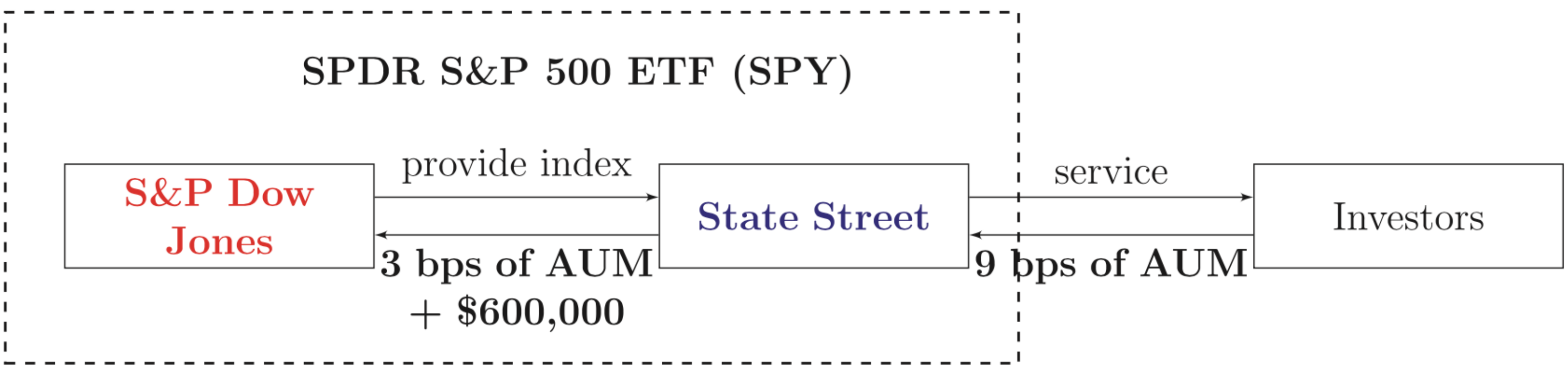
February 7, 2026

# Three Themes of My Discussion

- How good (or bad) are self-indexed ETFs and how does self-indexed ETF quality relate to potential conflicts of interest?
- How are self-indexed ETFs being used by investors and investment advisors?
- Does rise of self-indexed ETFs offer insights into evolution of financial markets and/or design of new financial products?

# Pitfalls of Public Indices?

- Passive portfolio manager can track a third-party index (**"public-indexer"**) or its own index (**"self-indexer"**)
- An, Benetton, Song (2023) study public-indexer ETFs
  - **Over one-third of ETF expense ratios are paid as licensing fees to index providers**
  - Example: SPDR S&P 500 ETF (SPY) charges **9 bps** to investors and pays **3 bps** plus **$600,000** to S&P Dow Jones



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  - Example: SPDR S&P 500 ETF (SPY) charges **9 bps** to investors and pays **3 bps** plus **$600,000** to S&P Dow Jones
  - In 2019, estimated licensing fee averaged 4.4 bps of ETF's AUM while estimated marginal cost of index provision was 1.6 bps
  - **Why the markup?** Concentrated market and ETF investors care about index provider identity despite little variation in returns

# Self-Indexer Pros and Cons?

- By creating its own index, an ETF issuer can potentially increase investor portfolio diversification...
  - For example, by creating indices that underweight AI/tech firms... or the industry an investor works in
- ... and decrease annual fees
  - If SPY adopted self index, it could reduce investor expenses **1-2 bps** (relative to current fee of **9 bps**)
- Alternatively, ETF issuers can creates self-indices that allow unsophisticated investors to pay elevated fees to chase sectors/styles with high past performance

# Data and Empirical Strategy

- ETF Global → all passive unlevered US equity ETFs between January 2012 and December 2020
  - **786** unique ETFs
  - **13** self-indexed ETF in 1/12 and **96** self-indexed ETF in 12/20
- **51% of issuers are public-only, 28% are self-indexed only, and 20% offer both types of ETFs**
- Test whether self-indexed ETFs have lower expense ratios, offer greater diversification, or have higher performance
- No, No, No → Test whether rise of self-indexed ETFs reflects conflict of interest between issuers that are investment advisors and their clients

# How Important are Self-Indexers?

- “self-indexed ETFs now account for nearly 20% of ETFs within popular investment styles such as broad equity and large cap categories” **→ true but if we want to measure aggregate impact on investors, we care about AUM**
- Robertson (2019): the 81 of 571 US equity ETFs that are self-indexers account for **5%** of AUM
- Table IA.1 reports statistics for December 2020:
    - Self-indexing **< 1.6%** of US equity ETF AUM... and fraction would be lower if we include index MF
    - Self-indexing **< 5.0%** of US equity ETF AUM within Top 10 issuers that offer public-indexers and self-indexers

# Differences in Fees & Returns?

- T3: Regress expense ratio on **self-indexer dummy**, controls, month-style FEs, and issuer FEs → **self-indexer 3.5 – 5.5 bps more expensive**
  - With issuer FEs, coefficient estimated using 20% of issuers with both types of ETFs
- T4: Cosine similarity and return correlations are higher for self-indexer... although we are arguably more interested in return within-issuer correlations and whether new self-indexer ETFs expand number of styles
- T6 & T7: Self-indexers have (weakly) lower alphas, lower volatility, and lower Sharpe ratios... but (differing from comment above) also curious about month-style-issuer FEs

# Conflicts of Interest?

- "Our analyses thus far reveal that, on average, self-indexed funds neither perform better nor provide portfolio differentiation"
- While analysis certainty raises questions about quality of average self-indexed ETFs... crucial question is how products compare to counterfactual products investors would have held (Reuter and Schoar 2024)
- Tough to answer with aggregate data but authors make good progress by comparing self-indexed ETFs issued by investment advisors to self-indexed ETFs from other issuers
- Higher fees point to COI as does evidence that self-indexed ETFs are included in investment advisor model portfolios

# Same as It Ever Was?

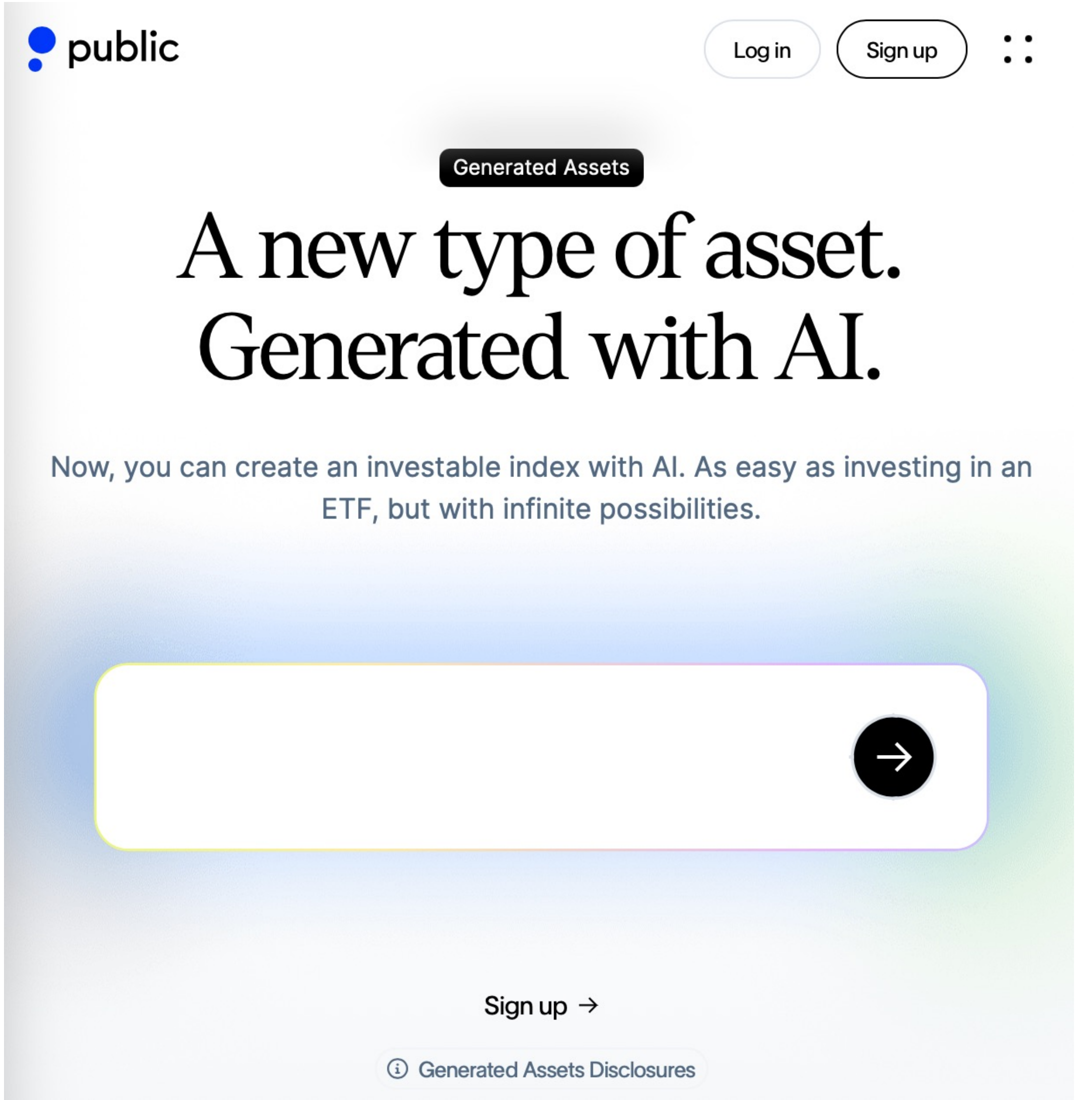
- Authors may overstate distinction between “client-paid fees” and “older commission model”
  - Paying steady stream of 12b-1 fee payments is not much different than paying wrap fee to invest in ETFs
  - Boyson (2022) argues dual-registered investment advisers charge RIA clients elevated fees
- Favoring proprietary self-indexed ETFs in model portfolios is conceptually similar to building TDF around proprietary equity and bond funds
- From investor perspective, interesting question is what ETF or MF or stock they sell to purchase the self-indexed ETF

# Future So Bright?

- According to Vanguard, **7%** of participants use managed account program in their retirement account
- To extent that managed account is customized to investor preferences and circumstances... and not too expensive... it will increase expected utility
- At same time, managed accounts can create benchmarking challenges for investors and third-party intermediaries
- Ideally want to understand how portfolio characteristics change when investment advisors introduce and begin to sell self-indexed ETFs...
- Replacing public-indexed ETF with more expensive self-indexed ETF with return correlation of 0.99 → red flag!

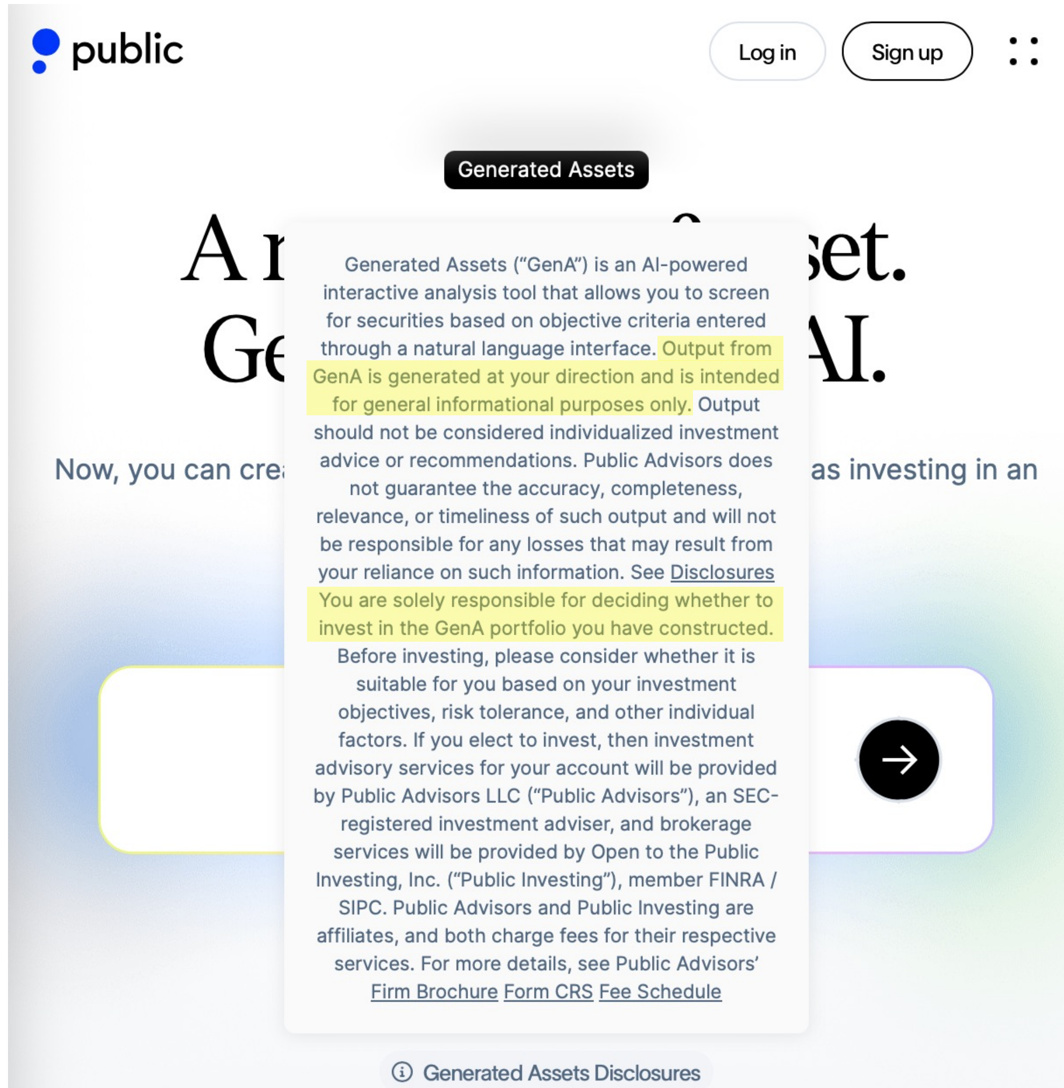
# Generated Assets!

Why create expensive self-indexed ETFs when investors can create their own fad-chasing portfolios…



# Generated Assets!

Why create expensive self-indexed ETFs when investors can create their own fad-chasing portfolios… with a management fee of **49 bps…** and possibly other costs



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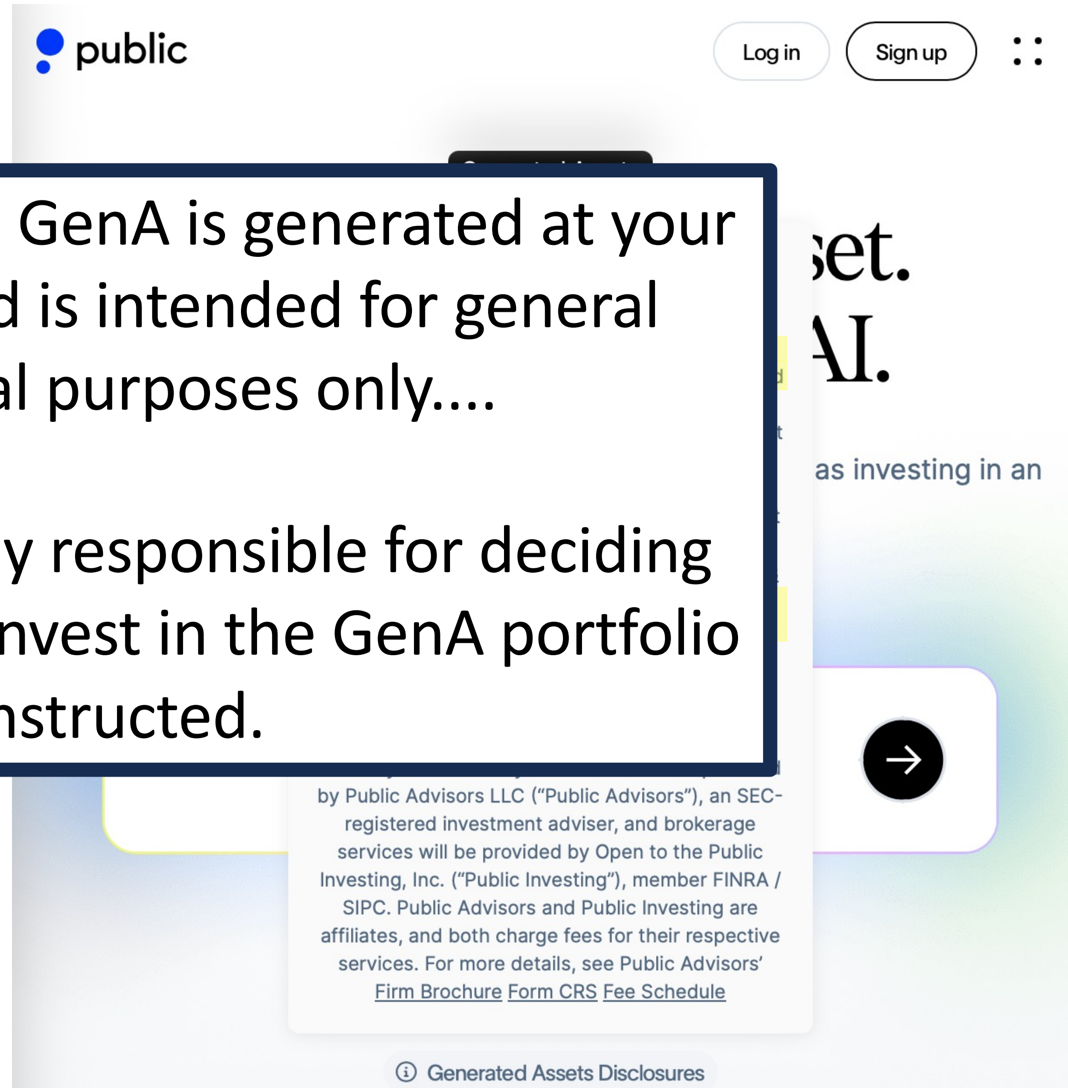


Output from GenA is generated at your direction and is intended for general informational purposes only....

You are solely responsible for deciding whether to invest in the GenA portfolio you have constructed.

# Conclusion

- First paper to focus on rise of self-indexed ETFs
- AUMs are still modest but likely to grow, especially if largest investment advisors continue incorporating them into recommended portfolios and/or managed accounts
- Evidence on COIs is provocative and believable and broadly consistent with earlier evidence on broker-sold vs. direct-sold mutual funds
- Logical next step is to seek out account-level data on who invests in self-indexed ETFs and how they impact portfolio risk and after-fee returns... which is the type of discussant suggestion the authors should probably ignore!