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The next generation of ETFs
Why every asset manager needs an ETF strategy

November 2013

This point of view is part of a series that will explore considerations around exchange traded fund (ETF) products, market infrastructure and distribution, and why every asset manager needs an ETF strategy.

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The next generation of ETFs

Exchange traded funds (ETFs) have enjoyed two decades of explosive growth. Propelled by compelling benefits for investors and the growing market for index products, global ETF assets grew to $2.2 trillion assets under management by August 2013.[1] Evolving and proliferating as they attracted new users, ETFs went from a single vehicle providing exposure to large cap US equities to thousands of products representing a dizzying range of asset classes and strategies.

1 ETFGI, 10/4/2013

Executive summary

Of the many changes that have swept the asset management industry in recent years, ETFs have proven to be one of the most effective disruptors of the status quo. The potential growth of ETFs may just be beginning and, if current trends persist and active ETFs gain approval and marketplace traction, industry observers suggest that there is no reason why growth cannot reach $5 trillion AUM in the next three to five years.

Despite the positive developments and optimistic outlook, there is no denying that a business-as-usual approach is unlikely to lead to success in the future. The flood of new ETFs and assets has been accompanied by new competitors entering the market. As this initial phase of growth matures, a growing number of funds are reporting negative asset flows, and sponsors are finding it necessary to prune product lines.

ETFs are now poised for their next phase of growth. Spurred on partly by a widespread move away from commissions toward asset-based compensation, advisors are increasingly focused on asset allocation rather than security selection. ETFs offer convenient vehicles for managing exposure, particularly for advisors adopting more tactical approaches or using more customized allocation models relying on more narrowly-defined asset classes. Nor will growth only be driven by advisors. The institutional client base will continue to become more diverse, with investors ranging from insurance companies to hedge funds and retail investors expected to contribute meaningfully to the growth of ETF assets. How ETFs are used will also change, with investors using them for everything from core holdings to sector exposure and transition management. While current and much of the future growth of ETFs has been a US story, all of this will play out on a global scale, with particularly rapid growth coming from Asia and Europe.

After a slow start, active ETFs are picking up steam and are likely to become major drivers of a wider range of uses and greater share of wallet across a more diverse client base. This will require creative solutions to the regulation-related portfolio transparency challenges that have held back active ETFs. Not all fund sponsors will benefit from active ETFs, which are not likely to replace the firmly established trend away from style-box investing. Even as they flood toward active ETFs in already popular categories, assets are unlikely to flow toward asset classes or strategies that have fallen out of favor among investors.

Some growing pains are inevitable. Critics have expressed concerns regarding a number of issues including, performance tracking error, trade settlement and liquidity. Regulatory challenges, operational risks, and a lack of technical understanding may impact demand in some segments. But it's safe to assume that ETFs will continue to play a growing role in the asset management industry going forward. Those who are hoping that a stumble will lead to ETF growth slowing or declining will most likely be surprised. ETFs disrupted the industry once, and they could do it again if active ETFs find traction in key market segments. As ETFs reshape their environment all over again, asset managers and intermediaries alike will want to have strategies in place to deal with the changes sweeping across the competitive landscape.

The ETF explosion

Since appearing quietly on the edge of the investment industry's radar 20 years ago, ETFs proliferated rapidly and grew into a phenomenon that's now impossible to overlook.

Used by individuals, intermediaries, and institutional investors alike, ETFs offer a number of compelling advantages that have contributed to their explosive growth. Five characteristics lie at the heart of the ETF value proposition:

1. Liquidity
2. Transparency
3. Low cost
4. Tax efficiency
5. Intra-day pricing

For many, ETFs represent a better 'mouse trap' when compared to traditional mutual funds. This is particularly true for advisors who have been at the forefront of a movement that places less emphasis on security selection while focusing more heavily on asset allocation. ETFs are an excellent tool for advisors assuming the role of portfolio manager and needing to dynamically manage exposure and risk.

Many investment professionals have found ETFs irresistible. They have been used to execute strategies at many hedge funds, riding the wave of demand for alternative investments of all types that swept the industry in recent years.

Other factors have contributed to the success of ETFs which emerged just as investment data was being democratized and becoming more widely available. Their rise also coincided with a growing scrutiny of costs and more widespread acceptance of indexing as a philosophy and core strategy. Demand for liquidity and transparency peaked in the aftermath of the financial crisis, and once again ETFs fit the bill for many investors.

ETFs offer a convenient way to adjust portfolio exposure on many fronts, including geography, market capitalization, industry sectors, credit quality and duration. ETFs are used as tactical vehicles and satellite holdings but also for strategic and core holdings. There is no question that they meet the demonstrated demand for cheap beta, but they also increasingly cater to investors looking for more complex strategies that generally come with the benefits of the ETF package.

After two decades of startling growth, there's every reason to think that ETFs will continue to grow into an even more prominent part of the global investment landscape.

Figure 1. Key Product Launches & Milestones

1993	• SPDR S&P 500 launched by State Street
1995	• US ETF assets reach $1B
1996	• Single country ETFs introduced
1998	• Sector ETFs introduced by State Street
2000	• iShares introduced by Barclays
2001	• Vanguard enters ETF market with VIPERs
2002	• First bond ETF from BGI
2003	• Fidelity enters ETF market
2004	• SPDR Gold Shares becomes first commodity ETF
2006	• Inverse and leveraged ETFs launched by ProFunds
2007	• Allocation & target date ETFs from multiple firms
2008	• First actively managed ETF launched by Bear Stearns
2009	• Schwab launches first ETF
2010	• ETF assets hit $1 trillion
2011	• First bear market ETF
2012	• PIMCO launches Total Return ETF

Source: Wall Street Journal, Strategic Insight, 9/25/2013

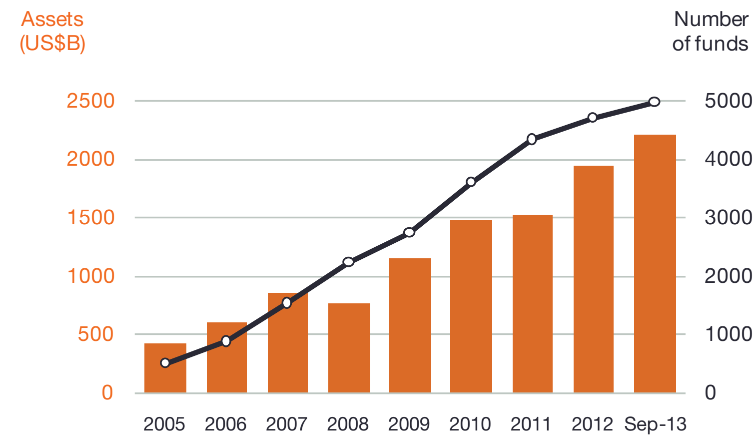
Key developments

As of August 2013, approximately $2.2 trillion was invested in almost 5,000 ETFs and exchange traded products (ETPs) around the world (Figure 2). This represents an almost three-fold increase in assets in the five years since the global financial crisis. Underscoring the relative maturity of that market, ETFs domiciled in the US represent just over 70% of global ETF assets.[2] Fund flows are in line with these figures, with US net inflows representing 76% of global ETF flows year to date.

Europe is the second largest market for ETFs, but its assets are only a quarter of those found in US ETFs. One of the most significant challenges facing the European market is that unlike the US, it is not a single market. Due to a lack of central clearing operations, European ETFs significantly outnumber their US counterparts (Figure 3).

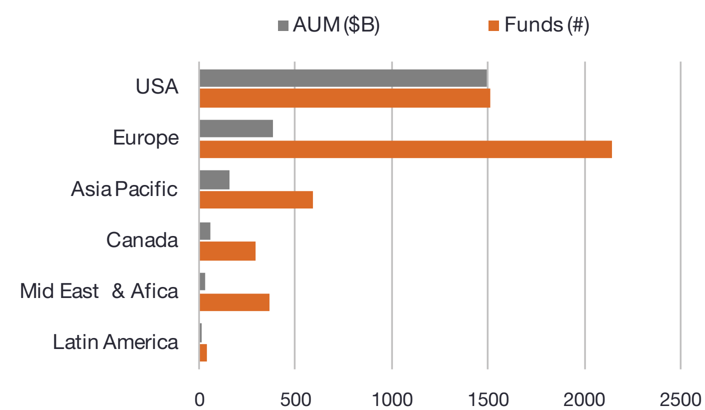
ETFs are growing the fastest in Asia during 2013, but a fragmented market akin to Europe's means a relatively large number of funds. Increasing intergovernmental cooperation and policies aimed at stimulating demand are likely to mean the pace of growth will accelerate in Asia.

Figure 2. Global ETFs and ETPs



Source: ETFGI, 10/4/2013

Figure 3. Global ETFs and ETPs



Source: ETFGI, 8/31/2013

2 Because the US market is more mature than other ETF markets and accounts for such a large part of the global total, US figures are used as proxies for the industry as a whole when data for other markets is unavailable.

ETFs came into existence 20 years ago as vehicles for investing in US equities. Funds focused on other equity markets soon followed, as did funds dedicated to equities in specific sectors (Figure 4). Taxable bond ETFs are a more recent phenomenon, having been introduced only a decade ago. Commodity funds and alternative funds followed shortly thereafter. Municipal bond funds and allocation (i.e. balanced) funds are the most recent entrants having been introduced six years ago in the US market.

Total asset flows to each asset class correlate roughly to the length of time they have been available. US equity ETFs attracted almost $400 billion over the past 20 years, for example, while alternative ETFs brought in a total of $64 billion in the past eight years. The increasingly specialized nature of the asset classes is evident when looking at average annual flows, which vary from $20 billion into US stock funds to the less than $2 billion flowing annually into municipal bond ETFs.

One of the most hotly anticipated developments in the world of ETFs has been the introduction of actively managed funds. Despite a variety of structural barriers (discussed later in this paper), actively managed ETFs have trickled into the market since 2008. With $13.8 billion under management in the US, they still account for approximately 1% of all US ETF assets in that market (Figure 5). When considered in the context of funds introduced during the past five years, active funds have played a bigger part, with their assets comprising 7% of the assets in all ETFs launched during that period.

The adoption rate of active ETFs matters a great deal because the existing ETF business is showing signs of maturing. Although ETFs have been launched in growing numbers, they're also being closed at an unprecedented pace. Despite unprecedented inflows in their largest market, an increasingly crowded market caused a record number of ETFs to report net redemptions in 2012.[3] As a result, some ETF sponsors are now choosing to prune their fund line ups, shuttering 117 ETFs globally during the first half of 2013.[4]

Figure 4. Net Flows to ETF by Broad Asset Class

	Years in existence	Cumulative net flows ($B)	Average annual net flows ($B)
US stock	20	398.5	19.9
Int'l stock	17	255.8	15.0
Taxable bond	11	216.5	19.7
Sector stock	15	151.7	10.1
Commodities	9	87.6	9.7
Alternative	8	63.7	8.0
Muni bond	6	10.9	1.8
Balanced	6	2.5	0.4

Source: Strategic Insight, Morningstar, 12/31/2012

Figure 5. Assets in Active vs. Index ETFs

	Active AUM	Index AUM
All ETFs ($)	$13.8 B	$1,425.7 B
Launched since 2008 ($)	$13.8 B	$181.4 B
All ETFs (%)	1%	99%
Launched since 2008 (%)	7%	93%

Source: Strategic Insight, 6/30/2013

Active ETFs are only in their infancy, but they are beginning to make waves.

3 Strategic Insight, Simfund, 30 September 2013.

4 Arash Massoudi, "ETFs Close in Record Numbers despite Industry Boom." Financial Times 7 July 2013.

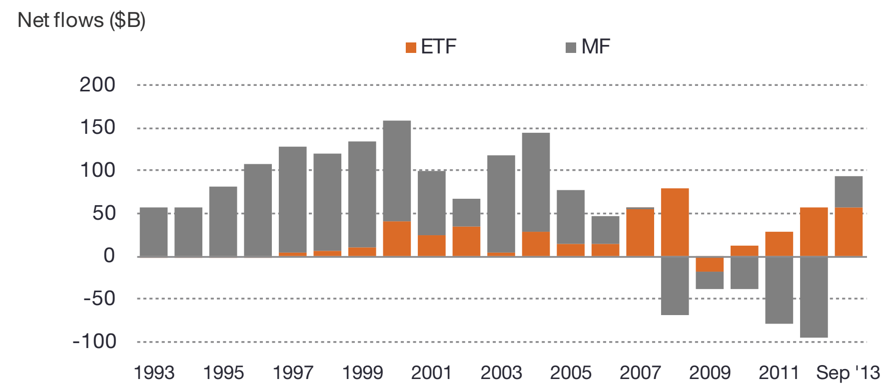
Migrating from security selection to asset allocation

As US-based investment advice continues to move toward a fee-based model, advisors have increasingly taken on the role of portfolio manager. This transition has occurred in parallel with the early evolution of ETFs, which provided advisors with a convenient and effective means of constructing customized client portfolios. Offering convenient, cost effective, liquid, and diversified exposure to countless asset classes globally, ETFs are facilitating a shift in the centre of gravity from security selection to asset allocation.

This change is particularly pronounced in large liquid markets where security selection offers fewer advantages. ETFs focused on US equities, for example, have displaced mutual funds in that category, which experienced net outflows for five consecutive years (Figure 6). The $36.7 billion of assets flowing into US stock mutual funds in their home market during the first three quarters of 2013 represent a significant turnaround, but $57.5 billion of flows to ETFs in that category continue to outpace mutual fund flows by a factor of 1.6x.

The enthusiastic adoption of ETFs as vehicles for asset allocation by advisors can be seen in Figure 7. While other factors including liquidity, transparency, and tax efficiency all motivate them, it is the ability to produce specific exposure that is particularly exciting to the advisor community. Enthusiasm for this particular feature is growing in tandem with the expansion of the industry and is on the verge of taking over from low costs as the number one reason why advisors use ETFs.

Figure 6. ETFs are Displacing Mutual Funds in US Equity Category

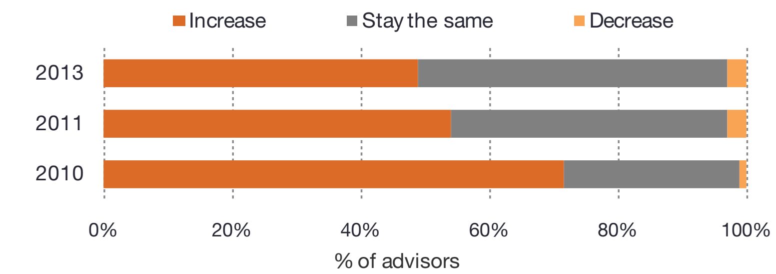


Source: Strategic Insight, 8/31/2013

Figure 7. Main Reasons Advisors Use ETFs

Source: Wealth Management, 2013 Advisor Benchmarking RIA Trend Report

Figure 8. Slowing Growth in Projected ETF Use



Source: Wealth Management, 2013 Advisor Benchmarking RIA Trend Report

Using ETFs as beta building blocks to generate alpha at the portfolio level is a compelling proposition that has propelled rapid adoption by advisors. With more and more advisors already using ETFs, though, growth will inevitably slow in that market. While two years ago 71% of advisors expected to use more ETFs in the near term, only 49% now expect their use to increase (Figure 8).

Even as the advisor market matures and growth slows, the broader move toward asset allocation is likely to continue unabated in tandem with new and innovative uses for ETFs. Allocation funds using ETFs are already being introduced. Greater ETF use in separately managed accounts (SMAs), annuities, and other wrappers is inevitable.

More segments adopt

As exceptionally versatile building blocks, ETFs are finding fans across a growing number of segments.

Institutional investors have always been big users of ETFs. How they use ETFs is changing, however. Many institutions began using ETFs primarily as transition management tools, but now view them as long-term holdings suitable as core allocation vehicles. This development could have profound implications for the growth of ETFs across institutional investor segments.

Almost 3,400 institutional investors in 50 countries already held ETFs and/or ETPs in 2012.[5] This is nearly twice the number of institutional investors using ETFs compared to seven years ago. Looking forward, nine out of ten institutional investors plan to maintain or increase their level of ETF investments in 2013.[6]

5 ETFGI, "Institutional Users of ETFs and ETPs 2012," 27 September 2013.

6 Greenwich Associates, "Institutional Investors' Relationship with ETFs Deepens," Q2 2013.

Investment advisors and hedge funds accounted for approximately 90% of institutional investments in ETFs.[7] The largest holdings are concentrated among global financial institutions, which often combine market-making activities with large networks of advisors. As wire houses continue to transition their identities from being brokers to platforms, ETF flow will continue to grow.

Some large hedge funds are reported to have more than $1 billion invested in ETFs. Some, like the large gold holdings of John Paulson, represent large strategic positions. Others, like those held by large computer-traded funds, comprise a variety of tactical holdings at any given time.[7]

Foundations and university endowments may not comprise the biggest investor group, but they were early adopters that in some cases seeded ETFs. ETF use in this segment may grow as more adopt tactical allocation models. Harvard University already holds $561 million in ETFs.[7]

ETFs are finding traction across a growing number of institutional segments, but the retirement market has been slow going. This is not altogether surprising, since mutual funds already have low-cost share classes designed for retirement plans and the record keeping systems are geared toward mutual funds. Tax efficiency is also not an advantage in the retirement market.

It would nevertheless be a mistake to write off the retirement market as unsuitable for ETFs. Uptake may be slower than other segments, but retirement plans could eventually become an important market for both broad-based and specialist ETF providers. A variety of actively managed target date and target risk funds are already being rolled out to defined contribution plans in the US. ETFs are also being used opportunistically by defined benefit plans, with such use growing by more than 25% between 2009 and 2013.[8] More than two thirds of the institutional investors using ETFs in this way were in North America, highlighting the size of the institutional opportunity in other parts of the world.

One corner of the retirement market where ETFs have been finding some traction is the annuity market. Lower costs are fuelling some of the growth of ETFs in a market that is sometimes criticized for being expensive. But it is their suitability for increasingly sophisticated tactical strategies and allocation models that makes them particularly appealing as sub-account options for variable annuity providers including Axa, Prudential, MetLife, and Transamerica.[9]

In addition to the annuity market, insurance companies offer another tantalizing prospect for ETF sponsors. ETFs are potentially well suited as balance sheet assets for insurance companies, and if widely adopted in that role would represent a substantial new opportunity for sponsors.

7 Chris Flood, “ETF ‘Treasure Map’ Revealed,” Financial Times, 22 September 2013.

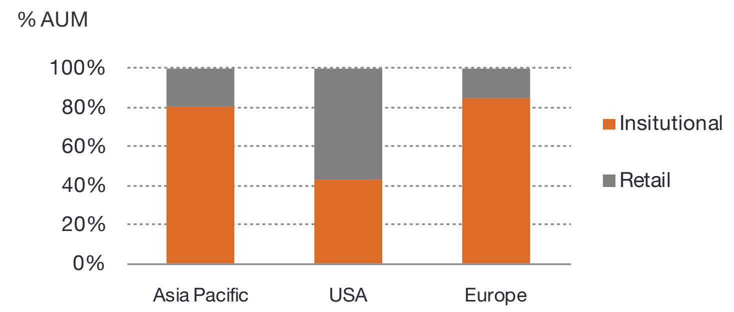
8 Create Research, “Asset Allocation - Leaders, Laggards and Newcomers: 2009-2013,” 16 September 2013.

9 Jackie Noblett, “ETFs Tapping Retirement Market Via Variable Annuities,” Financial Times, 4 August 2013.

The retail segment is also worth considering on a global scale. Retail investors in the US have already embraced ETFs and now account for more than half of all assets under management (Figure 9). ETF penetration of the retail markets is far lower in Europe and Asia, but a raft of upcoming regulatory and policy changes are likely to boost retail use of ETFs in these markets. Globally, only about 4% of self-directed assets are invested in ETFs, so there is vast untapped potential in that market.[10]

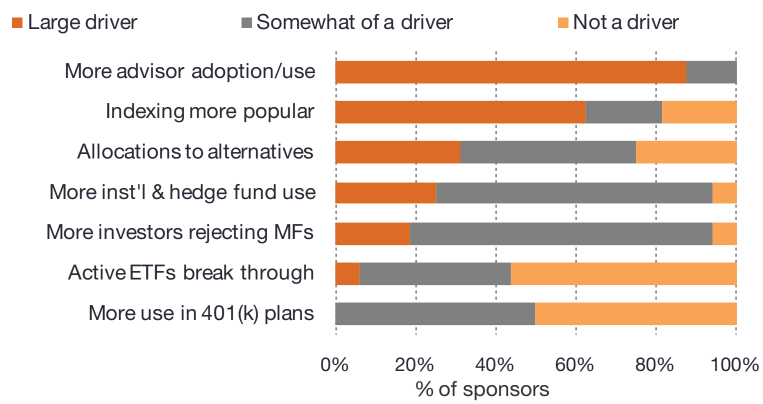
Households owning ETFs already tend to have higher incomes and greater assets than those without ETFs in their portfolios.[11] Given that there's nothing standing in the way of ETFs being adopted by greater numbers of affluent retail investors, it's safe to assume that their penetration of both the advised and self-directed markets will increase. ETF sponsors are particularly bullish about the prospect of growing use by advisors. Nine out of ten say they expect greater use of ETFs by advisors to be a large driver of future growth (Figure 10).

Figure 9. ETF Use by Region



Source: Deutsche Bank, 8/31/2013

Figure 10. ETF Sponsors Rate Growth Drivers



Source: Cerulli Associates, 12/31/2012

10 Dodd Kittsley, "US ETF Assets Could More than Double by 2017," ETF Database, 19 June 2013.

11 Investment Company Institute, "2013 Investment Company Fact Book," 30 April 2013.

From index to active

It's no coincidence that ETFs have flourished as passive investment strategies became more widely accepted. ETFs are so closely linked to indexing that it's difficult to tell which phenomenon is the cause and which is the effect. Despite phenomenal growth, however, index products still account for less than a quarter of all US fund assets, meaning that most ETFs are leaving a large swath of the market untouched.

Enter active ETFs. There continues to be a great deal of discussion about actively managed ETFs and their potential. There are structural challenges that need to be addressed and considerable resistance to the daily portfolio transparency requirements, but given the number of active managers in existence, the introduction of active ETFs will inevitably mean more managers – including many well-established names – competing for the attention of investors and advisors. Demonstrated success for active ETFs could open the flood gates for significant growth.

Some fund managers are already testing the waters. To date, they have found the most success with fixed income products. PIMCO currently has the lion's share of assets in active ETFs, with its $8.5 billion of assets accounting for 62% of the $13.8 billion industry total in the US market.[12] Since launching an ETF version of its popular Total Return fund in 2012, net flows to PIMCO's active ETFs have exceeded those to all other managers combined.[12] This is not to say that they do not have competition to their seven active ETFs. A dozen other fund complexes have already made 62 other active ETFs available to investors. A number of others have filed with the Securities and Exchange Commission (SEC) for exemptive relief in anticipation of launching active ETFs, but these firms have yet to introduce any active ETFs to date (Figure 11).

Active ETFs already come in many flavors. Fixed income strategies were an early application. These active ETF product offerings will only get more diverse in the coming months and years, encompassing a full range of government and corporate debt, credit quality from high yield to investment grade, and possibly geographic exposure from the developed markets to emerging ones if permitted by the SEC. Some will hedge interest rates. Alternative strategies in the vein of hedge funds are also likely to prove popular if transparency issues can be resolved.

Figure 11. Primed and Ready

Launching active ETFs	Approved but waiting
iShares	Fidelity
Cambria	T.Rowe Price
AdvisorShares	Franklin Templeton
WisdomTree	John Hancock
First Trust	Legg Mason
State Street	Federated
PIMCO	

Source: Strategic Insight, Financial Times, 6/30/2013

12 Strategic Insight, Simfund, 30 September 2013.

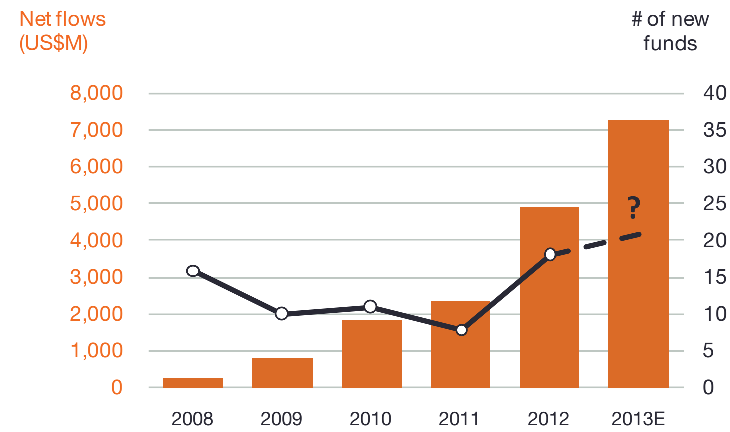
Active ETFs still account for only a miniscule portion of assets, and even that is heavily concentrated in a few funds. New product launches are pushing consistently higher net flows, but it remains to be seen how quickly active ETFs can grow over the longer term (Figure 12). In the near term, their impact may be limited to fixed income, alternative, and specialty asset classes while investors continue to choose low-cost investment options when it comes to equity exposure.

Two areas that show particular promise combine active management with ETFs in less conventional ways.

One of the most promising areas of "active" management is likely to be the move toward enhanced indexing techniques relying on non-traditional weightings or buy/sell signals generated by valuation, volatility, or other metrics. These types of funds – sometimes referred to as "smart beta" funds – will be enabled by the loosening of rules around what indexes are permitted for use with ETFs. As indexes themselves become more active, funds that utilize them can be expected to proliferate. A good example of this nascent trend is MSCI's announcement in August 2013 that it would be launching the MSCI Quality Mix Indexes.[13] These composite indexes comprise equally weighted exposure to the MSCI's quality, minimum volatility, and value weighted indexes.

Regardless of how successful active or semi-active ETFs become, the most important type of active management may not happen at the product level at all. ETF strategists are a relatively new type of player, offering managed portfolios that rely heavily on ETFs, typically holding 50% or more of their assets in this form. ETF strategists represent one of the fastest growing parts of the managed account business, and are led by firms such as Windhaven Investment Management (a unit of Charles Schwab & Co.) and F-Squared Investments. There were already more than 600 such strategies in place with $73 billion of assets by early 2013.[14] ETFs lend themselves to this approach, but it remains to be seen if the asset allocation services provided by these strategists are ultimately viewed as commensurate with the additional cost to the investor.

Figure 12. Active ETF launches

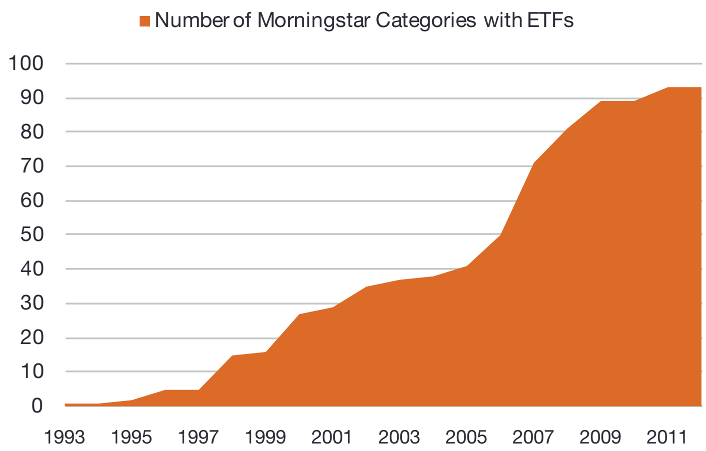


Source: Strategic Insight, 6/30/2013

13 Rebecca Hampson, "MSCI Launches New Quality-Mix Indexes, IndexUniverse, 6 August 2013.

14 Andrew Gogerty, "ETF Managed Portfolios Landscape Summary," Morningstar, 4 June 2013.

Figure 13. Asset Class Coverage



Source: Strategic Insight, 12/31/2012

Thinner slices & more customization

Active ETFs did not emerge until traditional passively managed ETFs had addressed virtually every conceivable asset class available in fund form. In the US, where ETFs were introduced and first took root, the industry went from a single asset class to 93 categories in 20 years (Figure 13).

Despite some claims that new entrants would find it difficult competing against entrenched ETF sponsors, the market continues to expand and accommodate new players and new products. Asset classes represented by ETFs have long moved beyond vanilla equity to include categories that would have been considered exotic only a few years ago.

With most types of traditional long-only exposure already represented by one or more funds, alternative investment strategies are more heavily represented by funds launched recently. Fund categories new to the ETF world in the past five years include bank loans, bear market, convertibles, leveraged debt, multi-alternative, market neutral, and long-short equity.

Not only is there comprehensive coverage of asset classes now, but also there are players with significant scale in more categories. Globally, 480 funds from 51 providers now have more than $500 million in ETF AUM, a key size threshold.[15] As recently as 2009, there were only 340 funds from 45 fund sponsors that exceeded the $500 million mark.[15] It is striking that the biggest change over that time period came in what is arguably the most mature ETF market. In the United States, 179 funds from 15 managers topped $500 million in 2009, compared to 317 funds from 27 managers at the end of September 2013.[16]

The market may not be saturated yet, but it is certainly crowded. As a result, there is growing pressure to be specialized. New products already allow portfolio exposure to be managed much more precisely. Rather than reaching the end of the road after penetrating most existing asset classes, this trend is likely to accelerate now that self-indexing is being permitted. Greater customization is the next logical development.

15 BlackRock, “ETP Landscape: The 12 Surprises of 2012,” 12 December 2012.

16 Strategic Insight, Simfund, 30 September 2013.

Global products and global markets

ETFs are one of the most widely used financial products ever seen. Global assets in ETFs (and ETPs) totalled more than $2.2 trillion as of September 30, 2013. These assets are invested in 4,982 funds from 212 sponsors. There are 10,019 listings on 57 exchanges.[17]

Investors and advisors are looking beyond their own borders to find ETFs that meet their needs. In some emerging markets, ETF adoption is mirroring the use of mobile phones. With limited exposure to traditional fund products, the newly affluent are choosing to invest first in ETFs, bypassing mutual funds in much the same way that they never adopted land-line telephony.

Growth can also come from some unexpected sources. The Bank of Japan, for example, has been a major investor in ETFs as it executes its asset purchase program. Its Policy Board has publicly stated that it plans to increase its holdings in equity ETFs to more than $35 billion by 2014.[18]

Still, there's no doubt that the industry's center of gravity remains in the US market. ETFs domiciled in the US not only account for 70% of global assets, but they attract funds from other areas as well. Some overseas investors are bypassing ETFs available on their home exchanges in favor of those listed in the US. As long as they can custody their funds where they choose, these overseas investors find reassurance in the regulatory regime, operational infrastructure, and market liquidity in the US. According to industry sources, a significant portion of ETF trading activity on the NYSE is accounted for by global investors.

17 ETFGI, "Global ETF and ETP Growth," 4 October 2013.

18 ETF guide, "Guess Who's Piling into Stock ETFs? Central Bankers," 22 May 2013.

From buy-and-hold to tactical models

Reassurance is important, particularly in the wake of a financial crisis that spooked almost everyone. Many investors have recovered their losses, but some lessons were etched permanently in their brains.

The evaporation of market liquidity in 2008 has since caused many investors – both institutional and individual – to address liquidity risk by minimizing lock-ups and opting as often as possible for more liquid financial instruments.

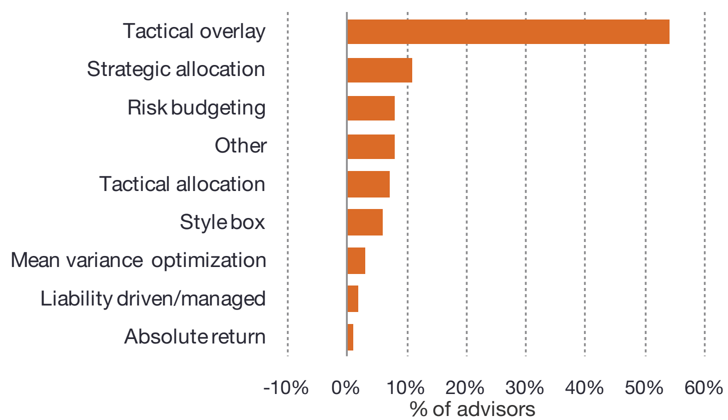
The lack of safe havens as almost all markets fell in unison was another catalyst for change. Investors and advisors are studying market correlations and taking diversification more seriously than ever before, incorporating a wider variety of asset classes in an effort to manage their overall exposure more effectively.

Both of these factors contributed to an even more significant changes in behavior: after decades of adherence to the buy-and-hold doctrine, a growing number of investors and advisors adopted a more tactical stance in an effort to manage risk dynamically. In the US market, this trend has been intensified by demographic pressures. The wave of baby boomers retiring in the coming years can ill afford to sit by and watch their life savings be decimated by another market crash. They will do everything in their power to minimize the damage, even if that means sacrificing some return potential.

More than half of all advisors now use a tactical overlay when managing client portfolios (Figure 14). Another 7% of advisors report using tactical allocation exclusively, meaning that more than six out of every ten advisors trade on a tactical basis to at least some degree. The portion of a portfolio dedicated to a tactical overlay can vary significantly and be relatively small in some cases. Nevertheless, the cost effectiveness and liquidity of ETFs often makes them ideal candidates for this type of trading.

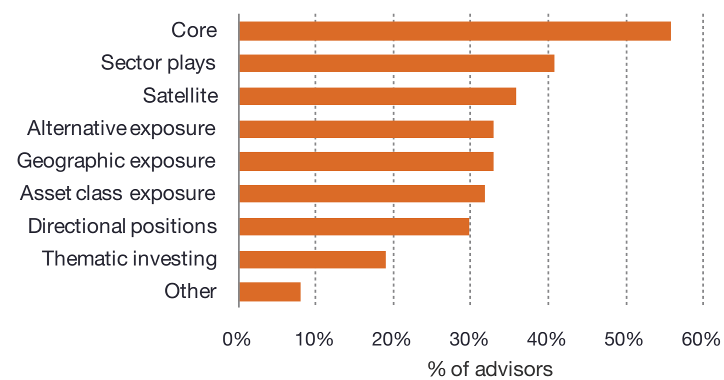
This is not to say that buy and hold approaches are disappearing or that ETFs are somehow inappropriate as strategic holdings. Tactical approaches have made inroads, but most portfolios retain a strategic core, and that is in fact where ETFs are most commonly used (Figure 15). Their use in this role is likely to be reinforced as ETFs incorporating increasingly sophisticated hedging strategies become more commonplace.

Figure 14. Advisor Portfolio Construction Method



Source: Cerulli Associates, Investment Management Consultants Association, Advisor Perspectives, 12/31/2012

Figure 15. Strategic Role of ETFs in the Portfolio



Source: Wealth Management, 2013 Advisor Benchmarking RIA Trend Report

Growth challenges

Given their inherent advantages as an investment product, unimpeded growth would appear to be all but inevitable for ETFs. This is not quite true. Five hurdles stand to potentially slow the growth of ETFs.

Retirement market rationale

ETFs are more immediately appealing to some segments than others. Some of the key benefits they bring to the table (e.g. low cost, liquidity, and tax efficiency) have limited utility in the defined contribution market. This is important because more than half of all defined contribution (DC) assets are held in mutual funds.[19]

ETF sponsors who are not already supplying the DC segment are understandably keen to address this $2.7 trillion market. They have their work cut out for them. More than three out of four ETF firms say 401(k) platform support and product proliferation is a major or moderate challenge.[20] Despite some recent entrants into the market with target date and target risk ETFs, there have not yet been any significant success stories. Some managers have little to gain, since their mutual funds already play a large role in that market. Others are moving cautiously, aware that sales are not likely to come as easily in the DC market and leery of investing too heavily in an unproven opportunity.

Lack of technical understanding

ETFs may run into roadblocks even in the advisory segment where they have been such an unqualified success. According to Cerulli, misconceptions about liquidity and trading volume are dragging down asset growth. Nearly 70% of surveyed sponsors say advisors all too often equate the trading volume of an ETF with its actual liquidity, mistakenly concluding that it will hinder their ability to move large positions in and out of funds with low volume.

Most advisors feel conversant with ETFs, but this particular gap in their knowledge underscores the need for more education. ETF sponsors will likely shoulder the burden themselves, but talking people out of their misconceptions can be challenging at the best of times and especially difficult when the educator is also trying to sell a product.

Structural impediments to active ETFs

Some firms have already jumped through the hoops necessary to launch active ETFs, but the process remains a challenge as active ETFs are not subject to the same generic listing requirements as passively managed ETFs. Thus, the ETF sponsor must obtain approvals for each active ETF portfolio on Form 19b-4, which can take a year or more depending on the novelty of the filing to obtain SEC approval.

The issue of daily transparency also remains a sticking point for active ETFs, particularly among traditional asset managers, which are required to divulge their portfolio holdings of their mutual funds on a quarterly basis. Half of all ETF sponsors say transparency concerns pose a major or moderate challenge that would constrain the growth of active ETFs.[20]

The operational challenges posed by active ETFs mean that even some of the largest managers (which normally handle operations in house) are likely to outsource the administration and accounting for these funds. Active ETF holdings change more frequently and changes need to be processed much more quickly than they are currently done for mutual funds. Centralized data repositories also need to be in place so daily basket files can be created in a timely manner.

19 Investment Company Institute, "2013 Investment Company Fact Book," 30 April 2013.

20 Cerulli Associates, "ETFs and Retail Alternative Products and Strategies 2012," 2013.

Operational risks

Because ETFs are a relatively new type of financial instrument, the operational infrastructure supporting them remains a work in progress. It has performed reasonably well to date, but servicing models continue to play catch up with the growth and innovation of ETFs. There is constant debate on the topic of operational risks of ETFs. This discussion is healthy and likely will lead to continued focus on enhancing the processes and technology related to servicing ETFs. Operational risks (real and perceived) related to many ETFs fall into the following categories:

1. Trade failures.

Industry participants believe there's a common misconception that ETFs suffer from failed trades more often than other types of securities. ETFs utilize a unique creation/redemption process that allows market makers to take three additional days to create or redeem shares. As a result, ETFs often settle outside of the three-day window familiar to most investors and are subsequently reported as failed trades by the SEC. The confusion is understandable but unfortunate.

2. Alternative investments.

Over the past few years some ETFs have been expanding beyond liquid, publicly-traded securities markets to hedge fund investment strategies. The SEC staff in February 2013 highlighted this as an area of focus during their 2013 examinations.[21] More specifically, the staff will assess whether: (i) leverage, liquidity and valuation policies and practices comply with regulations; (ii) boards, compliance personnel, and back-offices are staffed, funded, and empowered to handle the new strategies; and (iii) the funds are being marketed to investors in compliance with regulations.

3. Liquidity.

ETFs generally operate in extremely liquid environments, but there are some concerns about how they would react to an extreme market event. Most ETFs are supported by two or more market makers, but two might not be enough in an extremely illiquid market. This concern is particularly acute in more thinly-traded markets like small/microcap stocks, emerging market securities, and various types of fixed income. The Office of Financial Research (OFR) noted that it will be critical to study how ETFs' capital markets service providers and partners (e.g. market makers and authorized participants) cope with market stress and volatility.[22]

4. Counterparty, infrastructure and new product risk.

As ETFs are used by more investment platforms, retirement plans, and annuities and assets grow from today's $2.2 trillion to $5 trillion or more in the next few years, the current infrastructure and risk oversight mechanisms will be tested. The fact that ETFs may transmit or amplify financial shocks originating elsewhere was highlighted in the OFR white paper.[22] While the mutual fund industry relies on an infrastructure that has proven resilient in a range of market and economic challenges, the ETF infrastructure is relatively new, and is just now being tested with significant assets.

21 Securities and Exchange Commission, Office of Compliance Inspections and Examinations, "Examination Priorities for 2013," 21 February 2013.

22 Office of Financial Research, "Asset Management and Financial Stability," September 2013.

5. Concerns have been raised regarding tracking error.

This happens when performance differs from the underlying index. It is not unusual, but it can vary considerably by asset class or fund. Tracking error can be caused by fees, transaction costs, illiquidity of constituent securities, or changes to indexes. It can result in under- or over-performance, although the former is more common and understandably of greater concern to investors. Effective in 2013, ESMA requires European ETFs to systematically report and disclose tracking error, but no such requirement exists in the US.

Regulatory hurdles

ETFs have been extensively scrutinized by regulators as they try to understand and manage the risks to investors and markets alike. ETFs have reached a point in their evolution where some restrictions and regulations are being eased. But regulatory challenges of one kind or another still exist in almost every market around the world.

In the US, the SEC remains concerned about the use of derivatives in ETFs. Although it has dropped its ban on the use of derivatives in new ETFs, the SEC requires that fund boards periodically review and approve the use of derivatives as well as how the advisor assesses and manages risk with respect to the use of derivatives. Disclosure of the use of derivatives also needs to be consistent with SEC rules and guidance.

Other areas of focus by the SEC include the use of hedge fund strategies, the use of custom baskets and marketing compliance.

In Europe, the European Securities and Markets Authority requires additional disclosures for ETFs in a number of areas including tracking errors, efficient portfolio management and the use of derivatives.

Policy makers in Japan, China, and other Asian markets are largely focused on encouraging investment. Still, there's at least one unresolved issue that is almost certainly holding back asset growth in Asia, and that is mutual recognition between Hong Kong and mainland China. Once the details are resolved, mutual recognition will allow managers based in Hong Kong to sell ETFs directly to retail investors in China.

Everyone needs an ETF strategy

ETFs have already reshaped the investment industry in a myriad of ways. They have facilitated a sea change in portfolio construction techniques among advisors, provided institutional investors with innovative new tactical tools, and undermined traditional distribution models, among other things.

This is only the beginning. Going forward, there will be more providers, more users, and more penetration by ETFs in the worldwide market for managed assets. How can market participants prepare to compete in this new environment?

Monetize expertise

ETFs may have had a profound impact on the investment world, but at their core they are little more than a type of packaging for investment expertise. Every successful asset manager has expertise of some type. The question becomes how to best harness it in a world where ETFs are increasingly prevalent. While many asset classes have already been addressed by existing ETFs, opportunities remain. Ways in which expertise can be monetized with or alongside ETFs include:

1. Opportunistic products taking advantage of marketplace events
2. As building blocks for packaged solutions in the form of annuities or allocation funds
3. Actively managed, outcome oriented strategies utilizing ETFs
4. Going “back to the future” and repackaging existing style-box products in ETF format.

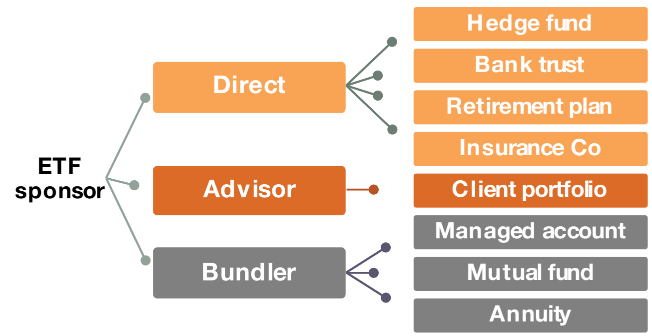
Whichever route is chosen, it is critical that the asset manager plug itself into the growing ETF ecosystem, including distribution platforms, databases, portfolio management tools and investor education.

Differentiate your offering

There is no denying the fact that early movers have been dominating the ETF market for some time. The top five ETF sponsors (iShares, State Street, Vanguard, PowerShares, and DB/x-trackers)[23] accounted for more than three quarters of global assets at the end of August 2013. Six out of ten ETF sponsors say that the dominance of early movers in the market has left little in the way of opportunities for others.[24] It's revealing, though, that a relatively small proportion of these characterized this as a "major" challenge. Most said it was a "moderate" challenge, underscoring that fact that there are likely to be a number of avenues open to enterprising managers willing to devote the resources necessary to effectively position themselves in the marketplace as a differentiated provider.

RIAs have already converted many of their core assets to ETFs and forced active managers to the periphery, but that status quo may be shaken up as ETFs go through their next round of innovation and transformation. Meanwhile, ETFs have penetrated most other segments less thoroughly. Competing effectively against the industry giants as well as innovative upstarts means carefully segmenting the market, and offering a differentiated product or service appropriate for the chosen distribution channel(s) (Figure 16).

Figure 16. ETF Distribution Channels



Source: Alphahut, 2013

23 ETFGI, "Top 5 ETF and ETP providers ranked by global assets at the end of August 2013," 23 October 2013.

24 Cerulli Associates, "ETFs and Retail Alternative Products and Strategies 2012," 2013.

Use content marketing

Thought leadership and content marketing have played a growing role in the investment industry. With growing transparency and awareness, traditional marketing can come across as inauthentic and fall flat. Instead, more firms are choosing to share their insights, giving away intellectual property in the hope that they will attract the attention (and assets) of investors and advisors hungry for thoughtful research.

This approach is tailor-made for ETFs. Most advisors understand ETFs well enough to use them, but they may not fully understand technical details or recent product developments. The latter is particularly important in the context of portfolio construction, so innovative ETF providers should be able to generate some buzz by simply telling advisors how they might effectively incorporate their products into various client strategies.

Investor education may be particularly effective in Asia, where the growth of onshore products is being hampered by the misunderstanding that heavily traded ETFs have greater liquidity. As a result, many Asian investors gravitate toward products with higher trading volumes, often in offshore (e.g. US) funds that offer exposure to their own markets.

Investor education can and will drive asset growth. The other thing it can do is inject some personality into the world of ETFs. The mutual fund industry has always had individuals who lent gravitas, excitement, and myriad other personality traits to the funds they managed. ETFs have largely been devoid of personality to date. Effective content marketing campaigns might bridge that gap.

Capitalize on regulatory demands

Markets will evolve differently depending on what is allowed or encouraged by regulators in various jurisdictions. Investment firms will need to be aware of these changes if they are to make the most of growth opportunities in each market. Some firms will inevitably be more proactive in monitoring regulators, engaging with them, and understanding new rules. Staying vigilant and adjusting course as regulatory environments around the world continue to evolve could prove to be a critical competitive advantage for some ETF providers, particularly in cases where a first mover advantage might be significant.

Cultivate pockets of demand

Despite ETF assets being concentrated among a handful of large managers, it would be a mistake to think that the industry is saturated or lacking in opportunity.

It is true, for example, that ETFs have been successfully integrated into the booming RIA market in the US but ETFs still only have a 7% share of wallet among advisors combining active and passive strategies, compared to 37% using mutual funds.[25] This indicates a substantial market opportunity even in one of the most mature market segments.

Similarly, ETFs are used by only 4% of self-directed investors, but this number has doubled since 2008.[26] Continued adoption at that rate means billions more in assets flowing into ETFs.

Adoption by new segments can be the result of finding new ways to use ETFs. Though most often thought of as core holdings or tactical trading tools, ETFs can also be used for transition management, cash equitization, rebalancing, or risk management. Fixed income allocations consisting of thousands of bonds can be reduced to a few ETFs, for example. ETFs can also be used as a liquidity sleeve for an institutional portfolio.

Though impediments are not trivial, ETFs are likely to gain some traction in retirement plans as well. Allocation funds are still a relatively immature part of the ETF landscape. Target risk, target date, and global allocation funds are all likely to proliferate, possibly in specialized forms not yet conceived.

25 Dodd Kittsley, "US ETF Assets Could More than Double by 2017," ETF Database, 19 June 2013.

26 Dodd Kittsley, "US ETF Assets Could More than Double by 2017," ETF Database, 19 June 2013.

Many institutional investors have yet to use ETFs, but there are exceptions blazing a trail in virtually every segment. Insurance companies, defined benefit plans, foundations, endowments, and others will continue to find ways to make ETFs work for them by reducing costs, adding flexibility, or otherwise improving their ability to manage their portfolio. Consultants and others involved in outsourced models will use ETFs to help perfect their asset allocation techniques.

All of these segments continue to show promise. It is worth considering that the opportunity is also a global one. The US may account for 70% of ETF assets, but that will change as investors gain confidence in locally available products and the benefits they provide in terms of currency risk and time zones. Despite a tendency for many Asian investors to go with ETFs based in the US, the Asian market has exploded from only $35 billion a decade ago to $150 billion today.[27] With most of those assets coming from institutional investors, the retail opportunity in Asian markets is substantial. Europe offers similar growth prospects.

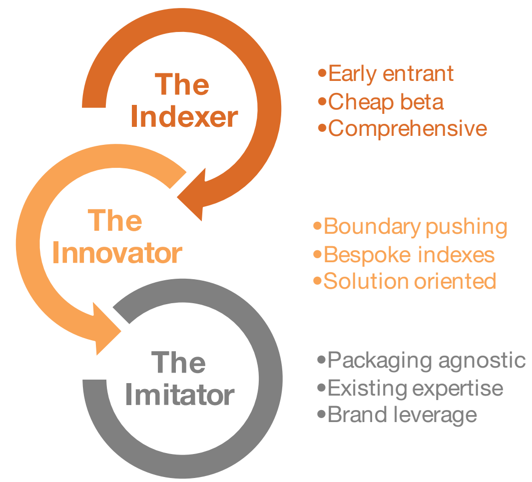
Demand should not be a problem for ETF sponsors, but some will be challenged by the need to consider each segment, channel, and region individually. A Japanese widower is likely to think about ETFs differently than a Dutch foundation. Niche products are fine, but niche marketing is just as important.

Solutions, not products

The key to a successful ETF strategy is envisioning how these products will address the needs of individuals, advisors, retirement plans, and other types of institutional investor.

ETF providers attempting to compete in the immediate future are likely to fall into one of three categories (Figure 17).

Figure 17. Three Archetypes of ETF Sponsors



Source: Alphahut, 2013

Ultimately, individuals, advisors, retirement plans, and other types of institutional investors are all looking for solutions rather than products.

27 Financial Times, "Education Key to Asia ETF Growth, Say Providers," Financial Times, 6 September 2013.

Indexers are already very much in evidence. These giants of the industry have already established themselves as providers of inexpensive beta and typically offer passive exposure to an extensive array of asset classes. They have strong brands that travel well. Their Achilles heel may be their strong association with indexing, which could limit participation in the nascent market for actively managed ETFs.

Innovators are not likely to have this problem. Largely relegated to the side-lines when it comes to traditional index products, these firms will compete viciously for assets as they begin flowing to newer types of products. Pushing boundaries and expanding the product set in novel ways will be a strategic imperative for these firms. A solutions orientation, use of custom indexes, and strong relationships with ETF strategists will be the norm for this group. Some Indexers from the first wave will almost certainly evolve into Innovators.

Active asset managers without an ETF business will enter the industry as Imitators. If they can meet the requirement for daily transparency, these managers will be free to clone their actively managed products in ETF form, potentially shaking up the business in a big way with their strong brands and marketing budgets.

How you view the future of ETFs is bound to be based in part on your ideological stance. Those who place a premium on security selection and individual talent may not view ETFs as a revolutionary force, while those who think solutions matter more than style boxes are more likely to be bullish on the future of ETFs. These are still early days, and the jury is out on which archetype will be most successful in what is sure to be one of the fastest growing parts of the global asset management business.

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