INTRODUCTION

HEADING IN THE RIGHT DIRECTION?

Exchange traded funds continue to prove incredibly popular, writes Elisa Trovato, but as the evolution in this space brings the possibility of more complex products, are these developments really in clients' interest?

Increasing assets under management in exchange traded funds (ETFs) are a clear evidence of investors' widespread interest for these open ended index-tracking instruments, which trade on stock-exchanges like any other stock and are cheap, liquid and transparent. At the end of 2009, global ETF assets broke through the $1,000bn (€728bn) milestone and in Europe, where ETFs were introduced around 10 years ago, assets hit an all time high of $223bn, according to data from BlackRock.

While the ETF industry is dwarfed by mutual funds in Europe, which account for $7,000bn of AUM, net sales of ETFs domiciled in Europe soared to $40.3bn during the first 11 months of 2009 versus net sales of mutual funds (excluding ETFs) of $230.1 bn according to Lipper FMI. The ETFs listed in Europe escalated to 896, surpassing the 791 in the US. But is this actual innovation or just proliferation, and is this expanding choice beneficial for investors or just confusing? Moreover, there are concerns that innovation may bring with it more complex products, which could somewhat betray the true nature of this passive instrument.

"We launch new ETFs systematically to meet client demand, but whatever the innovation we provide, we absolutely make sure that the ETF remains simple to understand and that the underlying index is liquid, clear and transparent" says Valérie Baudson, managing director of Amundi ETF, the newly re-branded ETF range of the asset management group formed by the merger of Crédit Agricole Asset Management and Société Générale Asset Management, previously Casam ETF.

An example of a successful innovation has been an ETF tracking the MSCI world ex EMU. The idea came from professional European investors who wanted to find a very simple, quick and transparent way to invest in the world equity market, without that interfering with their Eurozone investments, says Ms Baudson.

The French firm, which last year more than doubled its assets under management to €3.3bn and launched the highest number of ETFs in Europe, recently listed six

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VALÉRIE BAUDSON, AMUNDI ETF

unprecedented short bond ETFs, offering a reverse exposure to EMU government bonds with maturities ranging from one to 15 years. These short ETFs are for investors that have a view that interest rates are going to increase in the future, because if interest rates grow, the bond price will decrease and the short index will grow. "Investors can be bullish on a certain maturity and bearish on others, and they can express their views by investing in long and short ETFs," she says.

Buying a short ETF is different from shorting an ETF. For the majority of the European markets and a large part of the US market, shorting an ETF is either very expensive or just not possible for investors, due to the difficulties in finding the borrower in the ETF in order to be able to short it, ie selling borrowed assets with the view of buying them back at a lower price, thus making a profit.

"The key issue is that an ETF has to have enough assets under management that people are going to be able to lend, for the period you need and the price you think is acceptable," explains Scott Thompson, co-head of European sales at ETF Securities. The cheaper alternative is to buy an inverse or short ETF, which offers a similar pay-off structure. Investors earn one per cent, prior to the cost of management fee, for every per cent the benchmark goes down in one day. To make the monitoring of performance easier for investors, European ETF issuers, unlike their US counterparts, have tended to launch inverse ETFs that track inverse benchmarks, so that an inverse ETF just have to track that specific index.

"ETFs provide investors with the opportunity to play both the long side and the short side, depending on their views, and in an uncertain world that is incredibly valuable and useful." ETF Securities, which in 2009 almost tripled its assets to $17bn assets, of which the majority are in commodities, is within the top three issuers of inverse ETFs and ETCs (exchange traded commodities) in the world, he says.

"In 2008, when the oil price was very high, there was more trade going on in our short oil product than all the other ETFs on the London Stock Exchange put together. Clearly the investment community believed that the oil price was going to come down." Most recently, people are looking at short exposure to industrial metals, says Mr Thompson. "Inverse ETFs are more active type of products and people trade with short-term horizons. When the market sentiment begins to change, you find a big asset reallocation coming out for instance a long product and buying an inverse ETF."

LEVERAGED BETS

Stockholm-based ETF issuer Xact Fonder, a subsidiary of Handelsbanken, recently launched two new leveraged long and short ETFs, the Xact Europe Bull 2 and XACT Europe Bear 2, designed to give double the positive and negative Dow Jones Euro Stoxx 50 index daily return, respectively. "Xact Fonder was the first ETF provider in the world to launch leveraged ETFs in February 2005, but we did not know at the time that it would be such a great success," says managing director Henrik Norén.

Today the Nordic company offers a total of six bull and bear funds, and leveraged ETFs represent around 70 per cent of its total €2bn assets under management. "We see strong demand for this kind of high risk ETFs which are rather high volatility funds. Small private investors up to big institutions use leveraged ETFs when they want to take directional bets. Leveraged ETFs in general are very short-term instruments, they need to be managed very actively, they are not for buy and hold – that is why they have such a high turnover on the stock exchange."

Both leveraged and inverse ETFs are daily percentage

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SCOTT THOMPSON, ETF SECURITIES

change or past dependent products, as values are reset after each day's trading and losses or gains are compounded for all subsequent days. This means that the long-term returns of both leveraged and short ETFs are not the same as the underlying index times the leverage. The difference can be quite substantial, depending on the market environment. When the market is directional, leveraged ETF will generate returns higher than the index times the leverage, because of the compounding effect. On the other hand, in case of high volatility and not clear trend, the returns will be lower than the leverage times the index. Because of this, they are widely considered as suitable for sophisticated investors only.

Last year, Finra, the Financial Industry Regulatory Authority in the US, stated that leveraged and inverse ETFs were not suitable as a long-term investments and people should only hold them on a daily basis. A month later they retracted that, but warned investors in these instruments they should monitor their positions. The noise about these kinds of ETFs has been largely confined to the US, where in truth only a few of them, which were linked to specific sectors like financial and real estate and were three times leveraged, caused trouble.

"The upshot of the debate over the last six months has been it is important that people understand how these products work, they are not suitable for everybody, but they are a good trading tool for people to gain short-term, tactical exposure to implement different strategies within the portfolio," says Manooj Mistry, head of db x-trackers in the UK.

The Deutsche Bank platform, which claims to be the largest provider of inverse ETFs in Europe, offers only products that have no leverage and which track mostly broad benchmarks. "There are some sector products, but they are only one time inverse, so they don't have the issue of high level of volatility impacting the daily return," says Mr Mistry.

WIDER RANGE

Another major development in the rapidly evolving ETF space is the range of asset classes covered. "People are looking for the tools or building blocks with which they can do the asset allocation, they want a product that is liquid, tradable, low cost and transparent, and we have seen there is a need for alternative ETFs," says Mr Mistry.

The hedge fund ETF launched by db x-trackers has now gathered more than $1bn within nine months of its launch, showing that there is demand for this kind of product in the wealth management space, says Mr Mistry. "ETFs can complement existing processes where wealth managers choose their favourite hedge funds, in which they invest the majority of the portfolio. If they want to maintain the remainder in a liquid instrument, then the hedge fund ETF can meet that requirement."

Active ETFs, which are designed to bring active fund management to the index-tracking world of the exchange traded funds, are also attracting interest. The issue is that there is no standard definition of what they are. Perhaps the closest one acknowledged in the industry is a product that does not track an index having a transparent methodology, but this is determined by the manager's discretion. The key issue is that all ETFs have to disclose their entire portfolio composition on a daily basis so that market makers can make sure there is always a buy and sell price and liquidity in the ETF. Because of the trading nature of the ETF, it is important to keep tight the bid-ask spread, which is difference in price between the market price for buying the ETF and the market price for selling it, which substantially reflect the liquidity of the underlying index. Few active managers offer such transparency for fear that other market participants will front run them, buying stocks in advance and thus moving the price against the fund, or that they will simply copy the strategy free of charge.

The db-trackers hedge fund ETF tracks an index based on the performance of around 40 hedge fund managers, which sit on the Deutsche Bank hedge fund account platform. The way the index is constructed is meant to reflect the overall hedge fund universe, as the managers are split into the different hedge funds strategies, and within each strategy there is a minimum of five managers. The weighting of those strategies within the hedge fund index is based on the global HFR weighting, explains Mr Mistry.

"WE HAVE SEEN THERE IS A NEED FOR ALTERNATIVE ETFS"
MANOOJ MISTRY, DB X-TRACKERS

"Our hedge fund ETF is a passive ETF that provides exposure to different types of hedge fund strategies, it is transparent and it has a daily net asset value, where you can see the daily index level." In the case of a standard index, there will be multiple market makers providing liquidity, but a hedge fund index is more specialised. The long experience of Deutsche Bank in providing a secondary market in hedge fund related products allow having a tight spread of 20 to 35 basis points on this product and trading in large sizes, says Mr Mistry.

The recent announcement made by hedge fund Marshall Wace of the imminent launch of its market neutral ETF signals that even the hedge fund community have started viewing ETFs as a valid route, by which they can enhance their distribution and product offering. The Marshall Wace ETF will track the performance of the MW Topps global alpha index, which itself will be based on a basket of Marshall Wace's globally-diversified Topps investment strategies. The firm states this is the first ETF targeting an absolute return from a single investment strategy and the first ETF in Europe to be run by a dedicated alternative asset manager.

"As the ETF tracks an index, it is not an active ETF, but as changes in the underlying portfolio are made through the proprietary systematic process developed by Marshall Wace, which is rule-based, it is an alpha generating engine", says a spokesman at the firm. Because Topps strategies are very liquid, and have never used much leverage, they are easily transferable into the Ucits space. The firm has already launched five Ucits products in various strategies and views the ETF as a logical extension to that. Both the market neutral ETF, and a daily dealing Ucits fund which also is on the launch pad, will target lower returns that those of the equivalent offshore product offered by the firm. "Our decision is that all our Ucits products have a lower return target and a lower volatility band.

"What will be available to all in terms of transparency is the percentage allocation to the different sub-components of the index, the geographic allocation, but there will not be underlying position transparency below that. However because it is a market neutral strategy, and with low leverage, we are anticipating that the market makers will be able to have quite tight spread in making markets in the ETF." Also because it is market neutral, the entry point is not that relevant, says the spokesman.

Further ETFs from Marshall Wace will follow in the future, perhaps regional market neutral, and there is the possibility of having directional strategies ETFs going forward. These will bring additional challenges but they are absolutely surmountable, he says.

If only a part of the hedge funds can embrace the Ucits world, the subset of alternative managers who can launch an ETF is even smaller, says the spokesman. "An ETF has to track an index. The strategy has to be an index-like strategy like Topps, which is systematic, very diversified, there is no key man risk, and makes money through marginal shifts in the portfolio, where the constituent stocks are pretty constant."

STAYING PASSIVE

The world's largest ETF provider, iShares, decided not to offer leveraged or inverse ETFs a couple of years ago, one main problem being that the risks embedded in these products were not being fully explained to investors, explains Axel Lomholt, European head of product development at the group, now owned by BlackRock.

And although the firm offers a listed private equity fund, it has not launched a hedge fund ETF yet. Mr Lomholt says they are looking into it, but today the main focus remains on the passive space, on developing core ETFs, particularly in the fixed income area "which is a high priority", as well as giving deeper coverage within existing asset classes and in different geographical areas. The firm recently launched accumulating ETFs providing MSCI country exposure to Australia, Canada and South Africa, as well as the accumulating version of the iShares DJ Euro Stoxx 50.

"We see a huge demand for accumulating funds, which make the investments easier to manage operationally and remove the administrative burden for investors dealing with cash flows and dividends paid by the fund." What Mr Lomholt thinks are exciting developments are the so called advanced ETFs, which track indices that are not traditionally market capitalisation weighted, but take into account other factors such as price momentum. "I think it is still early days, but we are starting to see uptake and interest in those ETFs."

Indeed, indices built through innovative construction methodologies have emerged as interesting underlyings of ETFs. Fundamentally weighted indices – in which stocks are weighted by metrics such as book value, dividends or sales – have now wide spread usage as the basis of ETFs, says Andrew Buckley, executive director strategy at index provider FTSE.

"IF YOU OFFER AN ACTIVE OR EXPENSIVE ETF YOU WILL BREACH CLIENT TRUST"
CHRISTIAN RAUBACH, WEGELIN & CO. PRIVATEBANKIERS

The well-known problem with market-cap weighted indices, in which companies are weighted according to the value the market ascribes, is that investors have to hold too much of stocks that are temporarily overvalued and too little of undervalued stocks, and portfolios can be dominated by a few large companies. In a rising market, investors have increasing exposure to the biggest stocks and less exposure to the smaller ones, and in periods of market downturns investors get poorer performance. "While with fundamentally weighted indices you try and avoid market bubbles, the downside is that in a rising market, you run the risk of being underweight in stocks that are performing well. So it is not black and white. It is about having a diversified portfolio, which allows investors to smooth returns," says Mr Buckley.

The next evolution in this area is a family of risk efficient indices, launched by FTSE in collaboration with Edhec-risk institute, which aims to deliver the highest sharpe ratio, a measure of risk-adjusted return. "There are no ETFs built on these indices yet, but we are in discussion with a broad range of market participants, including ETF providers," says Mr Buckley.

While some wealth managers welcome these new instruments as good diversifiers in portfolios, others worry about the confusion they can generate.

"ETF has become a brand and they are going to conquer the world," says Dr Christian Raubach, managing partner at at Wegelin & Co. Privatebankiers in Switzerland. "With the ETFisation of the world, the whole universe is now available to you."

Clients are increasingly asking to replace some of the passive funds, which are used extensively in the Swiss bank's clients portfolios, with ETFs. But the Swiss bank does not employ active, leveraged or inverse ETFs. "In the clients' brain it is stored that ETFs equal passive and cheap. If you offer an active or expensive ETF you will breach client trust." Dr Raubach has also little confidence in the industry being able to educate investors.

"The fund industry is a master in diseducating clients; I think people completely overestimate the sophistication of the private client."