INTRODUCTION

AN INVESTMENT VEHICLE THAT IS HERE TO STAY

Exchange traded funds have proved very attractive during the recent economic crisis. But as their use has become widespread and clients have become more aware of their benefits, the growth of ETFs looks set to continue way beyond the downturn, writes Elisa Trovato

There is no doubt that the market downturn has accentuated and accelerated the growth trend of exchange traded funds (ETFs) in Europe.

Investors, increasingly concerned about counterparty risk, transparency, product structure and liquidity, worries triggered by the credit crisis and Lehman Brothers' bankruptcy, have found a safe harbour in these passive instruments, which trade on stock exchanges and are designed to deliver performance of the underlying index. In 2008, ETFs domiciled in Europe grew by 11 per cent to reach $142.82 (€113.4bn) in assets under management with net inflows of $76.5bn, while European domiciled mutual funds (excluding ETFs) registered net outflows of $495.1bn, according to Barclays Global Investors (BGI) research.

The key product strengths of ETFs – liquidity, cost efficiency, transparency and their multiple brokers model, which protects investors from the risk deriving from being tied to a single issuer as in the case of a certificate – have drawn significant investors' interest, says Deborah Fuhr, global head of ETF research and implementation strategy at BGI. Moreover ETFs are attractive in periods of high volatility and correlation to make tactical calls, as investors can trade them in small volumes at any time during the day.

It could be argued that when stock dispersion is limited or correlation between classes is very high, as it is today, active managers find it more difficult to generate alpha and as a consequence ETFs provide a better option to maintain market exposure. But the growth trend is likely to continue, even after the market recovers. In a way, the market turmoil brought these instruments closer to investors.

"The key challenge for ETFs is getting investors to do that first trade and once they do it, and they use ETFs, then they are kind of hooked, because they are a good tool," says Ms Fuhr at BGI. Regardless of the market cycle, there are always good ways to use ETFs, she says.

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According to BGI, in 2009 European ETFs assets will exceed $200bn. Global ETF assets are expected to exceed $1,000bn, a figure which will double by 2011. "The entire fund management industry, and particularly its active community is going to come out of the current downturn with their business models completely reviewed and changed," believes Dan Draper, global head of Lyxor ETFs, Société Générale Corporate and Investment Banking.

The ability to measure performance attribution and separate how much of an investor's return is coming from the market (or beta) versus how much is outperformance or alpha, is driving asset managers to focus on their core competency and decide whether to outsource the rest of their portfolios to active managers, or, when active managers are not able to consistently generate alpha, to use instruments like ETFs to gain market exposure in the cheapest way possible.

Sophisticated investors, able to distinguish whether they are paying for alpha or beta returns, are also driving these changes forward.

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INCREASED USE IN WEALTH MANAGEMENT

The fact that ETFs do not pay a rebate to intermediaries has represented a big hurdle in the uptake of these instruments by private banks, which traditionally operate on a commission-based model and are reluctant to give up the higher margins, often in terms of front end commissions, obtainable by more remunerative products, such as funds or structured products.

However, increasing demand from educated and more knowledgeable high net worth investors has made them more acceptable in the wealth management space.

"On the discretionary management side, wealth managers wanting to reach the efficient portfolio frontier have been adding new asset classes in their asset allocation such as emerging markets, commodities, private equity, real estate, which are now all available on ETFs," points out Mr Draper.

"But it is in the advisory side where we probably see much more use of ETFs at this time, because high net worth investors have become more aware of ETFs, like to have more of a hands-on approach in managing their own money and want to do it cheaply," he adds.

Indeed, on the discretionary side there are also interesting developments. In the past six months, wealth managers have started putting together discretionary portfolios of ETFs, where both strategic and tactical asset allocation is implemented using these instruments, explains Eleanor Hope-Bell, head of wealth management sales at iShares, the ETF brand spun out of BGI.

This recent development in the usage of ETFs is largely market driven and due to the fact that investors are not willing to pay fees to active managers who fail to outperform the benchmark, she says.

"We are seeing how a lot of private banks have created either portfolios or funds of ETFs and they charge a flat fee to manage them. Even IFAs, who are so commission-driven can use ETFs, but still make money," says Ms Hope-Bell.

Regulatory changes both in the UK with the Retail Distribution Review and continental Europe with the Markets in Financial Instruments Directive (MiFID) are also driving the use of ETFs in the more retail space too. Distributors are asked to clearly state what investors are paying and for what purpose, whether it is for the product itself or for independent advice, and to make sure investors are offered all possible product alternatives.

In February this year, UBS Wealth Management started a new discretionary model for its high net worth clients, an index managed world portfolio, where ETFs are used in the core part, reveals Christian Gast, head of UBS ETFs.

"With this dedicated portfolio we are at the forefront of development, as ETFs are still relatively new. With this programme, investors can actually get access to UBS ETFs but in a very systematic fashion," explains Mr Gast, mentioning that UBS MSCI Emu and MSCI USA ETFs, for example, are part of this programme.

Through its fund research entity, UBS Wealth Management, which has an open architecture approach, selects "best of breed ETFs" and include them into client portfolios, he says.

Current markets conditions have not really changed

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the usage of ETFs in clients' portfolios, according to Roberta Gamba, head of portfolio construction at JP Morgan Private Bank, Emea. "No matter the market environment, we look at ETFs as one of the vehicles we have available to implement our tactical views," says Ms Gamba.

"The main differentiation in current portfolios with respect to the past is that we are trying to make sure that portfolios are as liquid as possible," she says. So in an attempt to minimize lock-up periods, mutual funds as well as ETFs are preferred in implementing tactical calls.

"The fact that there is now a broader range of ETFs available in the market across equity, fixed income and commodities means that we are able to implement our tactical and sectorial calls efficiently across all the major asset classes, in a quick, easy and inexpensive way," says Ms Gamba.

ETFs are also used to gain exposure to specific regions or sectors in which active managers are recognised not to be able to generate excess return, or, in some cases to gain quick exposure to the region or sector while finalising due diligence process on an active manager, she explains.

Currently approximately 10-12 per cent of a balanced portfolio at JP Morgan Private Bank is allocated to ETFs within equity, fixed income and commodities but the percentage "is pretty much the same as a year ago," adds Ms Gamba.

"Clients are certainly becoming more aware of the uses of ETFs," notes Dennis Geelan, director, investment solution team at Credit Suisse Private Bank.

An interesting trend is the increased demand for fixed income ETFs, due also to the fact that it is difficult to generate net outperformance for active fixed income managers, he adds.

"We have seen a big pick up from clients in ETFs to gain exposure to the fixed income market. It started with government bonds a few months ago and has transitioned over to the corporate side. This is another argument where the ETFs have been able to fill in part of the core part of the portfolio," he says.

In fact, European fixed income ETFs last year have seen net inflows of $19bn, an increase of 94 per cent, according to BGI research. Investment grade corporates and inflation-linked bonds are the main areas of interest.

SELECTING PROVIDERS

There are a number of factors that enter into the equation when selecting an ETF provider. The first and most obvious is pricing, which includes management fees – which cover fixed costs – and the trading cost of liquidity, ie the bid and offer spread, which makes it important for the ETF provider to establish good relationships with market makers.

Another factor is tracking error, which indicates how well the provider can track the index. The type of replication is also fundamental. This can be physical, where ETFs replicate the index through the acquisitions of all stocks/bonds held in the index - sampling and optimising techniques have recently applied to very broad indices or less liquid markets, as they enable the ETF provider to buy only a sample of the stocks or bonds held in the index, while still keeping a low tracking error.

In more recent times, synthetic or swap based replication techniques, reportedly pioneered by Lyxor in 2001, have also become available. The track record of the ETF provider and how many investment professionals support the ETF are also essential differentiating aspects.

"There are few providers that have scale and few that have at least a few years track record" says Credit Suisse's Mr Geelan, stating his preference for larger players, which overall provide a good range of products.

Mr Geelan also explains than in the ETF arena especially, servicing clients has a fundamental importance. "We need to be educated around ETFs, not only for what we see in the market place today but also about future trends," he says.

"We like to have the relationship with ETF providers and be able call them on the phone, ask the questions, get them on a call with the client if we need to, walk through the risks, walk through any other major changes in the portfolio. That it is important to us."

Listing an ETF on multiple exchanges also adds to the credibility of the provider and helps it gather assets from a diversified group of investors. But an ETF provider really has to plan its marketing strategy first.

"You really have to think whether you really want to be

marketing in that country," explains Ms Fuhr at BGI. "You need to have a good web-site, you need local language, you need support staff, and the infrastructure to really provide a good offering to clients."

"A firm has to have the commitment on the longer term basis to be providing solutions, as opposed to just launching products and thinking people will come and buy them," she adds.

Liquidity of the ETF is also important and reflects the liquidity of the underlying basket of shares. It is down to market forces to drive the liquidity, says John Davies, senior director at S&P index services, as indices have just to represent that particular market. And broad market coverage is always appealing to investors.

Most indices are market cap weighted, where the price and number of shares available determine the stocks of the index. Designing and managing the index, ensuring that it is representative of underlying market and that the rules that govern the management of the index are clear and transparent - which helps ETFs providers to manage their portfolio against the index - are the key duties of an index provider, explains Mr Davies.

LIQUIDITY CONSTRAINTS

However high liquidity constraints in some emerging countries have driven index providers to work in collaboration with ETF providers to create liquidity rules that go over and above the normal market cap weighing of an index, he explains.

"What we see now is the next generation of ETFs where people are looking to try and wrap more actively tilted strategies in an index structure," says Mr Davies.

For example there are now leverage and short versions of standard markets, so that if investors are bearish on a particular market, they can buy these short versions of ETFs, which can be used to hedge their existing positions, for example, he says.

In the US, where the first ETF in the world was launched on the S&P 500, 16 years ago, there has been an increase in the demand for custom indices, says Mr Davies, where ETF providers are looking at systemising their proprietary stock selection processes in an ETF. The index provider has to be able to replicate that particular strategy in the index, in order to allow the provider to launch an ETF based on it.

But in Europe, where the first ETF was introduced only in 2000, players are still in the process of filling out their product ranges to cover the standard equity markets, fixed incomes, commodities, property and only starting to look at the more strategy oriented products.

"But there will be even more growth in Europe," assures Mr Davies, "and the next evolution will be these active ETFs."

An indication of how aggressively European players are pushing in the ETF arena is given by Crédit Agricole Structured Asset Management (CASAM) which, having launched 21 new ETFs in the second part of last year, plans to launch 10 new products every three months

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during the course of 2009, explains Valérie Baudson, head of ETF product range at the French firm.

"We started with the mainstream large indices and we are completing the range of our products with smaller indices, such as sector ETFs and country ETFs", says Ms Baudson, explaining that the French firm is the only provider offering MSCI country ETFs listed in Europe, which were launched last year to meet client demand.

"Our strategy is really to offer to our clients an all round range of ETFs covering the main asset classes and the main underlyings." Ms Baudson also states that Casam's ETFs are "systematically cheaper" than competitors'.

The large majority of ETF assets are concentrated in very few mainstream indices and equity ETFs still have the lion share, although fixed income has recently strongly benefited from flight to quality and safety. But growing public interest in specific sectors such as infrastructure, clean energy or biotech, fuelled by announcement of big spending plans by US President Obama, are also driving clients to ask for ETFs covering these areas.

Indeed at BGI, demand from high net worth investors, mainly on the advisory side, have strongly driven the launch of niche products. For example, the water, the timber, the clean energy and the Sharia compliant ETFs were all launched over the past 18 months because of growing demand and because it made sense from the product development point of view, in terms of sustainability and liquidity, says Ms Hope-Bell at iShares.