MAY 2004 ISSUE 20
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS

EXCHANGE-TRADED FUNDS

THE BENEFITS OF TRADING ETFS

After significant initial interest followed by rapid progress in Europe, exchange-traded fund products are now being fine-tuned to fit the needs of a more sophisticated market

In recent years, exchange-traded funds (ETFs) have been one of the fastest growing areas in the European asset management industry. While these products have been available in the US since 1993, their introduction in Europe only started from 2000.

Since then, assets under management in this new and innovative investment vehicle have risen to almost US$20bn. (See Chart 1.) The largest ETFs in terms of assets are those concentrated on either the DJ Euro Stoxx 50 or local indices (FTSE100, DAX, SMI and CAC40), together accounting for approximately 60 per cent of the European ETF industry.

SPECTACULAR

While a number of commentators were initially disappointed with the asset growth of ETFs in Europe, we believe that the growth has been – and still is – quite spectacular. Despite prolonged stock market declines between 2000 and 2002, ETF assets doubled in each of these years. This almost exactly mirrors the development of ETFs in the US, where between 1994 and 2000 assets under management doubled every year.

The growth in the US only slowed down with the onset of the equity bear market in early 2000, but this has picked up again, with assets growing by an impressive 50 per cent in 2003. In Europe, ETFs continued their growth trajectory during 2003, increasing by more than 90 per cent.

The ETF market is on track to again double in size during 2004, reflecting continued interest from European investors.

US MIRROR

While the early stage growth pattern of European ETFs mirrors the development of their US counterparts in asset terms, this has been achieved via a significantly different product offering. The relatively large number of different funds available in Europe (more than 100) is the direct result of a fragmented European market place. The ETF market is similar in many ways to the traditional European mutual fund market, where large numbers of products are needed to provide locally tailored solutions, as funds cannot always be distributed on a pan-European basis.

The average size of a European ETF is currently around US$220m, compared to US$1.2bn for US ETFs. However, this size differential looks less pronounced when compared to the average size of US$350m for US ETFs in 1997, at a similar stage of this market's development.

Sector ETFs remain the big disappointment of the launching spree that took place during the three-year period ending in Q3, 2003. These products were expected to grow dramatically, the only uncertainty being whether global or regional sectors were the game to

'The ETF market is similar in many ways to the traditional European mutual fund market, where large numbers of products are needed to provide locally tailored solutions'
Markus Hübscher, Credit Suisse Asset Management

play. It is now clear that neither of the two have, to date, proved a success. It is therefore no surprise that more than 30 sector products have already gone to the wall. Their failure is largely a result of the aftermath of the 2000-2002 equity bear market that saw investors return to a focus on fundamentals, avoiding 'theme' and 'idea' based investments.

WORKINGS

Exchange-traded funds are, as the name implies, funds traded on a stock exchange. ETFs consist of two different markets: a primary market for subscription and redemption of shares, and a secondary market at the exchange, where they are traded. (See Chart 2.)

In the primary market, market specialists create and redeem shares in the ETF at its net asset value (NAV) on a daily basis. This is done in large blocks of shares, typically in excess of €1m, which represents a creation or redemption basket. These new shares, once created, can then be traded in the secondary market.

In the secondary market, ETFs are bought and sold in exactly the same way as equities. This is a key difference between ETFs and mutual funds as investors do not subscribe/redeem units with the fund management company, rather they execute buy/sell orders through a stockbroker dealing directly with stock exchange market makers.

Due to the fact that an ETF is linked to an index, market makers can easily provide continuous pricing because its intra-day NAV moves in line with the respective index. This unique feature allows market makers, arbitrageurs and other market participants to trade the ETF close to its intra-day NAV, as any discount/premium is likely to be rapidly closed by investors for a risk-free profit.

'Some observers have also expressed concerns about the liquidity of these new vehicles. However, this subject is very often misunderstood'

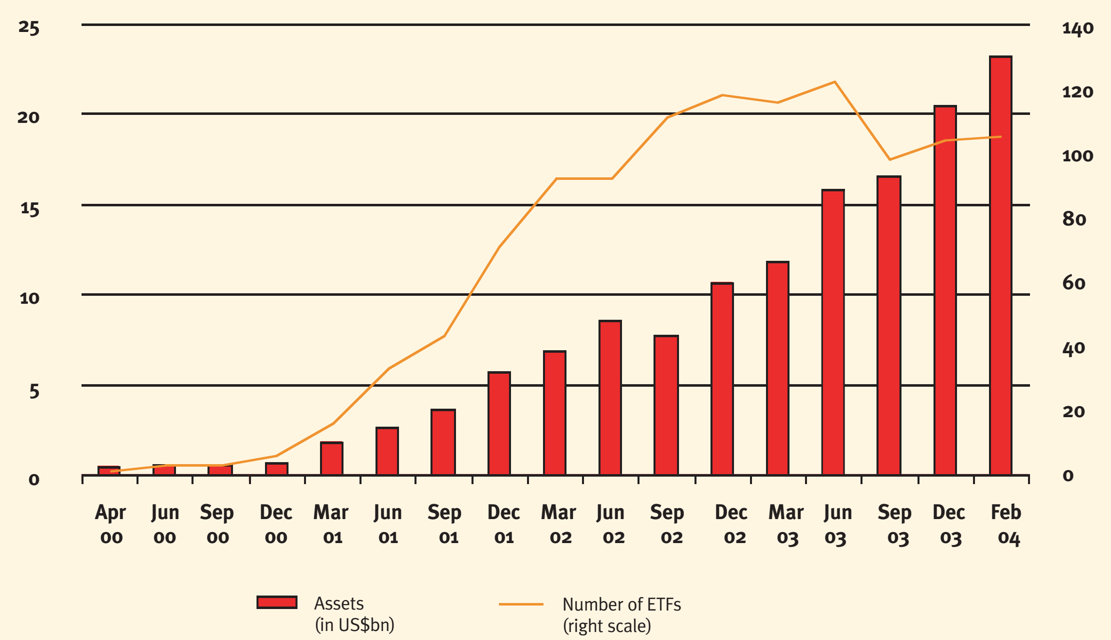
Some observers have also expressed concerns about the liquidity of these new vehicles. However, this subject is very often misunderstood, as an ETF's actual liquidity is a function of the marketability of the underlying securities held in the fund (and therefore of the index). Investors can easily go to a market maker and fix the price of an ETF off-exchange (ie intra-day NAV plus spread and commission).

USERS

There are a number of different investors that currently trade ETFs. These include private client stockbrokers managing discretionary portfolios, fund of fund

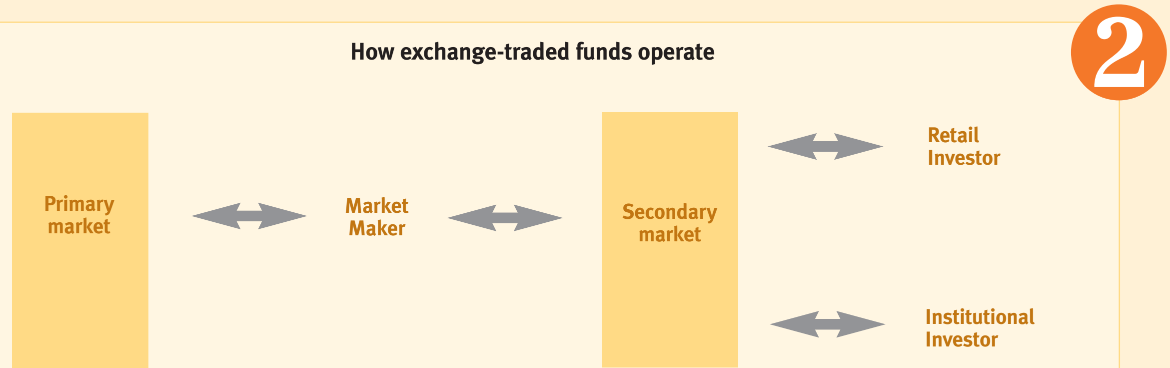
1

Significant growth record of exchange-traded funds in Europe



Source: Morgan Stanley

How exchange-traded funds operate



providers, as well as professional investors for specific strategies such as structured products and cash equitisation.

FUTURE TRENDS

The development of the industry in Europe over the near term will be characterised by further new product launches, together with consolidation amongst existing ETFs that have not achieved critical mass. We see established providers such as XMTCH and iShares continuing to grow and enhance their market share in Europe.

While we also expect more equity ETFs to be launched, the number of new vehicles is anticipated to be much smaller compared to previous years. This is due to the fact that most of the blockbuster products (Eurozone and local indices) have already been launched, with few product gaps remaining.

New product development will continue to focus on fixed income ETFs, which are expected to prove attractive to investors for the following reasons:

- Government bond ETFs with a specified term structure allow the investor to remain within a maturity window without constant portfolio re-balancing, and
- Corporate bond ETFs enable investors to obtain exposure to a diversified, investment grade credit portfolio.

The best of ETFs

Here are three key benefits of exchange-traded funds:

- **They combine the flexibility of equities (intra-day trading and pricing on a regulated exchange) with the diversification and efficiency of a fund.**
- **They are a simple, cost effective way to gain exposure to an asset class in a single trade.**
- **They provide a core building block for an investment portfolio as part of an asset allocation strategy.**

PROGRESS

One of the key developments over the medium to longer term will be the increased cross-border listing of ETF products.

Some progress has been made in this area, but more is necessary as this remains a cumbersome process in many European jurisdictions, largely due to a fragmented market place characterised by different regulatory regimes and stock exchanges.

Cross-listing is important in Europe, because securities bought in the domestic market are usually cheaper (through lower commission) than securities purchased abroad. Once this process starts to gather pace, a consolidation amongst ETF providers is anticipated as a more homogeneous market structure takes shape across Europe.

In summary, the European market has expanded rapidly over the past three years. Whilst development in certain areas went too far, ETFs remain one of the most interesting financial innovations of recent years and, going forward, they are expected to continue to grow significantly.

Markus Hübscher, managing director,
head of quantitative portfolios,
Credit Suisse Asset Management