fin-sight

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Sameer Kamath, Chief Financial Officer

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Exchange Traded Funds (ETFs), the next game changer: Learnings from the global experience

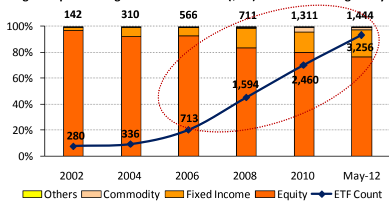
Recent growth of ETFs in the global context

Tough economic scenario, pressure to perform despite volatile markets, inability in attaining alpha consistently, increased regulations post-2008 and heightened competition caused the recent popularity in passive investing, especially low-cost ETFs

ETFs, mostly index funds trading like stocks that help achieve diversification, benchmark returns, access to multiple assets and real-time asset allocation at a low cost, have seen strong growth. Although in existence since 1993, the last few years saw them accumulating scale. As of May 2012, there were 3,256 ETFs with assets of $1.4tn globally vs. 1,171 funds and $797bn assets in 2007 and 280 funds and $142bn assets in 2002. Over 80% of US ETFs today were launched in the last 5 years. ETF AUM has advanced within mutual fund assets, though the proportion is still quite small at ~6%.

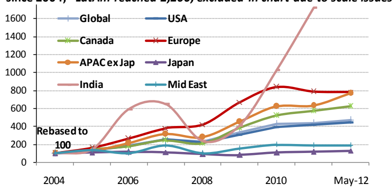
- Equity, though still the largest constituent within global ETF assets, has declined in proportion from 92% in 2007 to 77% as of May 2012. This is attributable to the recent volatile equity climate which shifted focus towards newer, uncorrelated assets for diversification and reducing risk. Main gainers were fixed income and commodities. Another emerging trend is the move towards international equities, as seen in USA
- In terms of geography, the share of USA, Japan and Europe has declined from 95% to 91% in the last decade. Asia Pacific (ex Japan), Latin America and countries like Canada have shown stellar growth, although they still comprise a relatively smaller share of the global ETF pie
- ETFs now account for over a third of US passive investing (index mutual funds). Tradability and lower costs are advantages it offers over most traditional index funds. Though active ETFs also started from 2008, they still constitute a very small portion due to the focus on beta
- ETF challenges traditional distribution models as it pays little to no distribution fees and it is tough to track subsequent flows coming through brokerages. However, it is finding favour from the fee for advice model as its low-cost and access to diverse assets benefits financial advisors

Fig 1: Exponential growth in ETF assets ($Bn) and fund count globally



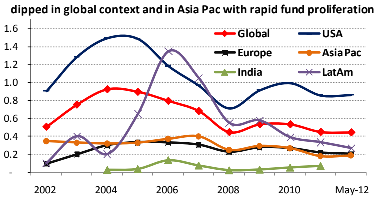
Source: Blackrock ETF report

Fig 2: Assets grew sharpest in LatAm, India, Asia, Canada, Europe since 2004; *LatAm reached 2,200, excluded in chart due to scale issues



Source: Blackrock ETF report, Capitaline, oanda.com

Fig 3: Though assets are growing, average AUM per fund ($Bn) has dipped in global context and in Asia Pac with rapid fund proliferation

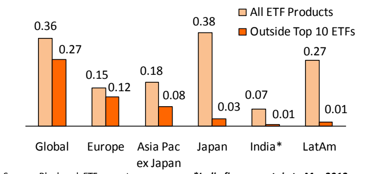


Source: Blackrock ETF report, Capitaline

Few takeaways from the growth trends seen globally

While ETF assets grew globally, the average AUM per Fund has declined, particularly in Asia Pacific and Japan, owing to strong addition to fund count. India has been an exception given its rapid addition to gold assets, though it is in line with Asia in terms of equity ETFs. Increase in smaller sized funds outside the Top 10 ETFs presents a concern, since this impacts players' profitability. The bigger the fund, the better it achieves economies of scale and break-even. As per recent research, a majority of the new funds launched in USA in 2011 are struggling to reach even $30mn of assets.

Fig 4: Diff in AUM per Fund ($Bn) between Overall and Outside Top 10 funds stresses the concentration of Top 10 ETFs in each market



Source: Blackrock ETF report; *India figures pertain to Mar 2012

Traditionally, ETFs were held initially by institutions, followed by financial advisors with retail acceptance building over time. ETFs became popular with institutions due to low cost, risk diversification, new beta exposure and short-term liquidity management. Though slow to pick up in the retail space, it has started gaining acceptance of late, to the extent that retail now holds nearly half of global ETF assets. However, many emerging markets like India actually saw ETFs demanded more by retail initially, though this is attributable to the proliferation of gold ETFs.

ETF growth has been more due to net inflows rather than price appreciation, given the recent volatility in asset prices. Global ETFs have seen consistently high net inflows since the past 4-5 years, with 2011 clocking $164bn. New money in 2011 was at par with 2010, though the overall growth was 26% in 2010 vs. 3.2% in 2011, stressing the overall impact of net inflows and asset price declines.

Fig 5: Global ETF industry growth attribution in 2011 (vs. 2010)

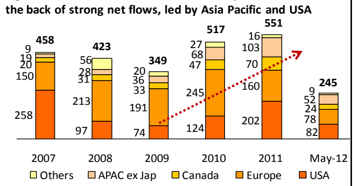
	USA	Europe	Global	USA	Europe	Global	USA	Europe	Global
	Total industry growth			From cash flows			From asset prices		
Equity	-0.4%	-8.7%	-1.4%	8.5%	9.2%	10.0%	-8.9%	-17.8%	-11.4%
Fixed Income	32.8%	-0.9%	23.5%	32.8%	-0.7%	23.6%	-0.1%	-0.2%	-0.1%
Commodity	NA	15.3%	15.9%	NA	16.8%	17.2%	NA	-1.4%	-1.3%
Total	5.1%	-4.9%	3.2%	12.5%	7.8%	12.5%	-7.5%	-12.7%	-9.3%

Source: Deutsche Bank report: 2011 ETF Market Review (*Total includes currency, multi asset, alternate assets also)

Increase in new money generated new ETF launches and product development. The industry has seen higher number of launches each year since 2009, led by Asia. New ETFs from China, South Korea and USA in 2012 rank amongst the largest fund launches made this year. With the industry maturing, the move towards novel funds should intensify, which also provides an entry for smaller, boutique AMCs.

ETFs' ability to increase in investors' access to multiple assets, many of which were not easily within reach earlier, has benefited the varieties available for new funds. Segments relatively successful in USA during the crisis, like Pan Asian bonds, US dollar and commodities, are some such funds.

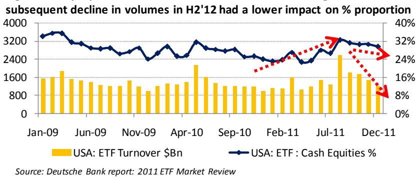
Fig 6: New fund launches increased each year since 2009 on the back of strong net flows, led by Asia Pacific and USA



Source: Blackrock ETF report

Trends in evolved markets like USA show that as ETF volumes grew, its contribution towards cash volumes have shown more resilience even during a drop in overall cash volumes. During downturns, there is a shift in the investors' preference towards passive products, rather than active investing. Despite lower trading volumes, one has seen significant asset addition in the ETF space, demonstrating the increased appetite for such products.

Fig 7: With proportion of ETFs to cash volumes in USA rising since 2010-end, subsequent decline in volumes in H2'12 had a lower impact on % proportion



Source: Deutsche Bank report: 2011 ETF Market Review

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Market trends that aided the recent surge in ETFs globally

- **Volatile markets and inability to generate alpha consistently**
  In volatile times, diversity is key. Since 2008, market volatility has risen globally, thus increasing perceived risk and the inability to beat benchmarks consistently (alpha). This brought the focus on benefits of passive, un-correlated and diversified investments. As investors seek to balance growth with risks, they are increasingly looking at lower-correlated assets and ETF products help in this.
- **Gradual move from 'Commission Model' towards 'For Fee Model'**
  Financial advisory is seeing a gradual shift from commission based to fee based advisory. This is largely due to the inability of investors to pick correct options, given the product proliferation, volatile markets and shifting focus to newer assets which many are yet to understand – thus increasing the demand for advice. Since advisory charges a fee for advice over and above other portfolio costs, they seek low-cost options and ETFs fit this bill. This trend is a boon for ETFs, as many distributors were otherwise reluctant due to the low commissions earned on ETFs.
- **Popularity with Financial Advisors (RIAs/IFAs) for their clients**
  ETFs are changing the way advisors work with clients. UK IFAs and US' fee-based RIAs are increasingly using ETFs for their retail clients (mostly in discretionary accounts in UK). This is due to its ability to take diversified, yet focused exposures while keeping portfolios simple and at low cost. With few ETFs addressing asset allocation, advisors now get more time to develop client relationships. Recent surveys by iShares and Schwab shows that IFAs and investors are keen on ETFs, though lack of understanding is a concern
- **Regulatory changes banning commissions to give ETFs a boost**
  A change from commissions to fee for service in Australia boosted ETFs. With Hong Kong evolving as a major force behind the ETF growth drive in Asia, its SFC recently announced to enhance transparency levels for investor protection. UK's Retail Distribution Review and USA's SEC 12b-1 rulings should also boost the market. According to Moody's ETF Industry Overview report, increased disclosure would help improve transparency, investor confidence and acceptance.

Features particular to ETFs that encouraged their popularity

- **Low fees, trading costs:** Most ETFs are not actively managed hence role of the portfolio manager is limited. ETFs usually have lower marketing and distribution costs. Its cost efficiency has been a critical driver, especially in period when cost-rationalization has came under intense focus
- **Diversification:** ETFs gain broad exposure to entire sectors, countries and assets, including specific exposures like the infra sector of Brazil, mining sector of Australia etc. ETFs made commodities accessible for retail investors - otherwise cost-prohibitive as it had to be bought in lots
- **Tradability:** Since ETFs are listed on an exchange, they are tradable like shares. Investors can trade real-time using intraday price movements
- **Costs:** Costs related to any short term inflows/outflows into mutual funds, like STT, brokerage and market impact costs, impacts all the investors in that fund. But in the case of ETFs, the cost of trade while buying/selling the underlying ETF basket shares is borne by those particular investors only. Thus, long term investors into ETF are not impacted by inflows/outflows from the ETF
- **Tracking error:** Apart from being passive funds tracking indices, which have of late been generally more successful than funds chasing alpha, ETFs are also able to maintain low levels of cash which helps reduce tracking error. This is because flows are added to its AUM only when the underlying portfolio baskets are received by the ETF, and not when applications are received originally. This reduces the ETF's tracking error
- **Features like an equity share:** Ability to buy on margin, sell short, trade with stop and limit orders, replicate hedge fund-like strategies etc
- **Transparency:** ETFs, including active ETFs, disclose the composition of their portfolios daily, hence investors know what they own each day

Some characteristics that were specific to the more successful ETFs, given the competitive scenario

- **Some of the best performing ETFs were linked to less exotic indices.** Performance of most exotic funds were unable to match that of regular ETFs, because exotic ETFs were difficult for most investors to understand – ***The simpler, the better***
- **Indices with long-term appeal:** Despite many ETFs launched to benefit from current market situations, they are recognized to have a limited success life. Being linked to an index with a long-term appeal have been more attractive for investors usually
- **Proliferation outside traditional equities:** Fixed income has been amongst the rapidly growing ETF segments in recent years. The potential for further growth exists as investors are yet to fully tap on-exchange trading opportunity in newer segments
- **Product innovations:** As the ETF market evolved, the demand for more innovative products grew. For ex: Non-cap weight index ETFs, alternate asset ETFs, inverse ETFs (which profit when the underlying index declines) etc
- **Minimal tracking error:** ETFs with low tracking error (difference between fund and benchmark returns) have generally been more successful

Certain investment strategies that investors globally have and can achieve with ETFs

Core-Satellite investing, like often used for institutional portfolios, is now popular in retail portfolios as well. Retail investors are increasingly using passive investing for core exposure, seeking benchmark performance to minimize the risk of lagging the market. This is ideally serviced by the numerous low-cost ETFs tracking broad indices. Actively managed satellites seek concentrated, targeted exposure to certain sectors, assets and markets to tap outperformance (alpha).

Tactical or arbitrage investing: ETFs can be a useful way to go overweight/underweight in markets, based on short term views. Arbitrage is facilitated by the transparency and liquidity of the ETF's portfolio

Dividend ETF portfolios for current income are appealing in the current scenario, with each underlying paying a dividend monthly, like the Monthly Dividend ETFdb Portfolio

Exposure to undervalued segments: Short-term market movements may render certain sectors relatively undervalued. Assuming such sectors to typically converge to their true value in the long run, such sector ETFs are often used

Pairs trading: Those with deep understanding of markets can use ETFs to capture stock vs. sector performance differential - buying the stock and shorting its sector ETF if the company is expected to better its peers, and vice versa

Fixed income ETFs often optimizes the index to comprise only part of the universe since many bonds trade in lower volumes. It lowers risk of investing in single bonds, offers a bond basket with single trade and replaces maturing bonds

Short-term traders may often look at buying above 200 DMA (markets above 200 DMA typically recover after short-term pullbacks) and exiting once markets closes above 5 DMA

Portfolio completion, access to alternative assets: Gain targeted exposure to certain sectors, markets and assets, and to assets like commodities, currencies which are typically uncorrelated to broader equities

Leveraging and shorting. Margin investing can be profitable, but interests may deteriorate returns. In USA, shorting stocks on a downtick is prohibited, while ETFs are exempt, thus easing short selling with ETFs

Investors with cash parked in their portfolios for some time can use ETFs like short-duration bond ETFs instead of money market funds, as they may often pay better yields than money-market funds

Investors could also use ETFs **as an alternative to futures**

How is the global ETF market expected to evolve going forward

The potential for ETF is unparalleled, since each index that can be replicated signifies a possible product

- **The initial period of entry** into ETFs ushered in first-movers who had manufacturing capabilities due to their experience in index MFs. **The next stage** will require AMCs to target specific, focused segments. Growing investor acceptance, new entrants and fund proliferation means competition will intensify. New entrants may also need to compete with niche, novel products to grab market share from larger rivals
- This will require product innovation to differentiate from a multitude of funds, incentivizing distribution channels, technology for service capabilities. **Thus, build a unique value proposition in an increasingly crowded market for clients who are becoming much better informed**
- **Smaller players are already making a mark,** especially in growth markets like Asia Pacific. For example: **Samsung and Huatai**, who did not figure amongst the Top 5 players by AUM back in 2009, have scaled up rapidly to break into the Top 5 rankings in May 2012

Product segments are diverging

1. **Vanilla, beta products** competing on being low-cost and high-volume, and passing economies of scale to its customers through favourable pricing
2. **Specific exposures** targeting non-correlated assets and using sophisticated products. This also comprises of few, smaller AMCs who can compete on costs only on reaching a level of scale
3. **Sophisticated products** targeting niche, unmet investor needs by very specialized fund houses
4. **Quasi-active ETF** products that track indices created for that ETF particularly, similar to active managers

Changes in the way business is run

1. Balance operating costs for higher marketing/advertising needs by outsourcing non-core processes
2. Distributors to seek manufacturing capabilities or using its own established client network to enter into partnerships with smaller ETF players who are looking to achieve scalability
3. Building operational processes that are scalable and adaptable to handle rapidly growing and evolving businesses across assets, markets, currencies and client types, while keeping costs low

Few potential opportunity areas

1. Grow ETFs as a substitute for index mutual funds, given the potential to tap passive space further
2. Segments where ETFs are yet to gain share: like mid-cap blend equity, high-grade fixed-income etc
3. Rise in costs due to newer regulations may boost other revenue sources like securities lending
4. ETFs of ETFs and ETF Wraps to become popular, negates exposure risk to a narrow-strategy ETFs
5. Non-traditional ETFs like commodity (copper, hard commodities), leveraged, inverse, quasi-alpha funds

Global trends that may support this growth

1. Growing focus on fund costs, owing to poor returns from active funds boosting cheaper passive demand
2. Demanding diversification through uncorrelated assets - ETFs now make such assets easily accessible
3. Growing trend towards fee-based advisory is aligning focus on low-cost products like ETFs
4. Pressure by distributors on AMCs for a larger revenue share or similar sharing agreements as incentive
5. Regulators demanding greater disclosures and transparency - ETFs are at an advantage here

Despite the growth story, some concerns linger

1. Possible increase in non-performing ETFs (reaching a profitable scale), given the rapid proliferation
2. Level of investor awareness and understanding is still relatively less, which can lead to misinformation
3. Although overall liquidity of ETFs has picked up, every ETF may not be very liquid by themselves

Game plan for India: Above sections highlight learnings from the global experience that may be relevant for India

The ETF market in India comprised 34 ETFs with $2.3bn assets by Mar 2012 - 52% CAGR in last 7 years. Surge in gold prices and volatile equity markets shifted focus to gold since 2008. By 2012, gold ETFs comprised 86% of Indian ETF assets, which include 8 out of Top 10 funds. Within equity, although their proportion stood at 10% in 2012, its 7 year CAGR has been 12%.

As Asia's growth outpaces its peers, India presents a large growth potential. For instance, with mutual fund assets at ~$122bn in Mar 2012 and ETFs comprising just ~2% of it, a significant opportunity exists to expand that 2% itself. Past figures show that this % proportion figure has doubled within the last 5 years itself. This opportunity is more expansive in the Equity ETF space which just comprised 0.6% of equity MF assets. **However, the market poses challenges as well:-**

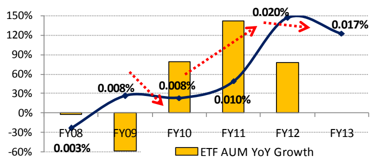
- Need to develop further products (including product varieties) at effective pricing and distribution strategies as an USP to tap market share away from mutual funds and players in the ETF space.
- Rapid growth of ETFs with small asset size (<$20mn) remains a key concern to remain profitable
- Banks, one of the largest distributors in India, prefer selling MFs as they don't require demat A/Cs
- Liquidity of the underlying stocks is a major driver for ETF players to mirror a particular index. This may restrict the number of indices on which ETFs can be modeled
- Lack of investor awareness & education may lead to misinformed decisions and slower acceptance

Fig 8: Rise in number of ETFs with AUM <Rs1bn ($20mn)

	FY06	FY08	FY10	FY12
> Rs 3bn	1	2	4	8
Rs 1-3bn	2	5	3	2
<Rs 1bn	3	5	14	24
Total	6	12	21	34

Source: Capitaline

Fig 9: In India, the proportion of ETF volumes to overall cash trading volumes has typically lagged the YoY growth rates in ETF assets, as seen during the last few years



Source: Capitaline

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