Elevating ETFs - digital assets, market trends and sector trajectories

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Executive summary

The global exchange-traded fund (ETF) market hit a new record of assets under management of over $11.6 trillion at the end of 2023 as strong market performance, and clear investor preference in the asset class fueled growth in the market. As we expect this trend to continue, and promoters look to unlock retail investment, we expect assets in global ETFs to surge to $25 trillion by 2030.

Active ETFs have been a hot topic in ETFs for a number of years, but 2023 has been a transformative year. Assets in the segment have grown 250% since 2020 to reach $700 billion. The United States (US) led this shift, with Europe poised for accelerated growth in 2024. Across both regions, we have seen a number of promoters launch product or put plans in place to launch product in 2024.

Artificial intelligence (AI) is reshaping the asset management industry with managers looking to complement efforts by personnel in back-office functions with AI. The ETF landscape is no different where we have seen the emergence of AI-powered ETFs. Although offering rapid responses to market events, it also introduces new challenges for the industry to overcome.

Inflows into environmental, social and governance (ESG) ETFs cooled in 2023, as market dynamics resulted in a flight to so-called safer asset classes, and attitudes toward ESG ETFs by investors have shifted. Despite short-term caution, ESG-focused ETFs are expected to remain a long-term investment theme, evolving toward themes generating fundamental long-term value.

Digital assets are starting to gain traction, particularly with SEC approvals for spot bitcoin ETFs, and may start paving the way toward tokenization of assets, although challenges in liquidity and mismatches in settlement prevail. Efforts to shorten settlement times may accelerate the trajectory of tokenization in ETFs.

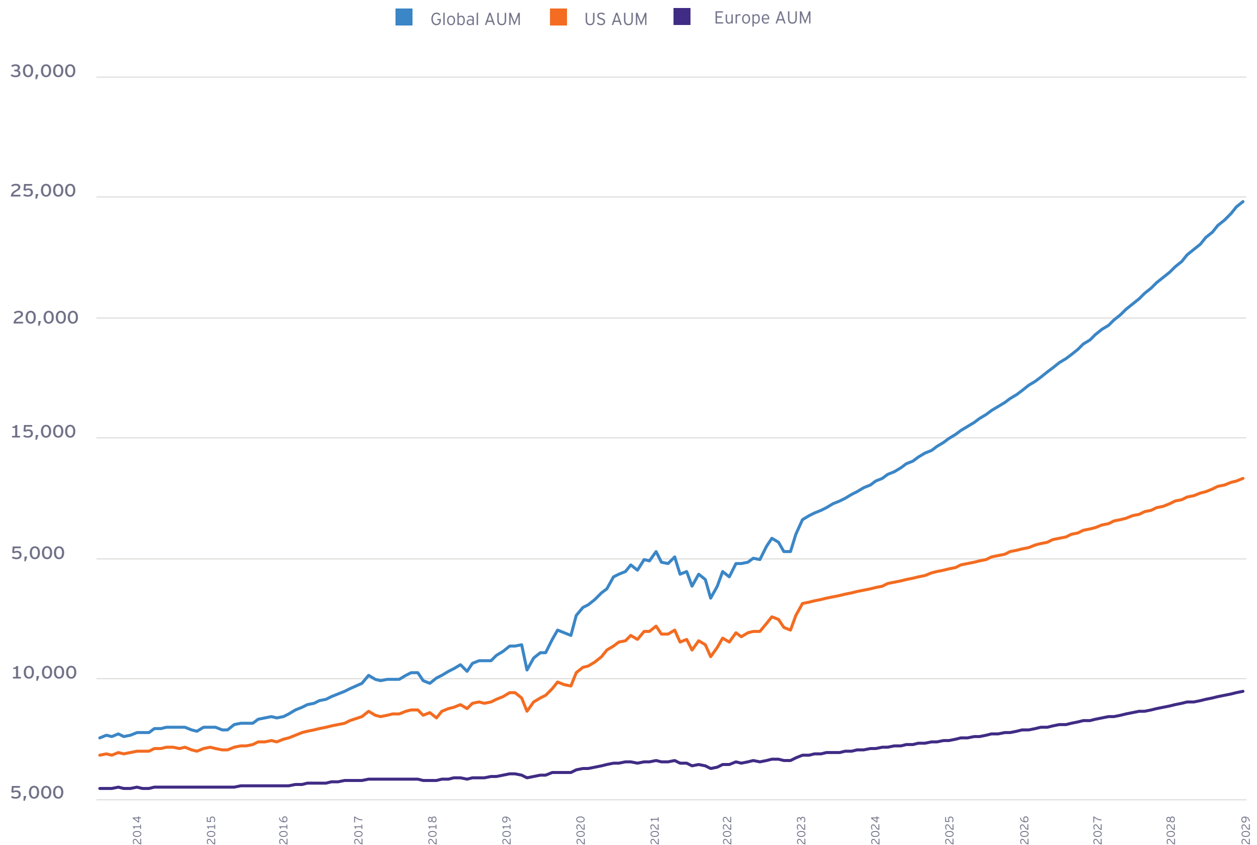
ETF market performance in 2023

The ETF industry is starting 2024 in a very strong position as it continues remarkable growth over the last decade, with monthly net inflows every month for almost five years. Strong market performance at the end of 2023 saw the industry hit record highs in assets under management (AUM) in each of the regions, with over $11.63 trillion invested in ETFs globally, doubling in the four years since the beginning of 2020.

2023 continued with the market turbulence we became familiar with in the 2020s. In an effort to tame inflation, central banks worldwide continued to tighten monetary policy, leading to recession concerns. A liquidity crisis within the banking sector led to the collapse of three mid-sized banks in the US and the takeover of Credit Suisse by UBS, all against a backdrop of continuing and escalating geopolitical conflict.

This caused markets to experience periods of sharp volatility while finishing the year with strong gains. Against this backdrop, continued inflows month-on-month combined with a strong market performance fueled assets invested in ETFs to new heights. We expect these inflows to continue. Momentum in the industry is buoyed by investor preference for the readily accessible ETF with a 'real-time' view of performance and by managers who see the benefit of ETFs as a distribution channel. The growth rate in this market segment continues to exceed expectations, and we expect assets in the industry to hit $25 trillion in 2030.

ETF market growth

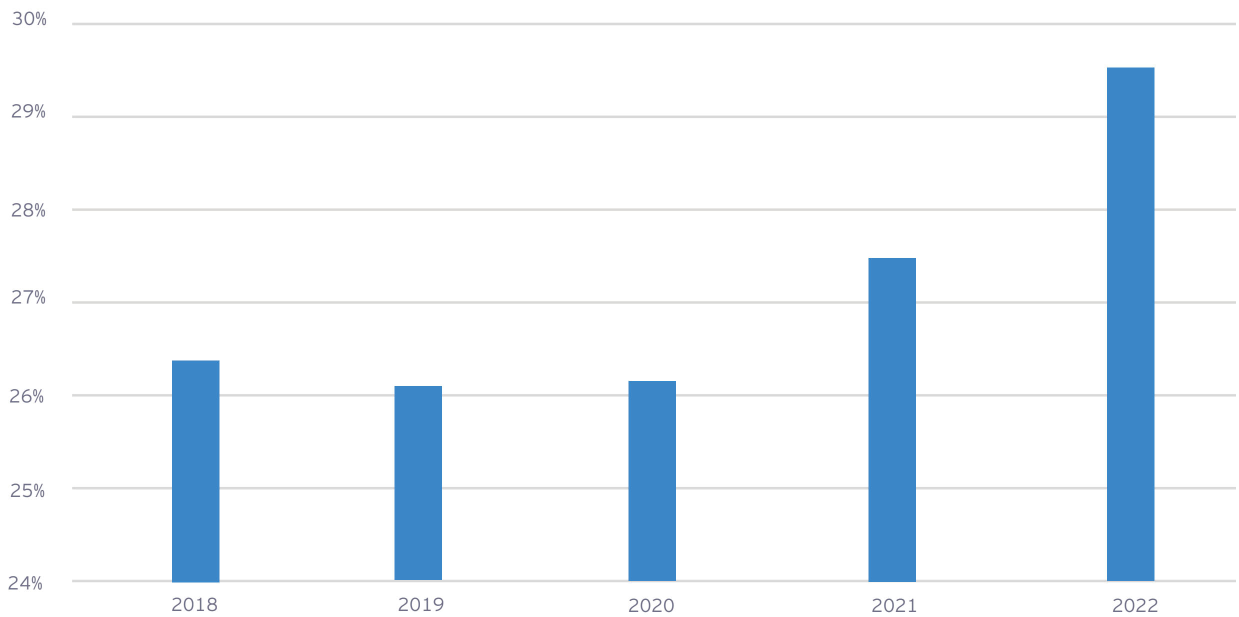


Is retail adoption ready for take-off?

With a population of almost 500 million people in the European Union (EU) and the United Kingdom (UK) – 1.5 times that of the US – there is a huge opportunity for growth for providers who can effectively target the retail investor market in Europe. However, this has proved to be a much tougher market to penetrate.

In 2023, the EU Commission launched its retail investment strategy as part of its capital markets union initiative to empower and encourage retail investors to participate in financial markets. Strides have been made with the participation of retail investors in the wider funds market in recent years. The European Fund and Asset Management Association's (EFAMA) December 2023 Asset Management Report highlights an increase in the share of financial assets managed on behalf of retail investors. Thirty percent of assets in all funds managed in Europe were attributable to retail investors, growing from 26% in 2020, and ETF providers will be eager to get their share of this.

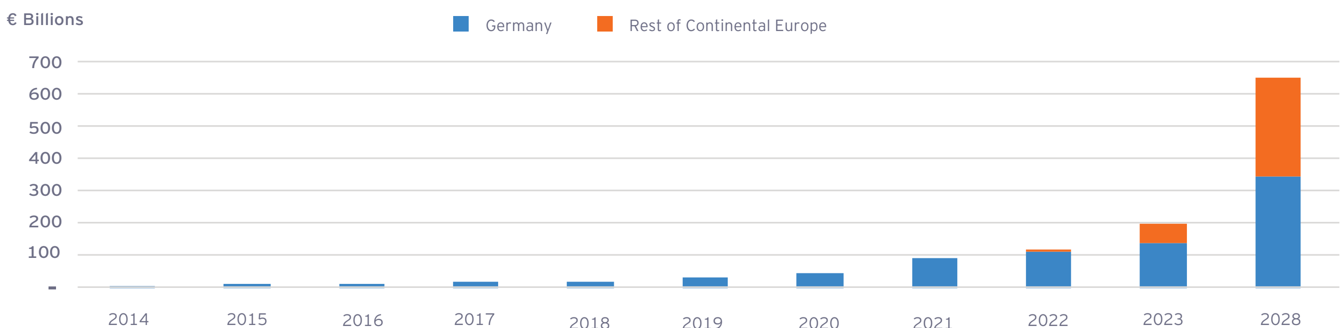
Retail investors share of European Fund AUM



Coupled with this, there are several initiatives by market participants directly empowering retail investors to adopt ETFs:

Savings plans in Germany have been very successful, with similar offerings starting to be introduced in other European countries. Across 2022 and 2023, several other countries across continental Europe have begun launching ETF savings plans, most notably across Italy, Spain, France and Austria. It's estimated these plans will have EUR200 billion invested in European ETFs in 2023. Research conducted by extraETF expects this to grow to EUR650 billion by 2028.

ETF holdings of continental Europe's saving plans



ETF providers are also partnering with online platforms or making acquisitions, for example JP Morgan's acquisition of Nutmeg and AXA IM's partnership with Italian online trading platform Directa SIM, to target direct distribution to retail investors.

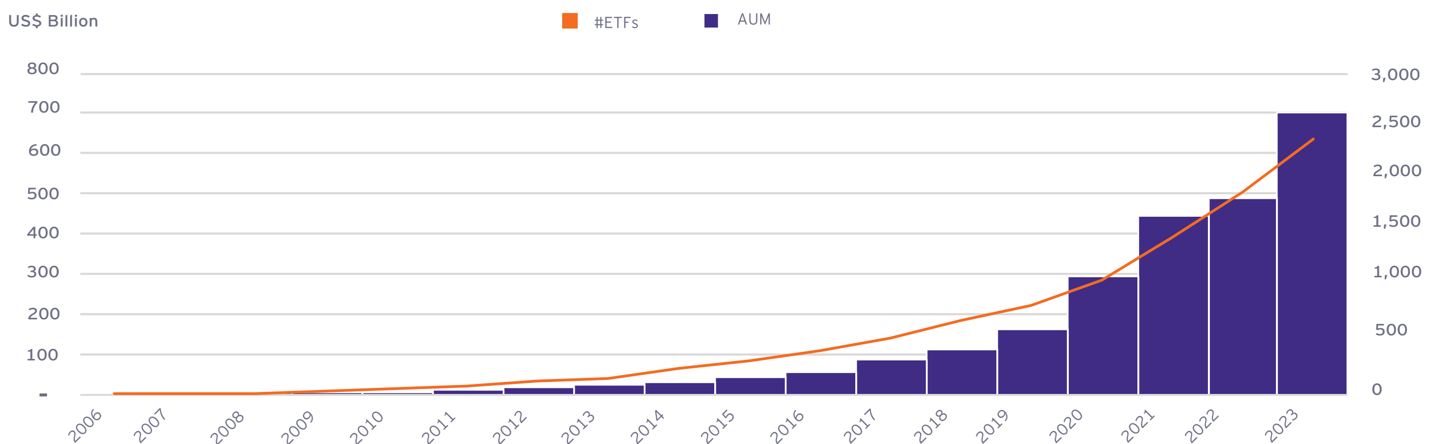
As these initiatives from regulatory authorities and market participants continue to evolve and mature, we expect retail investors' participation in financial markets to continue to grow, with the ETF market uniquely poised to see the benefit of this and propel the ETF industry to even higher levels of assets under management over the next decade.

Active ETFs continue to gain momentum but are we at a tipping point for the industry?

After years of promise in the active ETF space, the market began to accelerate in 2020 and has grown 250% since then.

Ending 2023 with $700 billion in assets under management, it now represents over 6% of the global ETF market.

Growth of active ETFs



Providers in the US have been driving this growth, with 2023 considered a tipping point, as most ETF launches during the year were in the active space. A combination of factors is powering the meteoric rise of active ETFs in the US over traditional mutual funds, most notably the inherent tax benefits of ETFs (predominantly in the US), more efficient cost structures and increased tradability.

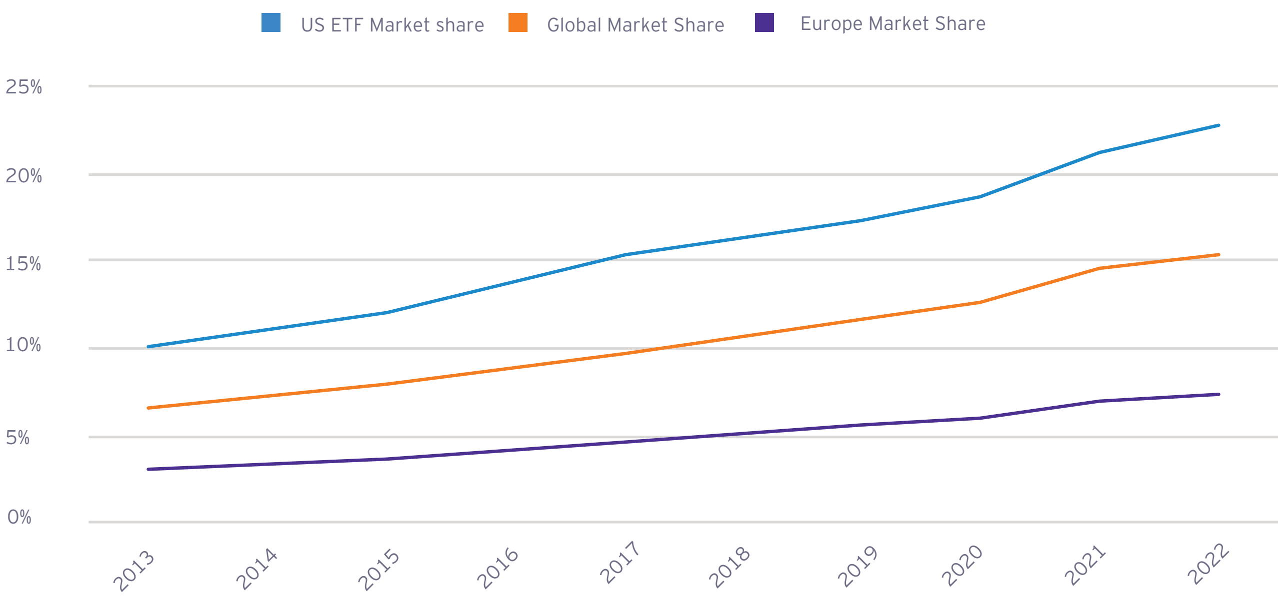
In the past, ETFs have been synonymous with passive products, but the increased popularity of active ETFs has seen managers eager to test the active ETF market. Large numbers of US managers have launched new products, with a

steady flow of managers converting their traditional mutual funds. These include industry powerhouses such as JP Morgan and Fidelity, which are converting large swathes of assets in their traditional mutual funds into ETFs.

In 2020, the first wave of semi-transparent ETFs was launched, as the structure was authorized by the SEC when transparency was a key concern of managers for this aspect of the industry. However, if we fast forward to today, these concerns appear to be receding. In 2023, less than 2% of the assets invested in active ETFs are in semi-transparent structures. While we believe there is still a place for the semi-transparent structure, this shows a clear preference from investors for a transparent structure.

We have seen the barriers to entry to the ETF market rapidly falling, with a proliferation of white-label platforms, among other areas, leading active managers to launch their first ETFs. Some of these are looking at ETFs as a core part of their current offering, while others are looking to future-proof their business to have a track record in ETFs for when they need to expand their offering.

ETF AUM as a percentage of Regulated Fund AUM for each of the regions

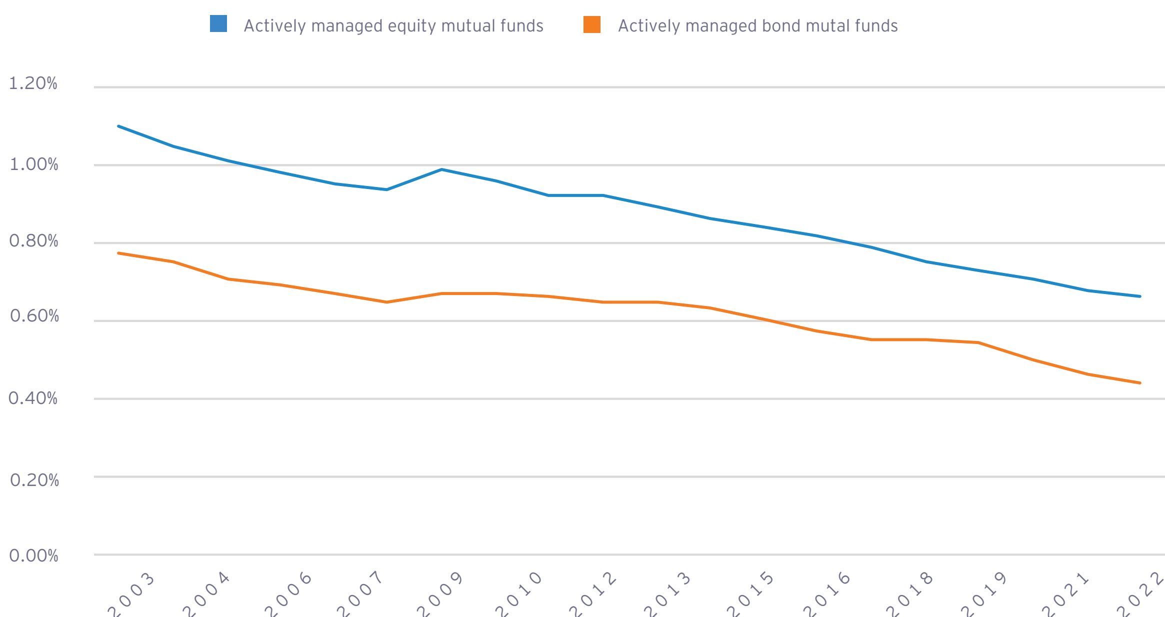


It's been a long-held argument that mutual fund managers launching ETFs would cannibalize their existing ranges, which has caused some reluctance from managers in terms of launching into the market. Over the last 10 years, we have seen ETFs' share of the global regulated open-ended funds grow from under 7% in 2013 to over 15% in 2022. This demonstrates that greater shares of flows are actively being directed toward ETFs each year, most notably in the US. Although this may reinforce the argument that ETFs could cannibalize mutual funds, it does demonstrate that traditional mutual funds are losing market share to ETFs. Traditional mutual fund managers do need to future-proof their business from ETF launches elsewhere.

Another question from active fund managers is concern over the impact of launching ETFs on the management fees earned. We have an overall downward trend in the average expense ratios of both index and actively managed mutual funds over the long term. This reflects, in part, investors' increasing tendency to buy lower-cost funds.

The average management fee for an actively managed US mutual fund was 0.66% in 2022 versus 0.44% for an actively managed US ETF in 2022. While this suggests that an active ETF will have lower fees, given the long-term trend of lowering fees, we expect that mutual fund fees will continue their trajectory toward those of ETFs. This lowering fee could be partially offset by the potential for economies of scale that could be gained through the ability to distribute ETFs to wide numbers of investors.

US actively managed mutual fund, total expense ratios (TERs)



Following the momentum in active ETFs in the US, many are looking to Europe. Uptake has been slower than in the US, with many suggesting no demand for active ETFs in Europe. However, it's becoming increasingly evident that lack of supply is the issue in Europe. As managers have become comfortable with transparency, many US managers are looking to Europe as an opportunity to open up a new growth avenue. Franklin Templeton and JP Morgan have been the latest providers to launch active ETFs in Europe, with JP Morgan's launch shaking up the providers in Europe, quickly claiming a spot in Europe's top 10 ETF promoters by the end of the year. HSBC has taken an innovative approach to their entry into the ETF market in Europe, launching exchange-traded share classes from its existing global fixed-income index fund. This may provide a path forward for some managers to enter, although there are some regulatory and taxation hurdles to be cleared for this approach.

Yet there's still an acceleration of providers with plans to launch imminently:

- Cathie Wood's Ark Invest has recently acquired Rize ETFs as a move to enter Europe.
- Dutch provider Robeco has hired experienced ETF veterans, showing their intent to enter the active ETF market in the second half of 2024.
- White-label platforms have also reported increasing interest in active ETFs.

Although 2023 may have been the tipping point for the industry in the US, the market is continually evolving and maturing, and we expect the growth in this market segment to accelerate further in 2024.

- **Popular trends in US active ETFs**
  - Low-cost active ETFs with rules-based strategies that seek alpha for a small premium.
  - Potential expansion of crypto ETP products.
  - Active equity income funds.
  - Thematic active ETFs are in vogue.
  - Asset managers are beginning to market portfolio managers with their ETFs, similar to the strong brand/association that Cathie Wood has with ARK.

AI and its impact on the ETF industry

AI as a concept has been around for many years, and numerous organizations have conducted pilots and tests in the area. However, 2022 was the first time AI captured the imagination of the public at large with its ability to have real-world applications. Social media was abuzz with the images created by generative AI and the human-seeming responses flowing from language models like ChatGPT.

Although these are impressive and attention-grabbing, they are only scratching the surface of the potential of AI. In fund management, with its ability to analyze vast amounts of information from various sources, AI can help identify patterns and trends to distil investment research and assist portfolio managers in making more informed investment decisions.

We are beginning to see AI being integrated across different parts of the value chain to complement the humans working in the area, enabling smarter decision-making, more efficient compliance and risk management in constructing and managing model portfolios.

These practical applications have focused on back and middle office functions or assisting active managers in decision-making. Investor interest has also been piqued in the ETF world, with a few AI-powered ETFs launched, such as WisdomTree International AI Enhanced Value Fund and VanEck Social Sentiment ETF. These ETFs have machine learning algorithms trained on large quantities of historical market data to quickly identify market patterns and trends and make investment decisions. AI-powered ETFs have the potential benefits of being quicker to identify and react to market events than human managers in active ETFs and being more flexible than in index-tracking ETFs.

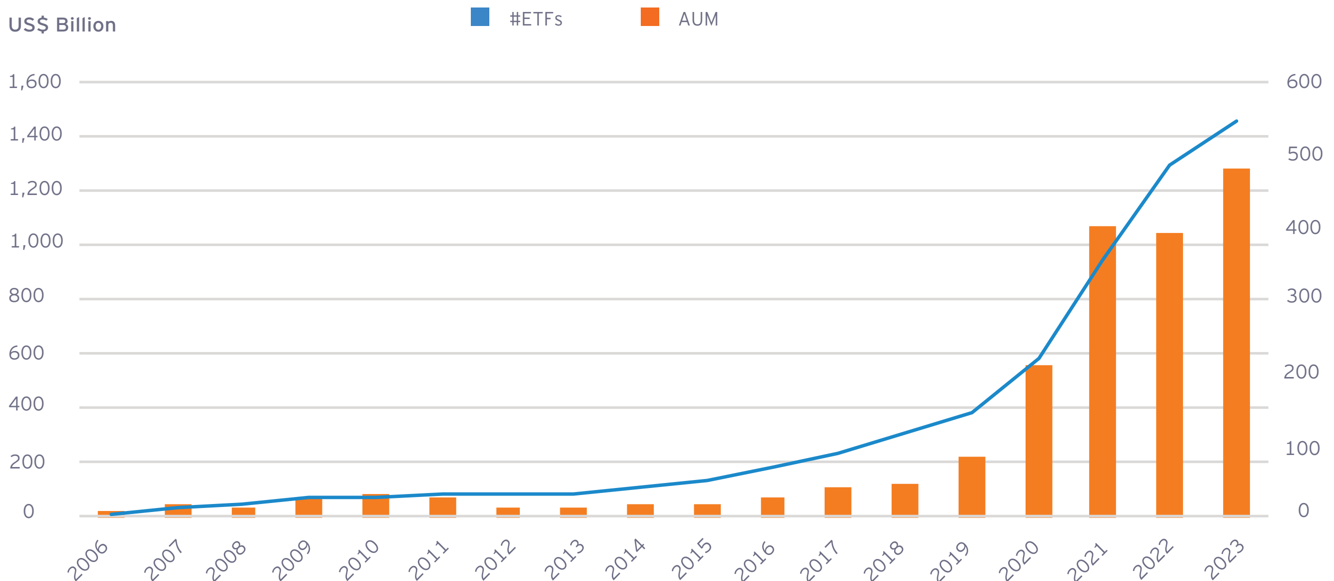
However, investor uptake of these still needs to be seen. AI's adoption and success rely very much on how it is positioned. There must be a balance between enhancing efficiency and maintaining investor trust – an essential building block within the ETF industry. With market volatility and a diverse investor base, there are nuances required in portfolio management that machine learning can only bring to a certain point.

Although AI brings several benefits to the ETF industry, it also presents challenges, including algorithmic biases and the need for skilled professionals to manage and interpret the results generated by AI systems. As technology continues to evolve, AI will likely play an increasingly prominent role in shaping the future of the ETF industry.

A maturing approach to ESG

In Europe, ESG investing has been a strong growth driver, with record inflows from 2020 to 2022. In 2022, over 55% of all inflows into European ETFs were into Sustainable Finance Disclosure Regulation (SFDR) Article 8 and 9 funds. In 2023, however, flows into ESG ETFs have tempered, with just under a quarter of this year's ETF inflows directed into these products. While the segment's overall European ETF market share is growing, it has received less media attention than in recent years.

Maturation of the ESG ETF market



Several factors have weighed on the wider ESG fund market:

- Higher market volatility and interest rate environment causing a flight to safer asset classes, such as government bonds, where it is more difficult to apply ESG strategies
- Poor performance of the markets these funds typically invest in (renewable energy, etc.)

- The poor quality of data on ESG factors from underlying companies
- Investor confusion between the labeling and classification regimes between different jurisdictions
- Investors' malaise and political backlash at the sector in certain regions of the world

These factors have sparked outflows from the wider ESG fund market, particularly led by the US. Increasing regulatory pressure on this area has also contributed, causing caution in the short term.

Varying ESG regimes in different countries do feed confusion in the sector. In recent years, the EU has had a series of initiatives under the European Green Deal, introducing the Sustainability Finance Disclosure Regulation (SFDR), the EU taxonomy and the Corporate Sustainability Reporting Directive (CSRD). The EU taxonomy was established to provide a common framework for evaluating the sustainability of investments and to promote sustainable economic activities. It underpins the SFDR and the CSRD, which were introduced to increase the level of sustainability information disclosed by companies to financial markets and, in turn, used to increase the level of sustainability information disclosed by investment funds to their investors.

The UK's Financial Conduct Authority (FCA) has published its policy statement setting out final rules for its sustainability disclosure requirements (SDR) and investment labels, which will bring in labeling and disclosure requirements over the coming years.

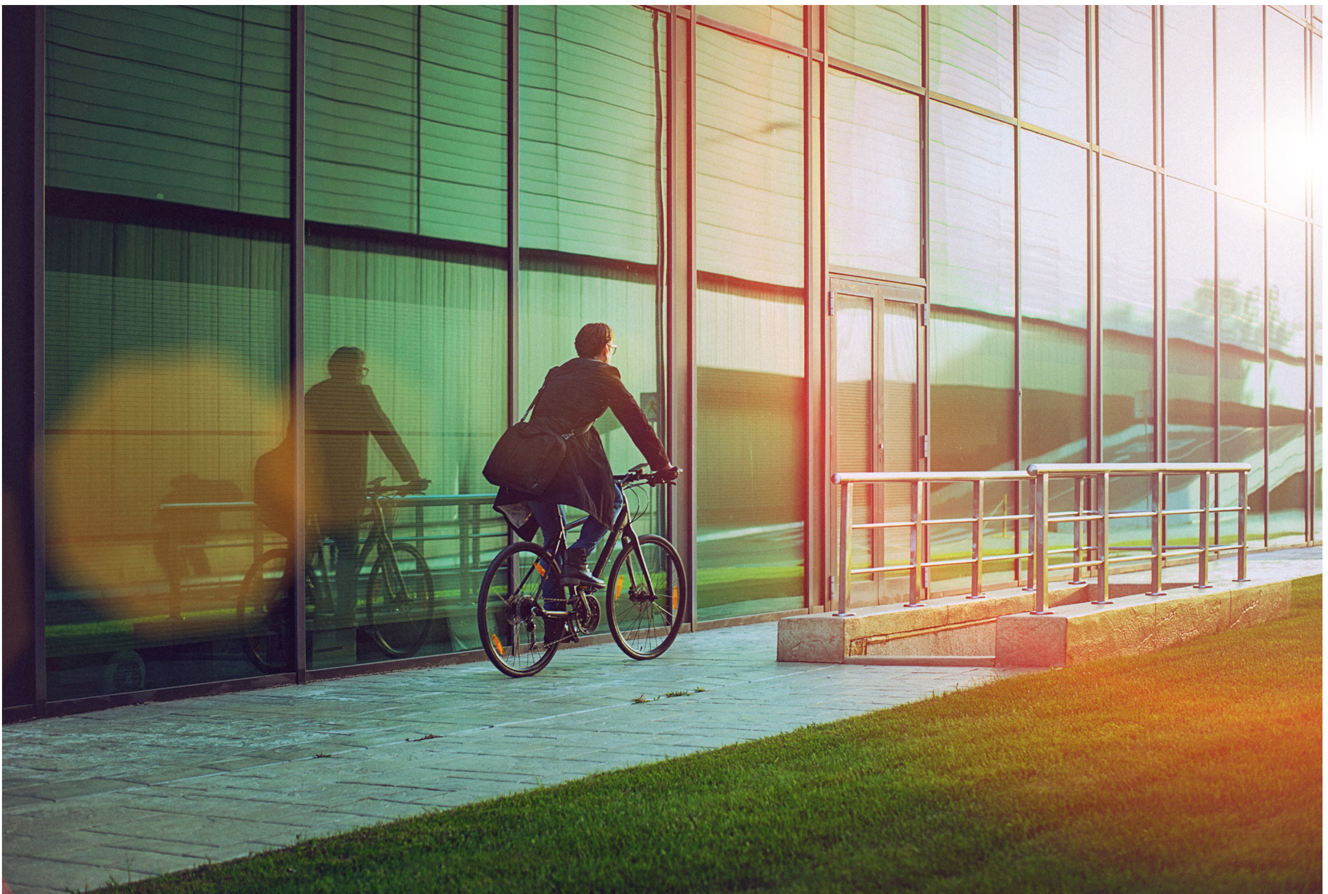
As the fund market, particularly for ETFs, operates as one market across the EU and the UK, differing ESG regimes in different jurisdictions across the one market add operational complexity.

The SFDR is currently undergoing a wide-ranging review by the EU Commission. Included is the potential establishment of a categorization system, which may be the most striking feature and could see the EU's proposals aligned with the UK SDR. Managers in the UK have been broadly positive about the SDR requirements and think it would be very beneficial if the two regulatory regimes were aligned.

With various other regulators around the world implementing their own regimes on ESG and differing appetites among investor groups for ESG strategies around the world, this has become a complex

landscape for managers, and some have become cautious in the area.

However, it is still a strong long-term investment theme, particularly with European investors. The EU has been introducing various measures (such as the revamped ELTIF regime) to encourage retail investor participation in the green transition, and we expect ESG-focused ETFs to be part of this. As the market matures, ESG will likely change from being a broad stroke 'feel good' investment theme to one focused on themes exhibiting indicators of long-term fundamental value as the economy transitions to a future state.



Tokenization: Is this the next evolution of the ETF?

We are seeing market participants increasingly interested in digital assets and tokenization. There have been many steps in recent years as financial markets moved in this direction.

Physically backed digital asset exchange-traded products (ETPs) have been on European markets for several years from providers such as 21Shares and ETC Group, which allowed market participants to trade this asset class on exchange in Europe, although subject to certain restrictions in terms of distribution. In January 2024, the SEC also recently approved applications for 11 spot bitcoin ETFs filed by firms such as Fidelity and Invesco, as well as the conversion of Grayscale Bitcoin Trust into an ETF. This approval fundamentally changed the shape of this segment of the industry from one that was largely unregulated, operating from Europe with under $13 billion at the end of November 2023, to one that is mainly regulated, operating from the US with almost $53 billion, at the end of January 2024.

Although the EU Commission is currently undergoing a wide range review of the Undertakings for Collective Investment in Transferable Securities (UCITS) eligible assets directive, which potentially may open the door for digital assets in the future, diversification requirements under UCITS would see single exposure products (such as the spot bitcoin ETFs approved by the SEC) remain as ETPs in Europe, similar to commodity products and single exposure stock products.

Nevertheless, the SEC approval of these products is fundamental and will see a wider adoption of, and familiarization with, digital assets across mainstream financial market participants. Heralded as the next revolution of the financial markets, this move will certainly galvanize what comes next for the industry. It remains to be seen if this is the approval of another on-trend product type or another step toward tokenization across the asset management industry. And with this, there are questions about the longevity of an ETF wrapper, given that real-time settlements will be at play.

Although the path toward transition of ETFs toward a tokenized product will be over the medium to long-term future, the industry is already working on efforts to speed up settlement across the value chain. May 2024 will see the US and Canada move from T+2 for settlement times of securities to T+1. To shorten settlement timeframes, providers have been working to enhance their trade systems and automate manual processes wherever possible, ultimately bringing operating efficiencies, cost savings and reduction of settlement risk.

This will have a profound impact on the ETF industry globally. It will create liquidity mismatches between ETFs trading in Europe (trading on T+2) and their portfolio of US securities (trading on T+1) or ETFs trading in the US (trading on T+1) and their portfolio of European securities (trading on T+2). This adds additional funding costs to trading, as market makers authorized participants for these ETFs will need to bridge the gap between primary and secondary market settlement cycles.

When trading T+1 becomes routine in the US, and market participants operate to a shorter cycle, we expect calls for Europe to follow the same path, with the European Securities and Markets Authority (ESMA) already having a consultation on this. Europe is a much more complex trading market than the US, with multiple stock exchanges, currencies, languages and legal systems. Shortening the settlement time will be much more difficult than in the US. However, once done, will investors demand that the industry shorten the cycle again?

Tokenization could be the next step if the industry is looking to speed up the cycle further and offer a solution for 'real-time' settlement. The wider asset manager industry is looking at tokenization to increase the efficiency and liquidity of trading in alternative assets (such as private equity or fixed income) and unlock new sources of capital. Some providers have been looking at pilot projects to tokenize the issuance of funds and to work through the commercial, legal and technological challenges before they explore expanding this. The FCA in the UK has announced they are working with the industry, with the Investment Association in the UK recently publishing a blueprint for tokenization implementation across the space.

Tokenization has the potential to fundamentally change the asset management ecosystem. It could improve the speed of settlement and open up new avenues for investors and ETF managers alike.

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