

EY Global ETF Survey 2015

ETFs: a positive force for
disruption



EY

Building a better
working world

Foreword

Despite volatile financial markets, the global exchange traded fund (ETF) industry has continued to expand during 2015. Worldwide, ETF assets have also continued to perform strongly against other investment vehicles, such as pension funds, mutual funds and hedge funds. At the end of September 2015, the ETF and exchange traded products (ETP) industry managed 5,978 products, representing total assets of US\$2.8t.¹

To monitor the rapid – and increasingly influential – development of ETFs, we are proud to launch our fourth ETF survey and third fully global study of the industry. Between July-September of 2015, we interviewed nearly 80 leading promoters, investors, market makers and service providers across the US, Europe and Asia-Pacific. Our respondents included issuers managing 86% of global ETF assets. We are deeply grateful to all our interviewees for their support and insight.

As our survey grows in size, we have changed the structure of this report slightly to focus on what we consider to be the greatest areas of interest. These include global trends, product innovation, digital distribution and the search for efficiency. We will also be presenting the results in greater depth at a number of international road shows over the next few months.

As always, we hope that readers will find this paper stimulating and helpful. If you would like to explore its findings or respond to it in any way, we would be delighted to hear from you.



Matt Forstenhausler
Global and US Wealth & Asset
Management ETF Leader



Lisa Kealy
EMEIA Wealth & Asset
Management ETF Leader



Julie Kerr
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¹ Unless otherwise stated, all historic industry data is sourced from ETFGI.

Executive summary

Our latest global survey of the ETF industry was conducted against a far less stable backdrop than in previous years. So it was striking to find that interviewees remain extremely confident about their prospects for growth. A weighted average of global responses suggests that respondents expect their businesses to grow by around 18% every year for the next three to five years.

Perhaps this should not come as a surprise. Experience has shown that the ETF industry has a rare ability to turn investment problems into investment solutions. The sector has also weathered a number of crises over the past two decades and, throughout that time, investors have continued to support ETFs by voting with their feet.

The industry's increasing size is not without its drawbacks. Chief among these is an ever-growing level of external attention. While most respondents welcome closer scrutiny, there are concerns about regulatory misunderstandings and the associated potential for reputational risks. And, while the ETF industry mainly continues to get a good press, some interviewees admit to frustration at the way that market volatility is sometimes labeled as "an ETF problem."

On the upside, greater size brings greater influence. Active managers with no history of issuing ETFs are being forced to respond to developments such as smart beta, with many choosing to launch ETFs or partner with existing providers. There could be no clearer sign of the growing impact that the ETF industry is having on the wider regulated funds sector and the asset management industry as a whole.

To explore these issues in greater depth, we have structured this report into several key sections:

- ▶ Section I examines the industry's global drivers of growth and profitability, and suggests that we may be seeing a permanent shift in the industry's vision for expansion.
- ▶ Section II reviews the defining themes of US, European and Asian markets. It shows that, while the industry as a whole is shaped by global trends, regional differences in regulation, demand and infrastructure continue to shape different ETF markets in different ways.
- ▶ Section III focuses on the crucial topic of innovation, and considers the potential benefits

and risks of recent and upcoming product developments. It concludes that, while innovation is increasingly central to the industry's growth, it is also creating some potential tensions for ETF providers to address.

- ▶ Section IV examines three hot topics: structural innovation, digital distribution and the search for efficiency. If there is one common theme to emerge from these areas, it is the need for promoters, market makers and service providers to keep the needs of investors at the top of their agenda.

Looking across the ETF industry as a whole, we see huge energy, exceptional creativity and immense promise for the future. The industry has a strong track record of adapting to different markets, and we expect that to continue as it expands into new regions, such as Latin America and the Middle East. We are also struck by ETF providers' desire to work with investors and tailor products to their needs – an attitude that is not always a feature of every corner of the asset management sector.

At the same time, we would like to remind the industry of a few eternal truths. One is that innovation and creativity always bring controversy and, inevitably, some risks. Another is that ETFs depend on a strong ecosystem and close cooperation between providers, authorized participants, market makers and service providers.

We would also like to sound a warning to the industry: in its rush to deliver growth over the next two to three years, it needs to ensure that it does nothing to harm its potential expansion over the next 5, 10 or 20 years. As it grows in size and influence, the ETF industry needs to ensure that it continues to act as a positive force for disruption.



A handwritten signature in black ink that reads "Lisa Kealy".

Lisa Kealy
EMEA Wealth & Asset
Management ETF Leader

1. A new vision for growth?

The ETF industry's growth over the last two decades represents one of the financial sector's greatest recent success stories. Can this continue? Our survey allows us to gauge the industry's own predictions for its future growth and profitability.

More than 90% of those surveyed expect the industry as a whole to enjoy positive net new business over the next 18 months, with 34% predicting net inflows of more than 20% (see Figure 1). Firms are even more confident about their own growth prospects. Almost all our respondents expect to achieve a cumulative annual growth rate of more than 10% over the next three to five years, and more than a quarter predict annual growth exceeding 25% over the same period – equivalent to a two-to threefold increase. Despite some regional variations, the overall picture is one of very strong confidence (see Figure 2).

Figure 1: How much net new business will the whole ETF industry generate in the next 18 months?

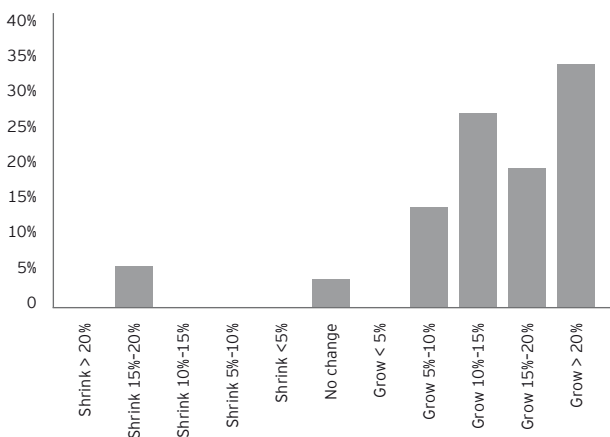
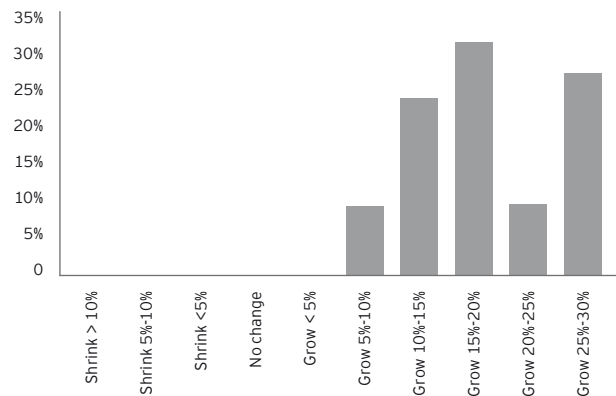


Figure 2: What compound annual growth rate do you expect over the next three to five years?



"ETFs have been one of the most successful financial innovations of the last 20 years, bringing institutional-quality investment management to the masses. In addition to providing investors with broad market beta exposure at low cost, ETFs have opened up a variety of investable asset classes and market segments for index investing, all at a fraction of the cost of the typical actively-managed fund."

"A trend we're seeing at the moment is the rise in appetite for sector ETFs amongst European investors. One reason for this is that returns are being driven more than ever by macroeconomic trends versus individual company earnings; and with markets anticipating the first US interest rate hike of the economic cycle later this year, US sector ETFs in particular allow portfolios to balance the potential for risk and return. Something which savvy investors are increasingly recognizing."

Alexis Marinof

Managing Director of State Street Global Advisors and
EMEA Head of SPDR ETFs



“We find the most sophisticated investors are increasingly using ETFs as a meaningful part of their portfolio ... Smart beta funds can complement, diversify or sometimes replace an active strategy. Therefore, the growth potential of this segment of the ETF family appears substantial.”

Byron Lake
EMEA Head, Invesco PowerShares

These bullish predictions are nothing new, but they are all the more striking for being made against one of the most challenging market backdrops the ETF industry has faced in recent years. Volatile equity markets during the first nine months of 2015 have led to global year-to-date growth of 0.9% in ETF assets, a far cry from the industry’s 10-year cumulative average growth rate (CAGR) of 24%. Our survey shows that several mutually reinforcing factors explain the industry’s confidence in the face of unstable financial markets:

- ▶ **A favorable macro view.** Investment philosophies that emphasize diversification and cost minimization as drivers of long-term performance have steadily gained ground since the financial crisis. Future decades are expected to see strong demand for affordable, diversified investment products that can be used to build tailored portfolios. The industry expects to continue to take market share from traditional active asset managers and passive mutual funds, and sees fiduciary managers as a very limited competitive threat.
- ▶ **The weight of institutional money.** Institutional investors continue to drive the bulk of ETF inflows, especially outside the US, but remain comparatively underinvested in ETFs. It follows that ETF providers see huge scope for further institutional growth. Our survey confirms this view: 92% of the investor groups we surveyed expect to increase their allocations to ETFs over the coming year. Institutional investors are using ETFs for core exposures, precision exposures and hedging. ETFs are increasingly seen as a substitute for fully funded futures, as the cost of holding long positions on key indices increases with every quarterly “futures roll.” Defined benefit (DB) pension funds are becoming significant users of ETFs in many markets. Insurers are also beginning to use ETFs for long-term investment, not just short-term hedging, although most respondents see them as slower adopters.
- ▶ **A wave of innovation.** Our survey shows that ETF promoters expect innovative products, such as smart beta funds, to continue to supercharge net industry inflows. Many providers see these value-added products as the key to attracting new institutional investors. Others also see innovation as a retail “investment story,” giving individuals the kind of flexibility only previously available to institutions. We focus on innovation in greater detail in Section III.
- ▶ **Long-term retail growth.** Many respondents to our survey view retail investors as the industry’s most important long-term driver of net inflows. But near-term predictions are more modest, suggesting that it will take at least a decade for retail adoption in Europe and Asia to reach US levels. Most respondents predict retail growth of between 5% and 15% over the next three to five years. In “Hot topic 2” (Section IV), we ask whether digital distribution could enable the industry to upgrade its predictions in this area.
- ▶ **A product for all seasons.** A significant number of survey respondents think that financial market volatility could play to the advantage of the ETF industry. Their belief is that ETFs compare well against mutual funds in bad times as well as good ones. The success of currency-hedged ETFs during 2015, and the fact that ETFs are often more liquid than their underlying assets, are cited as examples of this resilience. Political risks from markets such as Greece or Ukraine could hurt ETFs even less than other investment vehicles. Asian respondents to our survey believe that the recent challenges in Chinese equity markets has been a net positive for the ETF industry in their region.

“We will continue to see retail and institutional investors use ETFs for core portfolio building block exposure both in equities and fixed income. We also expect low-cost, active ETFs will gain momentum as investors increasingly select them in place of high-cost, traditional active funds.”

Philip Tychon
Head of ETF Capital Markets, Europe, Vanguard

“Easy access to passive low-cost investments was the first promise of ETFs, and it has largely been fulfilled The focus is shifting away from packaging to content. High-caliber ETF providers can add value to investors by providing access to niche markets, active strategies or alternative beta.”

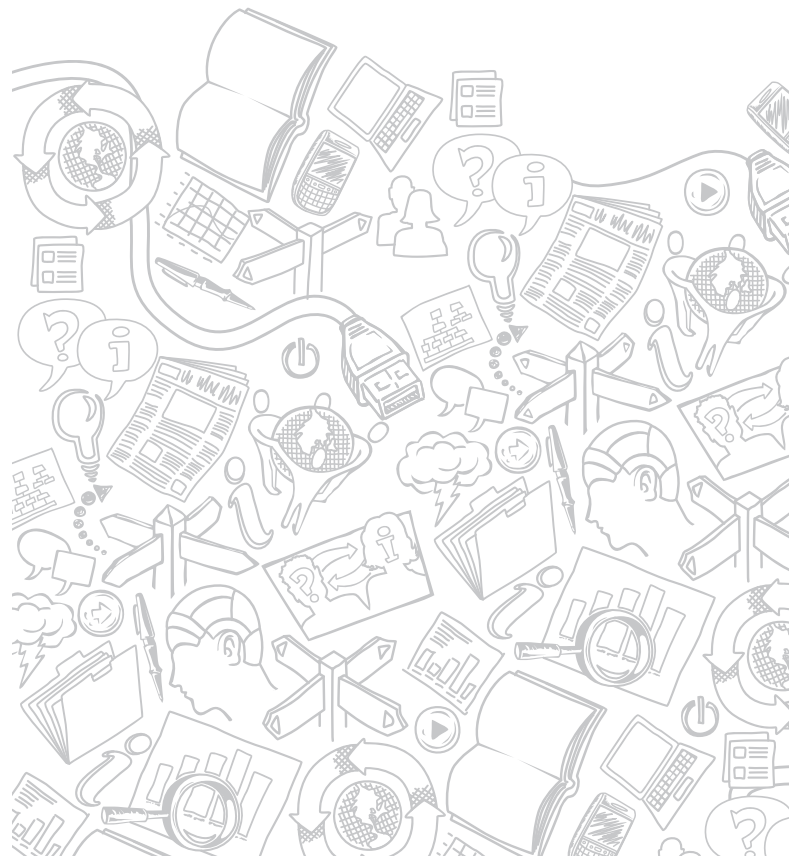
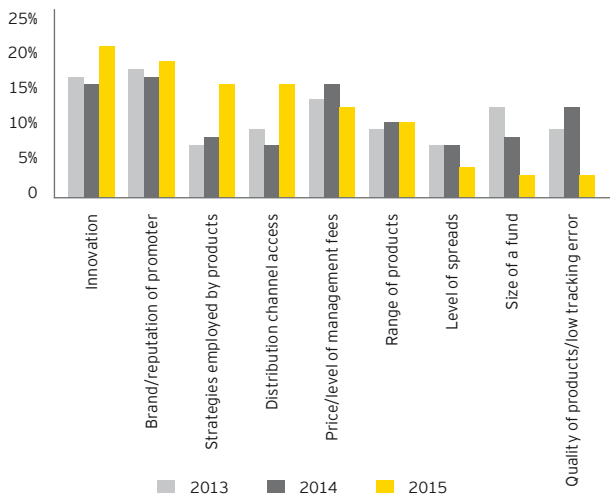
Jean-Philippe Royer
 CEO, Nomura Alternative Investment Management
 (Europe)


If the industry’s view of its own growth prospects remains almost universally upbeat, the same cannot be said of the outlook for profitability. Almost all respondents admit to concerns about pressure on management fees and overall profitability.

It is encouraging that the large majority of those surveyed see the expansion of their investment capabilities, not the reduction of costs, as the best way to relieve margin pressure. That upbeat response brings us back to the all-important topic of innovation, which is now identified as the most significant source of differentiation between promoters. Product strategies are also seen as increasingly important. By contrast, pricing is viewed as a slightly less important source of competitive advantage than in recent years (see Figure 3).

This striking finding is reinforced by the outlook for management fees, which is seen as more stable than in recent years. The overall pattern is of a highly significant industry-wide shift from a vision of growth focused on price competition and low costs to one driven by a more diversified and innovative product range.

Figure 3: What are promoters focusing on in order to differentiate themselves from others?





2. Regional themes: following parallel tracks

Our survey shows that respondents around the world often hold similar views on strategic themes, such as growth, innovation and distribution. But even if the key features of ETFs – and often the key players – are common to many markets, the day-to-day reality of issuing, trading, selling and administering ETFs varies significantly between regions and countries.

Our survey suggests that the ETF industry is evolving along parallel but distinct tracks in different markets. Although the US remains the paradigm that others aspire to, Europe and Asia look unlikely to match its levels of scale and efficiency. Providers, market makers and service providers are increasingly aware of the need to adapt their business models to local conditions. This flexibility will only become more important as ETF markets evolve in regions such as Latin America and the Middle East.

The US: still showing the way

After a decade in which cumulative growth rates averaged nearly 24%, US ETF providers now manage US\$1.905b of assets – 4 times the total for Europe and 18 times that of Asia, excluding Japan. Even so, ETF assets still equate to less than 12% of the US mutual fund market. All US respondents expect the industry to gain net new assets in the next 18 months, and half anticipate growth of more than 20%. We also highlight the following key themes:

▶ **Growing investor adoption.** The US market enjoys an ever-widening range of ETF investors. In addition to corporate and public sector pension schemes, insurers and hedge funds, US providers are seeing growing adoption by endowments and charitable foundations. Demand from retail and high net worth investors also remains strong.

▶ **Cutting-edge innovation.** The depth of expertise and experience in the US puts the market at the cutting edge of ETF product development. Innovation is being driven both by niche providers with specific sector, asset or structural expertise and by larger providers keen to offer their institutional clients a comprehensive range of products. Smart beta and leveraged ETFs are seen as key engines for growth. Active ETFs are also an area of focus, with several promoters planning to issue funds under the NextShares exchange traded managed fund (ETMF) structure launched by Eaton Vance.²

▶ **Active managers entering the market.** Despite the dominance of the top three issuers, which together manage nearly 80% of US ETF and ETP assets, asset managers without a history of issuing ETFs are now seen as the most important group of new entrants to the US ETF market, with Goldman Sachs the latest example.³ As well as launching active ETFs, these firms are forging partnerships with established ETF providers – such as that between State Street and MFS Investment Management.⁴

▶ **Digital fever.** The US is at the forefront of the global push for digital distribution in asset management. This trend is arguably at its hottest in the ETF arena, where there is an obvious potential crossover between online or automated advice and the use of ETFs to create model portfolios. US respondents are also the most likely to have begun test marketing via social media.

²Business Wire, 21 July 2015.

³Financial Times, 21 September 2015.

⁴Financial Times, 12 January 2014.



“In our view, European ETPs – likely to surpass US\$500b by year-end – will manage assets in excess of US\$1t by 2019, within a global market of US\$6t. Part of this growth will come from investors who have previously deployed capital using products traded over the counter – bonds and futures especially – who are turning to ETFs for the first time because of the liquidity and low costs.”

Ursula Marchioni
EMEA Chief Strategist, iShares

Europe: continuing to gather momentum

ETF assets have grown faster in Europe than in the US or Asia during the first nine months of 2015, and survey respondents believe this strong performance will continue. The majority expect their own firms to expand by at least 10% to 15% per annum over the next three to five years, and half predict annual growth of more than 20%. Some of the region's other key themes include:

- ▶ **Local and global growth.** There is huge scope for institutional growth in Europe, where ETF assets are equivalent to less than 4% of mutual fund assets. Pension funds in markets such as Germany and France are making increasing use of ETFs, and the favorable treatment of index-linked products under Solvency II is encouraging European insurers to use ETFs for long-term investment. At the same time, the global strength of the UCITS brand means that more US providers are expected to follow WisdomTree by acquiring in Europe and using the region as a base for their global distribution efforts. The possibility of “Brexit” from the EU is generally seen as an operational threat rather than a strategic one.
- ▶ **Growing sophistication – in some areas.** Innovation is as much a driving theme of ETF evolution in Europe as in the US. Smart beta is by far the greatest area of interest, with many factor-weighted products being introduced in UCITS form for international distribution. By contrast, European respondents are much less bullish about the prospects for active ETFs than their counterparts in the US or Asia.

- ▶ **Fragmented liquidity: fragmented responses.** A lack of liquidity remains a feature of many ETF markets in Europe, where 70% to 80% of trading typically takes place off-exchange. Many respondents expect MiFID II to improve transparency – eventually. In the meantime, request for quote (RFQ) platforms, which supply a range of broker prices and can help investors to achieve best execution, are growing in influence. But RFQs are arguably a symptom of the problem, not the cure, and by encouraging OTC settlement, they could add to the risk of unwanted regulatory attention. The gradual growth of ETF stock lending is another market-led response, although one that is not without controversy (see “Hot topic 3” in Section IV).
- ▶ **Retail growth challenges.** Developing stronger retail demand for ETFs remains the European industry's long-term preoccupation. Retail business is not only seen as a source of growth, but also as a potential solution to the region's liquidity problems. Many of our respondents believe that the industry could lift the retail share of European ETF assets from 15% today to around 25% by 2020. But, despite the confidence of retail specialists such as BlackRock's iShares and Vanguard, many respondents believe that strong retail growth in Europe remains two to four years away. The stars of regulation, education and technology will all need to be aligned for firms to crack this puzzle. In Section IV, we ask whether digital distribution might help to unlock that growth potential.

“The ETF market in Europe is only at the tip of the iceberg, despite recent strong growth rates. The market is growing consistently from new products, broader and deeper client usage, regulatory reform (e.g., RDR) and existing plain vanilla products becoming too cheap to ignore. When the naysayers of the ETF market start to enter the game, then AUM growth rates will increase even further.”

Nik Bienkowski
Co-CEO, WisdomTree

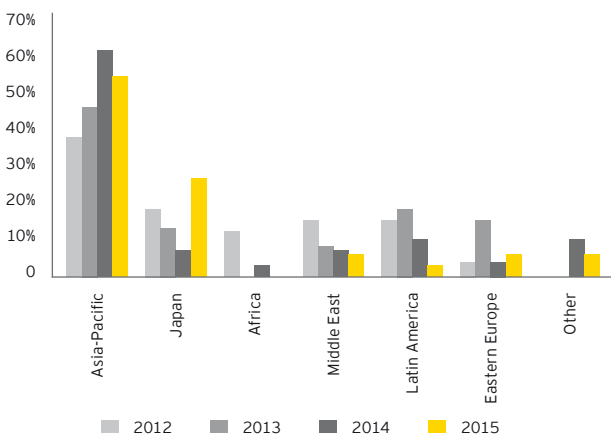


Asia-Pacific: rapid but localized development

Asian ETF assets have grown at an average rate of 29.9% over the past decade, but have followed a much more volatile path than in Europe or the US. This pattern looks set to continue for the foreseeable future, with the majority of Asian respondents expecting their own businesses to grow by 25% to 30% per annum over the next three to five years, despite a significant fall in Asianwide ETF assets during the first nine months of 2015.

In fact, as already mentioned, some Asian respondents believe that a period of volatile markets will help the ETF industry by reinforcing the attractions of diversification and liquidity. Asian markets, including Japan and Australia, are identified as the most attractive targets for geographic expansion by both global and local respondents (see Figure 4).

Figure 4: What expansion to your distribution network are you considering? (Promoter responses only)



Looking across the region as a whole, we identify several key themes:

▶ **Innovation with a local flavor.** As in other regions, investor demand is the most important driver of product development. But market-specific regulation means that a lot of innovation has a strong local flavor. For example, leveraged and inverse leveraged funds are enjoying significant success in markets such as Korea, Taiwan and Japan. Although Hong Kong is yet to authorize leveraged or factor-based ETFs, there appears to be significant investor demand and the industry is expecting some movement in this area soon. Currency hedged ETFs have

advanced fairly consistently across the region, but smart beta funds – readily available in Australia – are yet to take off in all markets.

- ▶ **Australia: blazing a path for active ETFs.** Recent developments in the Australian ETF market illustrate the potential that can be unleashed when innovation and regulation complement each other. Prevented from marketing non-passive products as ETFs, local managers have begun to list Exchange Traded Managed Funds (ETMFs). The first launch earlier this year attracted encouraging inflows and others have followed, including one using an IPO-type seeding approach. Australia's regulated savings and the effect of 2013's Future of Financial Advice (FOFA) reforms are making this a key regional market, and ETMF structures are attracting huge interest from domestic and international active managers. Providers in other markets – such as Indonesia, where active ETFs are already being launched – could follow Australia's example.
- ▶ **Breaking down barriers.** Asian respondents are hoping that regional reforms to fund distribution and trading will attract new investors and help firms improve their scale and efficiency. Although Mutual Recognition of Funds (MRF) between Hong Kong and China has been agreed, the greatest market buzz is still coming from the Shanghai-Hong Kong Stock Connect. Local firms are hoping that ETFs will be among the greatest beneficiaries, especially if other exchanges join the scheme. Survey respondents are less clear about the potential of other initiatives such as the ASEAN Passport and the Asia Region Funds Passport.
- ▶ **A desire for regulatory engagement.** There is a sense among some ETF providers that not all Asian regulators fully understand the structure and behavior of ETFs. Regulators in markets as varied as Singapore and Indonesia have historically placed restrictions on retail distribution. The growing demand for digital and online advice is also being inhibited in some markets, while embraced in others such as Japan, China and Australia. The ETF industry needs to ensure that it engages with regulators in a consistent way over potential areas of misunderstanding, such as the differences between physical and synthetic funds.

3. Focus on innovation

Innovation has always been integral to the ETF story, but product development is arguably moving forward faster than at any time in the industry's history. Our survey shows that 83% of respondents expect to increase spending on new products over the next 18 months.

The current explosion of innovative effort reflects a combination of factors. On the supply side, ETF providers view innovation as crucial to building profile, generating net inflows and defending profit margins. On the demand side, persistently low yields, the prospect of a rate hike by the Federal Reserve, aging populations and the shifting investment goals of pension funds and insurers are creating unprecedented demand for new investment solutions.

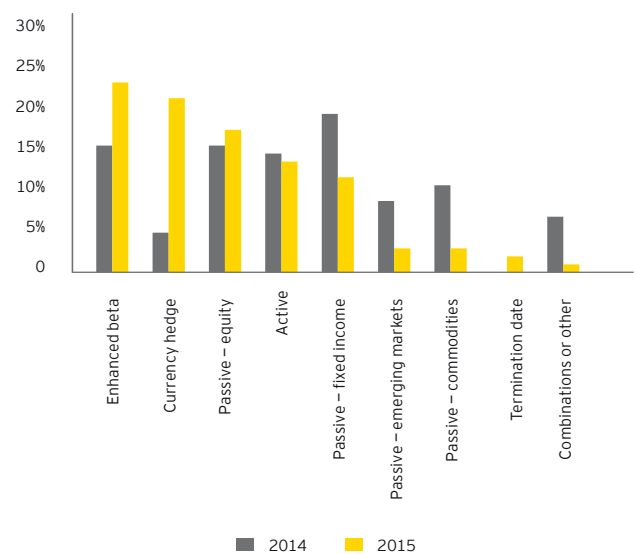
Currency hedged funds lead the way

Currency hedged ETFs have been the industry's success story of 2015, accounting for the world's two most successful funds during the first eight months of the year. Hedged ETFs have benefited from the volatility of foreign exchange markets and fears of competitive devaluation by key currencies.

The low cost of buying a hedged ETF compared with arranging a separate hedge means that a range of investors are using hedged ETFs to eliminate currency risk – and to speculate on currency movements. This includes increasing use by active fiduciary managers worried about currency volatility or with a low conviction on a particular market.


The success of hedged products is a perfect example of an ETF's ability to capitalize on market conditions. Although not without potential side effects – such as the splintering effect they could have on already-fragmented liquidity in Europe and Asia – investor demand is expected to drive continued growth in hedged ETFs, typically alongside matching unhedged share classes (see Figure 5).

Figure 5: Which products will generate growth in the future?



"We have continued to see increased interest in currency-hedged ETFs, not only in equities but also in the fixed income space ... Going forward, we would certainly expect investors to look at potential currency hedging as a key consideration in their fund selection process."

Andrew Walsh
Head of ETF Sales UK, UBS



“Thoughtful innovation builds the core of the European ETF market.”


Kevin Gopaul
Global Investment Officer, BMO Global Asset Management

Smart beta: time to move the debate forward

Mention innovation, and many ETF providers think “smart beta.” Some of our interviewees found the topic fascinating, while others were tired of talking about it. This reflects the fact that smart beta, although far from being a recent innovation, continues to generate exceptional debate within the industry. That, in turn, points to the paradoxical nature of smart beta, which is widely understood but nearly impossible to define.

So what are the merits of smart beta? Is it ETFs’ brightest hope for the future, or a Trojan horse that threatens to lead the industry astray? Instead of trying to answer every possible question on this topic, we opt to make a few observations, drawing on the findings of our survey:

- ▶ Debate about the “smart beta label” is over. In prior years, we have used “enhanced beta”; some providers prefer “alternative beta” or “strategic beta” and many use the more descriptive “factor investing.” These differences will continue, but the industry as a whole needs to accept that the wider financial world has adopted the “smart beta” label. Whether that is a curse or a blessing, it is time to move on.
 - ▶ The debate over what smart beta represents is much more important. Funds that merely tweak index composition can legitimately be viewed as quasi-passive, but complex multifactor funds with heavy manager involvement are hard to distinguish from active products. This blurring between passive and active is integral to the appeal of smart beta, but it also brings potential for reputational risks and regulatory attention.
 - ▶ However it is defined, smart beta offers unarguable growth potential. Developments in portfolio theory, combined with the changing economic and market environment, will continue to drive demand for alternative products that can blend growth, yield and diversification. Our survey shows that the exceptional growth rates of recent years are expected to continue (see Figure 5). Of those surveyed, 89% plan to increase their range of smart beta products over the next two years, and 95% expect investor allocations to smart beta to increase over the coming year.
- ▶ ETF promoters believe that smart beta products tailored to the needs of institutional investors put them in a sweet spot, enabling them to capture funds that would otherwise have been divided between passive mutual funds and actively managed accounts. Survey respondents seem to agree that smart beta will largely take market share from non-ETF markets, with limited risks of cannibalization. Smart beta is also seen as offering financial advisors a new tool for retail asset gathering.
 - ▶ Smart beta will support providers’ margins ... up to a point. Intellectual capital and the need for rebalancing are strong arguments for higher fees, but history tells us that margins are likely to be competed away over time. Respondents were divided over the sustainability of smart beta fees. That suggests a potential split between more and less complex smart beta products – a division that, if realized, could help to resolve the problem of “blurring.”
 - ▶ If smart beta does pose a risk to the wider ETF industry, in our view, it will flow from a failure to meet the weight of current expectations. This is not just about retail distribution, although complex multifactor products certainly pose potential conduct risks. Institutional investors will also need to be guided through smart beta performance. Promoters need to be clear about investors’ goals – are they looking to smart beta for outperformance, or risk reduction?



“The debate around active vs. passive needs to move on; investors want a blend of both in order to intelligently diversify their portfolios The rise of active ETFs will increasingly invalidate the need for this debate and give investors the ability to benefit from the ETF structure along the entire passive to active spectrum.”

Mark Weeks
CEO, ETF Securities

Opportunities and risks from active ETFs

Smart beta is not the only area of product innovation generating strong debate within the ETF industry. A majority of respondents expect investor allocations to active ETFs to increase, but opinions are much more divided than over smart beta.

Actively managed products are seen as a small but significant source of inflow in the US, where respondents are most likely to launch new actively managed products over the coming year. The development of ETMFs that strike a balance between transparency and confidentiality by quoting a daily price linked to net asset value (NAV) illustrates this trend. There is also real interest in Asian markets, led by Australia.

By contrast, European respondents see limited scope for meaningful growth in active ETFs for the foreseeable future. European respondents are also more likely to voice concerns that the introduction of actively managed ETFs could weaken the industry’s efforts to market ETFs to retail investors as low-cost, transparent vehicles offering market-wide risks and returns.

Will 2016 mark a turning point for fixed income ETFs?

Growth in fixed income ETFs has been strong in recent years, generating net inflows of 25% during 2014 and 16% during the first nine months of 2015. Many of our respondents not only see fixed income ETFs as a key driver of further growth, but also as a vital tool for broadening the appeal of ETFs to institutional investors. The prospect of a shift in the interest rate cycle also offers a golden opportunity for ETF providers to help investors bet on the shifting dynamics of global bond

markets. After all, fixed income ETFs represent just 16% of total ETF and ETP assets worldwide, and less than 1% of total outstanding global bonds.⁵

One of the key attractions of fixed income ETFs is that they are often more liquid than the underlying assets they track. This is partly about strong trading volumes, but it also reflects an increasing lack of liquidity in many corporate and emerging market bonds as broker-dealers reduce their capital allocations for market making.

That means that, while fixed income ETFs are far from new, there are some concerns that they could bring new risks to ETF markets. Regulators, including the Bank for International Settlements, are known to be worried about the possibility that bond funds and bond ETFs could be creating an “illusion of liquidity,” and cite the flash crash of October 2014, when some fixed income ETFs traded at a significant discount to NAV, as evidence for their concerns.⁶ The fact that ETFs have made it easier for retail investors to invest in bonds could be an additional cause for concern, along with the mixture of fully physical, sampled physical, funded synthetic and unfunded synthetic products in the market.

Many of our interviewees believe that these concerns are based on a fundamental misunderstanding of how ETF units are created and redeemed. Promoters point to the fact that ETFs have already weathered a number of financial market crises, and that investors have continued to vote with their feet. Even so, some ETF providers have let it be known to investors that they have made banking arrangements to ensure they can always honor redemptions, whatever the market conditions.

⁵Financial Times, 14 September 2015.

⁶Financial Times, 14 September 2015.

4. Hot topics

Hot topic 1: Can structural innovation give a further boost to growth?

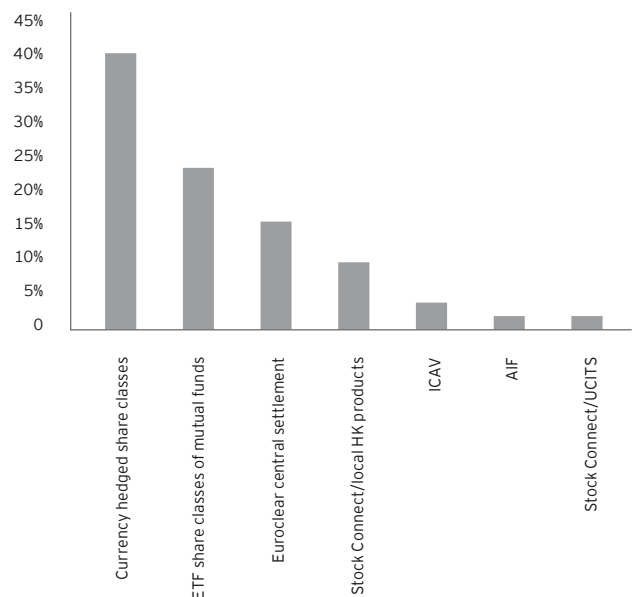
The industry's focus on innovation is not confined to fund content. The desire to enter new markets, to serve more investors and to broaden the range of available investment strategies, is leading to an increasing interest in structural innovation, especially in the fragmented markets of Europe and Asia.

The success of currency hedged ETFs – often created by setting up a sub-fund of an ETF – is a perfect illustration of how structural innovation can play a crucial enabling role in product development. Other examples of innovative fund structures include the use of alternative investment fund (AIF) structures rather than UCITS for commodity and other alternative European ETFs, and the emergence of ETMFs in the US and Australia. The pan-European ETF structure created by BlackRock for unique settlement at Euroclear, and since adopted by issuers including State Street and PIMCO, is an example of an initiative intended to improve transparency and reduce post-trade costs.

So what's next? Our survey shows that the development of ETF share classes of mutual funds – ETF sub-funds under a mutual fund umbrella – is seen as the second most promising structural innovation after currency hedged funds (see Figure 7). Vanguard has patented such a structure in the US,⁷ and Ashmore has set up a similar fund in Europe.⁸ Share class structures could appeal to asset managers with established

ranges of mutual funds. They would provide an entry into the ETF market, enabling firms to act as a “one-stop shop” for active and passive mutual funds and ETFs, with a wide range of distribution options. However, we also note that some interviewees believe combining two different vehicles in this way – vehicles that will track a benchmark in different ways – could open up suitability or conduct risks.

Figure 7: What are the biggest structural opportunities for the ETF industry?



⁷ Financial Times, 26 April 2015.

⁸ InvestmentEurope, 8 October 2014.



“One of the great achievements of the ETF industry in Europe is the level of transparency that providers have brought to the products This exceptional level of transparency should be maintained as the industry continues to grow and develop.”

Roger Bootz
EMEA Head of Passive Distribution, Deutsche Asset & Wealth Management

Structural innovations are not restricted to the fund level. As already discussed, some respondents are hoping that regional initiatives will help them to attract new investors. European examples include MIFID II, which is expected to improve secondary ETF market liquidity, and packaged retail and insurance-based investment products (PRIIPS), which should encourage retail investors to adopt ETFs. In Asia, many promoters are hoping that cross-border initiatives, such as the Shanghai-Hong Kong Stock Connect link and the proposed mutual recognition of funds between Hong Kong and mainland China, will not only open up fresh markets, but also help to improve scale and efficiency.

In summary: ETF promoters’ structural innovation efforts are increasing in line with their investment in product development. This is especially true in Europe and Asia, where local requirements and rules are much more fragmented than in the US. In many ways, the current wave of structural innovation is nothing new for the ETF industry. Structures are pioneered, individually or in partnership, and only achieve critical mass if investors see value in them. Investor approval is a strong safeguard, but ETF providers need to ensure that new structures reflect the needs of investors, not their own strategic goals.





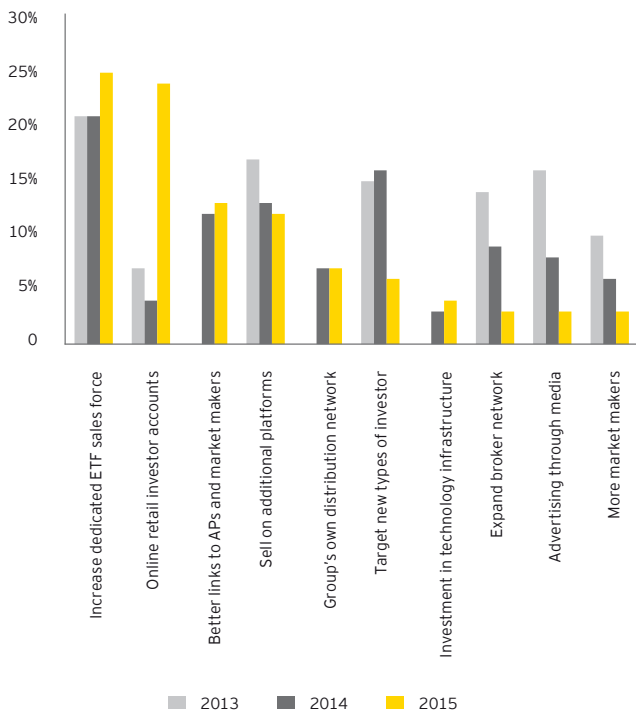
“Online banks and ETFs share mainly one thing: Low costs. That’s the reason why the fit is so perfect.”

Arne Scheehl
Product Manager ComStage ETFs, Commerzbank

Hot topic 2: ETFs and digital distribution – a perfect match?

Our survey shows that many ETF providers continue to see their current distribution models as inadequate for their needs, and that dedicated sales teams remain a vital area of focus, particularly within the institutional space. However, it also shows that the ETF industry is undergoing a huge surge of interest in online distribution (see Figure 8).

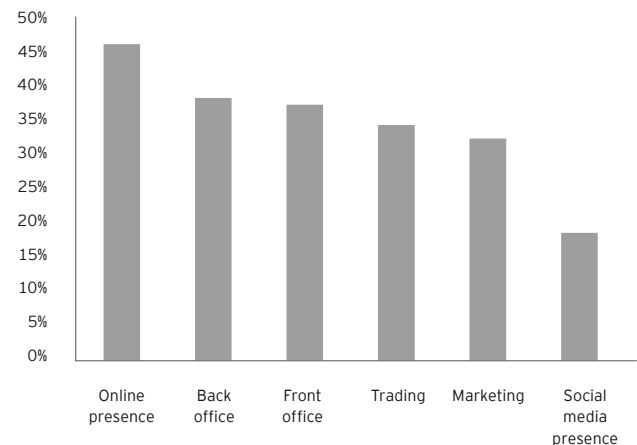
Figure 8: Which areas of distribution are you looking to improve?



Of course, a sudden focus on digital distribution is not unique to the ETF industry. Encouraged by factors as diverse as regulatory change, technological development and the global shift from DB to defined contribution (DC) pension saving, asset managers around the world are rapidly waking up to the potential opportunities of digitization.

Even so, there is a particularly strong sense that the digital dawn could be a “Eureka” moment for the retail take-up of ETFs. After all, the product and the technology share some common themes: low costs, transparency and breadth of choice. Of those surveyed, 90% view digital channels as an area of opportunity, and 89% expect robo-advisors to accelerate the growth of the industry. Developing an online presence is also identified as the leading priority for technology spending (see Figure 9).

Figure 9: How are you prioritizing your technology spend in the next 18 months? (High-priority responses)





“Strategies that were once exclusive to the largest institutional investors are now available to everyone, and at the same price. Tighter regulations, such as those around RDR and MiFID II, are also drawing investors to low-cost, passive investments, including ETFs, and financial advisors tell us they have started directing more of their clients’ money toward these vehicles. We believe this is just the beginning.”

Lee Kranefuss
Executive Chairman, Source

As their technology spending increases, ETF providers are becoming more interested in social media. Many respondents see it as a powerful tool for brand building and investor education, but a significant minority are skeptical about its value. So far, there is little sign of social media being used as a sales channel, although some US respondents have begun test marketing. By contrast, European respondents are more likely to identify potential regulatory risks in engaging with investors via social media.

This last finding illustrates the degree to which local regulatory conditions affect the evolution of digital distribution. The survey shows that the expectations of many respondents are not yet matched by reality:

- ▶ The US market is furthest ahead in the development of digital distribution. Online brokerage accounts are an established sales channel, and the development of automated and remote online advice is well advanced. US respondents are the most bullish about the growth of robo-advisors and most interested in the marketing possibilities of social media.
- ▶ Europe lags behind the US in a number of areas. Although online platforms have the potential to drive wider retail adoption, most lack the ability to handle intraday trading, and many still do not list ETFs at all. Financial advisors also struggle with a lack of ETF-specific research and guidance. The fragmentation of conduct regulation means that the development of a truly European robo-advisor remains far off, but there are bright spots too. These include the rapid growth of online savings accounts in Germany and the Netherlands, and the success of UK robo-advisor Nutmeg.
- ▶ Asian respondents make the strongest predictions for online distribution over the next three to five years and are the most likely to have begun planning a digital distribution strategy. Even so, the outlook for digital distribution varies widely between markets. Australia, where self-directed retail investors already make significant use of online platforms and robo-advisors, is the regional leader. But digital sales could prosper in developing markets, where ETF providers are already developing their own web-based

platforms. Asian private banks are also keen to make greater use of online distribution, which could help to boost the adoption of ETFs by high net worth investors.

Like any strategic opportunity, digital distribution also presents some potential challenges. For ETF providers, these include strategic questions about their plans for expansion. Some of the world’s largest promoters are developing their own online distribution capabilities, with BlackRock acquiring a US robo-advisor, Schwab developing its ETF e-trading offer and Vanguard entering the market for online financial advice. Our survey suggests that not all promoters will follow suit. Many will be deterred by the risk of cannibalization or fear of alienating existing distribution partners. If so, they will still need to decide what partnerships to build or which in-house developments to make.

ETF promoters are also aware that digital distribution could pose new threats. These could come in the form of disintermediation by new entrants. For example, a software or social media giant could partner with a single ETF provider, using its own strengths in branding and technology to accelerate price competition.

Reputational risks are also cited as a leading risk associated with online distribution, with 79% of all respondents viewing cybersecurity as a very important issue. Although most firms are yet to monitor cyber risk at an ETF-specific level, all are investing in threat prevention and this is identified as an important driver of spending. Regulatory risks are a connected area of concern, particularly in Europe.

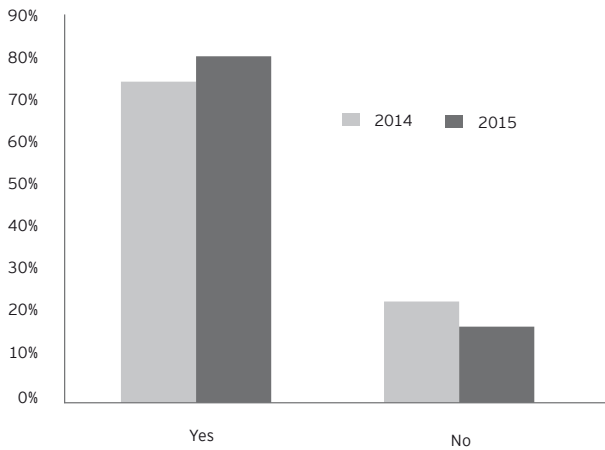
In summary: the long-term opportunities of digital distribution look compelling for ETFs, given the tendency of digital technology to disrupt existing industry structures. Digitization also offers providers the chance to build stronger links with investors and advisors. But the opportunities need to be balanced against the potential risks, including the dangers of cost buildup, strategic uncertainty and unwanted regulatory attention. ETF providers need to develop digital strategies that play to their own strengths and weaknesses, and recognize that online success may not come quickly.



Hot topic 3: Making efficiency work for investors

Despite its emphasis on ever-greater growth, the ETF industry's wafer-thin margins mean that efficiency is a perennial concern for promoters. Our survey shows that 82% of those surveyed are looking to reduce their costs (see Figure 10), even if some promoters – especially in the US – see limited scope to economize. Although regional reforms may help European and Asian promoters to achieve long-term improvements in efficiency, most firms also have a more immediate focus on reducing operational and fund costs.

Figure 10: Are you looking to lower your costs?

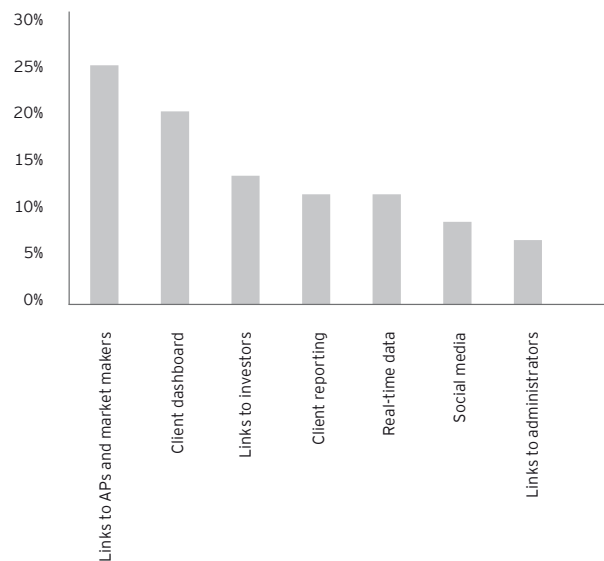


Product rationalization is one major area of focus. With the stigma of delisting and closing funds evaporating, European and US firms are moving to tidy up their product ranges. This is unlikely to be a one-off process. The industry's focus on launching new currency hedged and smart beta funds is leading to a fresh net increase in product numbers across all regions. A continuous drive for fund rationalization looks likely to become a near-permanent feature of the industry.

For most promoters, making more effective and efficient use of technology is an even more important area of focus. Connectivity seems to be the defining theme. The survey shows that stronger links with authorized participants and market makers are seen as the greatest priority for technology

improvement, with better client and investor dashboards and reporting also identified as key priorities (see Figure 11). In addition, leveraging digital media to strengthen branding at a comparatively low cost is seen as an emerging source of efficiency.

Figure 11: In which areas are you planning to make better use of technology?



Conversations with our interviewees show that promoters are clear about the need to pass on as many cost savings to investors. Investor demand is identified as the leading driver of operational change, with profitability improvement seen as an important but lesser concern.

It is highly encouraging to see that most promoters retain their focus on delivering low costs to investors, as well as pursuing internal efficiency. And yet there are potential risks for the industry too. This is illustrated by the increasing use of stock lending by ETF promoters. Over time, greater stock lending can provide a significant boost to returns – for managers and investors. In Europe, it is also seen as a long-overdue



“When choosing an ETF, you want to know three things: does it provide the right exposure, is it easy to trade and will it perform efficiently? Focusing on the TER alone will only tell you half the story. A cheap ETF by TER can cost you more if it tracks badly, or has a wide bid-offer spread. True efficiency considers the whole cost of ownership.”

Clarisse Djabbari

Deputy Head ETF & Index, Lyxor Asset Management

development that will help to boost levels of market liquidity. But even though stock lending by mutual funds is common practice, some investors and commentators seem to be uneasy about it in an ETF context, especially in Europe.

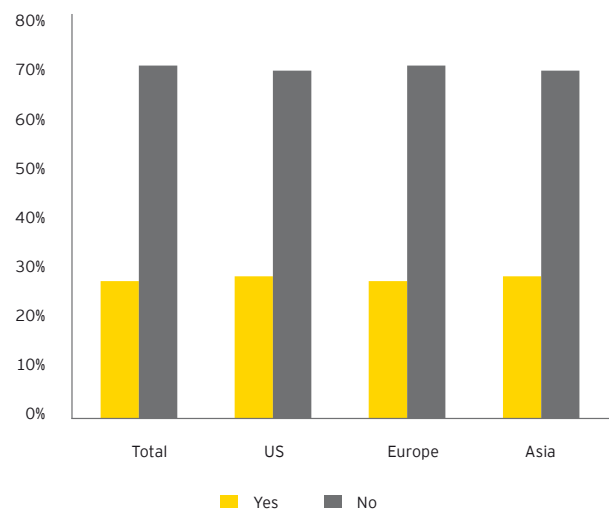
As we have seen elsewhere, this may simply reflect a lack of understanding. But ETF providers need to recognize that investors have genuine questions about the split of revenue between managers and funds, the collateral accepted by ETFs and the permitted levels of lending. The fact that different providers take different approaches to stock lending, with caps moving upward among firms that do allow it, may be adding to the confusion. The increasing use of stock lending is also creating uncertainty among some investors as to whether physical ETFs may be adopting some of the features of synthetic funds. Disclosure is key here. Liquidity may be a key selling point for institutions, but investors also need transparency in what they are buying.

Whatever operational changes promoters choose to make, third-party service providers have a vital role to play.

Our survey shows that the dynamics of ETF promoters' relationships with their service providers can be surprisingly complex. Some views are consistent between regions: promoters' worldwide want their service providers to be efficient, expert and competitive, and the number of respondents who believe service providers need to do more to support innovation remains consistently high across all regions (See Figure 12). But our conversations with interviewees suggest that priorities can vary significantly between markets – and between individual firms. And while issuers see getting the basics right as the greatest priority for service providers, they also expect them to help with emerging issues such as cyber risk.

- ▶ In the US, promoters place the greatest value on robust, reliable core services – a view that will only have been reinforced by BNY Mellon's well-publicized systems problems in August 2015,⁹ when some providers did not receive NAVs for a week at a time of high market volatility.

Figure 12: Do service providers do enough to support industry innovation?



- ▶ In Europe, service providers are seen to be taking on a slightly stronger partnership role with ETF promoters. The need to overcome fragmented liquidity, regulation and reporting means that promoters place a high value on technology links between service providers, exchanges and investors. One example is the ability of service providers to track and report indicative net asset value (INAVs). The growing burden of conduct regulation in Europe is only likely to add to expectations for service providers.
- ▶ Asian respondents are also looking to their service providers for greater support, although they typically have a more limited choice than their counterparts in the US or Europe. Many promoters would like to see service providers offering more help when launching new products or entering new markets.

In summary: as ETF providers search for efficiencies wherever they can find them, the need for effective cooperation with third-party service providers, market makers and others will only increase. Firms also need to remember that affordability is a vital element of ETFs' appeal, and ensure that efficiencies are passed on to investors wherever possible.

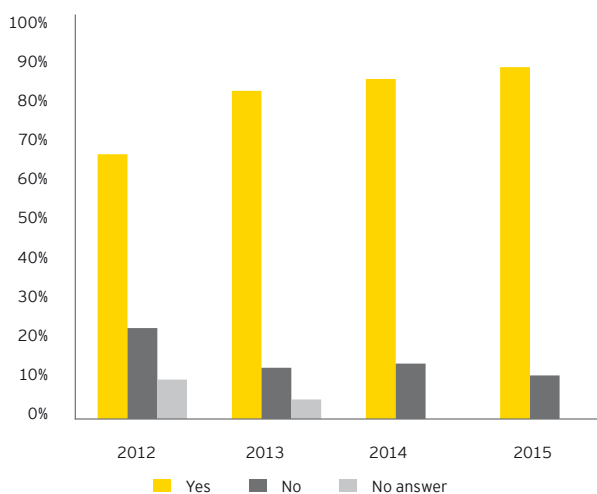
⁹Financial Times, 31 August 2015.

5. Review of underlying trends

In this section, we briefly review some of the underlying trends measured by our survey but not mentioned in the main body of this report. In our view, the following represent some of the most interesting findings.

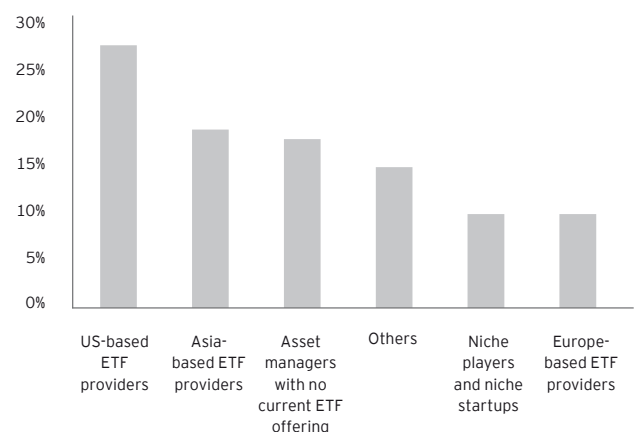
Competition and industry dynamics

Figure 13: Will more promoters enter the market over the next two years?



Respondents continue to expect to see more firms enter the ETF market. Even if most new entrants are unlikely to gather significant market share, they clearly hope to capture a small slice of an expanding pie.

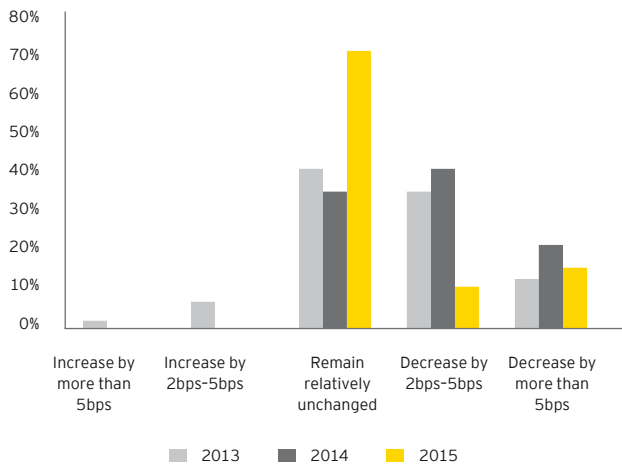
Figure 14: What type of promoters do you see entering the market over the next two years?



US providers are widely expected to use M&A to expand overseas, especially in Europe. Asset managers with no history of issuing ETFs are also seen as increasingly likely entrants in markets as diverse as the US, Australia and Southeast Asia.

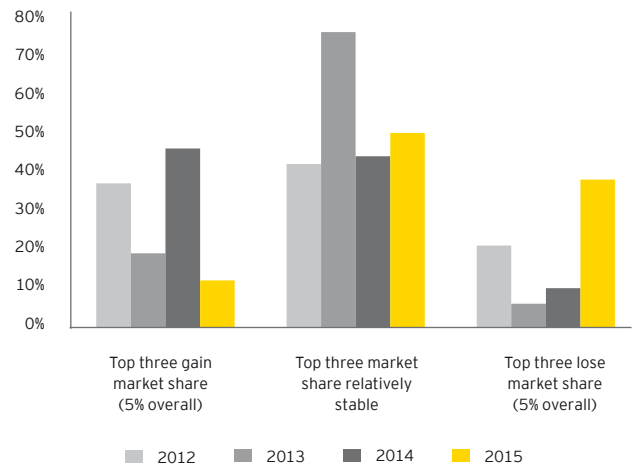


Figure 15: How will margins (management fees) for promoters change in future?



Although the balance of industry opinion remains tilted toward falling margins, a much larger majority than in previous years expect management fees to remain relatively stable. This suggests that an increasing emphasis on innovation could be starting to reshape the economics of the ETF industry.

Figure 16: How will the domination of the largest ETF providers evolve?



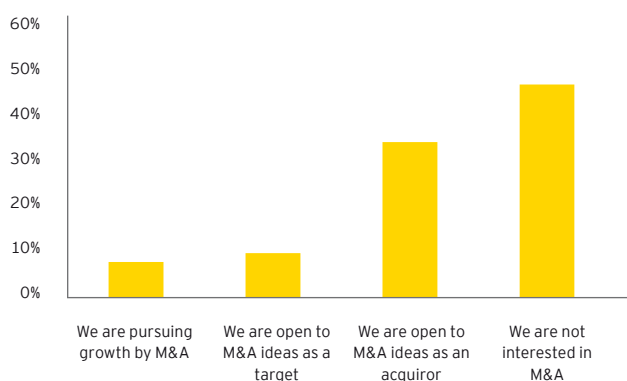
Predictions for the future dominance of the very largest ETF providers have shifted again, with far more respondents than before predicting a loss in combined market share. This is consistent with the vision of an increasingly diverse, innovative industry attracting new entrants. Even so, few respondents expect to see the global top three give up their leading position anytime soon.



“What are the challenges for ETFs? ETFs are the challenge – capturing an increasing share of net new asset flows in Europe from traditional fund structures.”

Adrian Mulryan
Partner, Arthur Cox

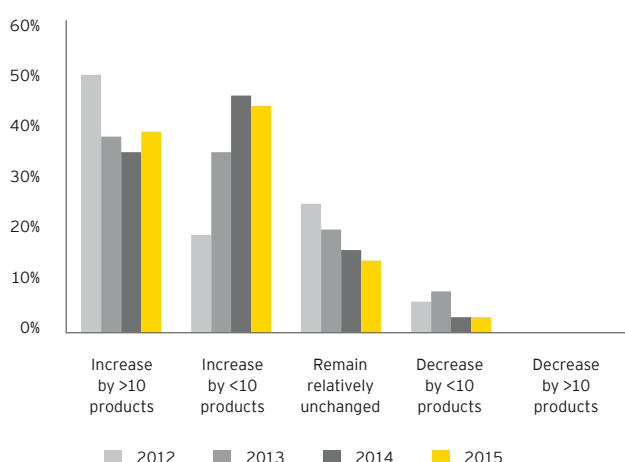
Figure 17: What is your company's current stance on M&A in the ETF industry?



As already mentioned (see Figure 14), a significant proportion of providers are open to using M&A to enter new markets. But in such a fast-growing market, few see the need to pursue an M&A expansion strategy in its own right.

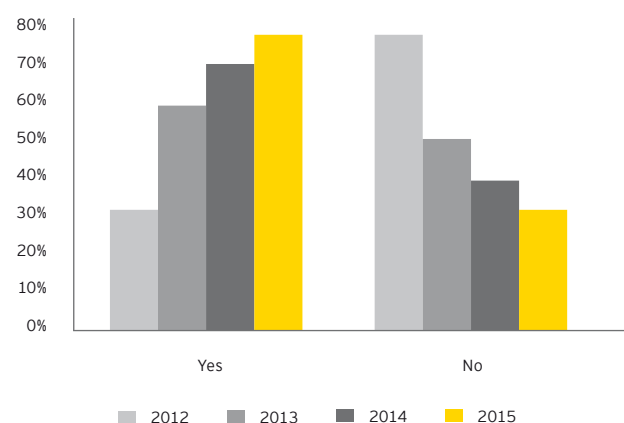
Products and innovation

Figure 18: What change in the number of products you offer do you plan over the next two years?



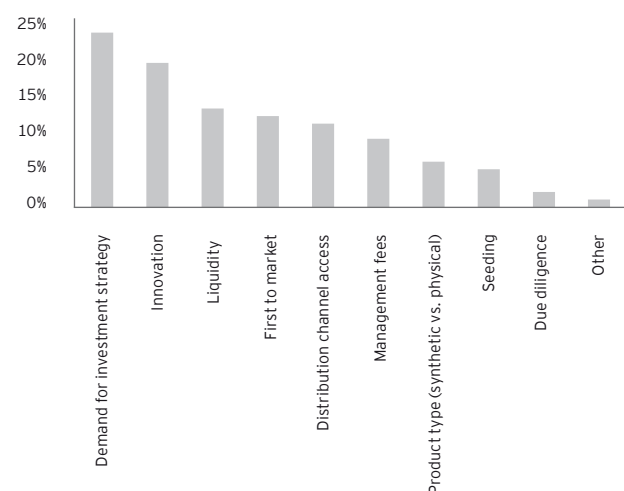
Product launches remain a crucial source of publicity and growth, both for established players and for new entrants. As a result, product ranges are expected to continue to grow in size.

Figure 19: Will the success rate of new launches improve in future?



Despite the growing number of new launches, respondents expect success rates to continue to improve. This is a strong sign of the industry's increasing self-confidence, and highlights promoters' desire to tailor new products to the needs of investors.

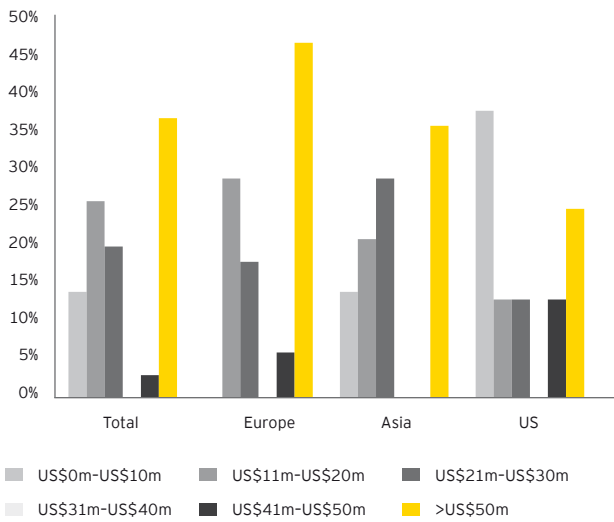
Figure 20: Which factors are critical to the success of new launches?



This finding underscores the industry's increasing desire and ability to tailor products to investor needs. Investor demand and innovation are seen as the most important drivers of successful launches. Speed to market and management fees are rated far less highly.

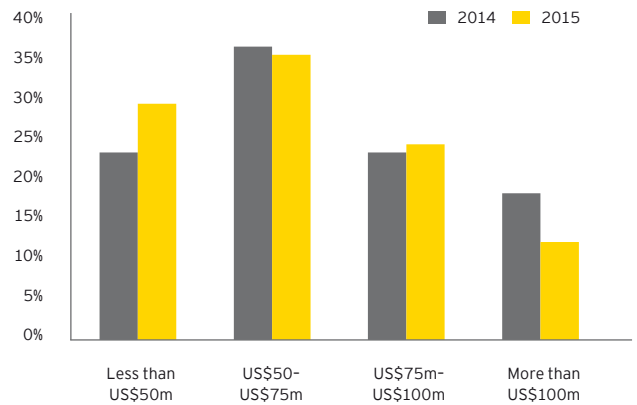


Figure 21: What is the optimal amount of seeding for a new product?



As in prior years, the survey reveals divided opinions about optimal seeding amounts. This reflects wide variations between product types and local market conditions. For example, the US market is seeing increasing use of IPO-type seeding by niche ETF providers. Some European respondents see institutional investors' compliance requirements as driving longer lead times for seeding.

Figure 22: What is the minimum size of a fund for it to be viable?

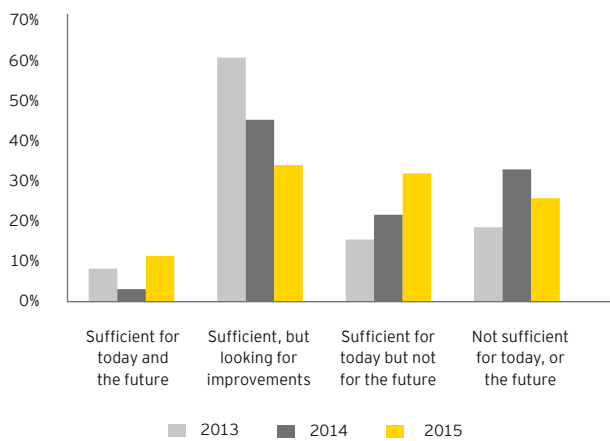


The survey shows a slight decrease in respondents' perceptions of average viable fund sizes. Again, this is consistent with the overall picture of an industry placing greater emphasis on smaller, innovative and more tailored products.



Distribution

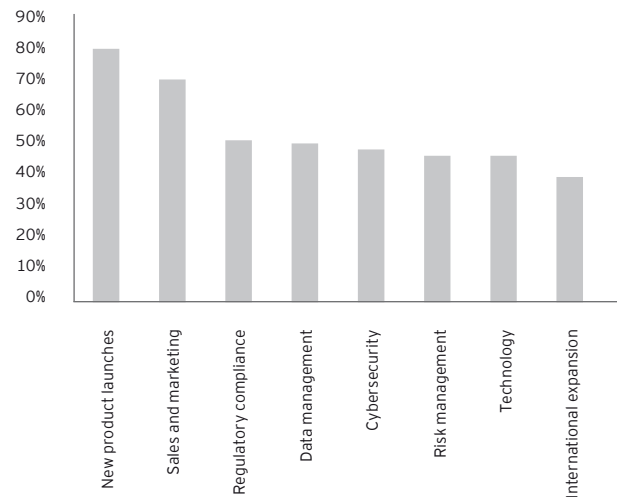
Figure 23: Is your current distribution model sufficient for today's market and that of the future?



The survey shows a further increase in the number of respondents who see their distribution models as inadequate for the future. However, there has also been a slight increase in those feeling confident about their distribution capabilities. The huge potential of digital distribution is leading many ETF providers to reconsider the suitability of their current models – and the potential need for investment.

Operations and infrastructure

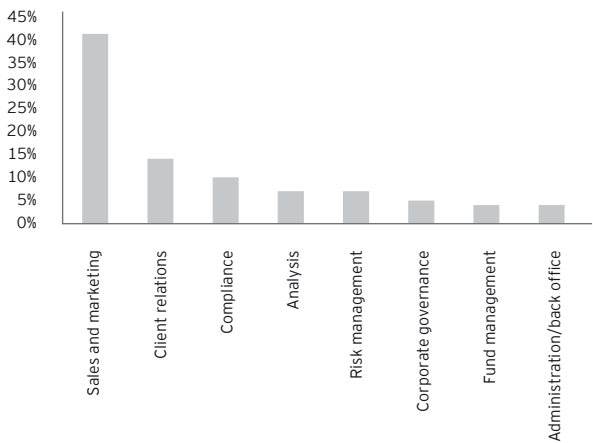
Figure 24: In what areas do you expect your spending to change in the next 18 months? (Positive responses)



Respondents' spending priorities underline the importance that ETF providers attach to innovation and growth, with new products and marketing identified as the leading drivers of spending. Even so, firms also see compliance, data, technology, cybersecurity and overall risk management as areas of focus – showing that the industry is alert to the potential side effects of its rapid growth.

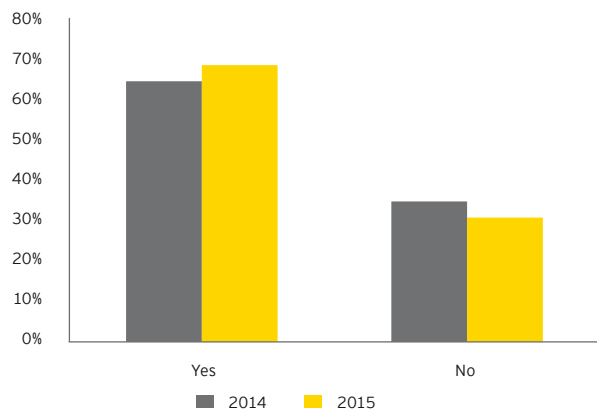


Figure 25: In what areas do you expect your headcount to change in the next 18 months? (Increase by > 5%)



Respondents identify sales and marketing as by far the most important driver of higher headcount over the next 18 months, highlighting the industry’s appetite for growth. By contrast, the much lower forecasts in other areas illustrate the scalability of the ETF model.

Figure 26: Do you see potential for a pan-European exchange model to be established for ETF trading?



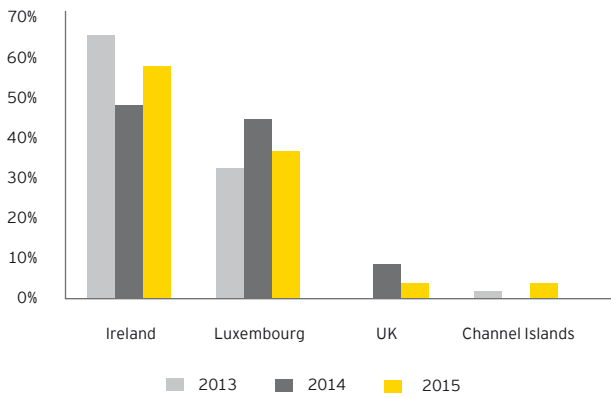
Respondents are increasingly confident that a pan-European ETF trading exchange can be established, even if there are few signs of such a model emerging so far. The growing optimism on this point may reflect hope that fresh industry-led responses will follow the implementation of MiFID II.



“The two biggest things that Ireland offers that no other EU domicile can match are experience and expertise Choice of domicile for an ETF is all about operational efficiency and reputation, and Ireland has built a very strong reputation as an ETF domicile and as a very efficient place to base ETFs.”

Philip Lovegrove
Partner, Matheson

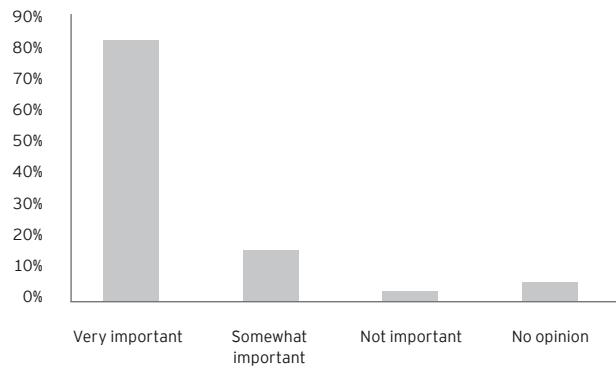
Figure 27: What is the preferred location in which to administer funds within Europe?



As in previous years, many respondents continue to see Ireland as the best location in Europe for ETF administration, particularly among European respondents. Asian respondents tend to favor Luxembourg, where many globally distributed UCITS funds are domiciled.

Risk and regulation

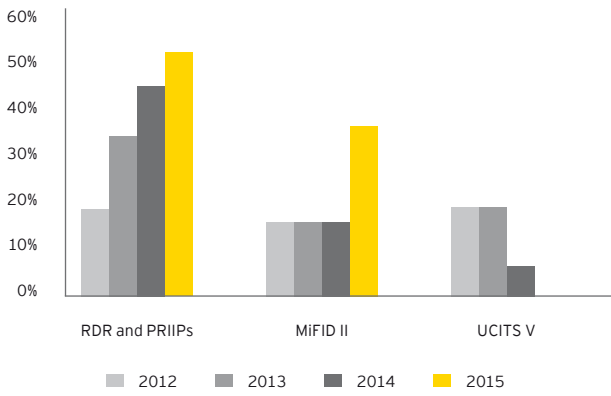
Figure 28: How important do you consider cybersecurity?



The overwhelming majority of respondents see cybersecurity – something that barely registered on the industry’s radar a few years ago – as a very important risk management issue. Promoters are increasingly aware of the potential reputational damage that can flow from security breaches or the loss of client data.

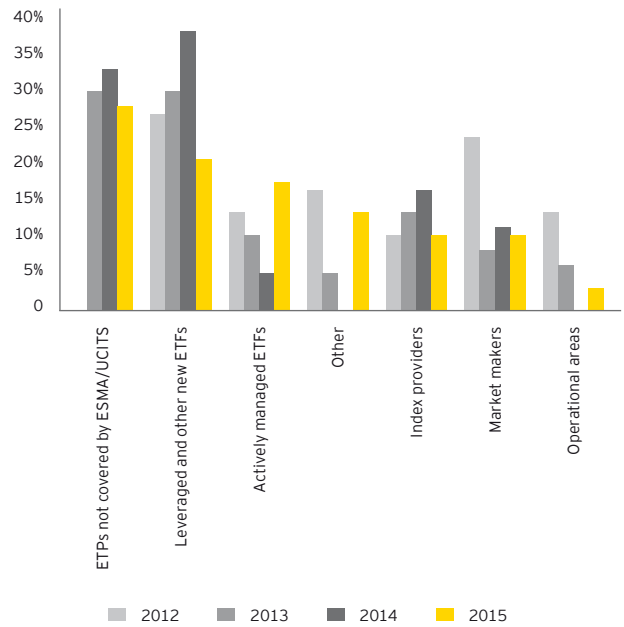


Figure 29: Which regulatory developments offer the greatest opportunity? (Selected responses)



Some US respondents see the SEC's focus on intermediary fees as a potentially valuable opportunity for the ETF industry. However, European regulations are seen as offering the greatest potential benefits. The reform of distribution rules is increasingly important to stronger European retail demand, while MiFID II is becoming a focus of hope for greater transparency in European markets.

Figure 30: Where should regulators focus their attention in the future?



The rapid evolution of product innovation is leading to shifting opinions about which areas merit regulatory focus. Leveraged and other new products, such as smart beta, are seen as a falling area of concern, but active ETFs are troubling some, especially in Europe. ETPs are now seen as the most important area for scrutiny.

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