ETFs 2019
Operating models

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Contents

Do operating models hold the key to ETF success

Faced with increasing competition, promoters need an operating model that's fit for the future.

The success of exchange-traded funds (ETFs) in asset gathering over many years shows little signs of slowing. But the ETF industry — like the whole asset management sector — also faces a challenge to reconcile fee and margin pressure with fast-changing demands for new products, different services, and better reporting.

We believe that best-in-class operating models could hold the key to success in an increasingly competitive market and that future operating models will look very different from those of today. This article examines these views in detail and suggests possible areas for improvement.

The ETF industry is growing fast, but faces a continued margin squeeze

There are many good reasons — including the shift to passive and the global focus on investor protection — to believe that ETFs can continue their track record of global expansion. Even so, it would be **wrong to think that ETFs are immune** to the growing financial pressures facing all asset managers.

In particular, EY research shows that 80% of promoters expect ETF management fees to decline over the coming three years, with nearly a quarter anticipating a fall of five basis points or more. ETFs issuers therefore urgently need to reassess their operating model in order to drive scalability and innovation while continuing to offer competitive pricing.

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As ETFs grow in complexity, there are ever-growing opportunities for asset servicers able to provide tailored support to ETF issuers.

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ETF promoters need a step change in capabilities and efficiency

This tough environment means it's vital for every ETF promoter to ensure its products will remain competitive — against mutual funds and other ETF specialists — well into the future. The growing **regulatory focus on value for money** will only strengthen the need to reduce the costs of ETF ownership at every stage in the value chain.

But firms need to do more than pursue sustainable gains in efficiency. They also need to develop new and innovative capabilities. With technology and investor demand evolving faster than ever, ETF providers face growing pressure to:

- **Deliver outcomes:** for example, by ensuring that ETFs can play a central role as one of the building blocks of customer-oriented investment solutions.
- **Enhance sustainability:** most obviously, by addressing the imperatives of environmental, social and governance (ESG) investing, which could soon become a "hygiene" factor for ETFs and other investment products.
- **Distribute digitally:** whether on a direct-to-consumer (D2C) basis, via online platforms, through automated robo-advice, or as part of a traditional advisory or wealth management service.
- **Provide experiences:** ETF providers may need to develop their branding, reporting, education and user interface capabilities, if they are to provide best-in-class investor experiences.

The four most valuable areas of potential improvement in ETF operating models

Faced with the need to simultaneously enhance their efficiency and capabilities, we believe ETF providers should respond by taking a critical look at existing operating models and be prepared to make radical changes.

It's no exaggeration to say that best-in-class operating models determine the industry's future winners.

The good news is that the rapid evolution of artificial intelligence (AI), automation and data analytics is creating operational possibilities that simply didn't exist a few years ago. The applicability of these tools is expanding beyond the back office, to encompass the whole ETF value chain.

The breadth and depth of partner organizations that can contribute to ETF operating models is also growing fast. It seems likely that the best future ETF operating models will encompass the capabilities of several organizations and service providers, not that investors will be aware of it.

In the next four sections, we briefly highlight what we see as some of the most valuable areas of potential improvement in ETF operating models.

1

Automation and rationalization

Lean process optimization (LPO) is an efficiency-focused methodology that challenges the value of individual processes, functions and activities. EY experience with clients shows that it can be a highly effective way for ETF providers to identify inefficiencies hidden in long-standing processes. Issuers can review the lifecycle of an ETF, and their own processes, from end-to-end to identify opportunities for optimization or re-engineering.

Developments in AI are also opening up the range of technological tools available to ETF issuers and could be used to enhance the efficiency of increasingly complex tasks within the ETF operating model. Robotic process automation (RPA) works within a firm's existing technology architecture to reduce costs, improve service levels, enhance data quality and reduce operational errors. Examples of ETF operations that can be enhanced by RPA include:

- **Client onboarding:** by increasing the speed, consistency and accuracy of data capture for institutional, high net worth (HNW) and retail investors.
- **Back office:** by performing repetitive, high-volume processes in areas, such as tax reporting, corporate actions, broker confirmations, derivative pricing and bank reconciliations.
- **Middle office:** by calculating customized benchmarks, and by pulling data from multiple sources into client and management reports.

Rapid developments at the other end of the AI spectrum are also creating new ways for ETF providers to apply big data analytics to front-office activities. Machine learning tools can now be applied to a range of portfolio management related tasks, such as logistic regression and other forms of predictive analysis.

Asset servicers and other external providers have a vital role to play when it comes to improving the efficiency and accuracy of a range of ETF specific activities. With their large technology investment budgets, these third parties can provide a valuable range of digital operational enhancements. Examples include the automation of manual net asset value (NAV) calculation processes, delivering faster and more accurate NAVs; and streamlining the creation and redemption of units via a web portal connecting issuers, exchanges and authorized participants.

2

Outsourcing and third parties

Established ETF promoters and new entrants alike can turn to a growing range of external parties to provide core elements of the ETF operating model. For their part, service providers have an opportunity to collaborate on providing integrated solutions. For example, asset servicers can partner with FinTechs and RegTechs to offer enhanced ETF focused operational support.

Securities servicers: ETF providers' appetite to outsource core operational processes does not mean this is a straightforward opportunity for securities servicers. A good understanding of the ETF operating model is vital. So too is the ability to build fast and efficient operational links with issuers, authorized participants, market makers, index providers, exchanges and other players in the ETF ecosystem. In addition to providing settlement and custody services, securities servicers already provide outsourced fund accounting, proxy voting, valuations, securities lending and many other tasks for ETF promoters. The servicers continue to increase their capabilities, adding ETF middle and front office functions, such as benchmark analysis, post-trade compliance and regulatory reporting. As ETFs grow in complexity, there are ever growing opportunities for asset servicers to provide tailored support to ETF issuers. Also, ETF providers can leverage the scale and investment budgets of asset servicers to benefit investors. Under quick takeaways, we take a more detailed look at how we believe securities servicers can best support ETF issuers.

Infrastructure providers: Software vendors can provide ETF promoters with an increasingly tailored, integrated range of services. Advances in cloud computing mean that ETF firms can now use "software as a service," instead of hosting and maintaining their own technology. Functions that can be performed by software providers include order management in the front office, processing and reporting in the middle office, and reconciliations, securities lending, unit creations and redemptions in the back office. External vendors are also developing their ability to support ancillary functions, such as compliance, finance and HR.

Data providers: ETF promoters can work with a range of external partners to source and analyze external data, and to integrate it with internal data to derive new insights. This includes market data, such as prices, analysis, ratings and company disclosures; client data, such as transactions and personal details; and alternative data, such as social media chat, web sales, app traffic or geo-locations. The growing importance of ESG-themed ETFs also provides an opportunity for the providers of sustainability related data — such as carbon emissions ratings — to support the development and management of innovative ETFs.

3

Partnering

The rapid evolution of technology will increase the importance of partnering within the ETF operating model. Promoters have growing opportunities to enhance their technological capabilities via cooperation with external partners. Some practical examples are:

- Working with FinTechs, professional services firms or specialized providers to apply advanced data analytics and AI to a range of data sources, thus providing tailored support for investment decisions taken by active ETFs portfolio managers. This could include providing market insights and tailored newsfeeds to the **managers of active ETFs**; generating enhanced performance attribution analysis and peer benchmarking; processing ESG-related information, such as carbon footprints; and using machine learning and natural language processing to filter investment research.
- Working closely with index providers, specialized data providers and consultants to develop new ETFs, sharpen product concepts, and refine the selection of factors and strategies. This might include working to develop new, tailored indices; developing issuers' ability to self-index; investigating the commercial and regulatory features of new geographic markets, such as China or India; and integrating sustainability-related factors into individual ETFs or across issuers' whole suite of operations.
- Partnering with FinTechs, robo-advisors, online fund platforms and wealth managers to build a digitized distribution suite that includes a range of direct and intermediated, advised, and execution-only channels catering for institutional, HNW and retail investors. External partners have the potential to provide insights into retail investor behavior or the needs of institutions. Asset servicers may also be able to leverage banking relationships in new markets — such as Asia — for distribution purposes.
- Working with asset servicers, technology vendors and specialized regulatory compliance technology to automate and enhance areas as varied as stress testing, risk analysis and the management of compliance data. Third parties with expert or local knowledge can help ETF issuers to understand and address the regulatory implications of entering new markets. They can also help to provide low cost, automated regulatory and tax reporting, helping ETF providers to meet the requirements of regimes, such as European Market Infrastructure Regulation (EMIR) or Foreign Account Tax Compliance Act (FATCA).

In our view, it seems clear that finding the right partners is crucial to ETF issuers' ability to develop the right operational capabilities at the right cost. In particular, asset servicers have a key role to play in helping ETF providers to achieve efficient, capable and flexible operating models.

4

Talent and "workforce of the future"

The potential of technology to automate and streamline processes has important implications for the role of human talent in ETF operating models. As AI, RPA and other technological tools take on a growing role, ETF providers will need to adapt their workforce accordingly. That is not just about reducing headcount, although staffing levels are likely to fall as efficiency grows. Firms will need to rebalance their human talent toward value-adding activities. Data analysis, in particular, will become ever-more important for running, changing, improving and growing ETF businesses.

That means that the ETF workforce of the future will be smaller, more skilled and more biased toward key disciplines, such as maths, engineering and technology. This more flexible, more fungible workforce will move between different areas of the business as required, working closely with technology to enhance efficiency and create value. Securities servicers and other third parties can contribute to greater workforce efficiency by ensuring that their technological ETF-tailored capabilities are supported by dedicated teams with in-depth knowledge and experience of ETFs.

Takeaway: How asset servicers can strengthen ETF operating models

We believe that asset servicers should be seeking to develop a suite of services to support the full "life cycle" of a typical ETF, including:

1. Product design, development and regulatory approval.
2. Pre-launch support and seeding.
3. Partnerships with a range of retail, HNW and institutional distribution channels.
4. The provision of market insights to portfolio managers.
5. Ongoing servicing, including NAV calculations, foreign exchange (FX) handling, unit creation and redemption, client reporting, regulatory compliance, risk management, and performance attribution analysis (PAA).

Other emerging capabilities that ETF issuers increasingly expect their service providers to offer include:

- Collateral management capabilities to monitor the location and status of fund assets, along with support for valuations, margining, transformation monitoring and transfers.
- The ability to support a wide range of indices, to help with the construction of new indices, and to contribute to low-cost self-indexing.

In summary, as ETF issuers require support for a fast-widening range of funds that go way beyond core equity to include fixed income, actives, alternatives, smart beta and other strategies, they increasingly require asset servicers to offer an integrated range of ETF-tailored capabilities.

Now is the time to develop the ETF operating model of the future

The strategic challenges we have outlined — and the opportunities found to improve operating models — are not unique to ETFs. Given their track record of growth, ETF promoters may even feel under less pressure than traditional asset managers to change the way they operate.

However, in our view, that would be to overlook a strategic opportunity. We believe that many ETF firms, relatively unburdened by outdated technology, are ideally placed to benefit from operational improvements. It holds true for niche providers seeking to optimize their competitive advantages and for traditional asset managers entering the ETF market. Larger asset management groups with significant ETF and non-ETF activities can also leverage improvements in their ETF models across other business units — or even aspire to a fully integrated operating model.

Of course, the individual circumstances of each ETF provider are different. But we believe streamlined operating models will be crucial to the success of every ETF firm over the coming 5 to 10 years. Few firms are as efficient as they could be and even operating models that have delivered success to date may not get firms "where they need to go." It is critical that ETF operating models are ready for future disruption, change, innovation and partnering. ETF firms should invest in technology and efficiency now to ensure they are well positioned for a "winner-takes-all" future.

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EYG no. 003063-19Gbl
ED 05/19

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