What's next for an industry that's evolving faster than ever?

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Executive Summary

The investment world has seen many transformations in recent years, but few can compare to the story of exchange-traded funds (ETFs). The ETF industry has achieved a remarkable track record of growth, almost regardless of market conditions. And the larger it gets, the greater its appeal to investors appears to become. In fact, the first half of 2021 saw a further acceleration in asset growth.

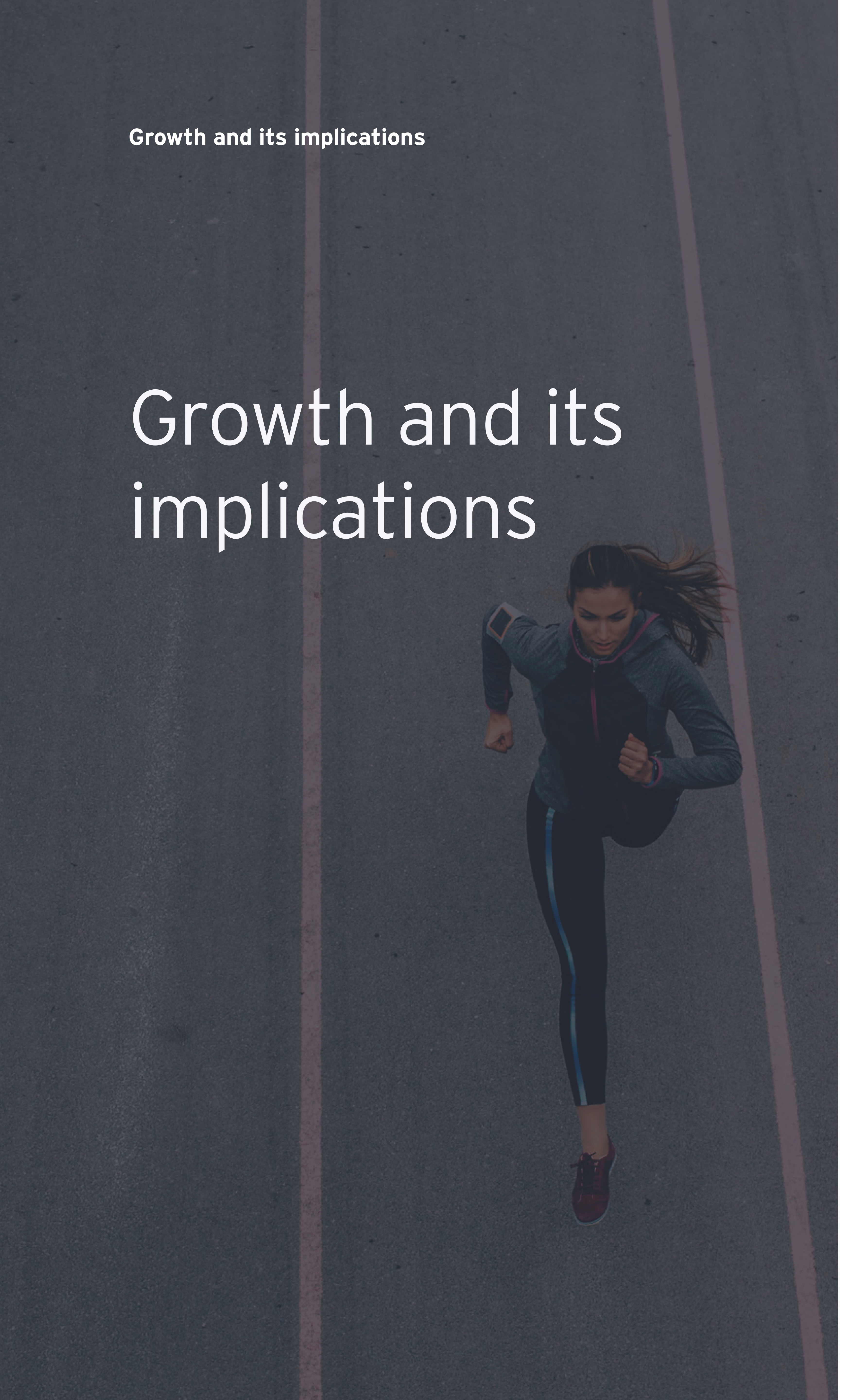
At the root of this success is the industry's ability to combine the enduring advantages of affordability, tradability and accessibility with continuous innovation. The industry's core products and its steady flow of new offerings reinforce each other as drivers of growth.

Nowhere is this more apparent than in the field of ESG, which has rapidly become one of the industry's leading sources of demand. But other innovations such as thematic ETFs, active funds and crypto-themed products also continue to appear.

Of course, growth isn't everything. The larger the ETF industry becomes, the greater the scrutiny it faces from investors, regulators and public authorities. Levels of expectation are growing higher, leaving the industry vulnerable to reputational damage. As ETFs offer investors an increasing range of exposures, the potential sources of risk – ranging from greenwashing to cryptocurrencies – are growing more varied.

It's not just the industry as a whole that needs to tread a careful path. Individual funds and firms face intensifying margin pressure. In many markets this is triggering consolidation, but a steady flow of new entrants suggests that profitability pressure is here to stay, and that M&A will remain a crucial tool in the search for scale.

The ETF industry today is about so much more than low-cost passive investing. That makes the future more exciting than ever – but also harder to predict. Balancing the emphasis on innovation and growth with a clear focus on investor outcomes holds the key to sustaining the industry's current success into the long term.



Growth and its implications

The ETF industry continues to expand at a remarkable rate. Asset growth accelerated during the first half of 2021, with inflows exceeding even the exceptional years of 2019 and 2020.

- EY research shows that global assets under management (AuM) in ETFs increased by 24.9% during the first ten months of 2021, reaching a total value of just under $10tn at the end of October and taking AuM growth since the end of 2019 to 57.2%[1].
- Worldwide net inflows to ETFs during the first ten months of 2021 were over $1tn, higher than 2020's full year total of $763bn[2].
- European ETF growth is also accelerating. Building on a 5-year compound annual growth rate of 21.5%, regional AuM reached $1.5tn at the end of September 2021 - 16.9% higher than at the end of 2020[3].

This track record reflects many drivers. The strong performance of ETFs during the stressed conditions of 2020 impressed many investors who doubted their ability to perform during extreme volatility. The long-term factors that have supported ETF growth in recent years – such as investors' growing focus on costs and transparency, and the shift to passive – also continue to gain momentum.

As a result, the industry's investor base is growing broader. Institutions and wealthy individuals remain Europe's leading ETFs investors, but the retail market is increasingly important to future growth. The shift to online distribution channels such as robo-advisers, fund platforms and direct sales triggered by COVID-19 is working to ETFs' advantage, suggesting there could be potential for European retail investors to develop a similar appetite for ETFs as their North American peers.

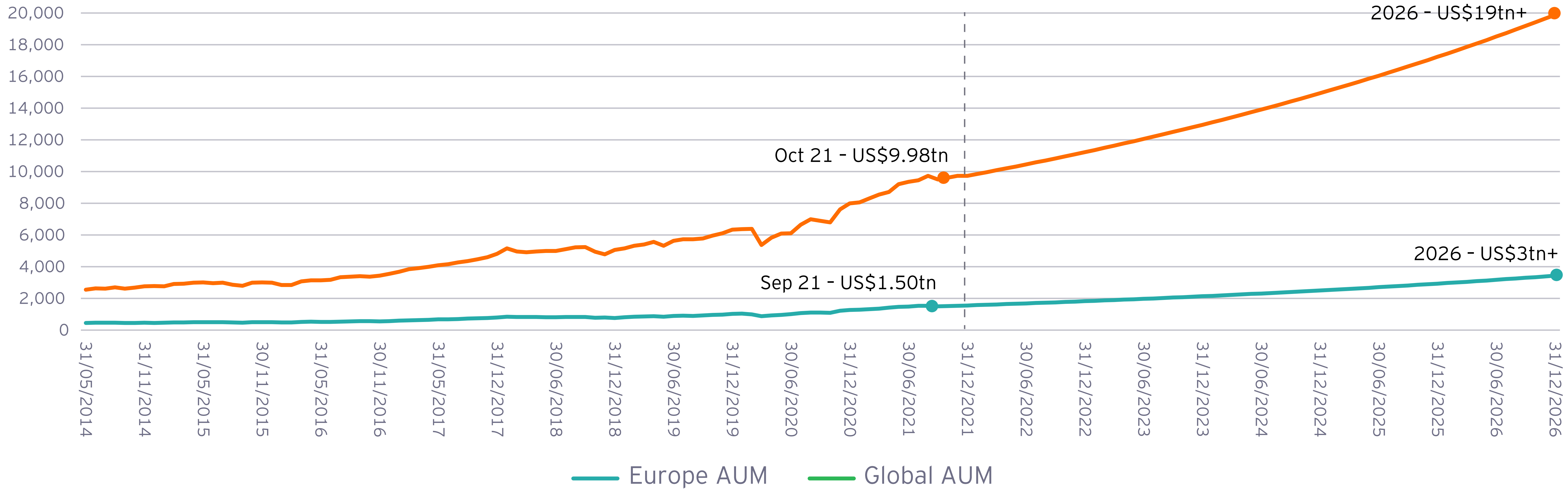
1 *ETFGI*
2 *ETFGI*
3 *ETFGI*

Finally, ETFs' ability to provide investors with a wide range of portfolio building blocks is growing, both for long term allocation and for trading or liquidity management. Among the industry's core products, equity funds remain highly successful and fixed income funds continue to grow strongly. For example, US fixed income ETFs attracted net inflows of $161bn for the first eight months of 2021, a year-to-date growth rate of 13.2%[4]. At the more innovative end of the spectrum, the industry's focus on product development is evident from the success of thematic ETFs - actively or passively managed funds that give investors tailored exposure to themes like cloud computing, digital health or electric vehicles.

Taken together, these drivers suggest that the industry's current growth will continue well into the future. EY's projections suggest that global ETF assets could reach $19tn by the end of 2026, with European AuM of $3tn by the same date[5].

However, growth is not the full story. The faster the industry expands, the greater the scrutiny of potential risks from regulators and investors. Nor is growth shared equally across the industry. A handful of firms continue to capture the bulk of European ETF inflows, and many funds are lacking in scale. The ETF industry will continue to grow, but the future will not be without challenges.

Expected Growth



What's next?

- When will retail demand take off in Europe? And what investments in disclosure, education, reporting and support will be required to achieve this?
- How much further can passive investing grow – is there a natural limit or is that too simplistic?
- Will rapid industry growth 'float all boats' or will a handful of ETF providers continue to capture the lion's share of inflows?

4 *FT.com, 'Blackrock US bond ETFs hit by large outflows as sector booms', 11.10.21*
5 *EY analysis of market data on ETFGI data*

ESG opportunities and challenges

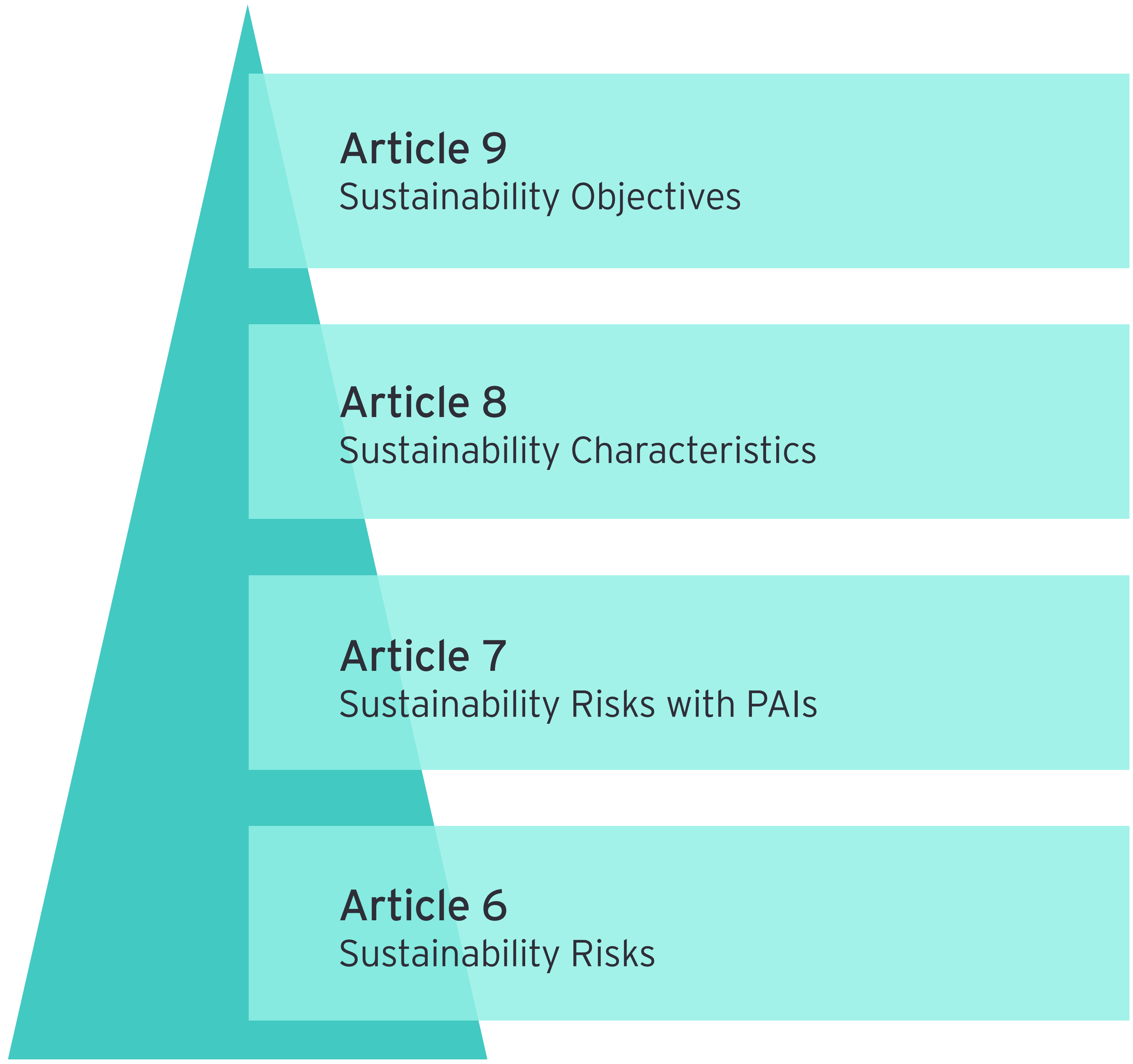
ESG-themed ETFs are becoming the industry's leading growth driver.

ESG-themed ETFs are becoming the industry's leading growth driver. ETFs apply a range of ESG filters across many asset classes and strategies, giving investors low-cost access to sustainable investing. ESG ETFs also performed well during the pandemic; a recent Morningstar study concluded that 25 of 26 ESG equity index tracker funds beat their conventionally-weighted counterparts in 2020. As a result, global inflows to ESG ETFs for the first seven months of 2021 were $97bn, more than the record $89bn gathered over the whole of 2020[6].

The Sustainable Finance Disclosure Regulation (SFDR) has helped to strengthen Europe's role as a hub for ESG investing. The SFDR, which took effect in March 2021, requires managers to disclose their approach to sustainability and to categorise each ETF as an Article 8 fund (promoting environmental or social characteristics), an Article 9 fund (setting sustainable objectives) or an Article 6 fund (any other product). The first six months of 2021 saw $47bn of net inflows into Article 8 and 9 funds, almost exceeding the $51bn recorded during the whole of 2020[7].

6 EY analysis of market data on Morning Star as Q3 2021.
7 EY analysis of market data on Morning Star as Q3 2021.

SFDR Categories

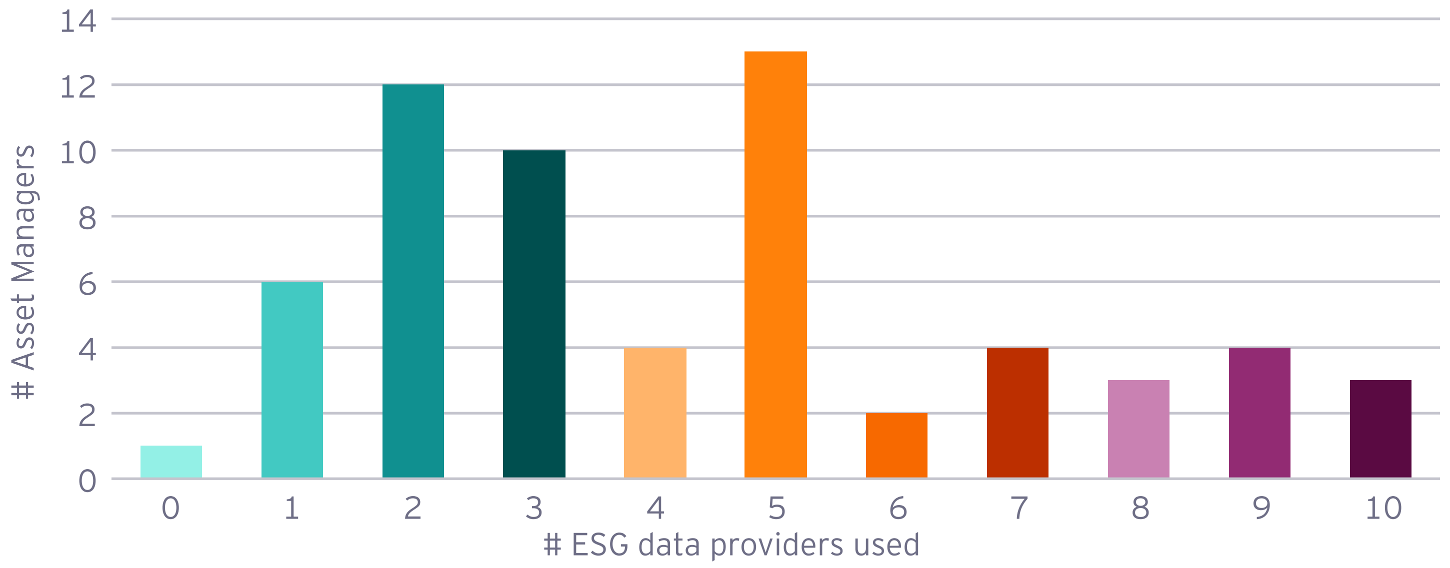


What about the future?

Looking ahead, increasing investor interest in capital deployment suggests compelling scope for long-term growth. One recent survey found that 425 institutional investors with a total AuM of $25tn plan to double their sustainable allocations from 18% of total assets to 37% by 2025[8].

Even so, ESG ETFs face challenges. Like all asset managers, ETF providers face limitations in the availability, consistency and reliability of ESG data. In some areas, multiple data providers must be screened; in others, barely any data sources exist. A few firms have opted to build internal ESG research teams, but the cost is prohibitive for most. And yet, despite the additional costs involved in running an Article 8 or 9 fund, competition is preventing most issuers from charging a premium price for ESG ETFs, eroding profitability.

Number of different data providers used by Asset Managers to cover their ESG data needs:[9]



- **Inconsistency is another challenge.** EY research shows that many industry participants see the SFDR's definitions as leaving too much room for interpretation. In particular, Article 8 funds risk becoming a catch-all category ranging from relatively 'dark green' funds to others with minimal ESG tilts or exclusions. Issuers even seem to take differing views on what qualifies as an Article 9 fund
- **These varying interpretations highlight a broader problem:** A lack of consensus over what ESG really means. For the ETF industry, with its hard-won reputation for transparency, the potential risks of 'greenwashing' are particularly acute. The faster that ESG ETFs grow, the greater the likelihood that inaccurate or inconsistent disclosures generate damaging publicity[10]. Like all passive ESG funds, ETFs are potentially vulnerable to accusations that limited ability to flex their holdings prevents them from having a positive real-world impact – something that underlines the need for effective stewardship.
- **Transparency is vital to issuers' ability to build investor confidence in ESG ETFs and mitigate potential greenwashing risks.** Managers need to ensure that users understand the differences between dark and light green funds, and between passive and active styles. This is particularly important in Europe, where investors across the region's fragmented markets often seek very different things from ESG ETFs. Investor awareness will be crucial to sustaining the growth of ESG ETFs into the long term.

What's next?

- Do investors understand what they're getting from ESG ETFs? How can investor education be improved?
- Can European ETFs avoid greenwashing risks and remain a leading light of sustainable investing?
- How can issuers overcome the data challenges they face?
- Should data quality standards be established for commercial ESG data providers?

8 *FT.com 'Do good investors drive demand for tailored ETFs', 13.09.21*
9 *EY Research*
10 *FT.com, 'DWS shares slide after greenwashing claims prompt BaFin investigation', 26.08.21*

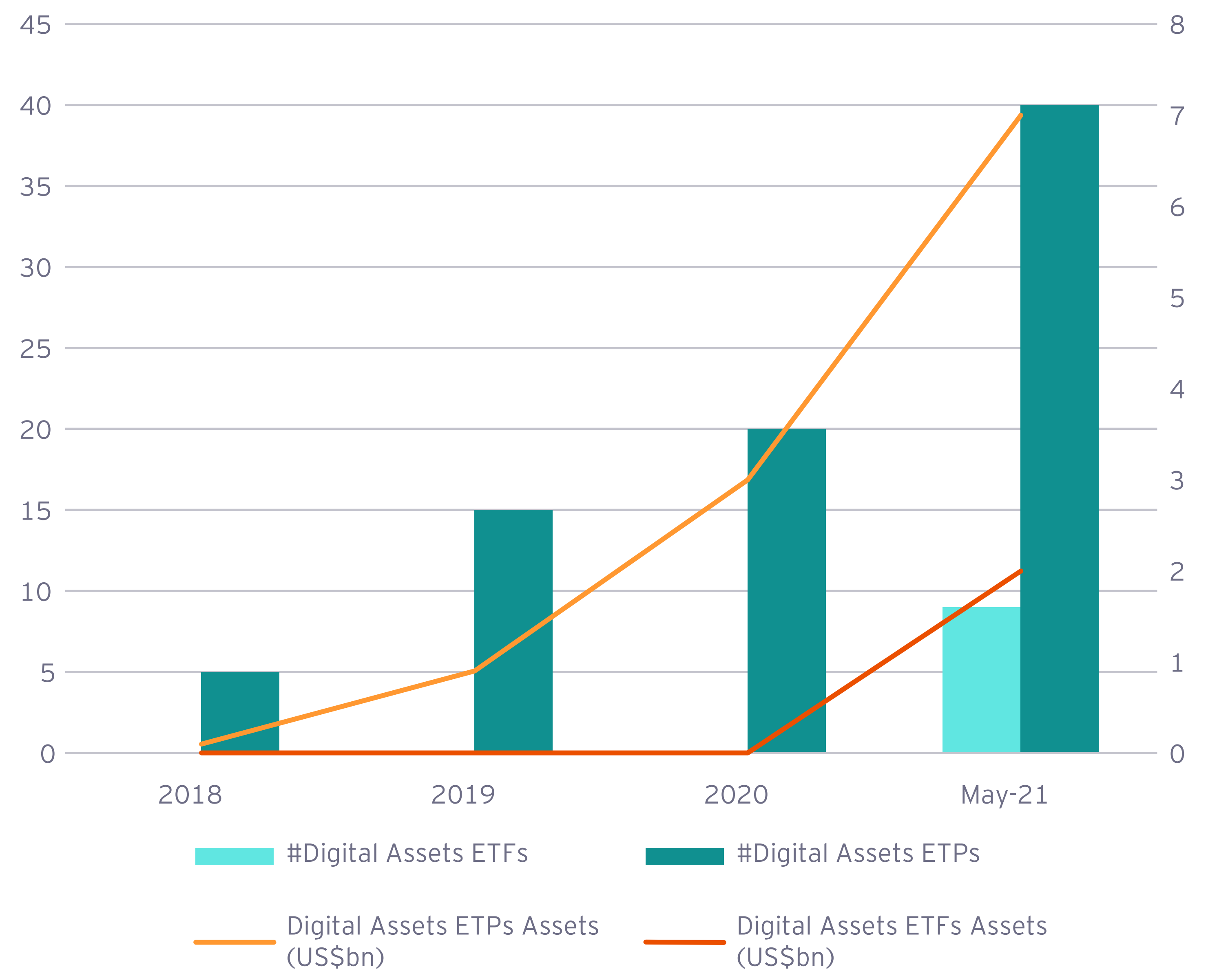
Innovation: Specialisation and sensitivity

ESG is not the only area of innovation driving growth for incumbent ETF providers and their challengers.

Thematic ETFs, including actively managed funds and those tracking sector indices, have boomed over the past year. Their success is typified by the ARK Innovation ETF, which grabbed headlines by generating returns in excess of 150% during 2020[11], spawning many imitators. The popularity of thematics reflects their ability to open up compelling investment stories to a wide range of investors.

Another example of this accessibility comes from **crypto-themed products**, a highly specialised asset class that is dividing industry opinion. Exchange-traded products (ETPs) focusing on cryptos have grown rapidly since the end of 2020. It's true that they are starting from a small base: there are currently just 37 crypto ETPs in Europe, with total assets of less than $4bn[12]. However, expansion has been dramatic, with trading volumes of crypto products on Xetra reaching €1bn a month within 8 months of their introduction[13]. In the US meanwhile, the ProShares Bitcoin Strategy ETF (which holds bitcoin futures) took just two days to reach AuM of $1bn[14].

Global Digital Assets ETF and ETP asset growth as at end of May 2021[15]



Year	2018	2019	2020	May-21
#Digital Assets ETFs/ETPs	5	15	20	49
Digital Assets ETFs/ETPs Assets (US$bn)	0	1	3	9

11 EY Research of market data
12 EY Research of market data
13 EY Research of market data
14 EY Research of market data
15 ETFGI

On the upside, crypto ETPs make this unique asset class available to investors otherwise unable or unwilling to own cryptos directly. Set against that, they are a costly way to invest. Market makers have reported high spreads, and clearing costs can be thirteen times those of a typical S&P 500 ETF. Furthermore, ETPs are typically not regulated as UCITS in the same way as ETFs are (although they are subject to much, if not all, of the same distribution and listing requirements). This regulatory status could pose reputational risks to the wider ETF industry. While regulators in Ireland, the UK or the US do not view cryptos as appropriate assets for investors, authorities in Germany, Sweden and Switzerland allow a degree of direct investment. The potential risks of cryptos and other digital assets mean that investor education is vital to ensuring this innovation remains trouble-free.

Looking further afield, **Chinese fixed income ETFs** have enjoyed robust growth during 2021 as investors were drawn to debt issued by the central government and its three major development banks. One UCITS ETF investing in Chinese bonds attracted net inflows of €4.5bn during the first seven months of the year[16]. Typical coupons on 5 year Chinese debt are around 200bps, compared with 75bps for US sovereign bonds. It remains to be seen whether ETFs will expand into China's commercial bond markets; events surrounding Evergrande are a reminder that attractive yields need to be weighed against potential risks.

Technology is another growing enabler of ETF innovation. Several US issuers now offer **AI-powered ETFs** with decision-making informed by machine learning, although human investment managers and data scientists continue to play an important role. There is also increasing interest in the potential of **direct indexing** – bespoke investment strategies that reflect personal values and circumstances, within an ETF wrapper. Automation, falling trading costs and fractional ownership could help to make these products accessible to a wider audience than in the past – something illustrated by several large fund providers' recent acquisitions of companies involved in direct indexing[17].

What's next?

- Will regulatory attention on ETFs and ETPs grow as the industry innovates further?
- Should ETPs continue to be unregulated? The SEC is probing a range of 'complex' ETPs with an eye to new regulation
- Can investor education alone eliminate the potential conduct and reputational risks of further innovation?
- How will regulators react as digital assets become more widespread and ETF infrastructures become increasingly digitised?

16 *FT.com, 'Blackrock ETF helps drive jump in Europe-based China fond fund flows' 03.09.21*
17 *FT.com, 'ETF pioneer Grossman urges asset managers to adopt direct indexing', 12.08.21*

Profitability, scale, consolidation and outcomes

Long-standing trends including strong competition, falling fees, product proliferation and new entrants continue to drive strong margin pressure in the ETF industry. Falling profitability is seen as a leading challenge by many providers.

Added to this, the need to invest in technology, data, automation and compliance is increasing rapidly. Areas where ETF promoters are keen to enhance their capabilities include integrated data infrastructures; AI, automation and operational efficiency; and investor education and awareness.

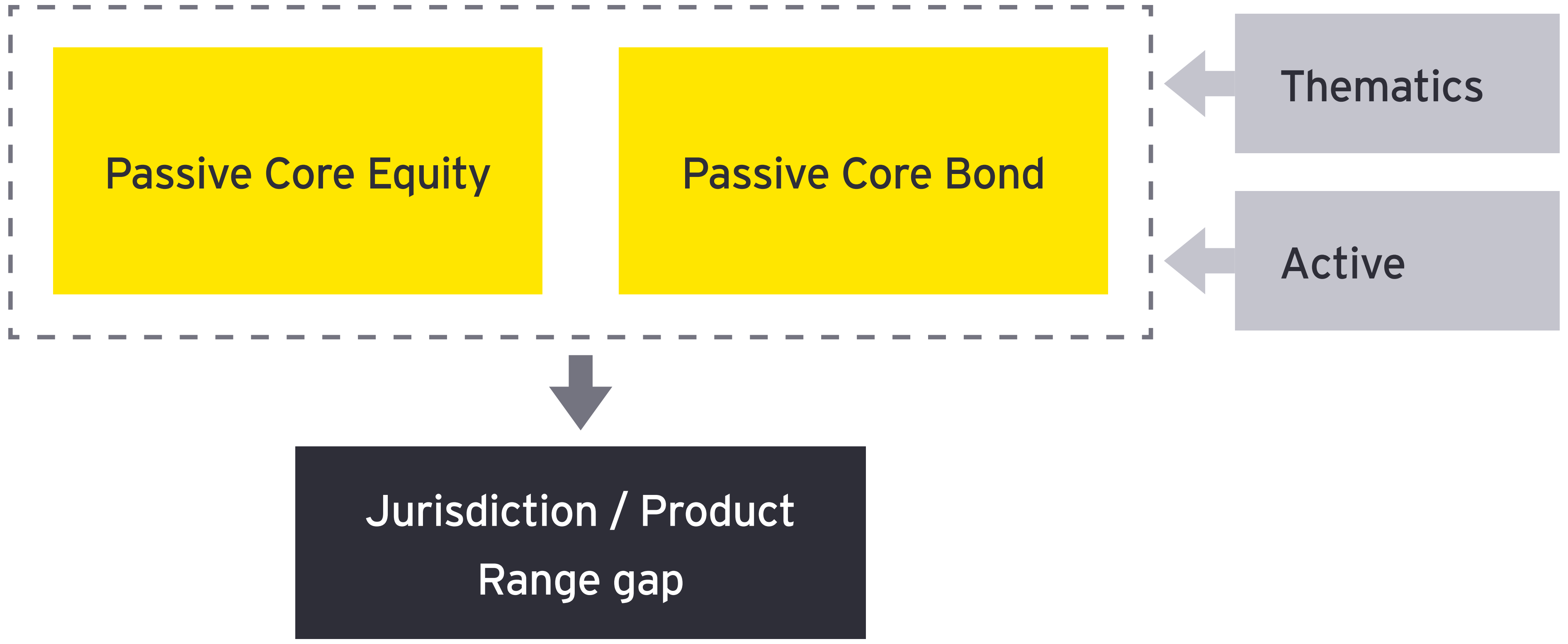
As a result, the need for scale is growing ever stronger. Consolidation is a growing trend in the ETF industry. Recent transactions have involved ETF promoters – such as Amundi's acquisition of Lyxor; administrators – such as State Street's acquisition of BBH; market makers and benchmark providers.

The asset servicing segment of the industry is also seeing increased private equity investment in fund administration, governance companies, custodians and corporate servicers, especially in established asset management hubs such as Ireland and Luxembourg. ETF providers are facing many of the same margin and transparency pressures as the wider asset management industry, creating a need for greater scale, wider ranges of services and deeper fields of specialisation.

M&A activity

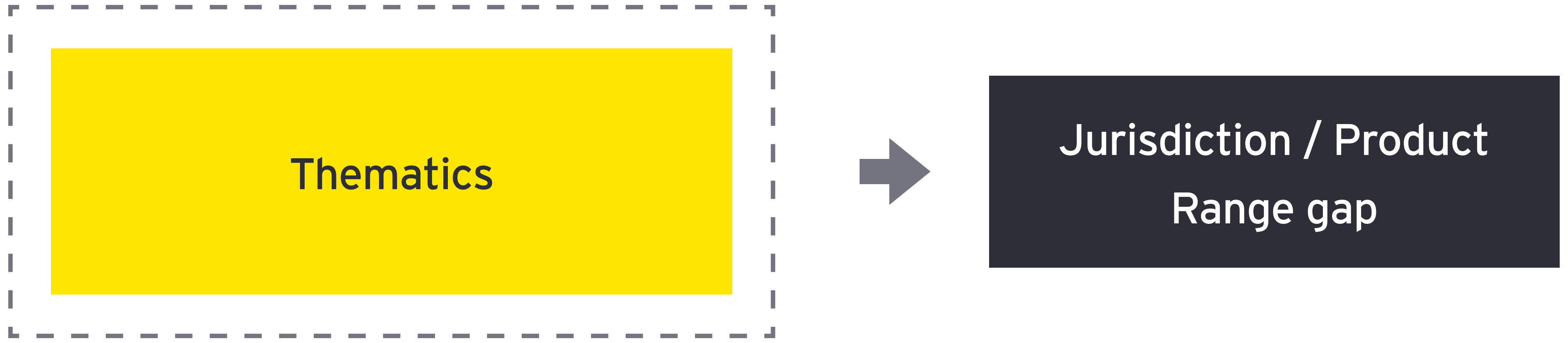
These forces point to continuing M&A activity in the medium term, reinforced by more players entering the ETF market. In order to succeed, new entrants typically need to build scale quickly, offering a one-stop shop offering or develop strong niche competencies, and a depth of service in its area.

Consolidation and Building Scale in a "one-stop shop" Provider



- In the **first phase** of mergers and acquisitions for a one-stop shop offering, we would see a promoter acquire the missing components of breadth of service (e.g. a passive core manager acquiring Active ETF Capabilities and specialism in Thematic ETFs) .
- In the **second phase** of mergers and acquisitions for a one-stop shop offering, we would see a promoter look to extend its client foot print, (via acquiring distribution capability in new jurisdictions, or extending it's product range to fill any gaps in client demand across it's suite of products).

Building Scale in a in a Niche Provider



- In a **niche provider,** we would see a promoter developing a depth of service, focusing on it's core competencies before look to extend its client foot print (via partnering with, or acquiring, distribution capability in new jurisdictions, or extending it's product range to fill any gaps in client demand).

The industry's unprecedented growth is attracting in a steady stream of new issuers, including many former 'ETF holdouts'. 2021 saw announcements from Capital Group - which plans to launch actively managed ETFs in early 2022[18] - and Federated Hermes, which is seeking regulatory approval for two actively-managed fixed income ETFs[19].

At the niche end of the spectrum AssetCo, run by former Aberdeen CEO Martin Gilbert, recently announced a majority investment in thematic ETF provider Rize[20].

Boosting scale at the fund level is important too, especially in Europe's relatively fragmented markets. Could Europe see an acceleration of mutual fund conversions in future? This is an established trend in the US – helped by local tax incentives – but fund mergers could also be a useful response to competitive pressures in Europe, helping to build fund scale and liquidity.

In the long term, consolidation should lead to better outcomes for investors. Greater scale helps to offset cost growth and often leads to tighter spreads, lower charges and larger pools of liquidity. But while niche providers will always have a key role to play in driving innovation, the profitability outlook for mid-tier providers will only become more challenging. Price-led competition has always been a hallmark of the ETF industry and there is little to suggest that margin pressure will evaporate any time soon. The challenge is to make sure that this does not prevent the industry from continuing to deliver value for investors.

What's next?

- Will we see continued consolidation among the biggest players in the industry?
- Will there continue to be an influx of new entrants to the ETF market?

18 *etftrends.com, 'Capital Group Has Filed for Six Active ETFs with the SEC' 08.24.21*
19 *investmentnews.com, 'Federated enters ETF market with 2 active bond funds', 08.19.21*
20 *etfstream.com, 'Martin Gilbert's AssetCo purchases stake in Rize ETF', 07.20.21*

Conclusion - what's next?

Globally, assets in passively managed ETFs reached $8.7tn at the end of June 2021, just $0.1tn less than those in index-tracking mutual funds[21]. ETFs seem well on the way to becoming the world's dominant collective investment vehicle. But ETFs are also a lot more than 'just' passive funds. The idea that 'ETFs can only go so far' looks increasingly outdated in the face of the industry's rapid innovation and growth.

Even so, the forces shaping European ETFs are very similar to those of the wider investment industry. Rapid growth is offset by falling margins, and the upside of innovation is not without its potential risks. Costs are climbing, competition is accelerating and profitability is under pressure. And yet while some firms are trimming their offers or exiting the market altogether, others continue to enter the industry and launch new products.

To ensure lasting success in this environment, many ETF providers will need to do more than continue on their present course. ESG represents a key pillar of future growth, but it is no panacea either. Firms must combine things the industry has always done well – such as transparency, tradability and value for money – with heightened standards and better investor outcomes if they are to stay ahead of the game.

21 EY analysis of market data on Morning Star

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