ETFs 3.0 - a leading light through uncertain times

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Executive Summary

Since they were first created, the exchange-traded funds (ETF) industry has achieved a remarkable track record of growth. In 2022, a year of incredibly tough market conditions, ETFs saw declines in assets under management (AUM) yet still attracted net inflows and had a very strong performance in the context of the wider market.

Supporting the industry's strong performance, is its foundation of affordability, tradability, and accessibility, combined with the strength of its products and how it embraces innovation.

This innovation can be seen across the spectrum, with ESG ETFs rapidly becoming one of the industry's leading sources of demand and active ETFs continuing to build momentum among other areas.

Digitalization is being adopted across all parts of the investment journey, with online distribution channels emerging across the industry, along with some providers testing the digital asset space and investing in the tokenisation of their issuances as part of the next evolution in the industry.

The appeal of ETFs with investors is obvious to see, but with this broader appeal comes greater scrutiny from investors and regulators alike. The ETF industry was initially known for low-cost passive investing – it has grown much wider than this making the future more exciting than ever. 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.

A time of global economic uncertainty

During 2022, the global economy was severely tested by a combination of factors such as the war in Ukraine, mounting inflationary pressure, and European and US central bank policy adjustments. This highly unstable geopolitical environment had a ripple effect on the investment community, and market performance fluctuated accordingly.

> *The global ETF industry ended 2022 with US$9.2t in AUM, representing its first annual decline (of 10.1%) over the last 15 years*

By the end of the year, the ETF industry had US$1.4t[1] AUM which represented a 11.3%[2] decline from December 2021 when the industry set peak records. This is only its second annual decline over the last 15 years and, in context of the wider market, is still a very strong performance. The same is true of the global ETF industry, which ended 2022 with US$9.2t[3] in AUM, representing its first annual decline (of 10.1%[4]) over the last 15 years.

We can clearly chart the factors across the world that have impacted this performance:

- Global economies began to fully emerge from COVID-19 restrictions in January; however, the undercurrent of inflation created fears that central banks would be forced to start tightening monetary policy. The Federal Reserve kicked this off with an aggressive series of rate rises in March – its first rises since 2018 – moving base rates from 0% to 4.25%[5] over the course of the year. Central banks around the world followed suit.
- Europe's first land war in almost 80 years – the War in Ukraine – sparked an unprecedented wave of financial sanctions against the Russian economy and led to spikes in commodity and energy prices.
- The UK experienced massive political turmoil, with abrupt changes in leadership seeing three successive prime ministers throughout 2022. A "mini budget" in September led to spiraling interest rates on debt across the country impacting mortgages, corporate debt and the nation's gilt market. This cast the country's pension fund industry into crisis, ultimately requiring intervention from the Bank of England.
- Throughout 2022, fears of a global slowdown in economic growth and declining spend resulted in a series of job cuts in the tech sector, the effects of which we are now seeing as we move into 2023.
- With such widespread economic uncertainty, global markets were significantly down overall, with the S&P 500 losing 19%, the Stoxx 600 losing 13% and tech-heavy Nasdaq losing 33%.[6]
- The wider European funds industry, which is predominantly actively managed and better positioned to protect itself from declining markets, also lost 10% of its net assets during 2022, and experienced outflows in eight of the 12 months to November 2022.[7] Money market funds, which were buoyed by the changing interest rate environment, and real estate funds, which operate in an investment market where demand outstrips supply in many developed economies and is attracting investment, were the only segments of the markets to see increases.

> *By the end of the year, the ETF industry had US$1.4t in AUM*

1. ETFGI
2. EY analysis of ETFGI data
3. ETFGI
4. EY analysis of ETFGI data
5. Forbes.com – 'Federal Funds Rate History 1990 to 2023'
6. EY analysis of Bloomberg data
7. EFAMA Press Releases

How did the ETF market perform in 2022?

Despite these challenges, ETFs in general have had a remarkable year. While the annual growth figures didn't quite achieve the 20%+ increases of recent years, they managed to maintain a healthy growth trajectory.

Total assets invested in ETFs have only fallen by approximately 10%,[8] whereas the main US and European markets have fallen by 15%.[9] The predominantly passive industry has experienced market-related declines; however, investor inflows continued throughout the year. In Europe, there were net inflows into ETFs for 10 of the 12 months in 2022, with the overall global market continuing a run of 43 consecutive months of inflows.[10]

The second-best year on record for inflows was 2022, while other fund types were largely seeing outflows. It's clear therefore that the market is continuing to adopt ETFs as the product wrapper of choice, and the sector's resilience over the last number of years has proved its ability to weather storms of volatility and market stress.

> *In 6 years' time, we anticipate the European ETF industry will grow at a CAGR in excess of 12% and past US$3t with global industry growing to more than US$20t.*

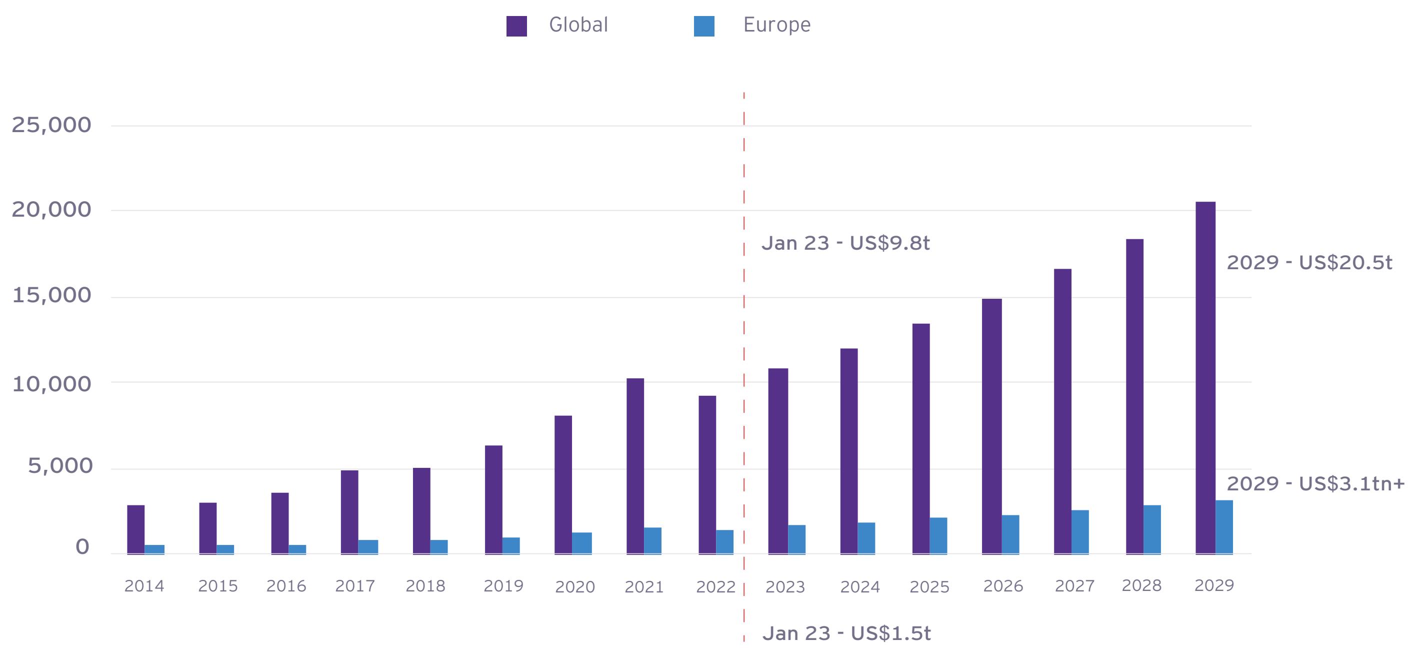
Core equity and fixed income ETFs have taken in the vast majority of inflows in 2022, with fixed income taking in more than its fair share. Thematics, which were hugely successful in 2020 and 2021, have fallen back as investors were looking to move back toward core products and having broad-based diversified investments to ride through the market volatility of 2022.

ETFs still represent a small portion of the funds market in Europe, with only 7% of all assets invested in European undertakings for the collective investment in transferable securities (UCITS) and alternative investment funds (AIFs), invested in ETFs.[11] As the markets

emerge from 2022's downturns, ETFs will return to growth in 2023 and continue to capitalize on their underlying driving forces of growth. However, slowing growth forecasts for the EU economy for 2023, before a modest increase in 2024 and thereafter, will dampen the 20%+ CAGRs we have seen in ETFs in the recent past.

In six years' time, we anticipate the European ETF industry will grow at a CAGR in excess of 12% and past US$3t with the global industry growing to more than US$20t.[12]

ETF growth trajectory (US$ billion) [12]



8. *EY analysis of ETFGI data*
9. *analysis of Bloomberg data*
10. *ETFGI*
11. *EY analysis of EFAMA Press Releases and ETFGI data*
12. *EY analysis of ETFGI data*

A shift to online distribution channels

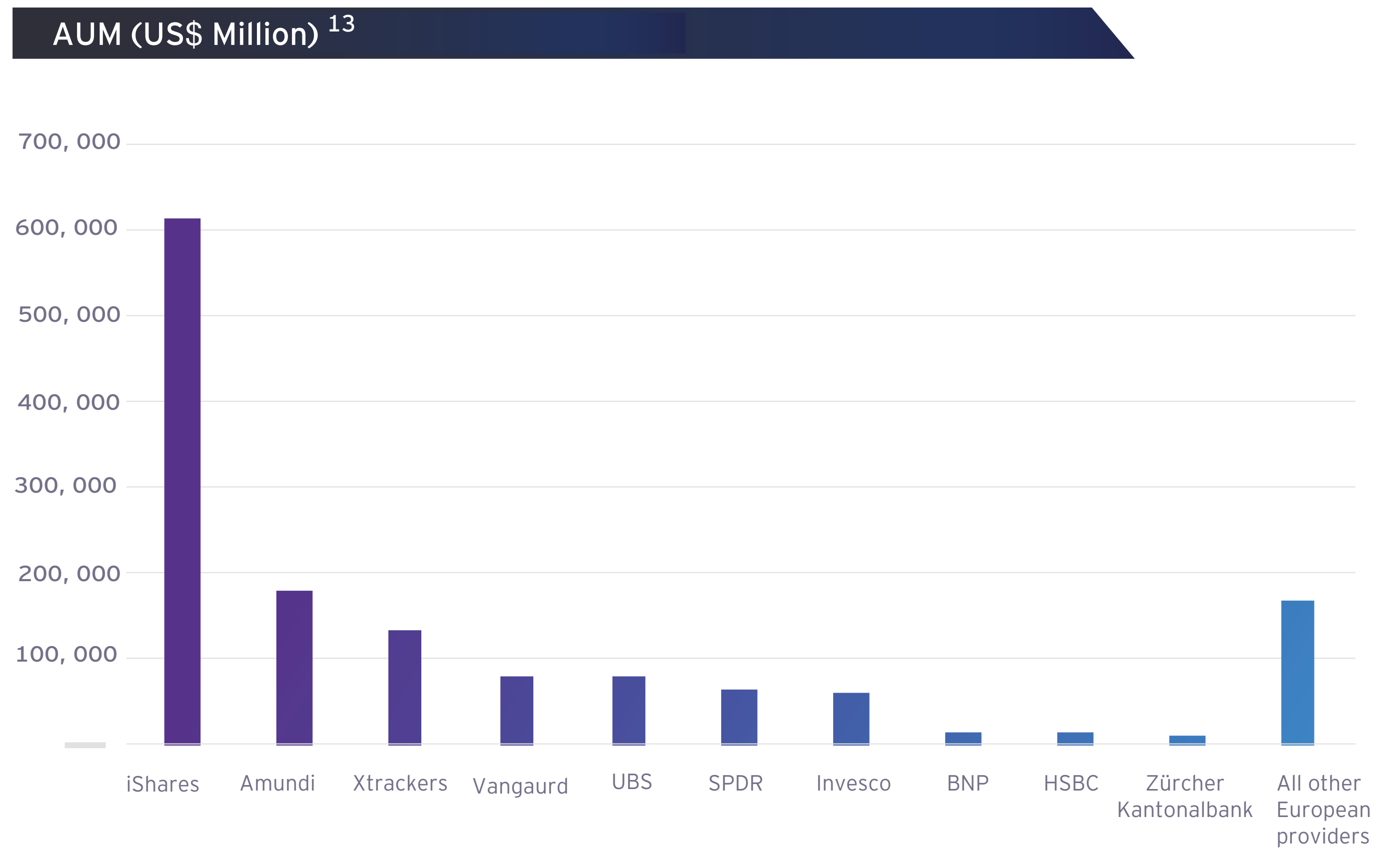
There is growing demand for digitalization across all parts of the investment journey. We are seeing greater adoption of online channels as a distribution method for ETFs: for example, in Germany, where online ETF savings plans have become very popular in recent years.

Europe hasn't historically demonstrated the same appetite for retail investing as the US, but the growing availability of online distribution channels is beginning to attract this increasingly important segment of the market. The market sell-offs of recent years have demonstrated that retail investors are typically "stickier" than their institutional counterparts, and European providers are keen to expand this aspect of the market.

Larger brands typically wield more power in the market, and we see this with the high levels of concentration AUMs invested in the larger providers' ETFs. With stronger, well-known brands and weightier budgets behind them, the larger providers have traditionally been in a better position to extend their distribution capabilities across Europe and should therefore be primed to capitalize on an increase in retail investors.

The top 10 providers of AUMs account for 94% of the market, with only 22 providers with assets above the €1b mark.[13] The proliferation of smaller players that lack scale poses a challenge in an industry where economies of scale are vital to success. The acceleration of online distribution channels is acting as a route into the market for smaller providers.

Many providers see ETFs as an upgrade of the traditional mutual fund, yet they are reluctant to cannibalize their existing businesses which have historically operated on higher fees. This poses the question: For how much longer will these providers continue to subsidize products that have assets below their viable threshold, and will new, innovative, distribution channels enable these players to come to scale?



13. *Refinitiv Lipper*

2023: The industry moves toward responsible investing

Increasingly, Environmental, Social, and Governance (ESG), is a core consideration for business leaders, investors, stakeholders and end consumers globally. From 2017 to 2022, ESG ETFs have moved from being perceived as a niche product to one that is now salient for most investors.

With the challenges faced by financial markets during 2022, many questioned if investors would remain committed to ESG investing as a theme. As we closed out 2022, any doubts in this regard were unfounded, with continued inflows into these products globally. Over the last five years, AUM has grown at a phenomenal 40% CAGR,[14] with 43 consecutive months of inflows, to reach US$403b invested in ESG ETFs at the end of November 2022.[15] This figure only represents 4% of the global ETF industry, itself a significant increase from 1% in 2017,[16] still leaving huge scope for continued growth in ESG ETFs.

Europe is really leading the way when it comes to ESG. By the end of 2022, ESG ETFs accounted for 19% of the European ETF market.[17] ESG is dominating the inflows into the European ETF market, representing 65% of all inflows in 2022.[18]

Providers are commenting that ESG is a key topic of conversation with investors as part of their distribution, and the EU's Sustainable Finance Disclosure Regulation (SFDR) classifications are actively being used as a scoping tool for their investable universe.

Other than money market funds and real estate funds, both of which had unique drivers, ESG is one of the only asset classes where AUM increased in 2022. We expect that ESG-focused ETFs will continue to expand and attract capital allocation.

Innovation has always been a core focus of the ETF industry and, given the change in underlying market dynamics in the ESG space, we expect this focus to be continued and to see new products being developed.

We increasingly see launches of impact investing thematic ETFs, as providers look to use their strategies to target aspects of the UN's 17 Sustainable Development Goals. While thematic ETFs fell back in 2022, we expect them to come back into vogue when markets stabilize. Within this banner, we expect to see biodiversity and nature emerge as a new priority in terms of risk, impact and product.

In 2023, providers will focus more intensely on the whole area of stakeholder engagement. While passive funds can't necessarily vote with their feet and sell their holdings in companies not aligned with their ESG values, they can exercise their voice as a shareholder, engaging with management, using their vote to influence these companies to align behavior with the fund's expectations. This will add value for ETF investors looking to pursue the change agenda and enable providers that follow this course of action to differentiate themselves in an already tough marketplace.

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> *By the end of 2022, ESG ETFs accounted for 19% of the European ETF market*

14. *EY analysis of ETFGI data*
15. *ETFGI*
16. *EY analysis of ETFGI data*
17. *EY analysis of ETFGI data*
18. *Morningstar*

Expect scrutiny over the ESG space to increase further in 2023

Regulatory scrutiny of ESG-labeled ETFs started to increase in 2022, with several of the industry's global heavyweights facing investigations or receiving fines relating to accusations of greenwashing. Let's look at the various regulatory challenges facing the industry overall:

- The EU released the Level II provisions of SFDR, with an effective date of 1 January 2023. The release of these provisions led to 70% of ETFs classified as Article 9 being downgraded to Article 8,[19] as providers look to tread cautiously in this area but also fear moving to Article 6 would trigger investor outflows. While the Level II provisions have provided some welcome clarity, they have also sparked questions from some in the industry about whether Article 9 is ever attainable, whereas Article 8 may be seen as too vague.
- Now that Level II of SFDR is effective, the European Securities and Markets Authority (ESMA) has flagged that the area is a key objective and, as a result, scrutiny in Europe will pick up.
- In the UK, the Financial Conduct Authority (FCA) has launched a consultation paper on its Sustainability Disclosure Requirements (SDR) regime, which some in the industry see as the most expansive framework of any country outside the EU. This is set to be a fundamental piece of regulation that will guide firms on disclosure; it should improve investor confidence and reduce the risks of greenwashing. The UK is paying attention to the corresponding measures in the EU, as well as best practices in markets further afield. The new SDR measures are due to be finalized in early 2023 and aim to assure consumers and investors, and improve stability within the financial ESG system. However, a diverging regime in the region, when providers typically distribute the same product in the UK and across the EU, will certainly add confusion to what is already a complex area.
- Further afield, 2022 saw regulation in this area starting to gather pace across the rest of the world. The Securities Exchange Commission (SEC) in the US amended disclosure requirements for investment advisors and funds regarding ESG investment practices and name requirements for ESG funds. The Canadian Standards Association (CSA) in Canada issued guidance to bring greater clarity to ESG-related fund disclosure and sales communications. Meanwhile, authorities in Malaysia, Singapore, India and Japan are leading the way in the Asia-Pacific region, introducing policies and guidance to encourage more investment in sustainable financial instruments, enhance consideration of ESG risks, and prevent firms from greenwashing their products.

Against this backdrop, we see boards and executive management becoming highly focused on the topic of greenwashing and working to develop the appropriate risk management and product governance to combat this. Data – and access to it – is the main challenge here and will continue to cause issues for companies going forward.

19. *ETFStream.com – 'Over 70% of Article 9 ETFs downgraded to Article 8'*

Where to now for Digital Asset Exchange Traded Products (ETPs)?

During 2021, we saw the peak of the Digital Asset market, with November's bitcoin price reaching over US$67,000.[20] At the same time, the digital asset ETP space experienced rapid growth, with over US$20b invested across 80 products.[21]

This took a dramatic turn in 2022, with many referring to this as the industry's "crypto winter." The price of bitcoin plummeted almost 75% to US$17,000,[22] with other digital assets down even further. The industry faced increasing market scrutiny with high-profile collapses such as Terra and the corporate failure of Futures Exchange (FTX). Consequently, the level of assets in Digital Asset ETPs has declined by 69% to US$6b.[23]

Could this be a reflection of growing pains for an innovative sector, or did the tide go out on the digital asset industry as central bankers raised interest rates around the world? Either way, the events of 2022 have eroded trust in the industry and have increased the calls for regulators to oversee the industry.

Despite concerns, interest in the area remains strong. ETP providers in the space are preparing themselves for a brighter future and a return to growth. There have been a large number of launches of these products during the year, with the number of digital asset ETPs doubling from 80 to 166 across 2022.[24] Investors in Digital Asset ETPs, which are largely institutional in nature, have continued to invest in these products, with net inflows in the 11 months to November 2022.[25]

While this is still very much in the niche end of the exchange traded space, there is cause for optimism in digital asset ETPs, as the providers operating in this space see 2022 as a bump in the road, which may speed up the regulation needed to bring digital assets into the mainstream. As this happens, we could see more securities being issued as digital assets and a move toward an environment with tokenized ETFs.

20. *Bloomberg*
21. *ETFGI*
22. *Bloomberg*
23. *ETFGI*
24. *ETFGI*
25. *ETFGI*

Active ETFs continue to build momentum in a passive world

Although markets fell back in 2022, the underlying driving forces in the growth of the ETF market are still strong. Investors remain focused on costs and transparency, and the shift to passive investing is continuing to gain traction.

Across the wider fund industry in the US, the Institutional Shareholder Services group estimates that active fund share will fall from 53% in 2022 to 44% across the next five years.[26]

That said, demand for active investment remains high, and during 2022, active ETFs proved their worth, many using their flexibility to outperform declining markets. While still a relatively small segment of the market (at US$488b,[27] it accounts for 5% of the global ETF industry), it has had a strong performance in 2022, growing 10% in AUM and almost 30% in number of products over the year.[28]

This is largely driven in the US, where regulators have approved an active ETF structure, and the tax benefits of an ETF over mutual funds has led to an acceleration of traditional active ETF providers to convert their funds into active ETFs. This is a trend that will continue in 2023.

In Europe, growth in active ETFs has been slow. At the end of 2022, they represented only 2% of the overall European ETF market.[29] European regulators still demand daily disclosure of portfolios, which has acted as a deterrent to providers launching active ETFs. As European ETFs do not have any discernable tax benefits over their mutual fund equivalents, we don't see mutual fund conversions to ETFs driving growth in active ETFs in Europe.

The recent stance of the International Organization of Securities Commissions (IOSCO) on ETF good practices would suggest the global body is not wedded to daily disclosure requirements. It remains to be seen how European regulators will move on this topic before we can expect to see any significant growth in European active ETFs.

26. FT.com - 'Passive US funds poised to overtake active, ISS says'
27. ETFGI
28. ETFGI
29. EY analysis of ETFGI data

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