Test of endurance

The ETF Risk European Survey has revealed an increase in holdings of ETFs over the past year by more than 30% of respondents – but the pace of growth in the sector has slowed compared to 2014. Duncan Wood **reports. Research by** Max Chambers

This year has broken records, yet again, for flows into European-listed exchange-traded funds (ETFs). But the latest iteration of our European ETF survey shows early signs of investors approaching saturation point, while issuers complain a fragmented market – and a lack of options for retail investors in particular – is making it harder than it should be to invest in these products.

"ETFs are taking an increasingly large share of fund flows and new money relative to some of the traditional fund wrappers," says Peter Thompson, president of Source ETF, a UK-based ETF provider. "They benefit from exchange trading, transparency, simplicity and an attractive cost structure compared with traditional mutual funds."

According to figures from London-based research and consultancy firm ETFGI, European-listed ETFs attracted $68.6 billion to the end of October, 11% higher than the $61.8 billion invested in new ETF issuances during the whole of 2014 – a year that itself saw roughly a doubling of flows compared with 2013.

However, among the asset managers, pension funds, insurance companies and private banks that responded to the survey, at least, appetite for increasing ETF holdings is lower than in 2014. This year, 37% said they planned to increase their holdings over the next 12 months (with more than three-quarters of those planning no more than a 25% increase in ETF assets). Last year, that figure was 52%. Most (58%) plan to keep their ETF holdings steady (compared with 47% in 2014), while almost one in 10 (9%) plan to sell down the product (1% in 2014).

This potential levelling off in demand comes after several years of double-digit growth in the European ETF market. Investors have been attracted to the low costs offered by these products, particularly in a market where higher-cost sources of alpha, such as hedge funds

HOW THE RANKINGS SURVEY WAS CONDUCTED

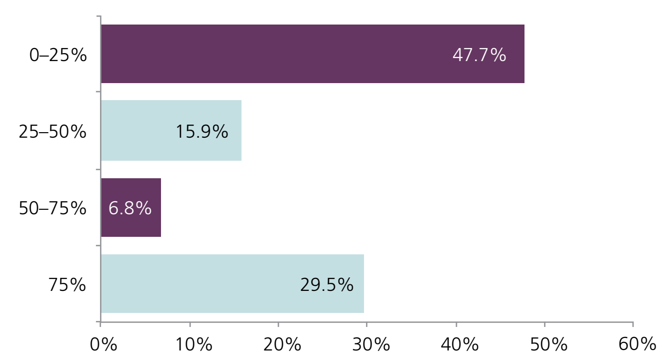
The ETF Risk European rankings and survey were conducted during September and October, with 97 respondents.

ETF Risk polled institutional investors, family offices, wealth managers, consultants, trading houses, ETF issuers, research firms and exchanges across Europe to determine the status of the market and the best providers in the ETF business. Participants were asked a series of questions relating to the operation of the ETF market and invited to vote for their top ETF issuers and service providers.

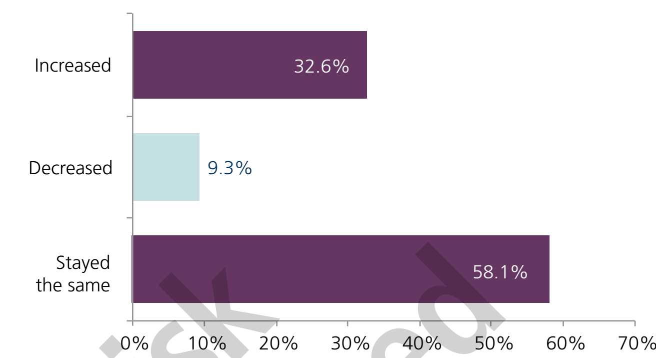
No weighting system was used, as respondents only submitted one vote per category. Only categories with a sufficient number of votes are included in the final poll.

When aggregating the results, we look to strip out what we consider to be invalid votes. These include people voting for their own firm, multiple votes from the same person or IP address, votes from people using non-work email accounts, votes by people who choose the same firm indiscriminately throughout the poll, votes by people who clearly do not use the product, and block votes from groups of people at the same institution voting for the same firm.

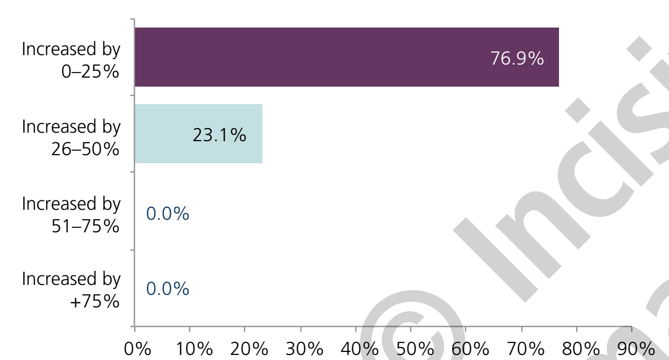
1 As a percentage of your portfolio, how much is invested in ETFs?



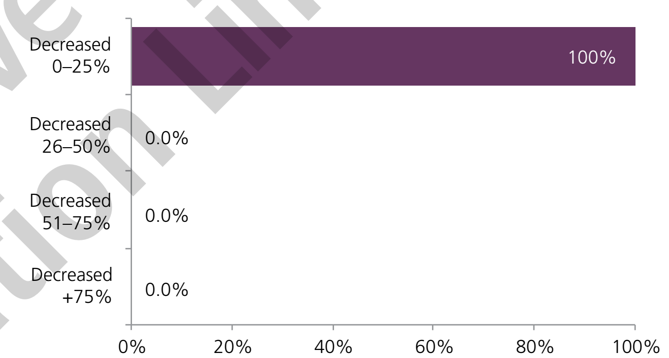
2 In the last 12 months to end-September 2014, have you increased or decreased your total ETF holdings?



3 If you have increased your total ETF holdings, by how much?



4 If you have decreased your total ETF holdings, by how much?



and actively managed mutual funds, have underperformed.

"Investors are rationalising where they can find consistent sources of alpha, and where they can't, they're embracing ETFs. As fees have come down, ETFs have become more efficient for investors to use than futures, if you're fully funded," says Deborah Fuhr, partner and co-founder of ETFGI.

Fuhr says that she sees no evidence of the growth in demand for ETFs moderating. But, she adds, access to the product could be better. "ETFs are often not included on the platforms that many financial advisers are using. Many online brokers don't include ETFs in the tracker or index fund category. There are a number of issues around ETFs not being dealt with in a level-playing-field fashion across Europe. Platforms claim there's not enough demand, but it's chicken and egg – if the platform only offers mutual funds, their customers are only going to buy mutual funds."

For investors selecting ETFs, liquidity remains the overriding concern, survey respondents say. Here, Europe is at a disadvantage to the US market, with no fewer than 26 exchanges listing ETFs. "Liquidity is definitely an issue," says Thompson at Source ETF. "In Europe, you have multiple exchanges and multiple listings – to some degree, that fragments liquidity."

Efforts are underway to reverse that fragmentation. For example, electronic platform Tradeweb, winner for the second year running of our Best ETF Trading Platform award, is aiming to aggregate liquidity through its ETF service (the full results are on page 32). Meanwhile, in November, BlackRock, announced it is moving 20 iShares ETFs to a centralised settlement platform, to reduce the complexity of issuing and settling ETFs across a number of European jurisdictions.

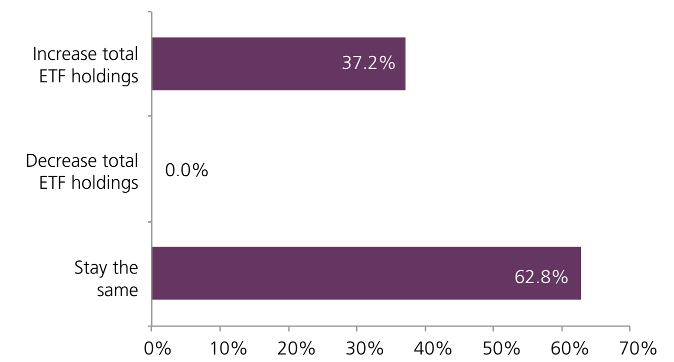
A number of survey respondents repeated calls for a so-called 'consolidated tape' for ETFs, a continuous electronic feed that would bring together ETF trading volumes and prices from European stock exchanges. "A consolidated tape would be part of the equation," says Philip Tychon, head of ETF capital markets at investment management giant Vanguard, noting that it would help to bring more visibility to the available liquidity, even if it did not concentrate it in one venue.

"Ideally, you'd have one market, but in Europe, that probably isn't realistic," he says. "As well as liquidity, exchange listings are also about distribution, and if you want to distribute an ETF into a specific market, a listing is important. Given some investors' 'hold biases', if you want to serve them, you need to list on their local market."

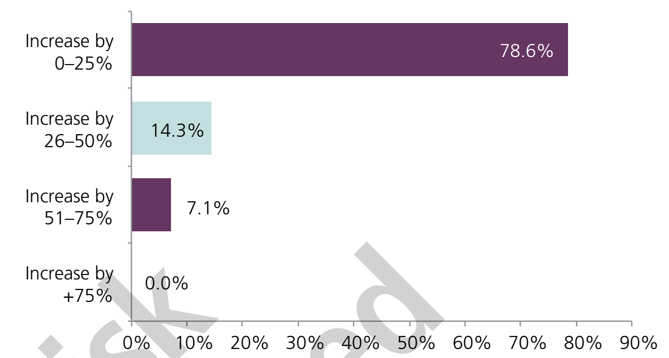
A related issue is that a significant percentage of ETF trading in Europe – between 50% and 80% – takes place off-exchange, and may not be captured in trading volumes, reducing the perceived available liquidity.

"Turnover on stock exchanges is only part of

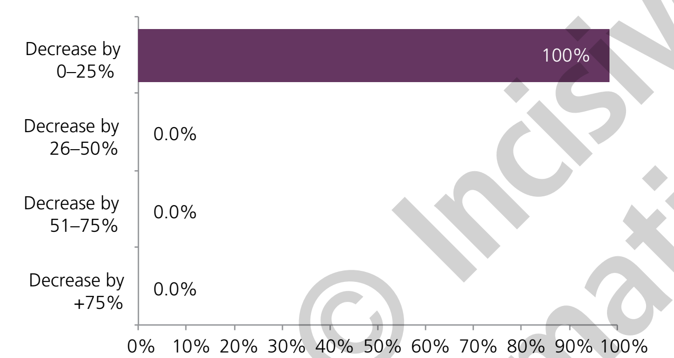
5 Over the coming year do you intend to:



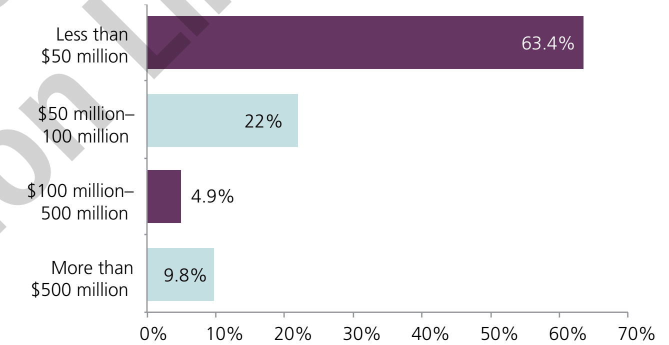
6 If you intend to increase total ETF holdings, by how much?



7 If you intend to decrease total ETF holdings, by how much?



8 In terms of its assets, is there a minimum size of ETF necessary for your investment?



the picture," says Source ETF's Thompson. "There is a case for OTC regulation. We would be supportive of changes requiring more trade reporting. More transparent sharing of volume figures would only benefit the market."

Tychon at Vanguard notes revisions to the Markets in Financial Instruments Directive (Mifid II) will require OTC ETF trades to be reported. "The sooner ETFs become Mifid II-regulated instruments, the better for the product and the better for investors." However, in November, the European Parliament accepted that implementation should be delayed by a year, until January 2018.

Liquidity issues can cut both ways, says Hortense Bioy, the London-based director of passive fund research at investment research firm Morningstar. "ETFs can provide liquid access to illiquid asset classes, such as corporate bonds." While they offer continuous pricing and the perception of an easy exit when needed, there are concerns about that perception, she says. "Regulators and some investors are concerned about what would happen in a worst-case scenario: how easily would you be able to get out and, more importantly, at what price?" although she notes that this isn't an ETF-specific problem.

"The liquidity of an ETF largely depends on its underlying. This is something investors shouldn't forget," Bioy says. "During periods of market stress, if the underlying is illiquid, the ETF tracking it will reflect that illiquidity."

Easing counterparty concerns

Meanwhile, survey respondents are less concerned about counterparty risk than in previous years. Over the past 12 months, 80% of respondents have lowered their minimum counterparty rating as it relates to the swap counterparty or counterparties to securities lending transactions. Last year, 95% had either kept their minimum rating stable, or had raised it.

"A lot of work has been done in terms of investor protection and disclosure," says Bioy. "Issuers have improved risk-mitigating measures and are much more transparent, which has reassured investors." She adds that the trend from synthetic ETFs – where issuers entered into a swap to replicate the performance of the ETF's underlying – towards physical replication, where the issuer owns the underlying index constituents, has helped reduced counterparty risk concerns.

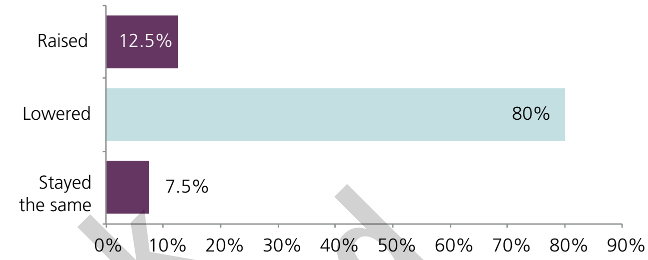
The survey findings show investors have a better understanding of how counterparty risk is managed in securities lending – with many issuers offering various layers of protection for investors, says Michael Mohr, head of exchange-traded product business development for Europe, the Middle East and Africa at Deutsche Asset & Wealth Management.

"The counterparty risk is collateralised, but the transactions can – depending on the issuer – also benefit from an indemnification. This means that if a counterparty were to default and the collateral amount was insufficient to recover the

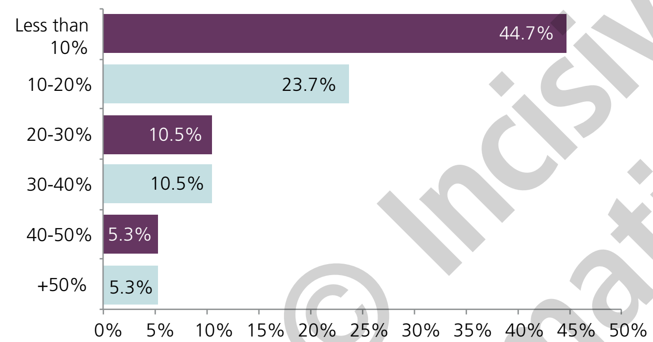
9 Factors in selecting ETFs, ranked in order of importance

Rank	Factor
1	Spread of the ETF versus the reported costs
2	Whether the ETF is structured on the basis of full or optimised replication
3	The amount and costs associated with portfolio turnover within the ETF
4	Tracking error
5	Tracking difference
6	Liquidity
7	Regulatory changes designed to improve transparency and execution
8	Taxation
9	Brokerage fees
10	Counterparty credit risk

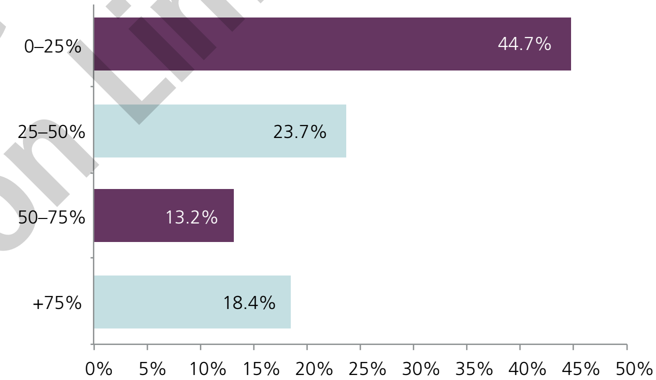
10 Taking into account counterparty risk as a factor (be it the swap counterparty or counterparty to a securities lending transaction), when buying an ETF, have you raised or lowered your minimum counterparty rating over the past 12 months?



11 What percentage of revenues do you consider appropriate for securities lending agents to retain from physically backed ETFs?



12 If you could impose a limit on the amount of securities lent out by physical ETFs, what would the limit be?



"Turnover on stock exchanges is only part of the picture… There is a case for OTC regulation. We would be supportive of changes requiring more trade reporting. More transparent sharing of volume figures would only benefit the market" Peter Thompson, Source ETF

full amount of shares lent out, then Deutsche Bank would step in and cover that risk, guaranteeing the trade with its entire balance sheet," he says. "There has been a lot of misunderstanding of securities lending in the past."

Other issuers say their investors continue to favour a conservative approach to securities lending. Tychon says Vanguard pursues a "premium" approach to lending underlying stocks. "Some securities, such as the stocks in the S&P 500, are so readily available, it doesn't make sense to lend them out – the margins aren't there. By lending out securities that are harder to get in the market, you can get a premium for lending them out." This approach, he says, allows Vanguard to earn attractive returns from securities lending, without needing to lend out a high proportion of the underlying stocks.

This preference is reflected in the survey. Nearly half of respondents (45%) consider it inappropriate for an ETF issuer to lend more than 25% of the underlying securities.

In terms of ETF flows, smart beta indexes continue to attract assets, says Bioy at Morningstar. These seek to capture outperformance by identifying factors such as value, yield, and momentum that have generated premiums over traditional market cap benchmarks and, as such, sit somewhere between passive and active management. Index provider MSCI reports compound annual growth of 79% in assets benchmarked to its factor indexes over the three years to the end of June.

Meanwhile, the ETF wrapper continues to prove attractive to investors seeking new investment approaches. "Environmental, social and governance (ESG) indexes are getting a lot of traction," says Alain Dubois, head of new product development at index provider and research firm MSCI. Equity ETFs tracking MSCI ESG indexes grew 30% between the start of 2015 and the end of July, the company says, with 11 ESG ETFs being launched over the period. "They are not yet a major proportion of assets, but growth has been gigantic," he says. ■