

ETFs

Striving for operational efficiency

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Asset managers' investment operations are undergoing a generational shift ...

Asset managers around the world are putting unprecedented effort into developing robust enterprise-wide investment operations. The industry's post-crisis push for innovation, stronger efficiency, risk management and governance is a key driver of this process.

EY's recent global investment operations survey¹ shows that other factors are also at work. As asset managers pivot towards long-term growth, the need to boost distribution and develop new products in order to reach investors in new ways has become the primary driver of operating models. A growing focus on international expansion is also encouraging firms to make more use of shared service centers, offshoring and outsourcing. And many asset managers see effective data management as becoming increasingly important to a range of their core activities.

¹ *Managing complexity and change in a new landscape: global survey on asset management investment operations*, EY, 2014.



... and ETF promoters are no exception

If we narrow our focus to the global exchange traded fund (ETF) industry, we see very similar dynamics at work. The strategic priorities shaping ETF operating platforms – growth, efficiency and stronger governance – are identical to those of other asset managers. In the same way, the changes ETF providers are making to their operating models have a lot in common with the wider asset management industry.

In the rest of this paper, we explore the specific factors driving changes to operating platforms in the ETF industry, some of the key developments taking place, and a few of the particular challenges and opportunities facing promoters and service providers.

The ETF industry's outlook is defined by huge growth potential

The ETF industry has been one of the fastest growing and most exciting sectors of asset management in recent years. The global ETF/ETP industry now manages more than US\$2tn on nearly 60 exchanges worldwide. We expect

global expansion in ETF assets to continue, with the potential to surpass the total level of hedge fund assets within the next two years.

The breadth of ETFs' appeal is central to this rapid growth. The product's unique features of transparency, liquidity, flexibility and low fees continue to attract a wide range of investors. Institutional investors and wealth managers are using ETFs to gain low cost exposure to specific markets and asset classes, while retail investors increasingly see them as a cheaper alternative to mutual funds. Meanwhile enhanced beta ETFs are gaining ground as a substitute for futures among derivatives traders.

Geographic expansion is another factor behind the growth of ETFs. Our latest global ETF survey² shows that industry participants expect the next few years to see annual asset growth of around 15% in the comparatively mature US market. Meanwhile in Europe and Asia, where ETF assets still represent less than 5% of mutual fund assets, annual growth rates of 15%-20% and 20%-30%, respectively, are commonly forecast. Overall, there is an enormous sense of potential across the industry. ETF providers expect to take market share from cash investors and passive managers, and increasingly have active managers in their sights too.

² *Global ETF Survey: a new era of growth and innovation 2014, EY, 2014.*

Distribution enhancement is increasingly driving changes to ETF operations

ETF providers are adapting their operating models to take full advantage of the industry's growth potential. Our latest ETF survey shows that more than 90% of promoters want to improve their distribution models. This reflects a growing view that a robust operating model is essential to driving a step-change in distribution capabilities.

Areas of focus vary between firms and markets, but improving retail distribution is a leading priority for many of the largest promoters. In the US, where retail funds already make up almost 50% of ETF assets, many providers are improving their links with fund platforms. Firms are also putting greater effort into brand development and direct distribution via online retail accounts. In contrast, ETF houses that focus on innovation – in the US and elsewhere – are putting more emphasis on building distribution links with institutional investors and wealth managers.

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Retail distribution is a particular area of focus in Europe and Asia

In Europe, where retail funds only represent about 10% of ETF assets, promoters are trying to stimulate demand through a combination of advertising, brand building and distribution enhancements. Firms are working on their connections with a range of distributors including retail banks, financial advisers and fund supermarkets. The region's largest promoters are making a particular effort to strengthen their links with online platforms, where second tier firms have enjoyed comparative success.

The focus on retail demand in Europe is further reinforced by the need to improve cross-border liquidity. As retail sales boost on-exchange liquidity more than institutional business, promoters have created a retail ETF forum to pool their efforts and unlock European retail growth.

Meanwhile, the diversity of Asia means that ETF providers are pursuing a range of distribution strategies in the region. In markets such as Korea, where retail distribution is dominated by banks and brokers selling to self-directed investors, firms are using advertising to build awareness and get their products onto leading platforms. In contrast, financial advisers and online distribution are much more important in markets such as Australia. Promoters are also building connections with the institutions that currently represent the majority of ETF assets in the region, hoping to capture a larger share of their passively managed investments. In China, the transfer of wealth through inheritance is changing the profile of the investor.

The end investor is young, tech savvy and willing to embrace new technologies; innovative distribution methods will be needed to reach out and capture this market.

ETF promoters' models face intensifying competition

Despite the ETF industry's focus on growth, distribution is certainly not the only factor reshaping business models. A wave of new entrants to ETF markets, from international fund houses to niche players, means that competition is becoming ever fiercer, especially for the industry's flagship index tracking products. Margin pressure is particularly intense in the US, where large players commonly use price wars to grab market share.

As major US promoters lead the charge into Europe and Asia, worldwide levels of competition are only likely to grow. Europe has seen a particular flurry of new entrants in recent months. Wisdom Tree's planned acquisition of boutique promoter Boost and Warburg Pincus' strategic investment in Source follows the comparatively recent entry of US giants State Street and Vanguard. The new arrivals will only add to existing pricing pressure. Established European players, such as UBS, Lyxor and DB X-trackers, have all recently secured additional inflows following fee reductions.

In time we expect to see a similar margin squeeze among Asian ETF providers, although the region's fragmented markets mean that competition may advance on a more localized basis. US promoters also see Latin America as a battle ground of the future, and some are beginning to explore the potential growth of Middle Eastern ETF markets.



Firms are responding with a push to simplify their operating models

In response to margin pressure, ETF providers are taking steps to simplify their operations and achieve economies of scale across their organizations. Product rationalization is one area of focus. The importance of fund launches to ETF inflows and the costs of fund closure mean that promoters have often chosen to keep underperforming funds open. However, increasing competition means that firms are becoming more willing to close uneconomic funds. In the US, funds are increasingly likely to be closed within 18 months if they fail to achieve the necessary scale. European promoters are becoming more ruthless too, although new entrants are likely to give their funds longer to grow.

As well as closing sub-scale funds, ETF promoters are increasing the time and money they invest in funds at the pre-launch stage. Seeding is particularly important to ensuring that new funds are launched at an attractive level of assets under management. The aim is to open fewer, more successful funds, helping to achieve a smaller, more profitable product portfolio.

Reducing fund listings is another potential source of efficiency. The opportunities for savings are particularly attractive in Europe, where many funds are listed on as many as five or six exchanges. Providers typically consider two or three listings to be the ideal number, but firms often hesitate to reduce listings for fear of limiting investor access. Strong inflows from Italian listings over recent periods illustrate the potential downside of focusing purely on major exchanges like London, Frankfurt or Zurich. Firms need to compare different listings in a consistent way, helping them to balance potential growth against potential savings.

Centralized operating models are helping promoters to extract value from technology

ETF providers are increasingly putting technology at the center of their drive for stronger, more efficient investment operations. This creates a virtuous circle, since consistent operating models make it easier for firms to harness the power of technology. Centralized improvements in technology are most likely to deliver worldwide benefits.



The importance of speed in ETF markets underpins the industry's need for robust technology, and increases the potential benefits it can deliver. Real-time data is central to delivering the ETF performance promise. This is very different from the daily liquidity and reporting requirements of mutual funds. Even the largest mutual fund managers tend to find the need for speed a major challenge when entering the ETF arena.

Creating centers of operational excellence is an increasingly popular approach to technology investment. This also creates an opportunity for ETF providers to move their operations workload to low cost near-shore or offshore locations. This not only helps to reduce overall costs, but also gives firms follow-the-sun processing support and a platform for global growth. As the expertise and capacity of shared service centers evolve, promoters will be able to move an increasing variety of functions offshore.

The importance of technology is closely linked with more effective outsourcing

The ever-growing importance of technology is pushing outsourcing further up the ETF industry's agenda. Like their counterparts

in other sectors of asset management, ETF promoters are increasing the range of functions that they outsource. Most firms have already outsourced their back office functions, and many are now focused on middle office processes, including post-trade execution, compliance, client reporting, tax management and even regulatory and board reporting. To meet these requirements, ETF promoters are also giving their service providers more responsibility for data management.

In future, more ETF promoters are likely to outsource the primary market trading required to manage their funds. This requires a high degree of connectivity with authorized participants, market makers, exchanges and clearing houses. The need for robust, real-time links is reinforced by regulators' focus on exchanges as a point of sale. This represents an opportunity for service providers able to deliver reliable, fast connections.

In common with other asset managers, ETF promoters are reviewing their existing outsourcing arrangements to maximize efficiency and service quality. Most firms view one or two service providers as the optimal number, but while a single administrator would be ideal, many firms find this hard to achieve in practice.



Robust operating models will also help firms to strengthen their overall governance

ETF promoters are under the same pressures as other asset managers to strengthen their risk management capabilities. The importance of strong governance is emphasized by media responses to isolated ETFs' occasional failures to track their benchmarks. A high profile breakdown in performance – even at a time of market stress – could do lasting damage to the industry's reputation just as it is winning over new investors.

In common with other investment products, ETFs are also coming under ever greater regulatory scrutiny. This is especially true in Europe, where ETFs are subject to cross-cutting requirements at both national and regional level. The rapid growth of ETF assets is prompting regulators in several markets to review the industry's standards of governance and risk management.

Creating a single enterprise-wide operating platform will help promoters to achieve more robust controls. Consistent operating models make it easier for firms to establish and monitor oversight roles and responsibilities, including escalation protocols. They also facilitate the monitoring and testing of controls, as well as helping to identify any overlapping or conflicting regulatory requirements. And as outsourcing in the ETF industry expands, robust operating platforms make it easier to maintain effective oversight of outsourced functions and fulfil ever

increasing reporting demands from regulators through centralized and efficient data collection and management. This is an area receiving increasing attention from regulators, such as the Central Bank of Ireland.

Service providers have a unique role to play in strengthening ETF operating models

The unique features of ETFs mean that service providers have a particularly important role to play in the industry. The strongest administrators do more than just helping promoters to run their businesses. By supporting their strategies for innovation and expansion, they act as an enabler of growth for the ETF industry as a whole.

Even so, our latest global ETF survey shows that promoters feel service providers could do more to support innovation. Part of this is about providing flexible, scalable platforms that can support new products, new investment strategies and new asset classes. But promoters also want service providers to help them develop stronger interfaces with investors and authorized participants. Ideally, they would like administrators to work in conjunction with authorized participants and exchanges to provide them – as well as investors and supervisors – with online dashboards showing real-time data.

The need to meet promoters' constantly evolving needs is a significant challenge for service providers. It is particularly hard to design and deliver technology that not only meets current best practice, but also has the potential to respond to future market developments. The introduction of T+2 settlement in Europe illustrates this difficulty. T+2 represents a particular challenge for ETF providers, given that most European ETFs are listed on multiple exchanges and that some exchanges are adopting T+2 earlier than others.

In short, successful ETF administrators need to offer an ever-wider range of capabilities across a growing range of products and markets, backed up by highly robust and scalable technological platforms with minimal human reliance. ETF promoters do not always appreciate the sheer complexity and difficulty involved, and our latest survey suggests that closer engagement with service providers would be in their own best interest.

From the service providers' point of view, there is no question that targeted investment in technology is the single most important step to overcoming these challenges. It also offers the greatest chance of commercial success. In the US, service providers with best in class technology are seen as making the greatest market share gains.

Conclusion

Operating models in the ETF industry are going through a wave of change, driven by the same factors affecting firms across the wider asset management sector. The speed of ETF markets only increases the importance of robust operating platforms. Promoters and service providers need to ensure they can consistently deliver on the product's promises of liquidity, transparency and low cost.

These factors mean that ETF operations pose particular challenges for promoters and service providers alike. Set against that, the economies of scale that are a feature of ETF markets means that the benefits of consistent, centralized operating models are particularly compelling.

ETF promoters need to look to the future and develop operating models that will not only help them to achieve their current goals, but also provide them with a flexible and dependable basis for future development. This in turn creates a huge opportunity for service providers that can help promoters to achieve their objectives. Targeted investment in technology and skills will enable promoters and service providers alike to maximize their exposure to the global ETF market's huge growth potential.

Lisa Kealy
EMEIA Wealth & Asset
Management ETF Leader

T: + 353 1 2212 848
E: lisa.kealy@ie.ey.com

Matt Forstenhausler
Global Wealth & Asset
Management ETF Leader

T: + 1 212 773 1781
E: matt.forstenhausler@ey.com

Julie Kerr
Asia Pacific Wealth & Asset
Management ETF Leader

T: + 852 2846 9888
E: julie.kerry@hk.ey.com

Your local contact

France:
Bernard Charrue
Executive Director

T: + 33 1 46 93 72 33
E: bernard.charrue@fr.ey.com

Germany:
Michael Eisenhuth
Partner

T: + 49 89 14331 27519
E: michael.eisenhuth@de.ey.com

Ireland:
Lisa Kealy
Partner

T: + 353 1 2212 848
E: lisa.kealy@ie.ey.com

Luxembourg:
Bernard Lhoest
Partner

T: + 352 42 124 8341
E: bernard.lhoest@lu.ey.com

Switzerland:
Christian Soguel
Partner

T: + 41 58 286 4104
E: christian.soguel@ch.ey.com

UK:
Nigel Nelkon
Executive Director

T: + 44 20 7951 6011
E: nnelkon@uk.ey.com

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