

EY Global ETF Survey

2015 and beyond



Building a better
working world

Executive summary



We opened our last survey of the global ETF industry with some bullish predictions for annual asset growth. If anything, experience has shown that we were too pessimistic. Stable financial markets and strong equity performance have given a tailwind

to ETF growth during the first three quarters of 2014. Even so, it is striking that growth in ETF assets continues to outpace assets under management (AuM) expansion in the wider asset management industry.

We expect the low costs, flexibility, convenience, liquidity and transparency of ETFs to push asset levels to new highs over the coming year. Barring any major market disruption, we predict growth of 10%-15% in the US market, of 20%-25% in Europe, and of 25%-30% in Asia.

But rapid growth, however eye-catching, is only part of the story. Sustaining the current growth rates of ETF assets into the future will depend on the industry's ability to keep improving the service it offers to investors. So it is reassuring that our conversations with interviewees show no hints of over-confidence. Promoters, market makers, administrators, exchanges and other players in the ETF value chain are working hard to overcome current hurdles and strengthen the industry's long-term growth potential.

Based on our analysis of the quantitative and qualitative results of the survey, in this report we group our findings under six key headings. In our view, each represents a crucial area of current and future change for the industry. We examine each one in detail in the "Key findings" section that makes up the bulk of this report.

Our key findings are that:

1. Customization and investor engagement are becoming vital to seeding, scale and success.
2. Pricing transparency and innovation offer the best defense against growing margin pressure.
3. Further improvements to products and liquidity will help to unlock stronger institutional demand.
4. Maintaining transparency will be vital as the industry grows more globalized and sophisticated.

5. Patience, education and technology will all be crucial to overcoming the retail growth challenge.
6. Coordinated use of technology by promoters and administrators holds the key to improving efficiency.

Despite these global trends, we realize that the ETF industry is as diverse as the countries in which it operates. ETF markets in Europe and Asia differ from each other, and from that in the US – the world's largest, most mature and most liquid market. Some convergence is to be expected as the ETF industry becomes more globalized, but significant differences will remain. In the "Regional themes" section that follows, we examine some of the current defining features of the ETF industry in the US, Europe and Asia.

There is clearly a significant degree of cross-over between the challenges facing the ETF industry and those affecting regulated funds.² After all, in its own way, the ETF industry is reacting to many of the same imperatives as the wider asset management sector.

What seems to set ETFs apart is the industry's confidence. Some common themes that underpinned all our conversations with respondents include a drive for continuous innovation in products and strategies; a belief in the value of ETFs to a wide range of investors; and a sense of certainty that ETF promoters will continue to take market share from other asset managers – both passive and active. Whether or not this confidence is justified will depend on how the ETF industry evolves from here. We therefore conclude this report with some recommended areas of focus.

We are great believers in the creativity and energy of the ETF industry, and we are proud to support its continued development.



Lisa Kealy
EMEIA Wealth & Asset Management
ETF Leader

²See EY *Global Regulated Funds Survey 2014*

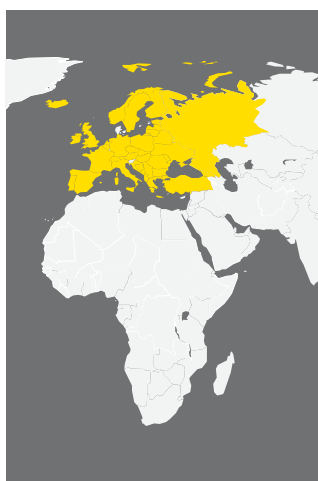
Regional summary



The US remains by far the world's most successful ETF market, distinguished not only by its size but also by its liquidity and its retail investor base. It provides a model for others to aspire to, even if no market will be able to match all of its features.

As the US ETF market matures, growth is cooling slightly from the levels of recent years. Even so, most of our respondents continue to predict double-digit growth. We expect growth of 10%-15%, reflecting the scope that still remains to reach new institutional and retail customers. The US market also remains a highly attractive destination for international ETF capital, illustrated by the increasing number of overseas feeder funds being set up by US promoters.

Active ETFs are seen as a major area for future growth, and especially for attracting new retail customers to the industry. Although active funds remain in their infancy, many providers expect them to take off soon and are positioning themselves to benefit. Online retail distribution is also a complementary and growing priority.



Europe has seen ETF growth of 20% or more in recent years, helped by a bull market in equities. There is huge potential for retail growth but growing acceptance that this will take time to realize. Regulatory reform has a role to play, but education and better digital distribution will also be crucial to success. Coupled with growing demand from local and Asian institutions, we see potential for annual asset growth of 20%-25%.

The fragmentation of Europe's ETF markets continues to present challenges to the industry's development. This results in small average fund sizes, making efficiencies harder to achieve. It also means that Europe suffers from a comparative lack of liquidity. Other challenges include the effects of tighter bank regulation on the availability of seed capital.

On the upside, the European industry has proven to be adept at using innovation to circumvent these obstacles. Enhanced beta funds are already enjoying significant success and are expected to strengthen ETF take-up among pension funds and insurers. A range of industry initiatives have also been launched with the aim of improving liquidity, scale and competitiveness.



Asia-Pacific's ETF markets are even more diverse than those of Europe. They do not just vary in their size and maturity, but also in their openness to innovation and their attractiveness to international capital. Japan has a large but inward-focused ETF sector; Korea's market is highly innovative, and Hong Kong is the leading center for cross-border ETF investment.

Asian ETF assets doubled in 2012 but expanded more slowly in 2013 as the region's markets encountered headwinds. Growth has accelerated again in 2014, and if favorable market conditions continue, we would expect to see future asset growth of 25%-30%. Mainland China A-share ETFs are once again attracting strong inflows of international capital.

Asian institutions are taking an increasingly global view of ETF investments. This includes growing interest in European products, but also in the markets of Southeast Asia, where ETFs are developing fast. The rapid evolution of Asian fund passports and investment links between Hong Kong and Mainland China are reshaping the industry and will have a significant impact on the development of ETF markets in the region.

Summary of key findings

1

Customization and investor engagement are becoming vital to seeding, scale and success

As ETF products and providers multiply, achieving scale is becoming more important than ever. Promoters, investors and market makers alike increasingly prefer large funds. Improving success rates reflect a growing emphasis on investor needs and product development. But European and Asian promoters that rely on bank funding are struggling with seeding. We expect product customization and stakeholder engagement to become central to the search for scale and profitability.

2

Price transparency and innovation offer the best defense against growing margin pressure

When is a price war not a price war? Relentless competition is squeezing management fees. With investors focusing more on costs, we believe the ETF industry needs to take a transparent, holistic view of pricing. Meanwhile, innovation is vital to defending margins and allowing new entrants to develop their brand. As a result, ETF strategies are multiplying. Active funds are a key US focus, and enhanced beta is gaining ground in Europe. Asian innovation is more varied, but no less vibrant.

3

Further improvements to products and liquidity will help to unlock stronger institutional demand

The survey shows clear potential for stronger institutional take-up of ETFs, especially among pension funds and insurers. Customization and innovation are seen as two of the industry's key weapons. Strong liquidity is also vital to attracting institutional money, but weaknesses in this area are holding back European and Asian ETF markets. We see cooperation between industry players, exchanges and depositories as vital to overcoming these barriers.

4

Maintaining transparency will be vital as the industry grows more globalized and sophisticated

International expansion, aided by acquisition, is reshaping the industry. Promoters are also responding to the increasingly complex flows of ETF capital among the US, Europe and Asian markets. As a result, ETFs are growing in versatility and sophistication. In our view, a strong commitment to education and transparency will give the industry the best protection against reputational damage or regulatory over-reaction.

5

Patience, education and technology will all be crucial to overcoming the retail growth challenge

Outside the US, low retail adoption is arguably the ETF industry's biggest long-term challenge. Inadequate distribution networks are increasingly seen as a roadblock to growth. Promoters in different markets are trying a range of approaches, but there are no simple or speedy answers. We believe that patience, education, partnerships and technology will all have a role to play.

6

Coordinated use of technology by promoters and administrators holds the key to improving efficiency

Despite margin pressure, ETF providers are finding cost savings harder to come by. Fund and listing rationalization offers short-term savings. In the longer term, we believe that technology offers the industry greater potential to improve operating efficiency. Significant gaps remain between promoters' goals and service providers' capabilities. Improved communication and reporting are two areas of common focus, but service providers could develop a stronger "front-office" mind-set.



Key findings

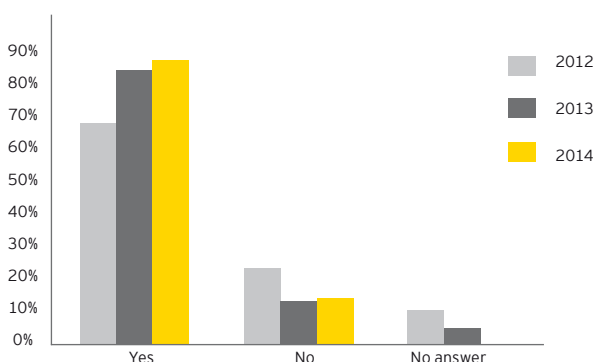


1. Customization and investor engagement are becoming vital to seeding, scale and success

As ETF products and providers multiply, achieving scale is becoming more important than ever. Promoters, investors and market makers alike increasingly prefer large funds. Improving success rates reflect a growing emphasis on investor needs and product development. But European and Asian promoters that rely on bank funding are struggling with seeding. We expect product customization and stakeholder engagement to become central to the search for scale and profitability.

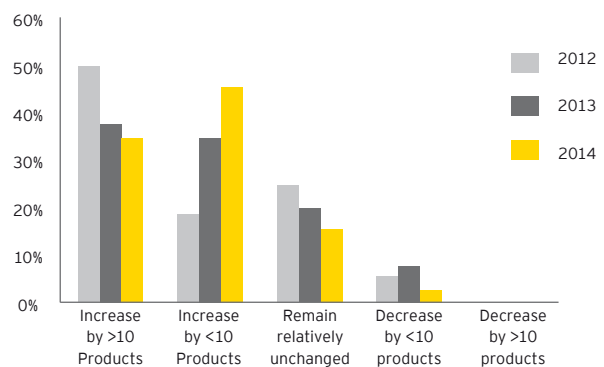
More survey respondents than ever expect new players to enter the ETF market (see Figure 1). Niche start-ups are part of this picture, but established US players are seen as the most likely entrants in Europe and Asia. This reflects the rapid expansion of leading US houses like Vanguard and State Street,³ as well as recent moves such as Warburg Pincus' investment in Source⁴ and WisdomTree's acquisition of Boost.⁵ Meanwhile, US respondents expect traditional asset managers to continue to enter the ETF market – an illustration of continuing convergence across the asset management industry. This could include partnerships with established ETF houses, such as MFS' joint venture with State Street.⁷

Figure 1: will more promoters enter the market over the next two years?



Fund launches are multiplying too. Almost all our respondents predict the total number of ETFs to increase further, with 38% anticipating rapid growth. And in total, four-fifths expect their own firm to increase its product range (see Figure 2). These are global trends, but expectations for ETF launches are highest in Europe – a sign of the region's fragmented markets.

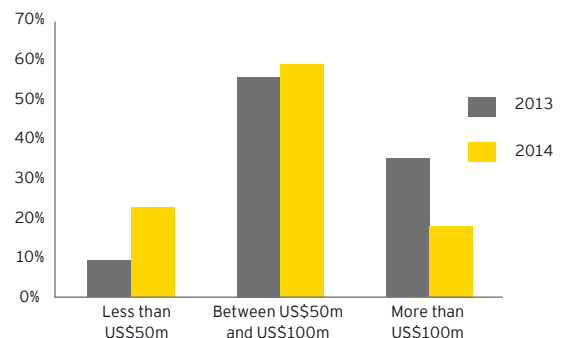
Figure 2: what change in the number of products you offer do you plan over the next two years?



Faced with increasing competition, ETF promoters are working harder than ever to grow funds, develop liquidity and attract institutional inflows. Many of our interviewees now give their new funds 18 months or less to achieve target size. But what size is that?

The survey shows a growing range of views on break-even size, with more respondents than last year seeing funds of less than US\$50m as economically viable (see Figure 3). However, this has a lot to do with the industry's rapid growth in Asia, where average fund sizes are smaller. Our interviews left us in no doubt that most promoters' target sizes are growing, especially in the US and Europe. Some now measure the ideal size in hundreds of millions of dollars.

Figure 3: what is the minimum size of a fund for it to be viable?



³ Press release, ETFGI, 07 Oct 2014

⁴ Press release, Warburg Pincus, 20 Jan 2014

⁵ Press release, WisdomTree, 31 Jan 2014

⁷ Press release, State Street, 09 Jan 2014

Market makers are also skeptical about funds of less than US\$50m. This is not just about economics. With size often seen as a proxy for liquidity, smaller funds can suffer from perceived illiquidity. Institutional investors are setting their own size requirements for ETFs, often exceeding promoters' own targets. Alert to breaching concentration limits, many institutions prefer to invest in funds of at least US\$100m.

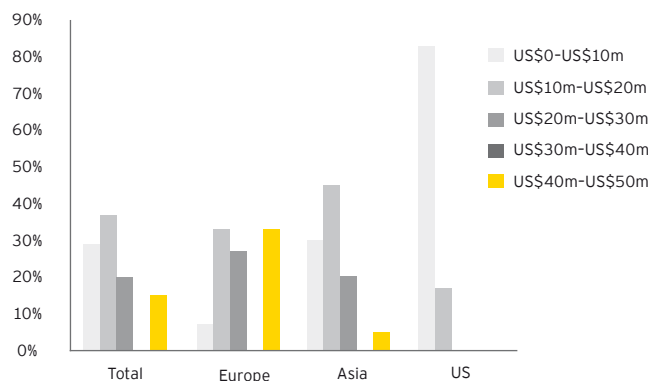
In our view, there is no simple answer to the question of size. A lot depends on the product: fixed income ETFs typically require greater scale than equity funds, and small innovative ETFs with higher fees can often reach profitability more quickly than large vanilla funds. So it is encouraging that the proportion of respondents expecting success rates to improve has reached 64%, compared with 56% in 2013 and just 29% in 2012.

This reflects the importance of innovation and speed to market as drivers of funds' success, which has spurred a step change in pre-launch due diligence over the past two years. This is largely due to promoters' own efforts, but in the US, especially, issuers are turning to external consultants for help during the pre-launch phase. It also shows the industry's increasing desire to listen to investors. Growing numbers of products are being abandoned before launch if institutional appetite is uncertain. In our view, building on this willingness to work with investors will be crucial to ensuring the ETF industry's continuing success.

Achieving a successful ETF launch is not just about due diligence. Our survey shows that seeding is a growing focus for promoters across the industry. Conversations with respondents tell us that different providers have very different experiences in this area. The largest firms generally find it easier to seed funds, often using their own capital. Set against that, they tend to be less patient in getting funds to viable stand-alone status. Smaller firms are more patient but often find seeding more challenging, with some seeing it as limiting their ability to develop new products. Seeding requirements also vary by product. Fixed income ETFs typically require more capital than equity funds, given bond markets' broad indices and large order sizes.

The survey shows that most promoters aim for seeding capital of up to US\$30m, with US\$10-US\$20m the most common overall figure. Again, preferences vary depending on local market conditions (see Figure 4). Seeding appears to be less of a challenge in the US, where many firms have tried and tested sources of capital, and 83% of respondents see US\$10m as sufficient seeding for a typical fund.

Figure 4: what is the optimal amount of seeding for a new product?



In contrast, weaker liquidity means that one-third of European respondents say they need US\$40-US\$50m of seeding per fund. It follows that many promoters are struggling to raise the funds they want from the region's capital-constrained banks. The picture is comparable in Asia, where bank-owned issuers see in-house sources of capital becoming constrained by the Volcker rule. Some independent promoters are finding it hard to raise seed capital too.

Faced with these challenges, promoters are increasingly keen to source seed capital directly from institutional investors. But gaining access is difficult without an existing relationship – something that can reinforce the advantage of incumbents. It also means tailoring funds to the requirements of a specific institution with no guarantee of attracting other investment. Market makers are seen as an alternative route to investors, especially for smaller promoters. But this route has its drawbacks too. Disappointing launches can damage a promoters' reputations and make it harder for them to raise capital in future.

As a result, promoters are looking further afield in the search for seed capital. A few European exchanges are beginning to offer help with seeding, in return for a share of revenues. And some Asian promoters are looking at retail seeding via IPO, although this route is only likely to suit issuers offering a local product through a local distribution network.

There are no easy solutions to some promoters' problems with seeding. Even so, we see issuers' increasing willingness to work with a range of stakeholders as a positive development for the ETF industry. In our view, building relationships with a broad range of stakeholders offers the best opportunity for success.

“The use of ETFs has spread into client segments where passive investment solutions have never been discussed before. This has additionally increased the level of competition amongst ETF providers, where innovation has now become a key differentiating factor.”

Thomas Merz,
Head UBS ETFs Europe, UBS

“Performance is often ignored when considering passive ETFs, however ETFs tracking the same benchmark can exhibit significant divergence in performance and in most cases this is NOT driven purely by the TER. The focus should be on the final outcome net of ALL costs and revenues.”

Chanchal Samadder,
Head of UK & Ireland Institutional ETF Sales,
Lyxor Asset Management

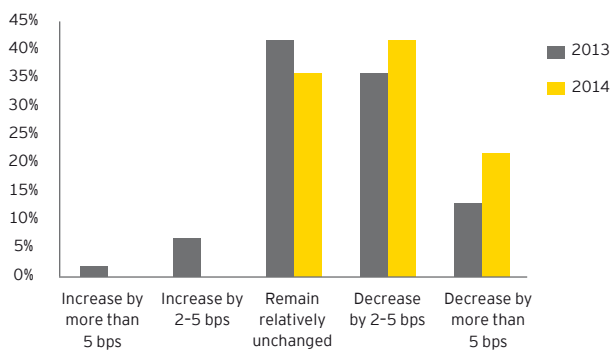
2. Price transparency and innovation offer the best defense against growing margin pressure

When is a price war not a price war? Relentless competition is squeezing management fees. With investors focusing more on costs, we believe the ETF industry needs to take a transparent, holistic view of pricing. Meanwhile, innovation is vital to defending margins and allowing new entrants to develop their brand. As a result, ETF strategies are multiplying. Active funds are a key US focus, and enhanced beta is gaining ground in Europe. Asian innovation is more varied, but no less vibrant.

The ETF industry is often said to have low barriers to entry but high barriers to success. There is a self-reinforcing circle between fund size, economies of scale, low management fees and net inflows. That puts market leaders in a commanding position and makes it nearly impossible for smaller providers to compete purely on price.

These dynamics explain why average ETF fees continue to fall, despite rapid asset growth. In fact, the survey is more downbeat on pricing than last year. No respondents expect fees to rise, most predict they will fall and one-fifth anticipate steep reductions (see Figure 5). US respondents are particularly pessimistic, reflecting intense competition in their home market. These findings are supported by the wave of price cuts announced during the summer of 2014 by issuers including BlackRock⁸ and Vanguard.⁹ This shows that promoters still see management fees as a key source of differentiation. After all, even a slight fee advantage can be decisive for a first-time investor choosing between near-identical funds.

Figure 5: how will margins (management fees) for promoters change in future?



Despite this level of price competition, ETF promoters are quick to deny talk of a price war. While every media splash on fee reductions helps to gather inflows, it adds to overall pricing

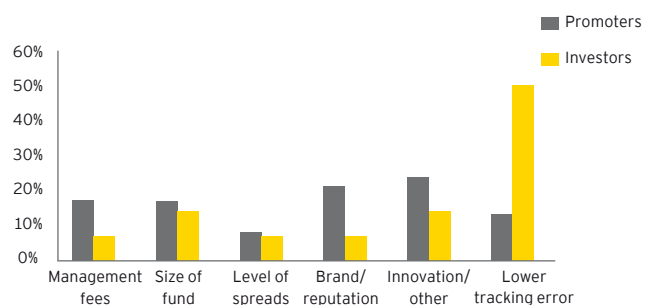
pressure on the industry. Fee reductions are typically limited to a handful of core funds, and promoters are able to charge higher fees for innovative new products. But media coverage often implies that prices are being cut across the board.

In our view, the image of ETFs as a cheap product – while central to their success – has become a burden for the industry. Promoters simply cannot afford to go on cutting prices indefinitely. Fee reductions are also unlikely to grow the ETF market. They are more likely to become a tool for cannibalization as investors move to cheaper products within each firm’s product portfolio. In the long run, that is not something that will help the industry.

We believe that moving the debate on price beyond a simple focus on management fees will help the ETF industry to reach the next level of size and maturity. This is illustrated by investors’ increasing focus on tracking error – the difference between the performance of an ETF and its benchmark. While tracking error is typically low for mainstream equity index funds, it can still be a significant cost for short-term investors. In the case of fixed income ETFs, tracking error can exceed management fees.

Tracking error is more difficult for retail investors to quantify than fees. But a true total expense ratio needs to include tracking error, along with commissions and the effect of bid-offer spreads. This is not just about retail investors. The survey suggests that promoters are underestimating the importance of tracking error to institutional investors, who see it as the leading differentiator between ETF promoters (see Figure 6).

Figure 6: how do investors select a promoter when rivals are offering competing products?



⁸ “BlackRock intensifies ETF price war,” FT.com, 01 Jun 2014

⁹ “Vanguard stokes ETF price war in Europe,” FT.com, 28 Aug 2014

“The world of investment is undergoing a profound change globally, driven by the evolution of exchange traded products. Our industry demonstrates a continuous drive to innovate and educate, and we see not only increased adoption amongst investors, but a clear shift towards maturity and sophistication in our markets. Going forward, we believe that cooperation and collaboration will become game-changers in the industry and alter competitive dynamics - a clear client strategy and differentiated positioning will be crucial success factors in this new environment.”

Mark Weeks,
Chief Executive Officer, ETF Securities

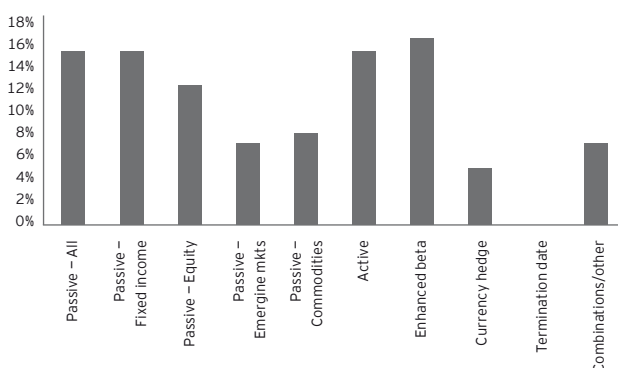
In our view, promoters need to put as much effort into explaining the true costs of ETFs as they put into explaining their benefits. If managers believe that the total costs of ETF ownership are typically less than for comparable mutual funds, they should have nothing to fear from transparency.

Innovation also has a crucial role to play in offsetting price competition. Funds that offer unusual or tailored exposures face less competition for inflows and can charge higher fees, helping to offset margin pressure across the portfolio. And innovation is increasingly central to ETF providers' branding. The scale advantages that flow to large, established funds mean that imitation is not a feasible strategy. Promoters need a distinctive signature product to build their reputation. That provides a basis for marketing efforts and makes it easier to build a successful product range.

At a global level, the survey identifies several product development themes. One is a resurgence of appetite for emerging markets funds. Another is the continuing growth of fixed income ETFs, especially in Europe. Conversations also point to the popularity of currency ETFs in Japan, demand for commodity funds in the US, and emerging interest in ethical products such as socially responsible and Islamic ETFs.

The survey shows that active and enhanced beta ETFs are seen as being among the most important drivers of future growth (see Figure 7). A range of US respondents are hoping to develop active funds, but the requirement for daily portfolio reporting creates the risk of front-running by traders. Promoters are hoping for SEC approval to report the portfolios of active ETFs on the same quarterly basis as mutual funds. Whether or not this succeeds, there is a growing view that most active managers in the US will need to offer their core products in ETF form in future. If so, those that launch active ETFs sooner than later should enjoy a first-mover advantage.

Figure 7: which products will generate growth in future?



Active ETFs are seen as having strong potential appeal to retail investors. Institutional investors already enjoy low-cost access to active mutual funds, but retail investors should make significant savings by switching to ETFs. Active funds should therefore allow new entrants to take market share from mutual fund providers, rather than from other ETF issuers.

If active ETFs remain largely aspirational, enhanced beta ETFs are already enjoying considerable success. This is particularly true in Europe, where enhanced beta dominates the innovation debate. Conversations with interviewees suggest that supply and demand for enhanced beta are reaching a tipping point, even if a vigorous debate continues over the accuracy of the “beta” label. Enhanced beta ETFs can be marketed as Undertakings for Collective Investment in Transferable Securities (UCITS) funds, so – like active funds – they could be an effective way for new ETF issuers to gather retail inflows at the expense of mutual fund managers. But enhanced beta is not without its challenges. European regulation of index providers could cause some headaches, and it is hard for investors to monitor fund performance.

Product innovation has a much stronger local flavor in Asia. Markets like Korea are highly innovative, and regulation in Japan and Taiwan is also seen as comparatively accommodating. In contrast, Singapore takes a far more cautious approach, with individuals required to pass an exam before they can trade ETFs. Hong Kong continues to see fixed income and sector ETF launches, but some respondents feel that innovation has slowed and that more relaxed regulation would give the industry a boost. There is interest in active and enhanced beta funds, and some promoters would like the SFC¹⁰ to approve riskier products, such as leveraged and inverse ETFs.

It remains to be seen whether active, enhanced beta and other innovative ETFs will generate long-term growth or just a short-term boost to inflows. In our view, innovation is central to expanding the long-term appeal and reach of ETFs. But we also believe providers should be wary of crowding risks, as well as the likelihood of renewed fee pressure.

¹⁰ Securities & Futures Commission (Hong Kong)

“Five years ago, investors would probably have just walked away from the idea of buying into the Eurozone equity market if they felt the euro was going to decline significantly. Now, with currency-hedged ETFs, UK investors, for example, can gain access to the underlying Eurozone equity market without having to worry about what the euro will do against sterling.”

Andrew Walsh,
Executive Director and Head of ETF UK sales, UBS

3. Further improvements to products and liquidity will help to unlock stronger institutional demand

The survey shows clear potential for stronger institutional take-up of ETFs, especially among pension funds and insurers. Customization and innovation are seen as two of the industry’s key weapons. Strong liquidity is also vital to attracting institutional money, but weaknesses in this area are holding back European and Asian ETF markets. We see cooperation between industry players, exchanges and depositaries as vital to overcoming these barriers.

Outside the US, institutional investors have been responsible for most of the global ETF industry’s growth in recent years. Even so, a wide range of institutions still make little or no use of ETFs. The survey confirms our view that institutional inflows still offer huge upside potential. Half of the investors we surveyed plan to increase their allocation to ETFs during the coming year, with the rise of goal-oriented investment only enhancing the appeal of ETFs’ flexibility. In Europe, the growing cost of running derivatives positions is also boosting ETF adoption by institutions such as private banks and sovereign wealth funds. Compared with financial futures, ETFs offer a greater choice of benchmarks, require less administration and do not involve margin calls.

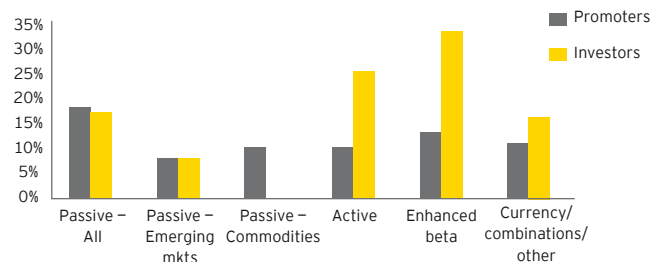
Nonetheless, some ETF promoters are disappointed by the comparatively low level of ETF take-up among pension funds and insurers, especially in Europe. The largest investors, who rarely require intra-day liquidity and typically enjoy low-cost access to mutual funds, have sometimes proved reluctant to switch to ETFs.

We believe ETFs have the potential to appeal to a wider range of institutional investors. As already discussed, providers are increasingly keen to customize funds to the requirements of major institutions. In our view, both defined benefit and defined contribution pension funds can benefit from the wide variety of emerging market and fixed income asset allocation options that ETFs offer. We see particularly significant long-term potential from Asian pension assets. This includes markets such as Australia and Hong Kong, where pension savings are mandatory, and individuals have a high degree of control over their own investment decisions.

We also see huge potential for independent insurers to make greater use of ETFs, whether for life insurers’ long-term investment requirements or for shorter-term fixed income investments in the non-life sector.

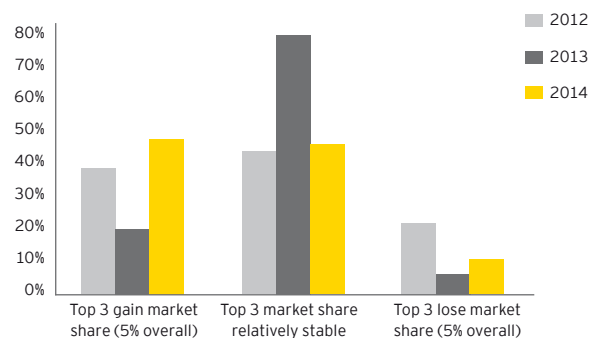
ETF providers are hoping that innovation will help them to unlock greater institutional demand. So it is highly encouraging that the investors we surveyed see active and enhanced beta ETFs as a more important driver of growth than promoters do themselves (see Figure 8).

Figure 8: which products will generate growth in future? (Selected responses)



However desirable institutional inflows might be, it is worth remembering that they can have unforeseen effects. One possibility we have already mentioned is crowding in specialized strategies. The more capital that chases a particular exposure, the faster investment advantages, management fees and margins will be eroded. In the short to medium term, institutional investors’ preferences for the largest ETFs could also reinforce the dominance of leading promoters. The survey hints at this possibility. The proportion of respondents expecting the industry’s top three players to increase their market share has more than doubled since the last survey (see Figure 9).

Figure 9: how will the dominance of the largest ETF providers evolve?



“To increase the number of transparent trades in the order book continues to be the main goal of SIX Swiss Exchange.”

Alain Picard,
Head Product Management, SIX Swiss Exchange

Nonetheless, we believe that institutional appetite for ETFs could help to promote the industry’s diversity in the long term. Over time, institutional use of a growing range of ETF strategies will encourage brokers to list ETF providers separately. And as ETF allocations grow, institutional investors will need to increase the number of ETF providers they use in order to meet their own concentration limits.

Liquidity is another vital element to attracting new investors. The importance of liquidity to institutions means that it is crucial to seeding, innovation, growth and profitability. The US market is the clear leader in the liquidity stakes, but even here, perceptions of illiquidity can damage a promoter’s reputation. Although experienced ETF investors use a range of metrics, such as trade volume or bid-offer spreads, to gauge liquidity, many new and prospective ETF investors still equate fund size with liquidity. Even small institutions such as foundations and family offices can be reluctant to commit capital to anyone but the largest providers.

This pattern is repeated globally. The largest promoters tend to attract the greatest inflows, reinforcing their liquidity advantages. As already discussed, second-tier providers and new entrants therefore need to develop at least one star product with good liquidity that they can use to build their reputation.

Liquidity remains a particular preoccupation in Europe, where fragmented markets and thin liquidity are seen as a major barrier to growth. Cross-listings present a particular problem for market makers, forcing them to buy and sell the same product on a number of different exchanges. The fact that Europe has become an OTC¹¹ market, with 40% to 90% of secondary trading taking place off-exchange, further reduces transparency. Exchanges increasingly find themselves competing with multilateral trading venues and quote request platforms. In response, many are investing in transparency, reporting and other areas that promote ETF liquidity.

For European providers and market makers the possibility of one central listing, one pricing source or one settlement venue is likely to remain a dream. Instead the industry is seeing a range of different liquidity-focused initiatives. These include:

- ▶ **Consolidated tape:** the European industry has seen several failed attempts to create a consolidated tape of trading data. It does not help that some exchanges do not always enforce their trade reporting requirements. MiFID II, due in 2017, will introduce mandatory trade reporting for the first time. In the meantime, BATS Chi-X is the latest organization to set up an ETF trade reporting service to consolidate OTC and exchange data from a number of promoters and market makers.¹²

¹¹ Over-the-counter

- ▶ **Quote request platforms:** quote request platforms such as TradeWeb, Bloomberg and RFG play an increasingly important role in the fragmented European market. Market makers use these platforms to get a picture of OTC liquidity. But while they help to encourage best execution, quote platforms are unable to interact with all brokers and are no substitute for on-exchange liquidity.
- ▶ **Pan-European exchange:** a true pan-European exchange is far off. But the fact that 86% of promoters see the potential for such a development is a sign of the desire for a single transparent European trading venue. For now, BATS Chi-X – a multilateral trading venue with recognized exchange status – is the closest substitute. Some respondents see it as a helpful development, others as an additional source of fragmentation.
- ▶ **Centralized settlement:** the existence of more than 30 clearing and settlement venues in Europe is a huge barrier to market making. Market makers would like regulators to encourage cooperation between securities depositaries. BlackRock’s settlement partnership with Euroclear¹³ is a welcome development, but also illustrates the hurdles involved. The platform is not connected to every major exchange, is closed to retail investors and is at least a year away from being opened to third parties.
- ▶ **Securities lending:** market makers believe that US-style stock lending of ETF units could unlock significant liquidity in Europe. Promoters are keen for fund units to be used as collateral, which would tighten spreads and reduce settlement costs. The fact that it is cheaper to borrow underlying stocks than corresponding ETF units suggests that custodians see fragmented settlement as a barrier.

These may all be European initiatives, but we believe they could be instructive in Asia as ETF markets evolve. The proposed Shanghai-Hong Kong Stock Connect link – sometimes referred to as “The Through Train” – is one example of a bilateral initiative that could help to improve liquidity. If there is a single message here, we think it is the importance of cooperation between promoters, market makers, exchanges and other members of the ETF value chain to enhance liquidity.

¹² Press release, BATS Chi-X, 16 Oct 2014

¹³ Press release, Euroclear, 04 Jun 2013

“Efficiency and transparency remain the two greatest constraints to the development of the ETF industry in Europe. If market participants work to build solutions that remedy these issues, we will be able to improve exchange-based liquidity, attract further investors and grow assets under management.”

Guy Simpkin,
Head of Business Development, BATS

“The evolution of the ETP market over the last few years has been quite significant, and this has led to impressive growth in the industry. As investors become more aware of what ETPs are available, they are finding that the products now fulfil a wider range of objectives than ever before. As a pioneer both in active and beta plus strategies, it has been rewarding to see European investors embracing higher value added solutions delivered within the efficiency and transparency of an ETP structure.”

Michael John (MJ) Lytle,
Chief Development Officer, Source

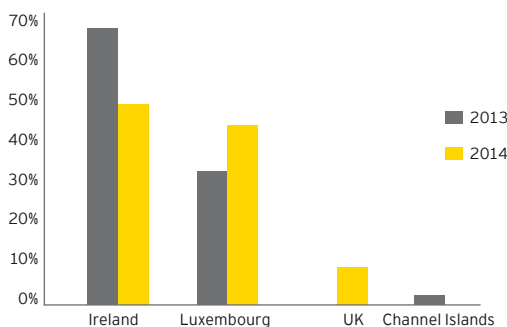
4. Maintaining transparency will be vital as the industry grows more globalized and sophisticated

International expansion, aided by acquisition, is reshaping the industry. Promoters are also responding to the increasingly complex flows of ETF capital among the US, Europe and Asian markets. As a result, ETFs are growing in versatility and sophistication. In our view, a strong commitment to education and transparency will give the industry the best protection against reputational damage or regulatory over-reaction.

The growing internationalization of the ETF industry emerges strongly from the survey. Promoters still see cross-border expansion as an important growth avenue. Although expectations of in-market consolidation are falling, many of our respondents expect cross-border acquisitions to reshape the industry and remove some smaller promoters from the market. As already discussed, partnerships also offer a useful strategy for market entrants to acquire local knowledge.

US ETF providers continue to build up their European product ranges, often by replicating existing funds. We expect to see further targeted acquisitions of European houses by US or even Asian players. This is partly about European growth, but it also reflects shifting capital flows. Institutional investors are becoming more aware of the tax differences between US and European funds. This, together with developments such as Foreign Account Tax Compliance Act (FATCA), is making it easier to sell European ETFs to Asian institutions. Asian retail customers are showing growing interest in UCITS ETFs too. This may explain why Luxembourg – well known in Asia as a UCITS hub – is seen as an increasingly attractive location for fund domiciles and administration (see Figure 10).

Figure 10: what is the preferred location to administer funds within Europe?

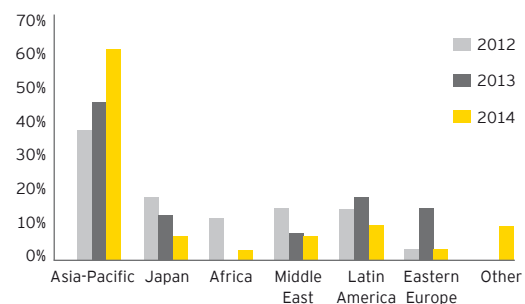


This is not to say that the appeal of the US as a destination for cross-border ETF investment is waning. The US ETF market continues to offer superior liquidity and appeals strongly to international investors. Recent months have seen US promoters set up feeder funds in emerging markets such as Latin America and the Middle East.

Respondents around the world identify Asia as a more popular target than ever for international expansion (see Figure 11). But each of Asia's highly diverse ETF markets has its own features. Although China is once again the most popular target for international capital, the survey also shows that some US promoters are turning their attention to Japan's largely domestic but highly liquid ETF market. At the same time, Southeast Asian ETFs are attracting increasing attention, especially from Asian institutions. The last year has seen ETFs launched in markets as diverse as Thailand, the Philippines and Vietnam, and a second sharia-compliant ETF issued in Malaysia.

The shifting flows of global ETF investment are most clearly seen in Hong Kong, Asia's largest cross-border ETF hub. International capital is rapidly flowing into Hong Kong-domiciled Chinese ETFs, with one provider taking the decision to restrict access to its physical A-share fund.¹⁴ The Shanghai-Hong Kong Stock Connect link also has the potential to shake up ETF flows in the region, and might provide an alternative to mutual recognition for ETF issuers looking to offer investors a route in and out of Mainland China's domestic markets.

Figure 11: what expansion to your distribution network are you considering? (Promoter responses only)



¹⁴“Chinese ETFs shut to new investment,” FT.com, 15 Sep 2014

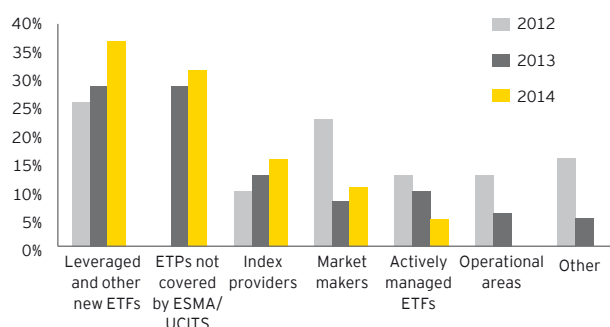
The increasing internationalization of the ETF industry is matched by growing sophistication. As the industry grows in size and creativity, the range of products, strategies and exposures offered by ETFs is expanding rapidly. ETFs are giving many investors far greater access to specialized markets and asset classes. One example is the way that ETFs enable individuals to achieve liquid, low-cost exposure to a broad range of high-yield debt with only a small investment.

ETF innovation is not only about underlying investments. Promoters in Europe and Asia have responded to investors' growing preferences for physical ETFs, with a wider range of core physical ETFs tracking mainstream indices and assets. At the same time they have continued to develop synthetic funds, and the survey shows that a majority of respondents still see a future for swap-based ETFs. The comparative ease with which synthetic ETFs can track emerging market assets illustrates their potential advantages for investors seeking complex or exotic exposures.

If the increasing versatility and sophistication of the ETF industry has a downside, we believe it could come from reputational risks. Despite the growing range of ETF exposures available, many retail investors, and even some financial advisors, still view ETFs as inherently low-risk, index-tracking, passive products. Even when investment risks are well understood – for example, when investing in bonds – not all investors understand the interaction between ETF units and underlying assets. If a fixed income ETF can be more liquid than the bonds it tracks, logic suggests that it could also be less liquid at a time of market stress.

The survey hints at concerns over the potential for higher-risk ETFs to provoke regulatory over-reaction. For instance, growing numbers of respondents would like to see regulators focus on leveraged products (see Figure 12). There are also concerns that investors in exchange-traded contracts and notes may not realize that they are usually, in essence, buying a bank-issued security.

Figure 12: where should regulators focus their attention in the future?



In our view, the ETF industry's innovative drive needs to be matched by a campaign for full transparency and education. ETF providers pride themselves on the value, choice and flexibility they offer investors. The price of long-term success may be ensuring that investors of all stripes not only understand how ETFs perform, but also how they work.



“Growth in ETFs in APAC is entering a new phase with markets in several locations showing exceptionally strong growth. What is needed now is a concerted efforts from all exchanges and regulators to ensure that investors have better access to low cost, efficient and transparent investment choices.”

Chris Ryan,
Managing Director - Asia Pacific, MSCI

“ETFs have benefited from the growth of low-cost passive investment, and the increasing regulatory focus on appropriate product selection and fees. While initially driven by the UK, this regulatory movement is taking hold on the continent as well.

Education and the evolution of traditional fund platforms to better support the trading of ETFs will be key factors in the growth of the retail market.”

Tim Huver,
ETF Product Management, Vanguard

5. Patience, education and technology will all be crucial to overcoming the retail growth challenge

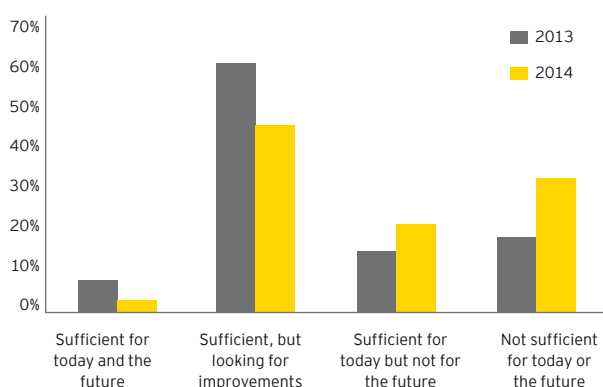
Outside the US, low retail adoption is arguably the ETF industry’s biggest long-term challenge. Inadequate distribution networks are increasingly seen as a roadblock to growth. Promoters in different markets are trying a range of approaches, but there are no simple or speedy answers. We believe that patience, education, partnerships and technology will all have a role to play.

Low retail adoption outside the US, aging populations and individuals’ growing responsibility for retirement savings all point to strong potential for global growth in retail ETF assets. Some respondents see scope for rapid retail expansion. One predicts 100% growth over the next five years, and several others feel that growing demand in China could act as a catalyst for Asian retail ETFs.

Even so, when asked to quantify retail growth over the next three to five years, most respondents are more measured. Of those surveyed, 38% anticipate growth of 5%-10%, 29% expect 10%-15% growth and 19% predict retail activity will expand by more than 20%. These are positive forecasts, but they are hardly dramatic. In our view, tapping into retail growth not only represents the industry’s greatest global opportunity, but also its greatest long-term challenge.

The survey suggests that overcoming the limitations of current distribution is the key to unlocking retail growth. Hardly any respondents now view their distribution arrangements as completely adequate. Many see a need for improvement, and 32% view current models as wholly inadequate (see Figure 13). It is striking that the last group includes some leading ETF promoters.

Figure 13: is your current distribution model suitable for today’s market and that of the future?



ETF providers are taking a range of steps to address these weaknesses. Few, if any, are pinning their hopes on a single distribution channel. Dedicated sales teams and fund platforms are identified as two important areas of focus, but conversations with respondents tell us that every firm has its own approach. Promoters are also using social media as part of their strategy to educate retail investors and develop their brands.

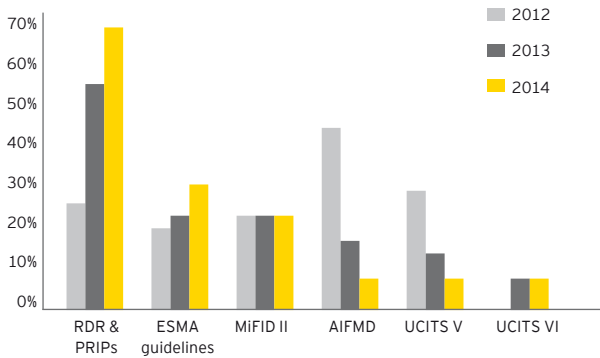
This pattern reflects the experience of the US, where many promoters have achieved strong retail growth through a variety of distribution routes. Most use dedicated sales staff, but this ranges from a handful of institutional salespeople to a national retail operation. The survey shows that two-thirds of US respondents are now focused on developing online retail accounts. E-platforms offer retail investors low-cost product access, reinforcing the appeal of ETFs to those who do not require paid-for investment advice.

The retail challenge is at its most acute in Europe, where retail funds represent about 15% of total ETFs compared with 45% in the US.¹⁵ European promoters are concentrating on platforms and educating financial advisors. In both cases, they face a struggle to enhance investor choice and information. Most European platforms offer ETFs, but there are significant exceptions, and many have a limited choice of providers and products. Most platforms and supermarkets do not allow intra-day trading. They also provide far less information than in the US, where retail investors can compare a wide range of ETFs, analyze costs and receive recommendations.

Increasing numbers of European promoters are therefore hoping that reform of retail sales regulation will come to their rescue (see Figure 14). Sweden, Germany and Switzerland are among the countries moving toward the sort of changes already seen in the Netherlands and the UK. Even so, we do not see regulatory reform as a silver bullet.

¹⁵ “ETF providers eye Europe’s retail market,” FT.com, 07 Sep 2014

Figure 14: which regulatory developments offer the greatest opportunity?



Asian ETF promoters are just as attracted as their US and European counterparts to the growth potential of other Asian retail markets. We see growing interest in the market entry possibilities of joint ventures. This was recently illustrated by announcement of a distribution partnership with BetaShares – owned by Mirae of Korea – to target retail markets in Australia and New Zealand.¹⁶

Respondents in Asia take an even more downbeat view of their current distribution models. Again, the survey suggests that there is no single solution. Different promoters are developing a range of distribution channels in different markets. As well as dedicated sales staff, broker networks are an area of focus – a nod to the dominance of banking distribution in many Asian retail markets. Promoters with strong local distribution are considering the possibilities of gathering retail inflows via IPOs.



“We believe the growth in the ETF industry is still in the early stages. There will be continued interest in smart beta strategies, especially those which make sense and are easy to understand. With many strategies coming to market, a live track record will be an important determinant in success.”

Nik Bienkowski,
WisdomTree Europe Co-CEO, Boost ETP

¹⁶ Press release, BetaShares, 12 Aug 2014

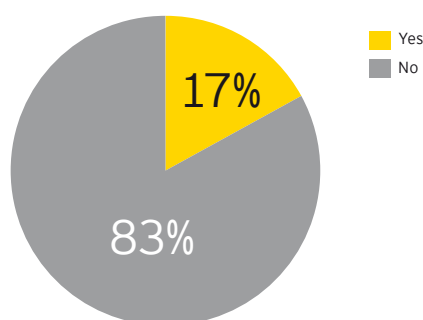
6. Coordinated use of technology by promoters and administrators holds the key to improving efficiency

Despite margin pressure, ETF providers are finding cost savings harder to come by. Fund and listing rationalization offers short-term savings. In the longer term, we believe that technology offers the industry considerably greater potential to improve operating efficiency. Significant gaps remain between promoters' goals and service providers' capabilities. Improved communication and reporting are two areas of common focus, but service providers could develop a stronger "front-office" mind-set.

As in other segments of the asset management industry, ETF promoters are finding their profitability squeezed by competitive pressure on fees. As a result, 71% of promoters are looking to reduce their costs. However, the survey also shows that the large majority of those surveyed do not expect to materially alter their operating models (see Figure 15).

While the industry's widespread confidence in the ETF model is reassuring, it does not mean there are no efficiency improvements to be made. But many firms are finding it progressively harder to deliver significant cost savings. This is especially true in the US, where fund sizes and economies of scale are at their largest and the most obvious efficiencies have already been achieved.

Figure 15: are you looking to change your operating model?



For some ETF providers, rationalizing their portfolios of funds offers significant scope for cost saving. We understand the importance of fund launches to generating inflows, as well as the one-off costs of fund closures. But we also believe that fund closures no longer carry the stigma they did a few years

ago. And the survey confirms that the number of ETFs being launched around the world, while lower than in the boom years of 2008-10, continues to outstrip the number being merged or closed.

In Europe, the ubiquity of cross-listings offers a way to reduce costs without closing funds entirely. Rationalizing listings can enable promoters to derive significant savings from marketing, administration and regulation. But in practice, European providers often have limited scope for delisting. In some cases this is because firms have already tidied their listings and set up more rigorous controls over new launches. But it also reflects a view that every delisting carries a risk of losing local access to retail investors.

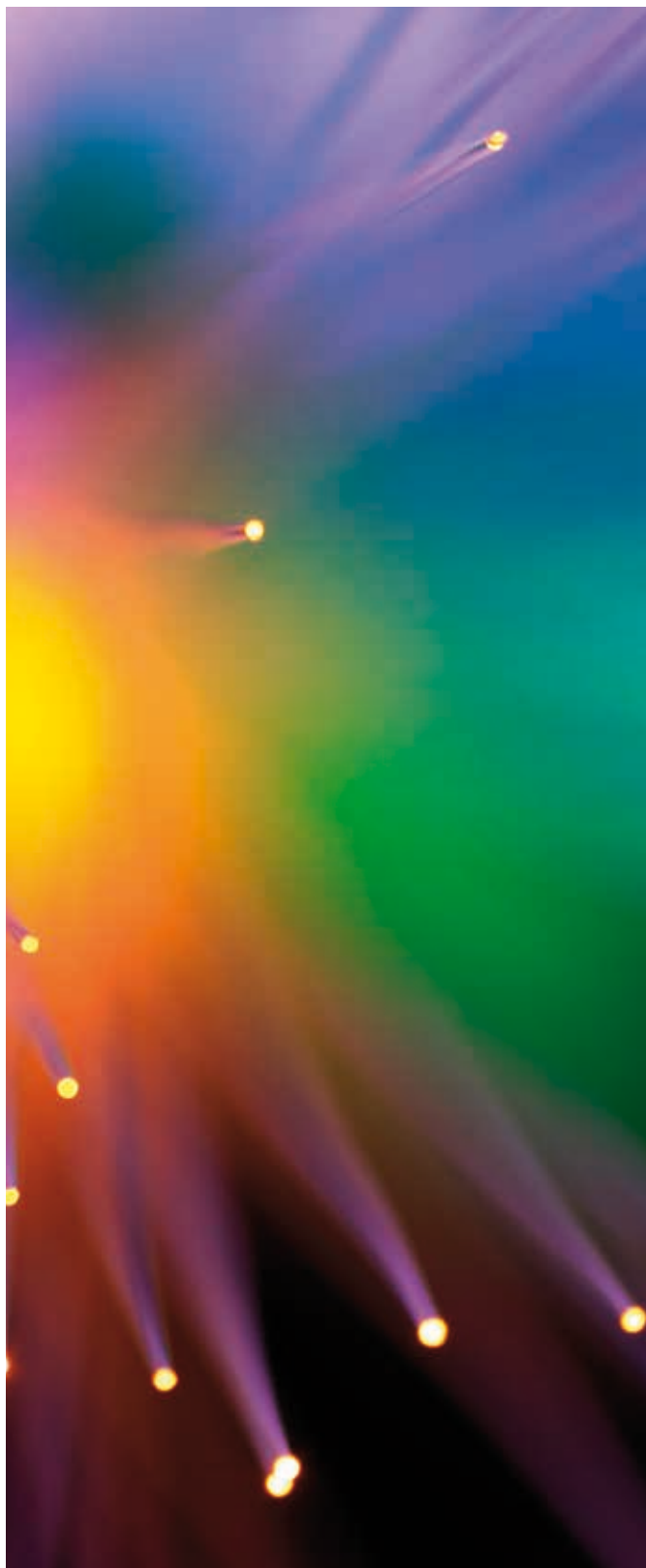
When it comes to longer-term efficiency gains, ETF promoters are turning to technology. Investments in simpler, more robust operating models are not only intended to boost efficiency, but also to achieve improvements in risk management and governance.

In our view, ETF providers have a better opportunity than most asset managers to put technology at the heart of their drive for greater efficiency. One reason is that the rapid growth of ETF assets across geographies and markets is making it easier for centralized improvements in technology to deliver enterprise-wide benefits. Another is that the speed of many ETF markets and the need for intra-day functionality mean that ETF promoters can leverage technology more effectively than mutual fund providers. As with other asset managers, investment in technology is also helping ETF providers to make optimal use of outsourcing and shared centers of excellence.

Our last survey showed that ETF promoters saw service providers as doing far too little to support innovation in the industry. The current survey shows a slight improvement, even if levels of satisfaction among promoters (41%) are only half those of other respondents (80%).

On the upside, the survey shows a marked improvement in European views. A majority of the region's respondents now feel positive about the support they are receiving. On the downside, Asian respondents remain largely dissatisfied. Lack of competition is a key factor here. Asian promoters simply

Recommendations



This short section summarizes some of the areas where we believe greater focus from a range of ETF stakeholders could help the industry to sustain its growth or strengthen its success:

- ▶ **Pricing.** The industry needs to emphasize the full range of ETFs' benefits, avoid an excessive focus on low costs and move the debate on pricing beyond a pure focus on management fees.
- ▶ **Engagement.** Working more closely with institutional investors and their representatives will help promoters to strengthen seeding and their ability to grow new funds to scale.
- ▶ **Customization.** Innovation and customization in the institutional arena should help to gather inflows from pension funds and insurers that do not yet invest in ETFs.
- ▶ **Education.** Outside the US, educating investors and intermediaries on the benefits of ETFs will be crucial to delivering the untapped potential for retail growth.
- ▶ **Transparency.** As the industry increases its sophistication and geographical reach, it needs to ensure that intermediaries and end-investors fully understand the structure, function and risks of ETFs.
- ▶ **Foresight.** Promoters need to be careful that their innovations have lasting value and are more than a short-term response to market developments. They should also be alert to the risks of crowding.
- ▶ **Cooperation.** Closer relationships across the ETF value chain will become vital to the industry's future development. One example is the need for promoters and market makers to work with custodians to broaden the use of ETF units as collateral.
- ▶ **Technology.** Investment in technology by promoters and service providers will support other goals, such as improving operational efficiency and developing digital distribution.
- ▶ **Partnership.** Promoters, market makers and service providers need to work together closely to improve the mechanics of the industry and help investors to achieve their goals.

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