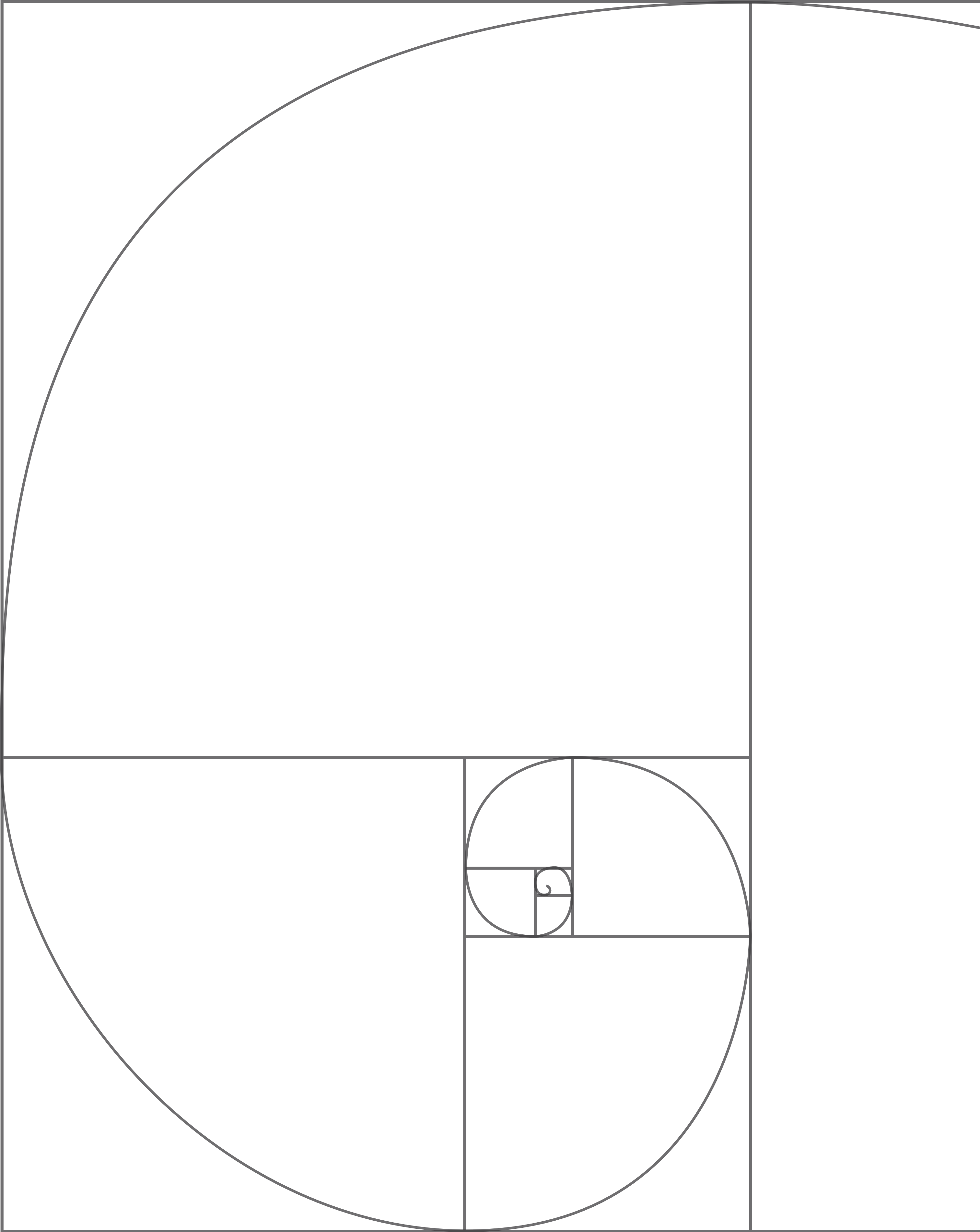
Integrated innovation

The key to sustainable growth

Global ETF Survey 2016

EY

Building a better working world



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Executive summary

In July-August 2016, we interviewed more than 70 leading ETF promoters, investors, market makers and service providers across the US, Europe and Asia-Pacific. Our sample includes respondents at issuers managing 86% of global ETF assets.

The exchange-traded fund (ETF) industry continues to extend its stunning track record of expansion. As of August 2016 the industry had enjoyed a decade of growth averaging 21.5% per annum, and was overseeing assets under management (AuM) of US$3.4t.[1] This achievement is even more impressive for having been made against a backdrop of unprecedented economic upheaval and financial market volatility.

We expect strong growth in ETF assets to continue, and we predict that industry AuM will reach US$6t by the end of 2020. We also expect ETF inflows to be twice those of mutual funds — both passive and active — over the same period. These predictions are underpinned by the ETF industry's commitment to innovation. Innovation is crucial to ETF's ability to meet an ever growing range of needs, and attract an ever wider range of investors.

Even so, our latest global study shows that the ETF industry's characteristically high levels of confidence are tempered with a growing dose of realism. The growing influence and complexity of ETFs is creating not only opportunities for ETF providers, but challenges too. As the industry grows, it is becoming progressively harder for firms to deliver continued expansion. Competition is getting more intense as new providers enter the market. And the need to invest in technology and compliance is making the ability to achieve scale more vital than ever.

In this environment, three strategic themes emerge as being of particular importance:

- Product development — the need to balance creativity and growth with prudence and transparency
- Market entry — the need to consider all options when searching for scale and expansion
- Digital distribution — the need to leverage rapid developments in technology and investor demand

We see these separate themes as being united by an underlying motif: innovation. In its own way, each topic illustrates the vital importance of innovative thinking to the industry. Taken together, we believe they point to a need for many ETF providers to develop a more integrated approach to innovation.

Integrated innovation aims to achieve balance among different imperatives, such as growth and profitability. It also encourages firms to bring creative thinking to all aspects of their activities. In our view, integrated innovation offers the potential for promoters to harness the disruptive power of ETFs across their full range of activities.

If the ETF industry is to fulfill its own lofty expectations for continued growth, then we believe promoters need to focus on four strategic priorities that will enable them to put integrated innovation into practice. We conclude this report by exploring these priorities in greater detail. They are:

- Smart, sustainable product development
- Creativity in the search for scale
- Transparency related to products, performance and pricing
- Control of the digital agenda

The ETF industry's track record of growth is compelling. The fact that so many mutual fund providers are entering the market is conclusive proof of ETFs' gravitational pull. But convergence between ETFs and other investment products also threatens the distinctiveness that has served the ETF industry so well. If ETF providers want to not only continue growing but do so in a way that lays the foundations for sustainable profitability, we believe that an integrated approach to innovation holds the key to success.

Matt Forstenhausler
Global and US Wealth & Asset Management
ETF Leader

Lisa Kealy
EMEIA Wealth & Asset Management
ETF Leader

Julie Kerr
Asia-Pacific Wealth & Asset Management
ETF Leader

1 Data excludes exchange traded products (ETPs). Unless otherwise indicated, all data sourced from ETFGI.

Strategic themes

Product development

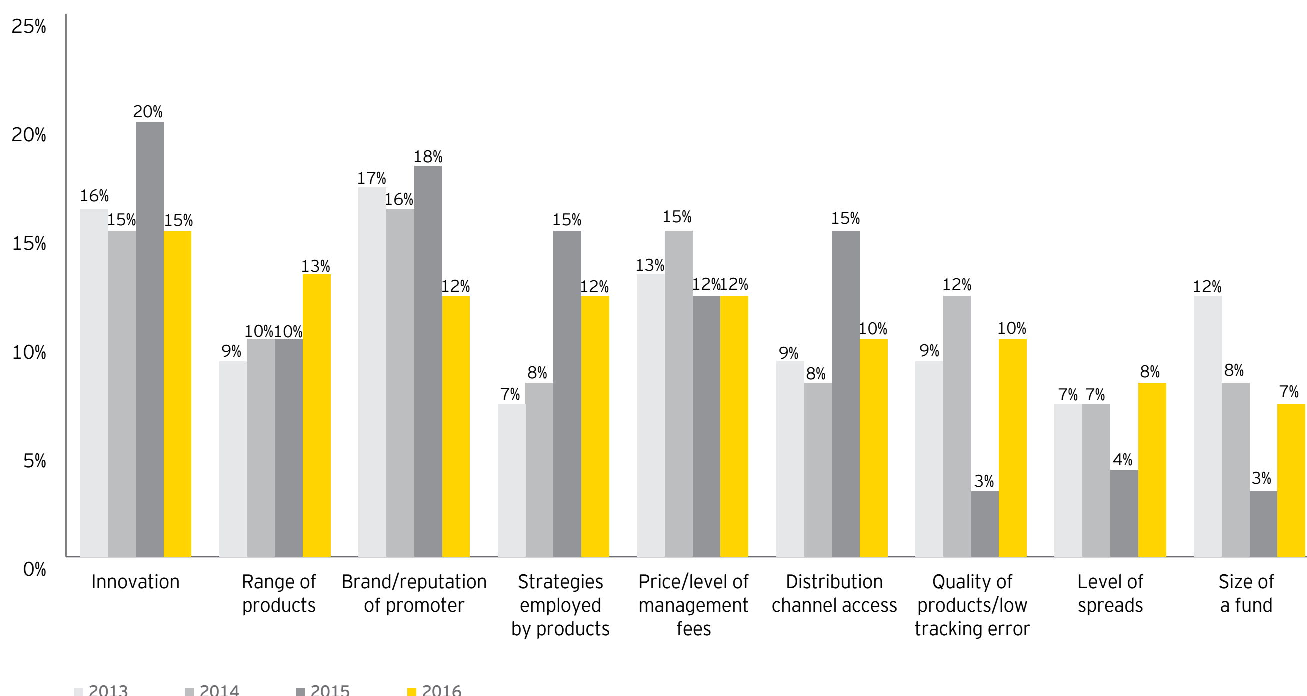
Product innovation only seems to grow in importance as the ETF industry expands. Providers are arguably more focused on product development than at any time in the sector's history. The reasons are simple and compelling. Product development is essential for:

- **Growth.** New products are vital to sustaining growth rates. For example, 67% of respondents expect smart beta and active products to support industry growth for at least five years. Successful innovation is essential to fulfilling these predictions.
- **Profitability.** Investment capabilities are seen as a key driver of margin improvement. The higher fees that new and specialized products command help to offset pricing pressure on existing ETFs.
- **Differentiation.** In an increasingly crowded field, innovation is seen as the leading source of differentiation, with product range climbing fast into second place (see Figure 1). New entrants depend on eye-catching products to stand out from the crowd, while incumbents rely on new products to open fresh conversations with investors.

"Socially responsible investing is certainly an area of increasing importance. Now, there's far more awareness of the merits of passive SRI ETFs – notably that they are very competitively priced and can in fact offer equal, if not better, performance than standard plain vanilla benchmarks."

Andrew Walsh
Executive Director, ETF, UBS

Figure 1. What are promoters focusing on to differentiate themselves from others?

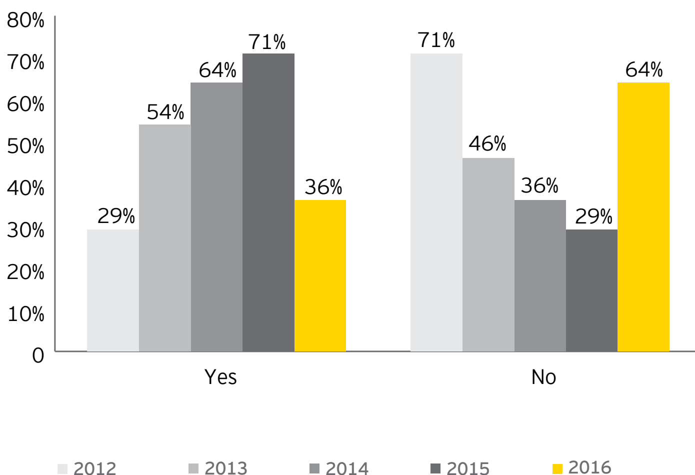


Considering these factors, it is no surprise that interviewees predict the number of ETFs to keep growing. What is striking is that a majority expect new products to become less successful in the future (see Figure 2). In the US, this view is universal. This reverses the trend of recent years, when improved due diligence was seen as boosting the effectiveness of product development.

Ironically, this change of mood reflects the cumulative effects of innovation. Even in a growing market, the supply of products is reaching saturation point. The growth of more complex ETFs such as multifactor smart beta is making it harder for promoters to test and seed new products while achieving speed to market. And regulatory approval for new products is becoming harder to acquire in many markets.

Unfortunately, product development is unlikely to get any easier in the future. Institutional investors, which have the greatest influence on product innovation, are widely expected to increase their ETF allocations. The survey shows that, as well as expecting new products to meet their needs, they also value speed to market highly (see Figure 3). And the needs of institutional investors are complex and varied. Each has its own goals, and investment decisions can be influenced by a range of technical factors. Insurers illustrate this perfectly. Insurance accounting and regulation create precise investment and reporting requirements. ETF promoters need to understand these and work with administrators to provide insurers with the data they require.

Figure 2. Will the success rate of new launches improve in the future?



> "The rapid increase in the number and diversity of fixed income ETFs means that investors are no longer limited to employing specialist active bond managers or accessing the underlying over the counter (OTC) bond market directly. The decision seems simple. Why trade multiple bonds OTC when you can invest in a fixed income ETF that holds the same issues in one share, and with a single TER?"
>
> **Alexis Marinof**
> **EMEA Head of SPDR ETFs, SPDR**

The survey also shows that institutional investors are putting ETFs to an ever wider range of uses, including:

- Investing in ETFs not only to achieve niche exposures, but also to execute core convictions
- Gaining exposures they might struggle to access directly, such as diversified small cap equities, or a spread of emerging market debt
- Using leveraged and inverse ETFs to anticipate or react quickly to market movements
- Using passive ETFs to build actively managed multi-asset investment portfolios – for example, by investment advisors creating tailored portfolios for high net worth (HNW) investors

> "The continuous growth of the ETF market in Europe does not hide the fact that competition is still extremely fierce. The industry has reached a new record high in July 2016 with 22 consecutive months of net inflows. This growth has been heavily supported by the growing adoption of ETFs by all investor types, the extensive growth of fixed income ETFs and the increased innovation in the investment strategies delivered especially in the smart beta space. This will drive and maintain the continuous growth of the ETF market over the coming years."
>
> **Nicolas Samaran**
> **Head of Product Development (EMEA), Invesco Powershares**

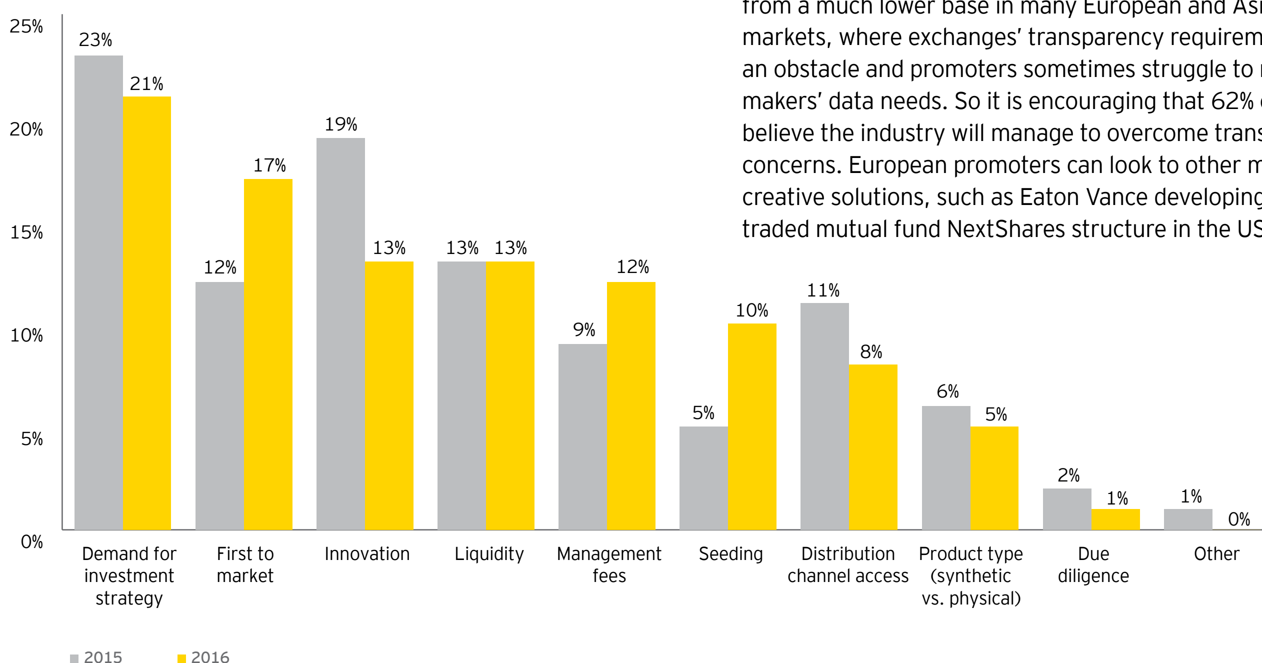
> "When allocating to smart beta strategies investors should fully understand the methodology of the underlying index. For example, there are many products on the market with a low or minimum volatility or variance label. However, they are very different in construction, leading to potentially significant disparity in outcomes."
>
> **Chanchal Samadder**
> **Head of UK & Ireland Institutional ETF Sales at Lyxor Asset Management, Lyxor**

- Substituting low cost ETFs for fully funded futures, or as a more liquid alternative to credit default swaps. Most respondents (75%) see ETFs as an ideal vehicle to replace certain derivatives.

Ever keen to anticipate the needs of investors, ETF promoters continue to pursue new areas of product innovation. Current and emerging trends vary among markets (see regional summaries), and we expect to see a range of future developments, as follows:

- **Fixed income.** As predicted in our last survey, fixed income dominated ETF inflows during the first six months of 2016. All those surveyed in the US and 85% globally expect demand to continue to grow, driven by supportive market conditions. Differences between the liquidity of fixed income ETFs and their underlying assets remain a topic of fierce debate. Some respondents admit to concerns about the potential for reputational damage, especially given the emergence of esoteric products such as asset-backed security and loan-based ETFs (see Focus on macro factors).
- **Smart beta.** Smart beta ETFs have generated the bulk of new product launches so far in 2016, attracting strong inflows from investors seeking enhanced returns and diversification at a lower cost than actively managed funds. Inflows are particularly strong in Europe, with investors favoring dividend weighted products. Product numbers are increasing in many markets, and this is predicted to persist by 94% of promoters. Furthermore, 67% expect smart beta growth to last longer than five years. That positive finding reflects untapped potential in areas such as fixed income, where promoters feel fundamentally weighted indexes should outperform conventional liability-weighted ones. But could the smart beta revolution carry hidden risks? Some interviewees have concerns over factor crowding, excessive reliance on back testing and the need to manage investor expectations. It remains to be seen whether smart beta will meet the needs of investors in all market conditions.
- **Active ETFs.** Active ETFs only represent 1% of global ETF assets but are seen as a very important source of future growth. They are particularly an area of focus in the US, Canada and Australia and are a popular entry point for active asset managers launching their first ETF. In contrast, active ETFs are growing from a much lower base in many European and Asia-Pacific markets, where exchanges' transparency requirements can be an obstacle and promoters sometimes struggle to meet market makers' data needs. So it is encouraging that 62% of respondents believe the industry will manage to overcome transparency concerns. European promoters can look to other markets for creative solutions, such as Eaton Vance developing its exchange-traded mutual fund NextShares structure in the US.

Figure 3. Which factors are critical to the success of new launches?



> "ETPs continue to help democratize the global investment industry. While investors and their intermediaries are becoming more informed, the educational job is far from done. In addition, no investment firm is immune to rising macroeconomic uncertainty, intensifying fee pressure and the threat of further regulation. So although the product 'land grab' maybe largely done, going forward, winning firms will be the ones that are best at distribution."
>
> **Mark Weeks**
> **Chief Executive Officer, ETF Securities (UK) Limited**

- **Leveraged and Inverse (L&I).** Helped by volatile market conditions, L&I ETFs are enjoying a burst of popularity in Europe and Asia-Pacific. Asian investors in particular use L&I products to execute short-term trading ideas. L&I is now available in Hong Kong, Japan, Taiwan and Korea. The fact that L&I products reset daily means that they offer different exposures to futures or short selling. Promoters need to ensure that investors understand these differences, especially when using L&I ETFs for multi-day periods. The desire of the Securities and Exchange Commission (SEC) to limit the use of L&I ETFs also suggests that European regulators could pay more attention to L&I products in future.
- **Currency hedging.** Currency hedged classes of ETFs continue to attract significant inflows, particularly in Europe. Over time, the growth of cross-border investment should also boost demand for currency hedged ETFs in Asia-Pacific. Promoters need to make it clear that the fluctuations of currency markets inevitably have an effect on the relative performance of these products.
- **Environmental, Social and Governance (ESG)/Socially Responsible Investing (SRI) themed ETFs.** Growing concerns about global warming and "stranded assets" are giving ESG/SRI themed ETFs a boost. There is increasing interest from millennial retail investors, especially in the US, where a number of promoters have issued ESG funds. Following the Paris Agreement of December 2015, institutions such as pension funds are considering ETFs as a low-cost alternative to actively managed ESG funds. As these products develop it will be interesting to see which use quasi-passive "screening" and which take a more active approach to portfolio selection.

This list provides ample evidence of the industry's innovative capabilities, but it also highlights a few potential risks. Conversations with interviewees confirm that some promoters are worried about the potential side effects of innovation. Cost buildup and excessive competition are concerns, but so too are reputational risks such as potential for mis-selling or the danger of a regulatory backlash.

In our view, transparency is the best defense against reputational risks. But though transparency is a point of pride for the industry, some investors feel that there is still room for improvement.

Stock lending is one example of this conundrum. Most managers see stock lending as a positive function. The majority of investors welcome the resulting reduction in cost, and stock lending has great potential to increase the liquidity of ETFs in Europe. Even so, stock lending can reduce the transparency of returns and give physical ETFs some of the features of synthetic ones. If promoters want investors to continue supporting stock lending by physical ETFs, they need to be as transparent as possible about lending limits, average lending levels, revenue sharing policies and the details of collateral received by funds.

Costs are another area where transparency could be improved. ETF promoters should make the total cost of ownership as clear as possible, for example, by pointing out that an ETF's low total expense ratio (TER) may sometimes be outweighed by transaction costs, such as bid/offer spreads and brokerage charges. This is especially true when investing in the short term.

Product development is a defining theme of the ETF industry, but it is becoming progressively harder to achieve. Innovation needs to be tailored but brought to market quickly and meet specific needs while offering scalability. The good news is that industry players recognize the dangers of oversupply and the importance of thoughtful innovation that meets clear investor needs. As ETFs grow more complex, promoters need to ensure that their desire for innovation is balanced by a commitment to transparency and an awareness of the need for sustainability.

> "As the trend towards passive investing continues to gather pace, so too will the broadening of interest in strategic beta. More investors are starting to see the appeal of the approach, especially for fixed income investing."
>
> **Eric Wiegand**
> **Product Specialist - Passive Investments at Deutsche Bank, Deutsche Bank AG, Deutsche Asset Management**

Focus on macro factors

So far, 2016 has arguably seen more geopolitical unpredictability than any year since the financial crisis. Respondents think macro factors — most notably a Chinese slowdown, Brexit, US politics and the threat of terrorism — pose significant risks to market stability. Of course, concerns vary among regions. European firms worry most about Brexit and a possible EU breakup, while those in Asia-Pacific are more anxious about the health of the Chinese economy.

On the upside, macro shocks are creating opportunities for innovation. It is highly encouraging that the numbers of respondents who see market volatility as an opportunity outnumber those who view it as a threat by a 2-1 ratio. This buoyant attitude reflects the fact that investors are finding two key features of ETFs particularly valuable in current markets:

- **Accessibility.** ETFs offer investors access to strategies and assets they might otherwise struggle to obtain. Low yields have sent investors flocking into ETFs tracking dividend-weighted equities, high yield corporate bonds and emerging market debt. Foreign exchange fluctuations continue to support demand for currency hedged ETFs. And volatile equity markets are boosting the popularity of L&I ETFs in Europe and Asia-Pacific.
- **Liquidity.** The "additional layer" of liquidity that ETFs can provide — most notably in fixed income markets — is highly attractive to asset managers and hedge funds. They value the ability to place large trades within quoted spreads. Liquidity does not just appeal to institutions. Retail investors in Hong Kong and China often take short-term positions and value the ability to trade quickly.

"Despite the political and monetary policy uncertainty witnessed in 2016 so far, both European and Global ETP markets have continued to grow healthfully. Focusing on Europe, we expect this growth to accelerate, fueled by a continued adoption of fixed income ETFs; new applications of ETFs for institutional investors and a reshaping of the wealth and retail advisory space."

Ursula Marchioni
EMEA Chief Strategist, iShares

Unfortunately, the same market conditions that make ETFs attractive also pose challenges. Despite the strong performance of ETFs in the aftermath of recent events such as the UK's vote to leave the EU, 37% of promoters fear that ETFs may be particularly susceptible to market instability.

Given the industry's confidence in the ETF mechanism, these fears seem to be reputational in nature. Conversations show that some firms have particular concerns about fixed income ETFs, which have generated negative publicity in the past — albeit unjustifiably, in the views of many. Fixed income ETFs are often more liquid than underlying assets, but this is not always the case. A stress event that makes it hard for authorized participants to redeem units quickly could bring reputational risk, attract unwanted regulatory attention and set the whole industry a step back.

To be clear, no one in the industry expects ETFs to create or even contribute to a crisis. But a significant minority clearly believes that ETFs may suffer, perhaps unfairly, from events beyond the industry's control. The industry needs to innovate thoughtfully and manage investor expectations carefully if it wishes to continue to benefit from market volatility.

Market entry

The rapid growth of ETF assets continues to attract new entrants to the industry, increasing the importance of creative strategic thinking. Of those surveyed, no fewer than 90% expect more new players to enter the market and in the US, the figure is 100% (see Figure 4). Wafer-thin margins mean that existing providers think there is no room left in the market. All this said, the growth potential of ETFs is impossible for new entrants to resist.

Firms entering the ETF market are changing as the industry grows more sophisticated. The survey shows that niche players and active managers are seen as much more likely entrants than in prior years, along with newcomers from other sectors of asset management (see Figure 5). That is a notable change and illustrates a strategic response by active asset managers to the challenge from smart beta ETFs. In the US, niche and active managers are now considered the most likely entrants. European and Asia-Pacific respondents expect to see a mixture of US-based promoters and traditional asset managers enter local ETF markets.

The survey also shows that geographic expansion remains a key goal for established ETF promoters keen to tap into fast-growing markets. Asia-Pacific remains the most popular target, especially among US respondents but also for European and Asia-Pacific promoters (see Figure 6). Korean, Japanese and Australian issuers are among those looking to expand across the region. Some other eye-catching findings are that:

- Japan remains a popular target for foreign promoters, especially those from Asia-Pacific (25%). This reflects the size of Japan's domestic market and the growing demand for ETFs, not least from the Bank of Japan.
- Almost a third of Asia-Pacific interviewees are now targeting "other" regions, which means the US or Europe. Chinese issuers are among those launching 40 Act and Undertaking for the Collective Investment in Transferable Securities (UCITS) funds for distribution in their home markets.
- The approval of L&I products in Hong Kong is drawing in Korean promoters and is expected to attract the attention of US players.
- A minority of European respondents (15%) are considering expansion in Latin America for the first time.

Figure 4. Will more promoters enter the market over the next two years?

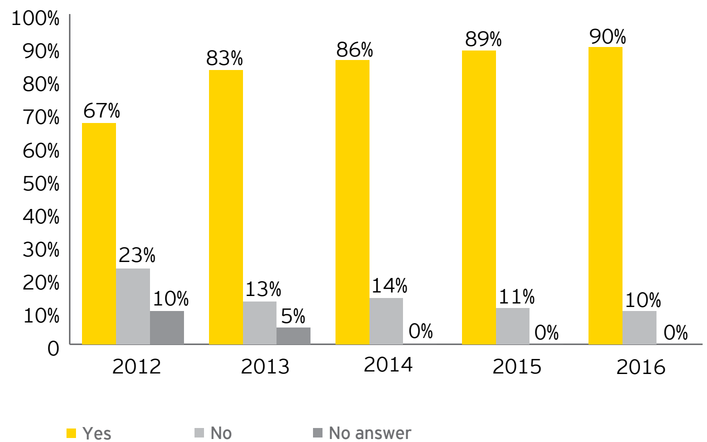


Figure 5. What type of promoters do you see entering the market over the next two years?

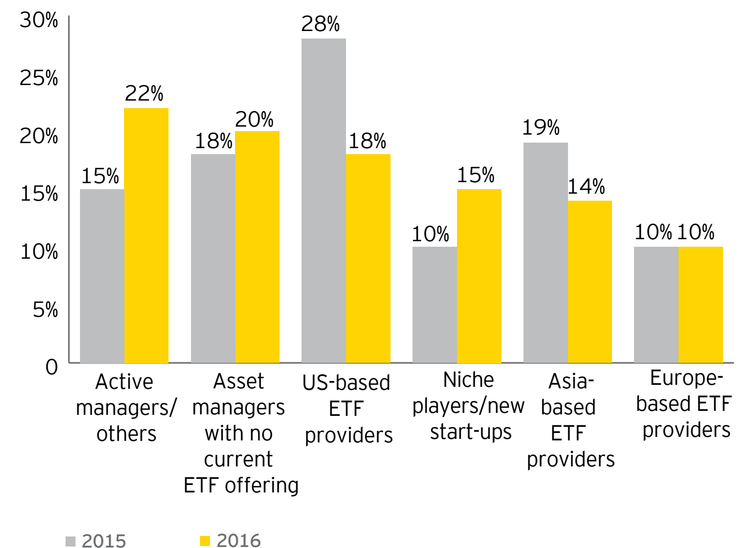


Figure 6. What expansion to your distribution network are you considering?

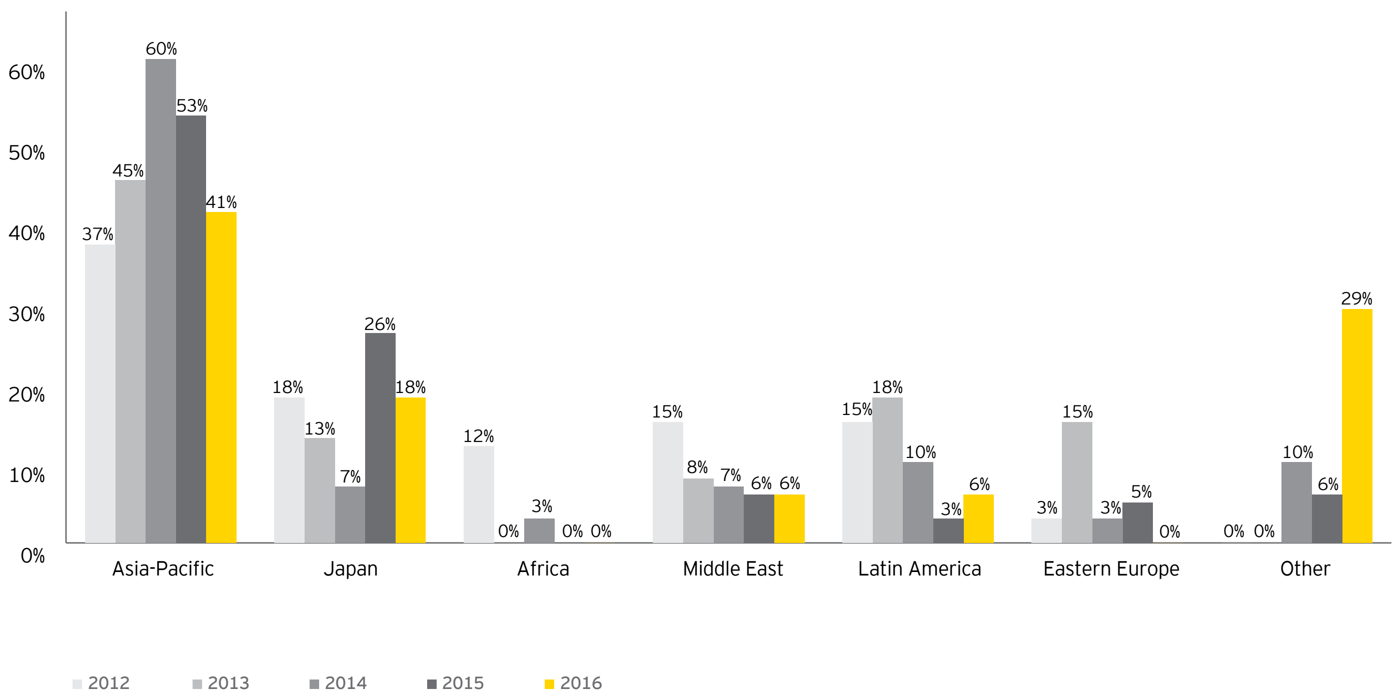


Figure 7. Market entry analysis

Type	Role	Ability to gather assets	Fee income	Time and cost initial	Time and cost ongoing	Level of control	Selling and distribution	Other considerations – need to ...	Suitable for promoters looking to ...
Partner with an existing promoter	Sub investment manager	High – use of their brand and track record	Very low – receive sub-IM fee	Low – already established platform	Very low – existing promoter to manage operations	Very low	Through existing promoter channels	Identify most suitable partner to manage and sell your product	Enter quickly, who are happy with white label deal
Acquire an existing promoter	Monitor promoter and manager	Low – no brand in ETFs, dependent on acquired brand	High – full management fee on products	High – identification and acquisition process	Medium – overview of existing promoter	High	Through existing promoter channels	Identify player who can offer advantage that you cannot develop	Build presence quickly to capitalize on distinct opportunities
Set up new operation	Promoter and manager	Very low – no ETF brand or track record	Very high – full management fee on products	Very high – establishment of entire infrastructure	Very high – responsible for operations	Very high	To be developed in full	Have clear distribution channels and investor base in place	Enter a new region, who are existing ETF promoters
Launch products on an existing ETF platform	Sub investment manager	Medium – good partner brand	Low – receive sub-IM fee	Very low – time focused on determining products	Low – operations managed by platform	Low	Both promoter and platform provider involvement	Ensure that you are happy with this as a long term approach	Create defensive strategy for a small number of products
Set up ETF share class of mutual funds	Promoter and manager	High – use of own brand and track record	Medium – full management fee on products	Very high – establishment of entire ETF infrastructure	High – responsible for additional operations	Medium	Through existing channels with additional ETF infrastructure	Clear all regulatory hurdles in advance	Create defensive strategy for a small number of products

	Positive	Medium	Negative
Color	(green)	(yellow)	(red)

Market entry is becoming not only a more important strategic theme, but a more complex one, too. That means that market entrants – whether established ETF issuers or total newcomers – need to be increasingly innovative in their use of different strategic options. These vary from a complete "greenfield" start to the acquisition of an existing promoter. In between, there are a range of approaches for partnering, sub-advising or using established ETF platforms (see Figure 7). Each has its advantages and disadvantages, depending on the competitive position of the entrant and any partner organizations. Strategic preferences also seem to vary among markets. US players are most likely to favor setting up new "own branded" products.

Recent months have seen several examples of all these approaches. One is the UK partnership between Legal and General Investment Management (LGIM) and Source, which will see LGIM manage a range of physical ETFs while synthetic specialist Source handles the operational aspects. The use of white-labeling is growing too, with newcomers using "plug and play" services such as those provided by ETF Securities' CANVAS platform.

Whichever approach they follow, experience shows that new entrants are likely to face some key hurdles:

- **Scale.** A lack of scale is seen as the greatest barrier to entry. Most options do not allow new entrants to achieve profitable scale quickly. Even an ETF promoter with a strong track record and good scale in one market will struggle to replicate this quickly in another.
- **Distribution.** Distribution emerges as the second most critical barrier to entry. Local knowledge and connections are vital, particularly in those Asia-Pacific and European markets where banks and brokers still dominate retail distribution.
- **Branding.** The survey identifies strong branding as an increasingly vital element of a successful market entry strategy. This reflects not only the growing influence of retail and HNW investors, but also the increasingly crowded ETF marketplace. With the appearance of so many "me too" ETFs, a strong brand can provide a vital competitive advantage. But branding is becoming more challenging as the uses and users of ETFs become more varied. Specialist providers can focus on a single attribute, but large promoters need more sophisticated branding. The challenge is especially acute for second tier issuers without a clear source of differentiation.

Of course, one strategic option — acquisition —offers the possibility of getting around these obstacles. M&A has the potential to deliver instant scale, an established brand and immediate distribution access. So it seems surprising that more respondents than before (74%) claim to have little appetite for acquisition-led growth (see Figure 8).

However, this response may not tell the full story. For one thing, players currently outside the ETF market may be more willing than incumbents to use M&A for market entry. Active mutual fund managers including Hartford Funds, Columbia Threadneedle, and Legg Mason have all acquired smart beta ETF specialists in recent months.

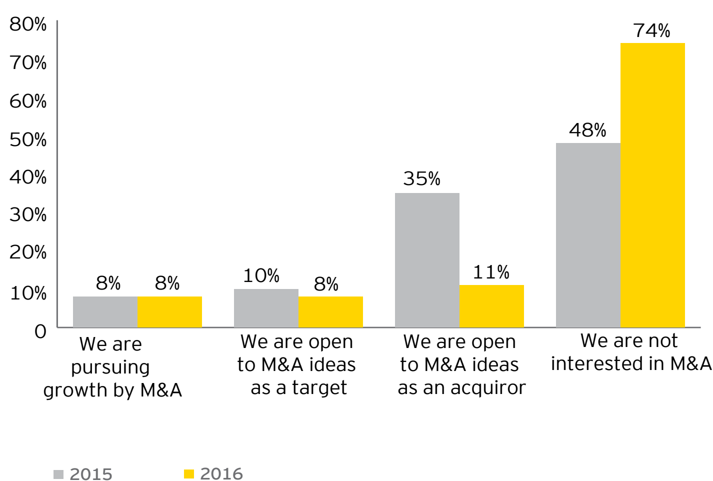
"It is essential for any new entrant to differentiate their ETF offering. Smart beta ETFs are one way that managers can differentiate by incorporating some of their investment ideas and expertise. With the increased complexity of smart beta ETFs it is important that the ETF issuer is able to easily explain and demonstrate the investment outcome or solution that the product is providing."

Nick King
Head of ETFs, Fidelity International

It is also worth remembering that the ETF industry has a track record of using M&A to build scale. Larger promoters continue to acquire smaller ones in many ETF markets, and 60% of those surveyed expect to see further consolidation over the next two years. In Asia-Pacific, where markets are less mature and many players are too small to warrant being acquired by rivals, only 42% predict consolidation. But 67% of European interviewees expect consolidation to persist, and the figure rises to 100% in the US.

Despite its potential value, M&A is only one approach to market entry. We see a need for greater innovation in market entry strategies and in the all-important search for scale (see *Focus on profitability, efficiency and scale*). Promoters need to embrace the same level of creative thinking about product and geographic diversification that they routinely apply to product development.

Figure 8. What is your company's current stance on M&A in the ETF industry?



Focus on profitability, efficiency and scale

Competition keeps pushing ETF fees lower. Average global total expense ratios (TERs) fell from 33 to 28 basis points in the two years to June 2016. The decline was greatest in core markets, with TERs falling from 31bps to 27bps in passive equity and from 24bps to 21bps in fixed income.

It is hard to believe that average fees can fall much lower. But the US — where TERs are already at their lowest — continues to see intense competition, and rivalry in large European markets is fierce, too. The survey shows that the outlook for fees has shifted downward again, in contrast to the last survey's stabilization (see Figure 9). Conversations with interviewees also suggest that pricing pressure is becoming greater in niche product areas. This will hurt smaller, specialized promoters and implies that innovation may not support margins for as long as the industry had hoped.

ETF promoters not only face falling fees. Operating costs are rising, too. Regulatory expenses are becoming more onerous, especially in Europe. And firms face increasing pressure to invest in digital technology, middle and back office automation, client reporting and cybersecurity. Asia-Pacific firms, which often operate on very tight budgets, look particularly vulnerable to cost inflation.

The combination of margin pressure and cost growth means that scale is becoming ever more central to profitability, although the survey shows significant regional variations. For example, nearly 70% of US and Asia-Pacific respondents say ETF promoters can break even with less than US$4b in AuM, but that figure is just 17% in Europe (see Figure 10). There is a similar picture at product level, where 69% of all ETFs (those below US$100m in size) account for just 3% of industry AuM. A majority of those surveyed (60%) see US$40m or more as the minimum break-even hurdle, but anecdotal comments imply that this figure can be US$100m for vanilla funds. In Europe, where regulation and multiple listings push up costs, 38% set the bar at US$80m or higher.

So how can ETF promoters achieve greater scale – particularly in the fragmented markets of Europe and Asia? Aside from M&A, we see two key possibilities.

The first is via collaborative innovation by promoters, brokers, exchanges or clearing houses. Current examples include a European cross-border issuance and settlement platform managed by two clearing houses and a leading ETF promoter; the Shenzhen-Hong Kong Stock Connect; and the London Stock Exchange's (LSE's) upcoming launch of an RFQ function .

The second option is consolidation at the product level. In practical terms this should be the easiest option, though it has been unpopular to date. But with numbers of ETFs continuing to grow, the survey suggests a growing willingness to de-list or close sub-scale funds. This is particularly true in the US. So far, 2016 has seen record levels of US fund closures, and 67% of US respondents expect to reduce their range by up to 25 products over the coming year. Given the US market's leadership role, this is a highly positive signal for the whole industry. Promoters may be reluctant to "take the lead" on product consolidation, but should find safety in numbers. If issuers can find the confidence to routinely review product profitability – say every two years - the ETF industry would be all the stronger.

"ETFs are a great investment innovation, lowering the cost of investing for millions of individuals around the globe. We believe simple, low-cost and highly diversified ETFs will ultimately lead to better investing outcomes for these investors. In particular, we expect ETFs alongside index funds to play a more significant role in retail investment portfolios."

Mark Fitzgerald
Head of Product Development, Europe, Vanguard

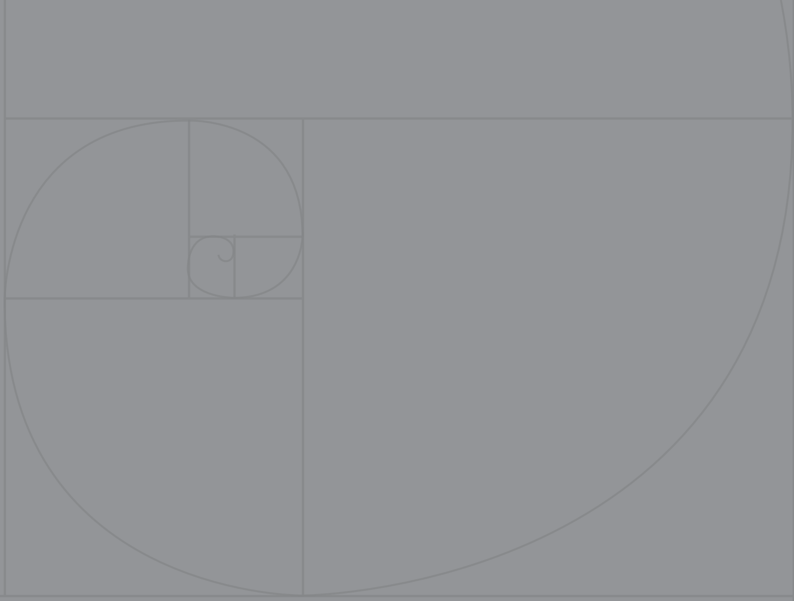


Figure 9. How will promoters' margins (management fees) change in the future?

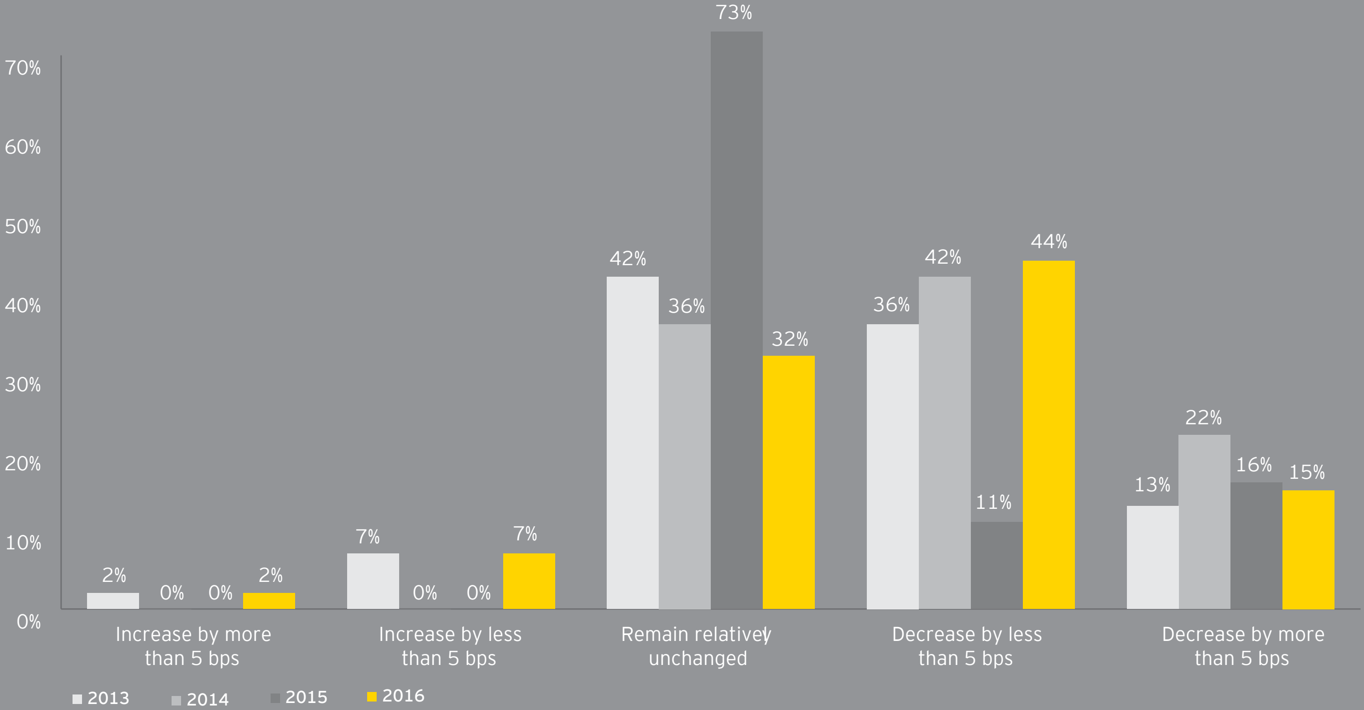
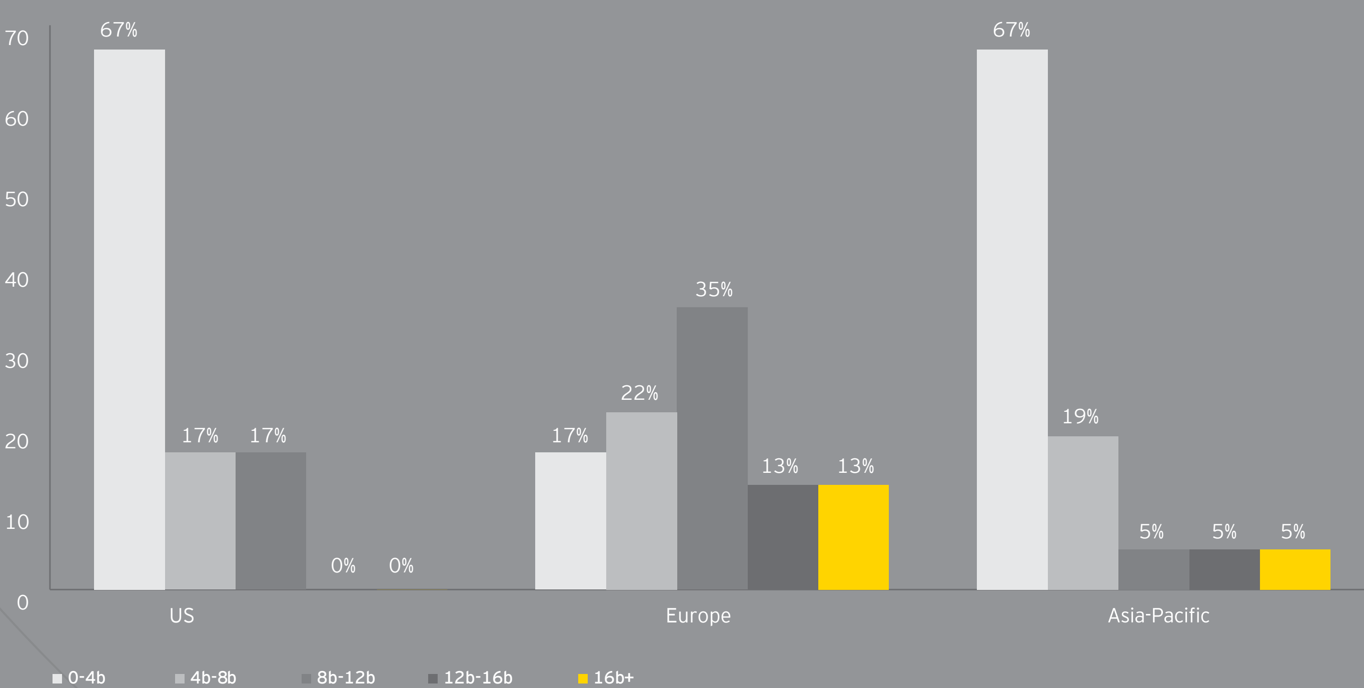


Figure 10. What do you see as the break-even point for an ETF promoter? (USD)



Digital distribution

The ETF industry has an exceptional track record of innovation, not only in product content but also in fund structures, price discovery, trading and settlement. However, the industry has arguably been slower to embrace innovative distribution. Of course, ETF promoters face the same distribution challenges as all fund providers, in addition to the need to educate investors about ETFs. Even so, it is striking that the survey shows little improvement in the adequacy of distribution models over recent years, despite clear evidence that investors are increasingly enthusiastic about digital distribution (see Figure 11). Only 10% of respondents believe their distribution model is suitable for today and the future, compared with 20% who view it as insufficient.

The emergence of robo-advisors as a scalable retail channel could overturn this picture. The survey shows real excitement about robo-advisors, with 88% of those surveyed expecting them to accelerate ETF growth. Nearly half of interviewees (45%) think robo-advisors will deliver in excess of 10% of annual industry inflows within three to five years. That is particularly appealing in the US and Asia-Pacific, where retail investment is seen as a leading source of growth.

"We see exponential growth in ETF savings plans for retail investors in Germany. These are mainly offered by online banks and brokers, but increasingly by high street banks as well. The average savings amount is around 150 Euros per month. Investors prefer well-known and diversified indices."

Arne Scheehl
Head of ETF sales, ComStage ETF

"Online distribution has become dominant for both ETFs as well as equities in Japan. We may need to approach the retail market by utilizing the latest technology such as FinTech."

Katsumasa Matsumura
Senior Manager, Nomura Asset Management

Conversations with interviewees reinforce the impression that robo-advisors could play a key role in the industry's future, not only by boosting direct sales but also by supporting investment advisors. There is an almost universal view that smart beta is a perfect fit for robo-advisors. Many respondents feel that the robo-advisor promise of low-cost, diversified, tailored investment management can only be delivered using ETFs.

So are robo-advisors and ETFs a "match made in heaven"? Not necessarily. The survey shows that excitement about robo-advisors is tempered with increasing realism. Two-thirds of those surveyed believe it will take three to five years for robo-advisors to deliver accelerated growth, and nearly a quarter think it will take more than five years. Enthusiasm also varies among markets. Robo-advisors are gathering billions of assets in the US but they are at a much earlier stage in Europe and Asia-Pacific. Many interviewees see them as overhyped and nearly half of European and Asia-Pacific respondents believe robo-advisors will take years to boost retail demand (see Figure 12).

Figure 11. Is your current distribution model sufficient for today's market and that of the future?

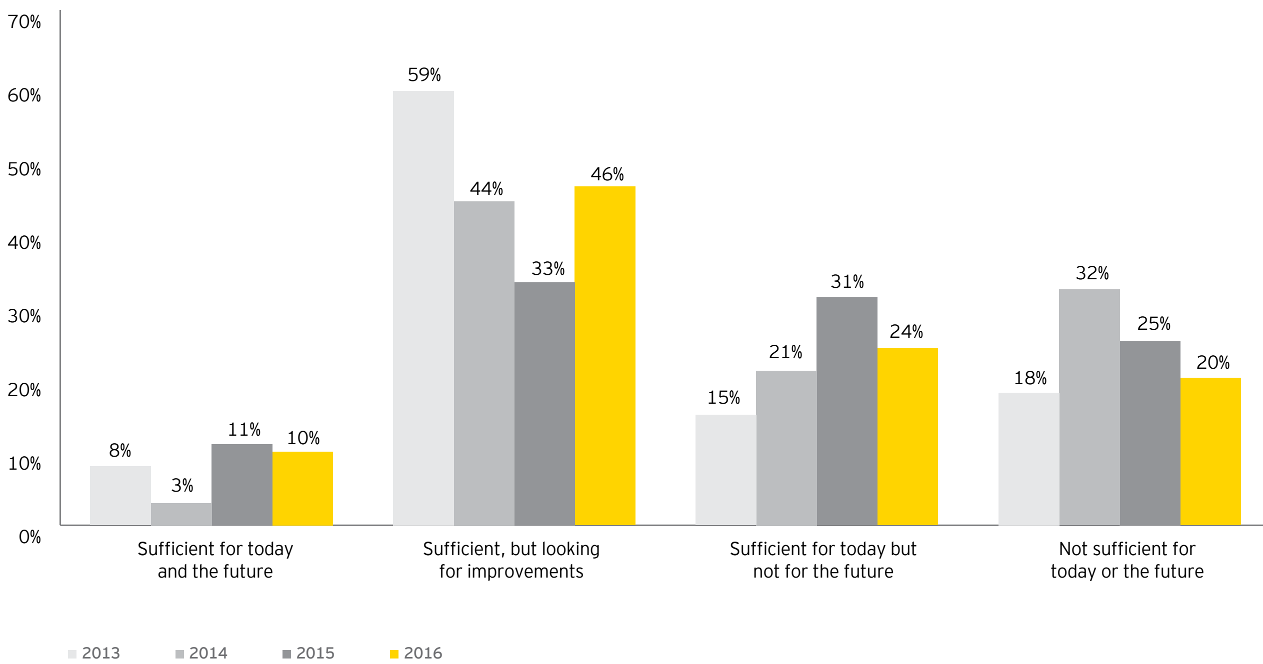
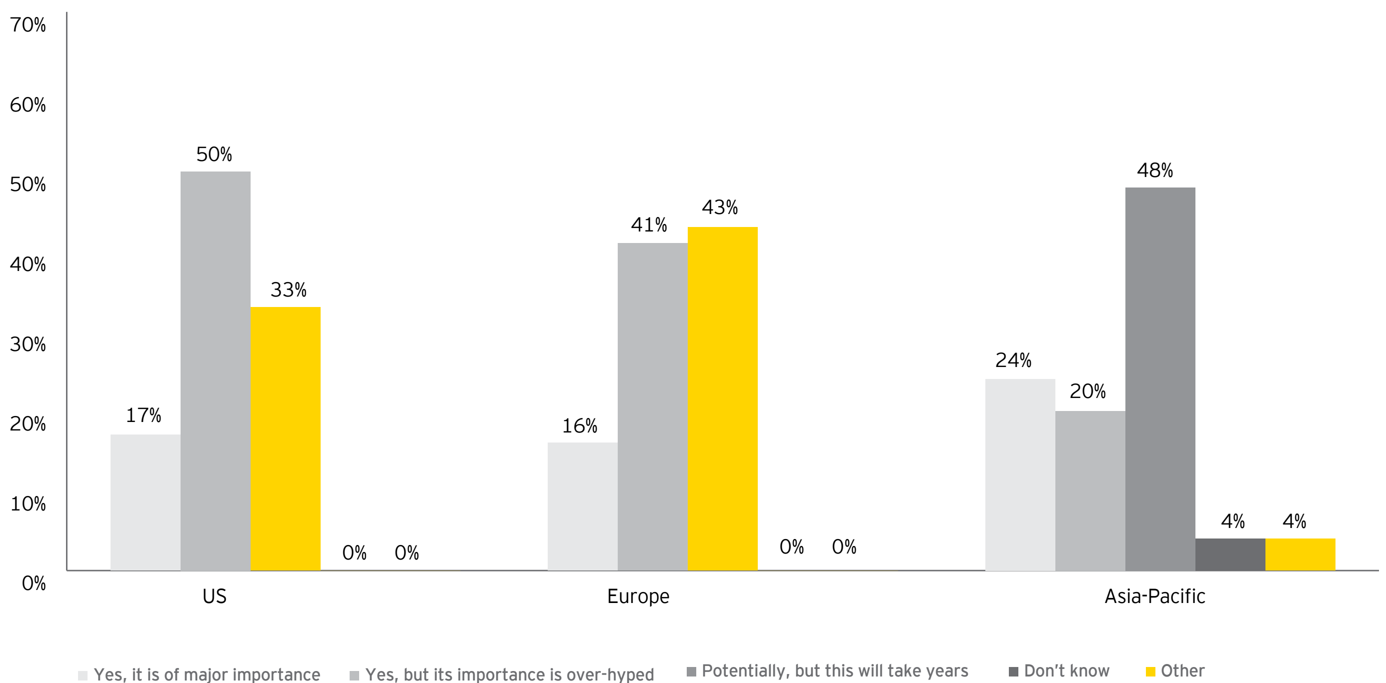


Figure 12. Is digital/robo-advice the key that will finally unlock retail demand?



Regulation is one reason for these variations. Asia-Pacific providers may be more enthusiastic than those in other regions, but regulators in several Asia-Pacific markets seem skeptical about stand-alone robo-advisors. The situation of individual firms is another factor. In particular, larger promoters are typically more open to using a wide range of distribution channels, have more capital to invest, can leverage stronger brands and are better placed to negotiate with partners.

In short, the survey suggests that, despite investors' growing willingness to embrace digital distribution, promoters will need patience to realize long-term robo-advisor growth. It also implies that a joined-up digital strategy that recognizes the need to build emotional engagement through direct and social media will be vital. In our view, such a strategy would need to consider a number of complex factors, including:

- **Wider patterns of digital distribution.** Robo-advisor tactics need to fit into broader distribution strategies. The most obvious application is for direct retail sales, but robo-advisors can support advised sales and HNW channels too. Will they complement other channels or cannibalize them? Promoters need to choose which routes to prioritize.
- **Changing investor preferences.** Millennial investors may seem the ideal target for robo-advisors, though they often have less investible income than older generations and face other pressing financial priorities. But firms should avoid generalizing. Generation X and baby boomer investors with greater financial assets may not be as resistant to digital distribution as widely assumed. Different segments also have different preferences, with recent EY research showing that HNW clients may be more open to robo-advisors than mass affluent investors.[2]
- **Regional differences.** Expectations for robo-advisors vary among regions. For example, many European promoters expect most digital distribution to retain elements of traditional advice. Established digital platforms also vary widely among markets, including online brokers in the US, fund supermarkets in the UK and Australia, online savings accounts in Germany and Alibaba in China.
- **The human element.** Outside the US, robo-advisors still have a long way to go to win the trust of investors. ETF providers need to do all they can to encourage investors to use this channel. While some investors are ready to adopt fully automated robo-advisors, others may prefer hybrid models that combine automation with a degree of human guidance.
- **Ownership vs. partnership.** Promoters can take a number of approaches to robo-advisor distribution. Those that can afford it could buy established robo-advisors. Building a proprietary platform is another option. Firms could also partner with established robo-advisors, providing them with a suite of investment tools, or co-operate with banks or brokers to offer online investment accounts.
- **Integration with social media.** Although 35% of respondents consider social media to be very important, most promoters are only beginning to develop social media strategies, and 72% have yet to appoint a head of social media. A successful digital strategy will need to use social media to build relationships, not just to "push" marketing information.

As a disruptive force in its own right, the ETF industry should embrace the way that investors' growing appetite for digital technology is reshaping retail and HNW distribution. Robo-advisors are a golden opportunity, but at present rates of development could take years to reach their potential in many markets. Promoters need smart, innovative digital strategies that not only allow for future changes in technology, but also in investor preferences and industry practices (see Focus on mutual fund convergence). That will not only support near-term growth but will also allow firms to retain their long-term flexibility.

"We believe that bringing more transparency to the European ETF market will benefit the market significantly, increasing assets under management, as well as trading volume."

Guy Simpkin
Head of Business Development Europe, Bats Europe

2 *The experience factor: The new growth engine in wealth management*, EY 2016

Focus on mutual fund convergence

"I believe that ETFs will continue to be a major disruptive force in the fund industry and asset growth is most likely to focus on innovative smart beta strategies."

Nizam Hamid
ETF Strategy, Wisdom Tree

One of the most interesting qualitative findings to emerge from the survey is the impression that convergence between ETFs and mutual funds may be accelerating.

This sounds counterintuitive. ETFs have a unique structure and have traditionally been defined by their differences from mutual funds. But over the past five years, these distinctions have become blurred in some areas, including:

- **Cost.** Combined with the reform of retail distribution in many markets, the strategic threat from low-cost ETFs has forced the mutual fund industry to reduce management fees and other charges.
- **Content.** The range of options that ETFs provide has led many investors to re-evaluate the flexibility of indexing – including via mutual funds.
- **Structure.** The structural boundaries between ETFs and mutual funds have been eroded by the emergence of hybrid vehicles. Exchange-traded managed funds have dominated headlines, but exchanges in Italy and the Netherlands now allow mutual funds to be traded. ETF classes of mutual funds have also been launched in a number of markets.

More recently, the global shift toward passive investment has served to stimulate convergence. The first five months of 2016 saw global active outflows of $213b and passive inflows of $240b.[3] The strength of these flows is encouraging asset managers to reduce costs by integrating both sets of products into a single index-based offering. After all, it makes sense for ETFs and mutual fund ranges to be complementary, not competitive. A third of promoters say they do not differentiate between ETFs and other products, but are led by investor preferences.

So, does convergence with mutual funds represent a threat to the ETF industry?

We suspect the answer is "probably not." If many investors are becoming "vehicle agnostic," that is because mutual fund providers are increasingly focused on providing the features that have made ETFs more successful than other index funds – including low costs and flexibility. That can only be good for investors – and for those institutions able to compete in the ETF market. And, to be clear, the survey does not suggest that ETFs and mutual funds will ever fully converge.

Nonetheless, we do expect convergence to present existing ETF promoters and new entrants with a twofold challenge: to ensure that they are strategically placed to take advantage of convergence and to ensure that they deliver optimal outcomes to investors, whichever investment vehicle they choose.

"ETFs are attracting investors from across the industry, including from hedge funds, who are using the liquidity and efficiency to meet a variety of their specific needs. "

Jürgen Blumberg
Head of Capital Markets Europe, Source

3 *Asset management: Actively failing*, Financial Times, 18 July 2016

Regional highlights

Regional summary: US

The US is the world's largest ETF market, enjoys strong demand from both retail and institutional investors, and continues to capture a large slice of global inflows. ETFs offer tax benefits to domestic investors, and concentrated trading on just three exchanges helps the industry to achieve high levels of efficiency. We expect total AuM in the US market to grow from US$2.3t at the end of August 2016 to US$4.2t by the end of 2020, an average annual growth rate of around 15%. We identify the following key themes:

- **Growing adoption.** The US ETF industry continues to increase its range of investors. Self-directed retail investment is growing. Robo-advisors, online brokers and other retail distributors increasingly use ETFs to build standardized portfolios and customized solutions. Institutions are substituting ETFs for futures and credit derivatives, and they would welcome a wider range of leveraged ETFs. The survey shows that US respondents are also upbeat about demand from HNW advisors.
- **Competition, margins and new entrants.** Competition is more intense than ever. Low fees are a leading point of rivalry, and this will only increase as more issuers enter the market. Active asset managers are seen as the most likely entrants. The effects of competition are stark. US respondents are finding it harder to make new products successful and take the most downbeat view of profitability. Fund closures are expected to accelerate.
- **Further consolidation.** All US respondents expect further consolidation among promoters, the strongest response of any region. Margin pressure and competition mean that firms without real advantages in scale or performance will face increasing pressure to merge or restructure. Small, high-performing players can also expect to attract the attention of larger ETF providers.
- **Product innovation.** Innovation is the leading source of competitive advantage after fees, and speed to market is increasingly important. Fixed income assets — which make up 17% of US ETFs compared with 24% of European ETFs and 23% of US mutual funds — are seen as a major growth area. However, the SEC's proposals for ETF-specific regulation could create headaches by increasing cash holdings and limiting less liquid investments. Active ETFs are a key area of focus and will receive a boost as more active specialists enter the market. The approval of periodically disclosed ETFs could be a game changer.
- **Branding investment.** As competition increases and products proliferate, branding is becoming an ever greater priority. A strong brand is vital to make products stand out when marketing to advised and self-directed retail investors.
- **Digitization.** The survey suggests that US firms are more ready than others to seek operational improvements through digitization. Digital distribution is another major theme, with robo-advisors widely seen as the future of retail advice. Some US robo-advisors have already attracted billions of dollars, and are expected to take mass affluent and even HNW customers away from human advisors in the future.
- **Convergence with mutual funds.** The gradual convergence of ETFs and mutual funds is a global theme but is most notable in the US. The growth of exchange-traded managed funds (ETMFs) is blurring lines, as is the entry of more mutual fund specialists into the ETF market. Some promoters make little branding distinction between ETFs and other index funds (see *Focus on mutual fund convergence*).
- **Regulation: headwind or tailwind?** Interviewees feel that regulatory scrutiny is increasing as the ETF industry grows — and not just in fixed income. But many see US regulation as generally supportive. The SEC's focus on "distribution fees in guise" and a new suitability standard for advisors are both expected to encourage retail demand. The Department of Labor's new Fiduciary Standard Rule could also give ETF adoption by 401K investors a boost.

Regional summary: Europe

Europe's ETF markets are growing rapidly, driven by strong institutional take-up. Fragmentation is the biggest operational headache for the industry, and local differences continue to make themselves felt. We expect total AuM in Europe to grow from US$533b in August 2016 to US$1.1t by the end of 2020, an average annual growth rate of about 16%. Some of the key themes of European ETF markets are:

- **Institutional opportunity.** Asset managers are the leading users of ETFs, making pension funds and insurers the industry's most valuable targets. The substitution of ETFs for fully funded futures continues to grow, and the gradual shift toward passive strategies is playing into the hands of ETFs. However, variations in regulation and demand mean that promoters need to tailor their approach to each market.
- **Retail potential vs. retail reality.** Stronger retail adoption of ETFs remains a key long-term ambition. There is huge interest in digital distribution, but few see it as a magic bullet. Despite some success in markets like the UK and Scandinavia, robo-advice remains in its infancy and is expected to complement traditional channels for the foreseeable future. Different markets also call for different approaches. Online savings banks are increasingly successful in Germany, but many of the UK's fund supermarkets have yet to list ETFs alongside other investment funds.
- **Margins and new entrants.** European ETF markets are seeing significant price erosion, with local issuers coming under pressure from global leaders. At the same time, operating costs are being pushed up by cost duplication and heavy regulation. As a result, break-even levels are higher than in any other region. New entrants are expected, with more North American promoters expected to follow their peers into Europe, and Asia-Pacific firms launching UCITS products for distribution in home markets. Traditional European asset managers – both passive and active – are also expected to enter in greater numbers. Traditional asset managers — both passive and active — are also expected to enter in greater numbers.
- **The drive for efficiency.** Stronger operating efficiency is a strategic priority for many firms. In the absence of industry-wide cooperation, individual institutions are taking the lead. The desire for cross-border trading is illustrated by the success of pan-European stock exchange BATS. Issuers are also exploring the capabilities of the international settlement platform established by a large promoter and two clearing houses. At the product level, the need for fund closures is arguably at its greatest in Europe.
- **Product innovation.** Fixed income ETFs are expected to be a key driver of future inflows. Europe is at the cutting edge of smart beta, which many promoters see as crucial to stronger institutional adoption. Dividend weighted equity funds are popular, multifactor funds are gaining ground and a number of promoters are launching sector ETFs. Interest in Environmental, Social and Governance themed ETFs and property ETFs is growing. In contrast, transparency concerns mean that interest in active ETFs is limited, although a handful of promoters are seeking to build a track record in these products.
- **The threat of Brexit.** More than 80% of interviewees see Brexit as a threat to the UK and European ETF markets. Most European respondents (80%) have set up working groups to consider its impact. With questions about market access, labor movement and UCITS unanswered, promoters worry that the UK's status as Europe's largest and most promising market will be undermined. Brexit also threatens the proposed merger between the London Stock Exchange (LSE) and Deutsche Börse, and the LSE's importance as a trading venue. For example, many promoters currently list their ETFs on the Irish Stock Exchange, allowing it to be traded on the LSE — a connection that is now called into question. In the event of a "hard Brexit," ETF firms in Ireland and Luxembourg expect to enjoy an influx of talent and investment.
- **Complex effects of regulation.** European regulation, already complex and costly, has the potential to become more onerous. The European Securities and Markets Authority's (ESMA) consultation on index regulation is creating uncertainty, and there is a sense that scrutiny of ETFs is increasing. Even so, some initiatives are seen as more helpful. Markets in Financial Instruments Directive II (MiFID II) should help to throw a light on off-exchange trading, which can be as high as 70% in Germany. And while Solvency II has complex effects, it should favor fixed income ETFs that give insurers "look through" transparency. Distribution reforms are also leveling the playing field in several retail markets.

Regional summary: Asia-Pacific

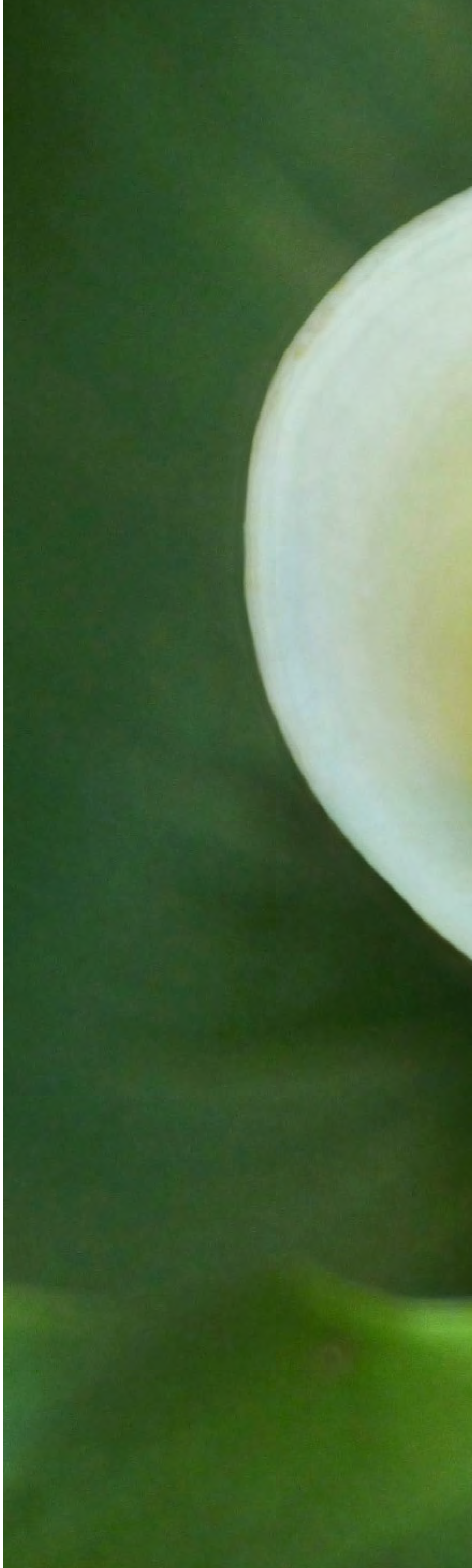
Asia-Pacific includes one of the world's largest ETF markets — Japan — and many of the fastest growing. As a whole, it is relatively immature and fragmented, but there are wide variations in concentration and sophistication. We expect ETF AuM in Asia-Pacific outside Japan to grow from US$119b in July 2016 to US$320b by the end of 2020, an annual growth rate of around 22%. We expect Japanese AuM to grow from US$182b to US$380b over the same period, an annual rate of about 16%. The region's key themes include:

- **Varied product innovation.** ETF innovation continues to evolve in different ways across the region. Institutions are being drawn to the accessibility and liquidity that ETFs provide, and low counterparty risk is encouraging them to substitute ETFs for OTC derivatives. Smart beta funds are being launched in many markets, but while active ETFs are expanding in Australia and Korea they are virtually absent in other markets. The approval of L&I ETFs is spurring innovation in Hong Kong.
- **Regulation shaping the industry.** Opinions about regulation are highly varied. In some cases, regulatory caution is seen as a brake on product innovation. Promoters in several markets would also like regulators to help ETFs compete more effectively with mutual funds. Respondents in Hong Kong are among those who would like to see Australian-style regulation of retail commissions.
- **The HNW opportunity.** The survey shows increasing optimism about the potential for HNW investment. A number of interviewees say private banks are engaging actively with ETF promoters for the first time. Wider adoption by private banks and wealth advisors would be highly valuable given the size and profitability of this segment, along with the potential trickle-down effect on mass affluent markets.
- **New entrants and competition.** Levels of competition and margin pressure vary across Asia-Pacific. Average fees for core equity index funds continue to fall, but price wars are rare and there is less pressure on other asset classes. Break-even levels for promoters and products are lower than in the US or Europe, as are expectations for consolidation. However, new entrants could shake up this picture. Many of those surveyed expect more US and European promoters to enter Asia-Pacific markets, and some Asia-Pacific issuers are expected to pursue regional expansion.
- **Importance of structural reforms.** Many Asia-Pacific promoters are seeking to enter new markets, including in the US and Europe. Within Asia-Pacific, the ASEAN Passport, Asia Region Funds Passport and Mutual Recognition are encouraging promoters from markets such as Japan and Korea to consider regional expansion. Following approval of the Shenzhen-Hong Kong Stock Connect it has been announced that approval for ETF Connect should follow in 2017, a development that is expected to boost cross-border ETF trading between China and Hong Kong.
- **Banks vs. robo-advisors?** Retail investors are seen as a strong near-term source of growth in many Asia-Pacific markets. Asia-Pacific respondents, particularly in China and Australia, are enthusiastic about digital distribution. Promoters in markets like Japan and Hong Kong would be delighted to develop these channels and reduce their dependence on banks and brokerage houses. However, a degree of caution from local regulators suggests that stand-alone robo-advisors could need time to take off in Asia-Pacific.
- **Need for operational investment.** Many Asia-Pacific promoters are able to operate at a smaller scale than their counterparts in Europe or the US. But this is a double-edged sword. Many struggle to attract talent, and smaller firms can find themselves underweight in terms of operational capabilities. For example, underinvestment in cybersecurity could explain why Asia-Pacific promoters are by far the most likely to have been successfully hacked.

Regional highlights

Key developments in three of Asia-Pacific's most important ETF markets include the following:

- **Hong Kong.** Recent months have seen a number of exciting developments, including the launch of several oil ETFs and the The Securities and Futures Commission's (SFC) approval of L&I products. L&I ETFs are well established in Taiwan and Korea, but international institutions typically prefer to trade in Hong Kong. With the SEC expected to limit L&I approvals in the US, Hong Kong could become a hub for regional L&I distribution, and administrators are developing their capabilities in this area. Promoters and market makers expect the Shenzhen-Hong Kong Stock Connect to give liquidity an even bigger boost than the Shanghai-Hong Kong linkup.
- **Australia.** Retail investment continues to dominate the Australian market. Promoters believe that the regulatory reform of commissions will continue to give them further traction among HNW and mass affluent investors. In contrast, Australian institutions remain slow to adopt ETFs and typically use them for short-term investment. The approval of ETMFs by the Australian Securities Exchange is helping active providers to expand. The recent partnership between ETF specialist BetaShares and prominent active manager AMP Capital illustrates the potential for new players to enter the active ETF market.
- **Japan.** Japan's ETF market is unusual for the influence of the Bank of Japan (BoJ), which uses ETF investments as a monetary policy tool. The BoJ holds around half of domestic ETF assets, with the bulk tracking the Nikkei 225 or Topix indexes. In a move likely to stimulate innovation, the Governor of the BoJ has also expressed a desire to invest in capex-weighted ETFs. Domestic and international issuers are launching smart beta ETFs, and there is more ESG-themed activity than elsewhere in Asia. Promoters are interested in the potential of robo-advice, but are less enthusiastic than their regional peers. Several Japanese firms are thought to be considering expansion into faster growing Asia-Pacific markets, perhaps using passporting as a springboard.



Conclusion

The ETF industry grows larger, more varied and more sophisticated every year, and we expect this to continue. Even so, the industry needs to avoid thinking that it is predestined for indefinite expansion. Growth will become harder to achieve as ETFs grow in size and influence. That is particularly true now that so many mutual fund providers are actively seeking to enter ETF markets.

So how can ETF providers — including existing incumbents and future entrants — optimize their strategic positioning? We think an integrated approach to innovation, which maximizes the industry's disruptive power while maintaining a balance among growth, profitability and sustainability, holds the key.

We see four key areas where individual promoters can capitalize on this insight and put integrated innovation into practice.

1. **Smart, sustainable product development.** ETFs are meeting valuable needs for investors seeking higher yields, giving them liquid access to exposures they might otherwise struggle to obtain — such as emerging market debt. However, issuers need to ensure that product innovation — so vital to growth, profitability and differentiation — is suitable and sustainable. The risks of hasty innovation are growing as more exotic ETFs are created and speed to market becomes an increasing priority. At a micro level, product innovation needs to address specific concerns over issues such as the transparency of active ETFs and the illiquidity risks of fixed income products. At a higher level, firms need to ensure that innovation is being guided by the evolving needs and priorities of investors as varied as global insurers and millennial savers.
2. **Creativity in the search for scale.** ETF providers need to be more creative in the search for scale, which is essential to achieving sustainable profitability. This is not just true in Europe and Asia-Pacific, but also in the ultra-competitive US market. Promoters, market makers and other members of the ETF value chain need to view scale through as many lenses as possible. Not only promoters, but also exchanges and clearing houses can build scale through in-market or cross-border M&A. Product consolidation has an important role to play. For some providers, the common features of ETFs and other indexing products could also offer economies of scale. And there is huge untapped potential to build scale through cooperation and partnership, especially in the fragmented markets of Europe and Asia. For example, there is an opportunity for European firms to build on the development of international settlement by creating a market for stock lending in ETF units, as already exists in the US. Firms should take inspiration from examples of collaboration in other markets, in areas as diverse as market entry, distribution, trading and settlement.
3. **Transparency related to products, performance and pricing.** The ETF industry sees transparency as one of its key selling points, but we see scope for broader, all-encompassing commitment in this area. Transparency should not be limited to disclosure over indexes and product structures. Promoters need to ensure that they are informing investors about the possible performance of ETFs in all market conditions, over both the long and short term. This includes setting out how the performance of ETFs may differ from substitutable products and instruments. A commitment to complete transparency over pricing, including total costs of ownership as well as TERs, would also show that ETF promoters are confident in the value that their products create.
4. **Control of the digital agenda.** Like ETFs themselves, digital technology is renowned for its disruptive capabilities. The ETF industry should embrace these similarities and use digitization to build stronger investor engagement. This is not just about online sales or robo-advice, although those are important retail distribution opportunities. It is about connecting with institutional and retail clients to strengthen their belief in ETF investing. Firms need to pay more active attention to areas such as social media and cybersecurity, which are viewed as important but which can suffer from underinvestment. This requires more than tactical initiatives such as working with platforms to develop their suitability for ETFs — although that is a valuable goal. ETF promoters need to develop holistic digital strategies that address topics as varied as operational efficiency, cybersecurity, digital distribution, and client reporting. In doing so, they should learn from other sectors of asset management while taking an approach suited to the unique features of ETFs.

If ETFs are to fulfill their lofty expectations, they need to do more than sustain the innovative factors — such as accessibility and flexibility — that have driven their success to date. In our view, ETF promoters of all sizes and types will benefit from pursuing a more integrated approach to innovation. Promoters that achieve an enterprise-wide culture of innovation will be able to not only sustain high rates of growth, but also to continue finding new ways to create value for investors.

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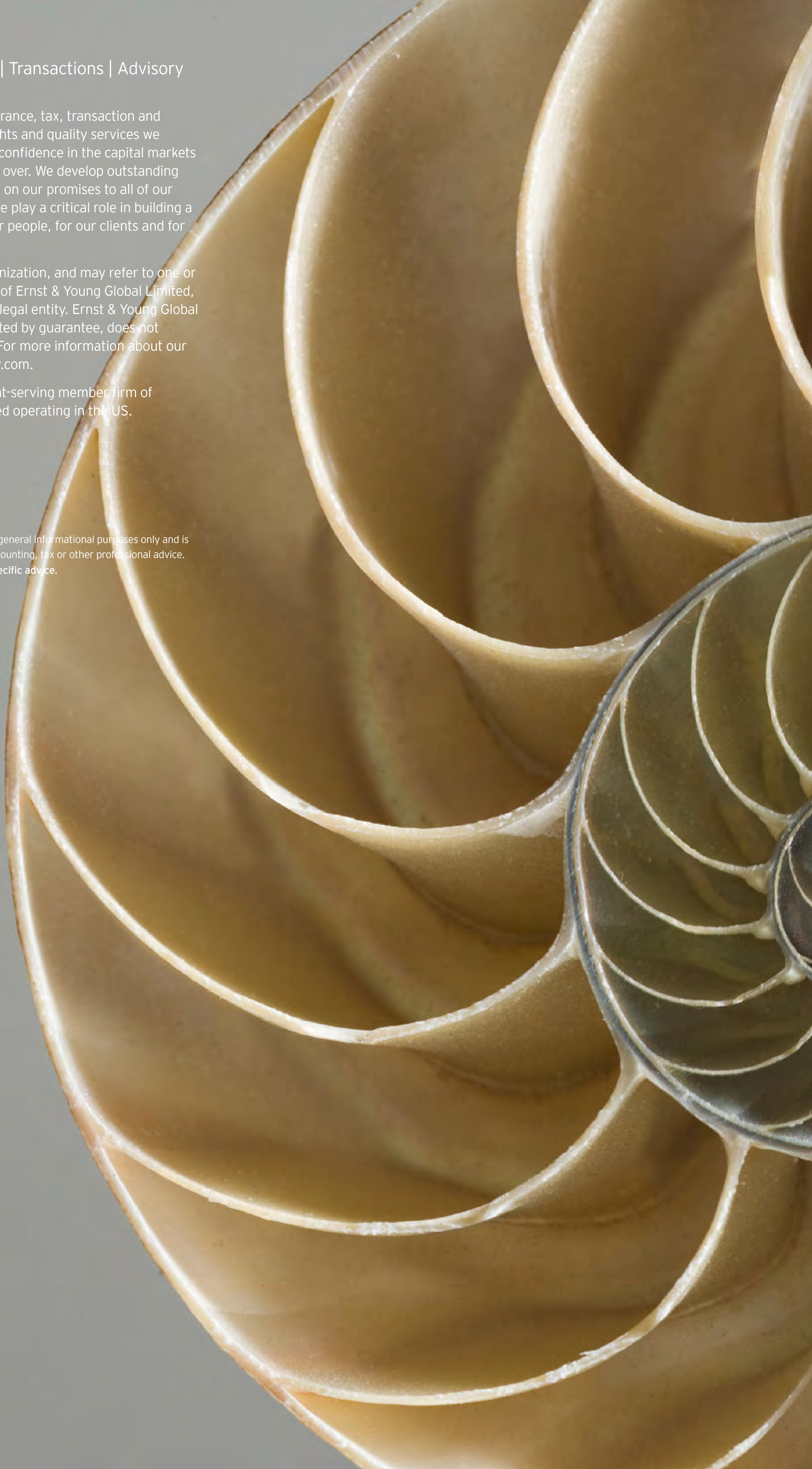

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