ETF growth continues its march - but how can the industry sustain this?

With 22 consecutive months of growth and a summer of record highs, momentum continues in the ETF industry writes LISA KEALY. Investors' global trend towards passive products continues and in the first five months of 2016, passive inflows reached $240 billion globally, while during that same period active outflows were $231 billion. ETFs not only benefit from the global trend towards passive, they lead the way as tech-savvy and cost-conscious investors drive flows into ETFs, she says.

ETFs continue to be the fastest growing asset class. As of the end of July 2016, the industry has enjoyed a decade of growth averaging 21.5% a year and assets under management now stand at $3.4 trillion globally. In Europe, that figure is $540 billion.

Over 50% of European assets are administered in Ireland and ETFs continue to be a very important industry for Ireland.

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These figures represent new record highs for the ETF industry, but what's more impressive is that this is happening at a time of more geopolitical stability than any year since the financial crisis.

We are in a time of unprecedented economic upheaval and financial market volatility. Brexit, the U.S. presidential elections and China's slowdown have created an environment of fear globally, and for the first time in a long time, the familiar is becoming deeply unfamiliar and with that comes significant challenges for investors.

Despite market conditions - ETFs continue to Trump

As we continue to face high market volatility, EY spoke to the global ETF industry to gauge their confidence in the asset class. We conducted EY's global ETF survey in August which saw over 70 industry players interviewed across 20 cities in Europe, the United States and Asia Pacific. Respondents included ETF issuers who manage 86% of global ETF assets.

Lisa Kealy

Since the launch of the first European ETF survey in 2000, Ireland has been the most popular European domicile for ETF issuers. The maturity of the Irish service model ensures that ETF issuers have access to service providers with highly automated and scalable global models. We predict that Ireland will continue to see new players enter the market.

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In order to grow innovation is critical

If the ETF industry locally and globally is to fulfil its lofty growth expectations - innovation is critical. We believe that integrated innovation is key in achieving this. Our survey highlighted three areas where this innovation is needed:

- Market entry
- Product development
- Digital distribution

As market entry continues - how do we choose the right way to enter?

Of those respondents surveyed, 90% expected new players to enter the market, while in the US, the figure was 100%. With the level of new entrants expected to grow significantly, it is crucial that players take their time to choose the right way to enter the market. Promoters need to become more creative in their search for scale - there are a number of market entry mechanisms that can be taken.

Market entry is becoming not only a more important strategic theme, but a more complex one too. This 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. Setting up 'own branded' products is another option that has becomes popular.

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Whatever option is chosen, it is critical that new entrants consider the pros and cons of all options - in an increasingly crowded field, this is crucial.

In recent months, we have seen several examples of players entering the market using all of these approaches. One example 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. In Ireland, we have seen many new players enter the market such as BMO Global Asset Management.

Whatever way players enter the market, we see a need for greater innovation in market entry strategies and the search for scale.

What is the product of the future?

In our opinion the product of the future is fixed income. It has dominated the ETF industry during the first six months of 2016 - 85% of ETF issuers we surveyed expected demand to continue to be driven by supportive market conditions.

At present, the fixed income market for ETFs is significantly underweight. Fixed income only represents 18% of the total ETF industry and ETFs only make up 0.5% of the fixed income industry in comparison to equities which make up 4%.

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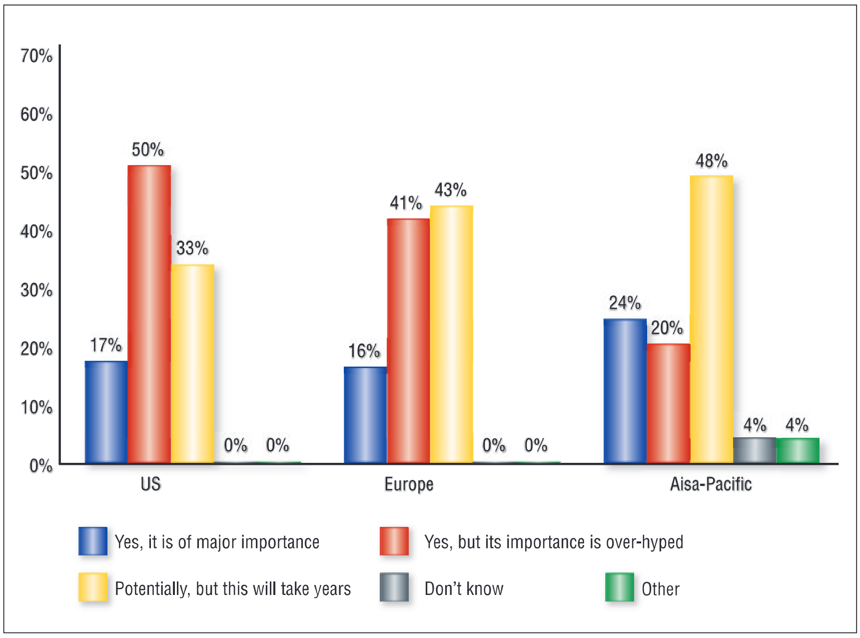
50% of respondents we surveyed have also followed global flows into fixed income, with market shocks creating opportunities for innovation. The number of survey respondents that saw market volatility as an opportunity outnumbered those who viewed it as a threat by a 2-1 ratio. Investors find two key features of ETFs particularly valuable in current markets.

Accessibility: Low yields have sent investors flocking into ETFs tracking dividend-weighted equities, high yield corporate bonds and emerging market debt.

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. Liquidity does not just appeal to institutions, but also retail investors are attracted to taking short-term positions and value the ability to trade quickly.

New products are vital to sustaining growth rates. 94% of ETF issuers we surveyed said they expect to launch new products in the future. 67% expect smart beta and active products to support industry growth for a least five years. We believe that successful innovation is essential to fulfilling these predictions.

IS DIGITAL/ROBO-ADVICE THE KEY THAT WILL FINALLY UNLOCK RETAIL DEMAND?



Source: EY's global ETF survey 2016

Smart beta ETFs have generated the bulk of new product launches so far in 2016 and inflows are particularly strong in Europe, with investors favouring dividend weighted products. Product numbers are increasing in many markets and this is predicted to persist by 94% of promoters.

> **'There has been little improvement in the adequacy of distribution models over recent years, despite clear evidence that investors are increasingly enthusiastic about digital distribution.'**

Only 10% of those surveyed believe that current distribution models are suitable. The ETF industry here faces the same distribution challenges as all fund providers with the added challenge of educating investors about ETFs. What is striking from our survey results is that there has been little improvement in the adequacy of distribution models over recent years, despite clear evidence that investors are increasingly enthusiastic about digital distribution. Only 10% of respondents believe that their distribution model is suitable for today and the future. The emergence of robo-advisors as a scalable retail channel could overturn this picture. The survey shows real excitement about robo-advisors. 88% of those we surveyed expect robo-advisors to accelerate ETF growth and believe they could play a key role in the industry's future, not only by boosting direct sales but also by supporting investment advisors.

So are robo-advisors and ETFs a match made in heaven?

Not necessarily. While the survey highlights excitement about robo-advisors, it is tempered with increasing realism. Two thirds of those surveyed believe that it will take three to five years for robo-advisors to deliver accelerated growth and nearly a quarter think it will take more than 5 years. Robo-advisors are gathering billons of assets in the US but the industry is at an early stage in Europe that many feel will take years to boost.

Sustaining growth

As the industry grows larger, more varied and more sophisticated every year, it needs to avoid thinking that it is predestined for indefinite expansion. Growth will become harder to achieve as ETFs increase in size and influence - in order to sustain this growth, an integrated approach to innovation which maximises the industry's disruptive power while maintaining a balance among growth, profitability and sustainability, holds the key.

Lisa Kealy is head of EMEIA ETFs at EY.