

Reshaping around the investor

Global ETF Research 2017

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Welcome

EY is proud to launch our fifth annual global study of exchange-traded funds (ETFs). Despite persistent economic and political volatility, the ETF industry continues to grow in scale and sophistication. In the process, it is breaking new records in terms of global assets under management (AuM), which had reached \$4.4t by the end of September 2017.

This paper summarizes EY's views about the most important developments in the industry and the most urgent areas for enhancements. We also offer some hypotheses about the future evolution of ETFs. As in prior years, our research finds much to celebrate in terms of creativity, innovation and growth. It also identifies a few areas of potential concern – but with challenge comes opportunity.

We hope this report and its accompanying series of industry events will be of practical value to ETF promoters and the brokers, service providers and other institutions that make up the expanding ETF ecosystem.



Lisa Kealy
Partner, EMEIA Wealth & Asset Management ETF Leader

About the research

The study draws on interviews with 70 leading ETF promoters, market makers and service providers and is supplemented by our own analysis and knowledge. Our respondents, who manage 85% of global ETF assets, were interviewed across the US, Europe and Asia between May and September 2017. We are very grateful to all our interviewees for their insight.



Executive summary





The growth of the ETF industry continues to defy superlatives. Global ETF assets, which totaled just \$417b in 2005, had reached \$4.4t by the end of September 2017 – a cumulative average growth rate (CAGR) of around 21%.

It seems that almost every trend that has shaped investment markets in recent years has worked in favor of ETFs. This includes global themes such as the shift to self-directed retirement saving; economic factors such as low yields; regulatory efforts around suitability and value for money; technological developments such as digital distribution; and investment themes such as the “shift to passive.”

Supported by these factors, we expect the ETF industry to continue its rapid global expansion, outgrowing the wider asset

management industry. The prevailing conditions remain favorable, and the industry retains its many innovative characteristics.

Our view – ETF assets have the potential to hit \$7.6t within three years

Our survey respondents predict ETF asset growth of around 15% per annum for the next three to five years (see Figure 1). If anything, we think this understates the industry’s growth potential. We believe global ETF assets could reach \$7.6t by the end of 2020 – equivalent to a CAGR of approximately 18% (13%-14% of which will come from net new inflows) – underpinned by the shift to passive, the size of ETFs relative to the overall market and ETFs’ suitability for digital distribution (see Figure 2).

Figure 1 – How do you see the compound annual growth rate of the ETF industry growing over the next three to five years?
Source: EY

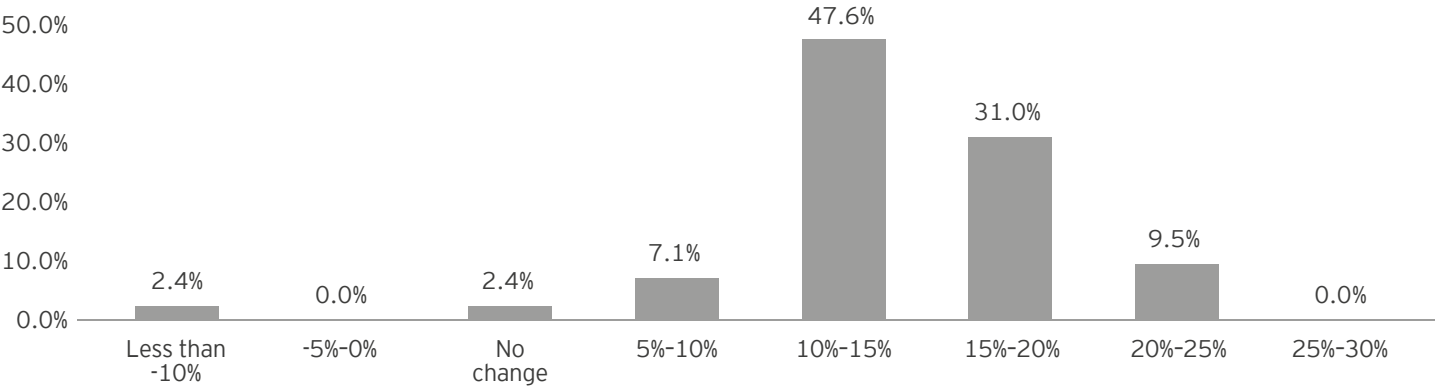
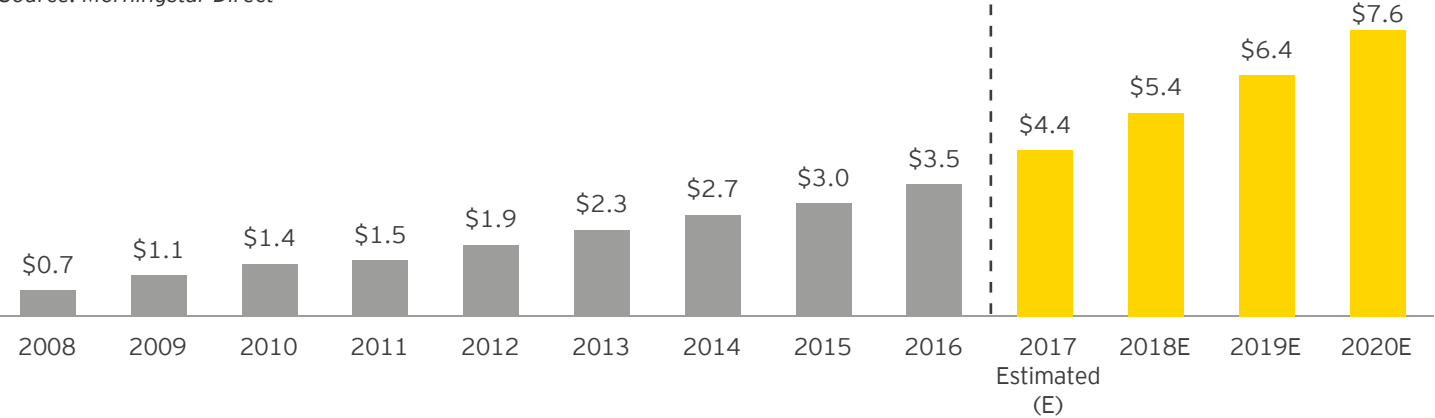


Figure 2 – The future growth of global ETFs: market analysis and forecasts 2017 to 2020 (net assets in US\$ trillions)
Source: Morningstar Direct



However, it would be foolish to think that the success of ETFs is preordained. Our predictions could easily be threatened by external crises or by failings within the industry. Individual providers also face growing competition from inside and outside the sector.

In fact, as the industry grows in size and influence, it faces far more complex challenges than in its early days. It is no longer sufficient for an ETF to be cheaper, more liquid or more innovative than a competing mutual fund. If the ETF industry is to fulfill its undoubted long-term potential, every ETF provider needs to stand out in its ability to meet the needs of investors.

We believe that individual firms, and the industry as a whole, need to reshape around investors. In particular, we see a need for providers to:

- ▶ Innovate around investors' needs
- ▶ Refine journeys for new and existing investors
- ▶ Reduce investor costs and enhance transparency
- ▶ Respond to evolving regulation in a way that helps investors

In the four main sections of this study, we examine these four areas in greater detail. In our view, each has a vital role to play and all four can interact positively with one another.

In summary, we believe that promoters who reshape around investors will find it easier to protect themselves against the growing strategic pressures facing ETF providers of all sizes. They will also be more likely to emerge as long-term winners in the ETF space. Firms should act now to maximize the potential opportunities – and avoid unnecessary risks.

"ETFs will increasingly be the main input into the assembly line of asset managers and allocators. They allow the chassis to be built, freeing up time and resources for managers to concentrate on alpha sourcing."

Roger-Marc Noiro
Chief Operating Officer - Passive Asset Management,
Deutsche Asset Management





Innovating around investors





Passive investments continue to gather more inflows than active strategies, and ETFs are the greatest beneficiaries. There is a growing view that, after costs, very few active strategies consistently outperform index-based investments. Recent political volatility in the US, the UK and elsewhere has given ETFs a further boost. We expect the shift to passive to continue to favor ETFs.

“More ETF issuers will develop indices that incorporate their investment ideas and intellectual property. This allows differentiation and implementation of active ideas within a systematic strategy.”

Nick King
Head of ETFs, Fidelity International

Our view – passive AUM could exceed active AUM by 2027

Our research suggests that passive funds will exceed active funds by 2027. We see an increasing consensus that both active and passive strategies can create value within most portfolios. In the US, the “shift to passive” has now been at work for 10 years (see Figure 3). ETFs should continue to benefit disproportionately, thanks partly to low fees and partly to market volatility, which often increases the appeal of ETFs’ intraday liquidity. For example, the highest ever days of UK ETF trading occurred immediately after the Brexit vote and the 2016 US presidential election.

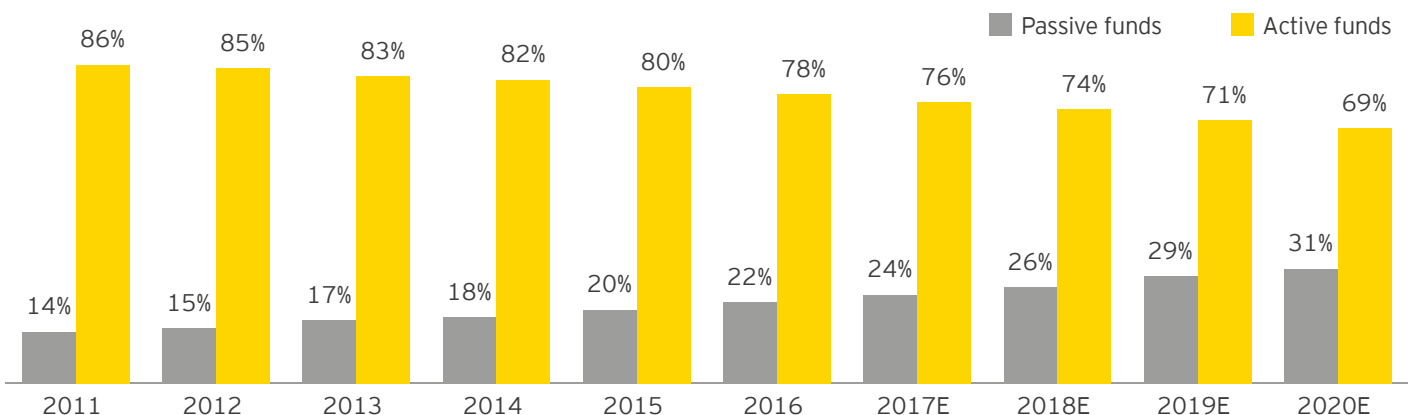
Even so, the shift to passive is no panacea for ETFs. In fact, our survey shows that 50% of respondents think it may not matter whether investors buy ETFs or conventional trackers in the future. This reflects several factors.

- ▶ **Indexing convergence.** ETFs and conventional funds are not as distinct as they used to be. As the influence of ETFs grows, hybrid structures are emerging. Examples include mutual funds with ETF share classes and mutual funds listing on exchanges in Italy, the Netherlands and Australia.
- ▶ **Blurring between providers.** As mainstream asset managers enter the ETF market, many are stressing the similarities between index-based ETFs and mutual funds.
- ▶ **Varying investor needs.** There is growing understanding that ETFs are not always the best passive vehicle for every investor. For example, not every retail investor needs intraday liquidity.

Furthermore, traditional active managers are fighting back against the shift to passive. Active houses are developing their own alternatives to smart beta, and focusing on illiquid assets that cannot easily be replicated by ETF providers. Some are also changing their fee structures, levying low management fees with additional charges for index outperformance.

Figure 3 – Market share percentage of total net assets of globally regulated open-end funds

Source: EY





These challenges reflect the maturing of the ETF industry. Product numbers are growing as new providers enter the market, and ETF success rates are declining. An ever-decreasing proportion of assets (2.4% in September 2017 compared with 2.9% in September 2016) are in funds with AuM of less than \$100m, and 55% of respondents expect success rates to fall further (see Figure 4). Competition will continue to increase as most asset managers develop some form of ETF offering.

Our view – within five years, almost all asset managers will offer passive or active ETFs

Two-thirds of our respondents expect most asset managers to offer ETFs in the future (see Figure 5). This reflects a variety of strategic goals, including competing in the ETF space; defending against the “hollowing out” of mutual funds; and tapping into digital distribution. Many new entrants will focus on areas such as fixed income or smart beta. In most cases, ETFs will only form part of their product range.

Now, more than ever, it is vital for ETF providers to develop the right products, for the right investors, at the right time. In the callout, we review some of the most important trends in ETF innovation. The industry remains as creative as ever, and we expect this to continue. But we also see the potential for excessive cost build-up, and possibilities for investor disappointment. We believe that innovating around investors will be crucial to achieving the long-term sustainability of ETF growth. In our view, product development needs to:

- ▶ **Anticipate investor needs.** If ETFs are to continue to shape the future of indexing, promoters need to understand that different groups of retail and institutional investors have very different needs – something we explore in more detail in Section II. The need must shape the product.

- ▶ **Remember the big picture.** Providers need to anticipate the effect of factors outside investment markets, such as the power of regulation to affect product performance (see Section IV); the potential of artificial intelligence (AI) to identify and manage new products; and the impact of macroeconomic policies.
- ▶ **Look beyond the short term.** Taking advantage of short-term openings is one of ETFs’ strengths. But promoters need to keep an eye on longer-term opportunities, too. This could include new adaptations such as multi-asset ETFs, or listing UCITS ETFs in new regions such as the Middle East.
- ▶ **Focus on education.** Promoters need to confirm that all investors fully understand the products they use. The rapid rise of smart beta ETFs – often sold on the basis of paper-based performance – makes it more important than ever to avoid disappointing investors.

“The innovation of index investment will fuel further growth in the investment industry.”
Mandy Chiu
 Senior Product Developer, State Street Global Advisors

Figure 4 – In your opinion, will the success ratio of new launches improve in the future?

Source: EY

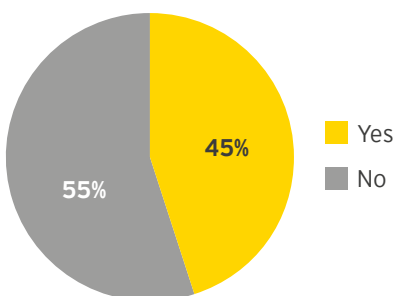
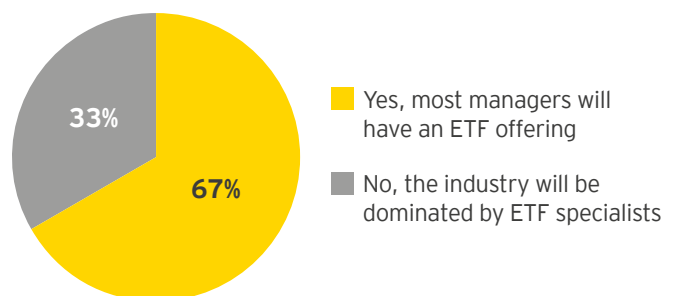


Figure 5 – Will most managers have an ETF offering in the future or will the industry continue to be dominated by ETF specialists?

Source: EY



Emerging trends in ETF innovation

I. Fixed income

Fixed income ETFs will remain the industry's greatest area of focus over the next few years. They have huge untapped appeal to medium-sized institutions that might otherwise struggle to access corporate, high-yield or emerging market debt.

Our view – fixed income will drive ETF growth in the medium term, but will never exceed equity

Fixed income ETFs remain very small relative to the wider fixed income and credit index markets. Given the limitations of bond liquidity, fixed income products are unlikely to ever exceed equity ETFs. But our survey points to strong growth potential, especially in the US. We expect global fixed income ETF assets to reach \$1.6t by 2020, compared with \$0.6t at the end of 2016.

"Institutional investors are increasingly recognizing the benefits of bond ETFs. Active investors are even supplementing portfolios of individual issues with bond ETFs in order to quickly capitalize on investment opportunities."

Brett Olson
Head of Bond ETFs EMEA, BlackRock

Tighter monetary policy could provide an additional catalyst for growth, as investors seek flexibility and liquidity amid volatile markets. Smart beta products are seen as having particular potential, as providers apply factors such as duration or leverage to bond indices instead of traditional debt-weightings. Socially responsible investment (SRI)-themed ETFs could also generate strong growth as demand for environmental, social and governance (ESG)-screened investing increases, especially in Europe.

Despite this optimism, concerns persist over the rapid growth of fixed income ETFs. Just over a fifth of our respondents (22%) see the potential for systemic risks. Although ETFs only represent a fraction of global bond markets, some commentators are concerned

that many have not been tested by prolonged illiquidity. Anecdotal evidence also suggests that ETFs can account for up to 30% of trading volumes in some markets. At a time when liquidity risk is climbing, the agenda of investors, asset managers and regulators need to ensure they address concerns of ETF-related risks.

II. Equity

Equity ETFs remain a major priority for new and existing promoters. Recent political shocks have highlighted the benefits of ETF liquidity, and macro themes are becoming a focus of innovation. We expect more promoters to develop products tailored around themes like Brexit.

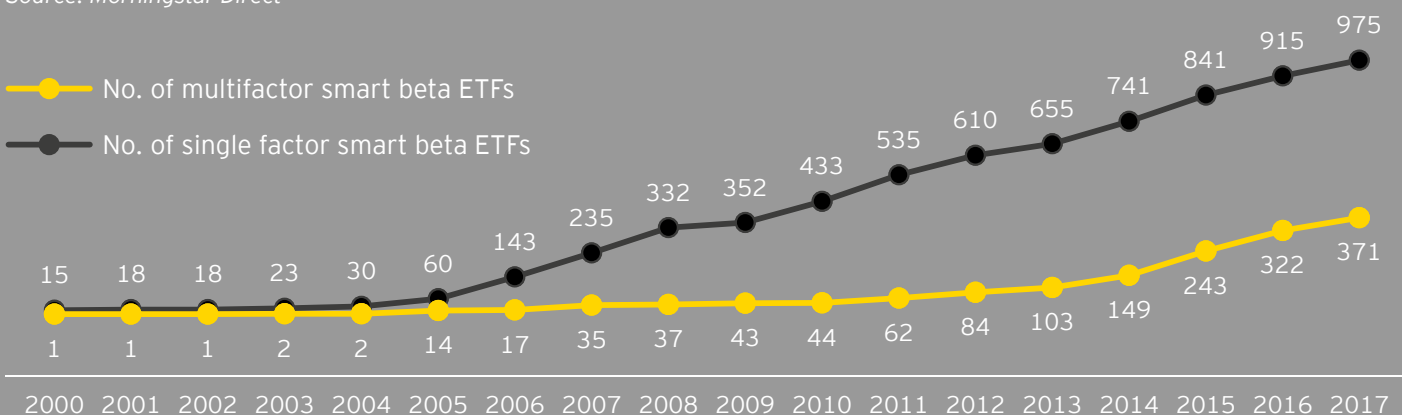
We expect global smart beta ETF assets to reach \$1.2t by 2020, compared with \$0.6t at the end of 2016. Single factor, particularly low volatility and dividend yield, remains a key focus. These funds are relatively simple to launch, and have broad institutional appeal as a substitute for mutual funds, making them a popular entry point for traditional asset managers. Our respondents also see multifactor as a key growth area. This includes negative correlating ETFs, which allow investors to take a "hedged" view of two factors and are sometimes seen as a transparent alternative to stock-picking. Multifactor ETFs have grown from 44 in 2010 to almost 400 in September 2017 (see Figure 6). The US has driven growth to date, but Europe offers increasing potential.

"The interest in socially responsible investing (SRI) continues to grow. Investors are increasingly aware of the merits of using SRI ETFs. There is clear evidence that using a robust underlying SRI screening methodology can act to enhance fund performance."

Andrew Walsh
Executive Director - Head of Passive and ETF Specialist Sales, UBS Asset Management

Figure 6 – Growth of multifactor smart beta ETFs

Source: Morningstar Direct



Emerging trends in ETF innovation

Thematic ETFs are another fast growing area, and one that takes ETF providers further into the territory of traditional managers. Technological themes such as cybersecurity or mobile payments are popular. SRI or ESG tilted funds are also seen as a growth area, reflecting the influence of millennial investors. And we see increasing scope for promoters to tailor products to local or regional themes.

Our view – Asian promoters should develop more Asian ETFs for Asian investors

Asian institutions outside Japan and Australia often prefer US or European ETFs to their less liquid Asian counterparts. But we believe Asian promoters could benefit from more local or regionally themed products. For example, ETF Connect will offer the chance for promoters to sell their Hong Kong-listed products directly to China's increasingly sophisticated retail investors. Chinese firms manage over \$7.5t, including \$1.3t of mutual funds (see Figure 7). ETFs currently represent 3% of that total.

III. Actives and alternatives

Active management is seen as increasingly important to equity and fixed income growth. This may seem odd, given the small size of actives and their vulnerability to front running. But active ETFs enjoyed record inflows in May, June and July 2017, and saw AuM growth of 45% during the year to September. Fixed income products, less at risk of front running, now account for

72% of active ETFs. More promoters are seeking approval for nontransparent ETFs, and we believe active ETFs could grow to \$217b in 2020, from \$51b at the end of 2016.

Like traditional active managers, ETF providers want to supplement the decisions of portfolio managers with AI. Our respondents see potential for alternative ETFs that use AI to develop and apply stock selection strategies, moving promoters further into the active management sphere.

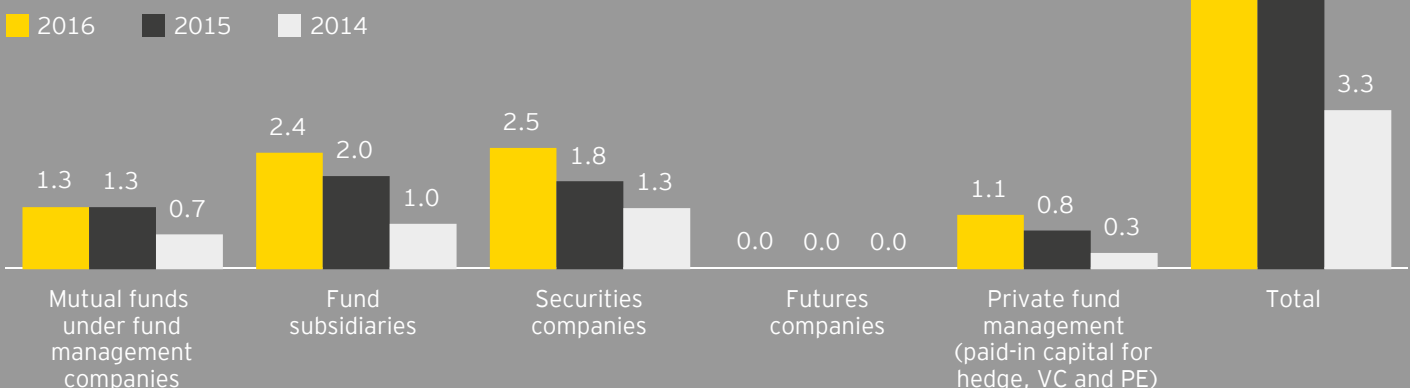
"We believe hedge fund investors will continue to push the boundaries in how exchange-traded products (ETPs) are used due to the efficient structure of ETPs and low costs."

Jürgen Blumberg
Head of Capital Markets EMEA, Invesco PowerShares

Asia is an important market for active ETFs. In Korea, an active equity ETF drew the largest inflows in the first half of 2017, and Hong Kong's approval of leveraged and inverse (L&I) funds led the number of Asian L&I ETFs to jump from 79 to 163 in the year to September. Australia continues to see active launches, with promoters taking a range of approaches to transparency. Some disclose their strategies quarterly, while others make their own market to preserve confidentiality. As actives evolve, it will be interesting to see if a standard vehicle emerges, or whether variations between key markets such as the US, Australia and Korea persist.

Figure 7 – Overall size of Chinese opportunity

Source: Asset Management Association of China (AMAC)





Refining investor journeys





“ETFs are empowering a new generation of investors and democratizing the power of asset allocation.”

Shaun Port
Chief Investment Officer, Nutmeg

To sustain current growth rates, the ETF industry needs to do more than innovate around investors. It also needs to attract and retain new investors – an area where incumbents will see growing pressure from new entrants. Our survey confirms that distribution has a vital role to play in attracting new investors. However, it also shows that a growing number of respondents (36%, compared with 10% in 2016) believe current distribution models are sufficient for future needs (see Figure 8). At a time when the whole investment industry is enhancing its focus on client experiences, this looks worryingly complacent.

Our view – new entrants will need to target new investors

Our survey suggests that 15%-25% of ETF inflows over the next three years will come from new ETF investors (see Figure 9). If we apply this prediction to our growth projections for the industry, this could equate to around \$250b of inflows from new investors. Given the loyalty to promoters that many investors develop, this new capital represents an attractive target for new entrants. However, 56% of respondents believe that the cost of entry could be prohibitive. New entrants will need to be creative in their approach – a topic we explore further in Section III.

We believe that refining investor journeys – customizing experiences on the basis of enhanced segmentation – will be crucial to sustaining industry growth. The first step toward this goal is for the industry to understand how, and why, different investor groups use ETFs – in particular:

- ▶ **How the use of ETFs is evolving.** As the industry matures, the uses of ETFs are becoming more varied. Five years ago, few would have predicted that ETFs could become an important substitute for futures, or that many investors would use passive ETFs to implement active strategies.
- ▶ **How different investors use ETFs.** The very largest institutions have been comparatively slow ETF adopters, reflecting asset managers' willingness to offer them low-cost, tailored accounts. And there are wide variations in usage within the more promising medium-to-large institutional segment. According to our survey:
 - ▶ Pension funds, insurers and investment funds are most likely to use ETFs for liquidity management, and sometimes to access selected exposures.
 - ▶ Private banks are most likely to use ETFs as building blocks, or to achieve selected exposures to international markets.
 - ▶ Wealth managers are most likely to use ETFs to achieve core exposures – for example, via model portfolios.
 - ▶ Some hedge funds use leveraged and inverse ETFs to help them execute high conviction long or short positions.

Figure 8 – Is your current distribution model suitable for the market today and in the future?

Source: EY

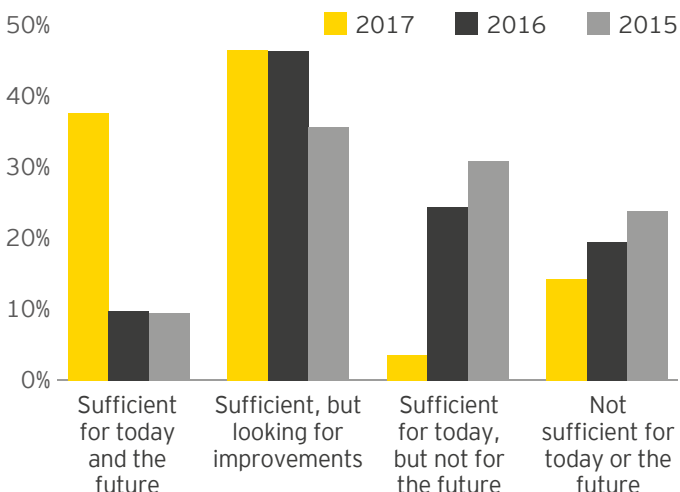
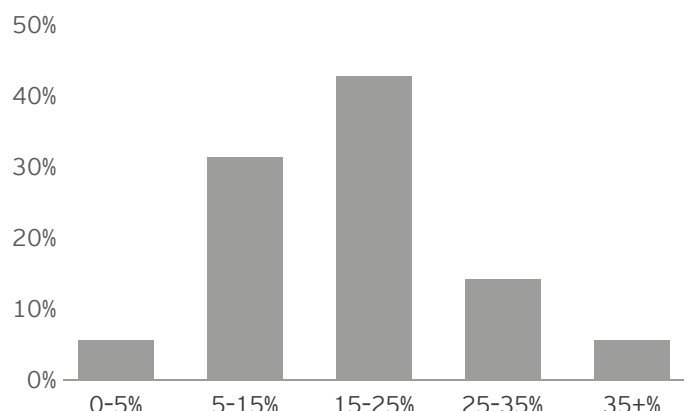


Figure 9 – What percentage of flows do you expect to come from new investors in the next three years?

Source: EY





- ▶ **How investors learn from experience.** Investors using ETFs for the first time typically seek out selected exposures they could not access elsewhere. They tend to value strong brands and ease of use, and are more likely to assess costs on the basis of fees or total expense ratios (TER). With experience, investors begin to use ETFs as the building blocks for portfolio construction. Eventually, investors such as wealth managers may use ETFs to construct entire portfolios. As time goes by, investors develop a better understanding of total costs of ownership, leading to closer attention on bid/ask spreads, tracking error and brokerage costs.
- ▶ **How external factors affect ETF investors.** A number of factors beyond the industry's control affect investors' use of ETFs. As already discussed, market reactions to political or macroeconomic events can encourage ETF trading. Tax is one of many factors that can affect product performance, and a majority of respondents expect regulation to affect the distribution of ETFs – topics we explore further in Section IV.

"ETFs have become firmly established in the investment landscape. Going forward, investors will increasingly focus on smart beta strategies to provide innovative solutions."

Nizam Hamid
Head of European ETF Strategy, WisdomTree Europe

The second step for ETF promoters is to use their understanding to refine journeys for new and existing investors alike. Retail user experiences are already a major area of focus, but we feel the industry could do more. This is especially true in Europe, where retail investors remain underrepresented in ETFs. The good news

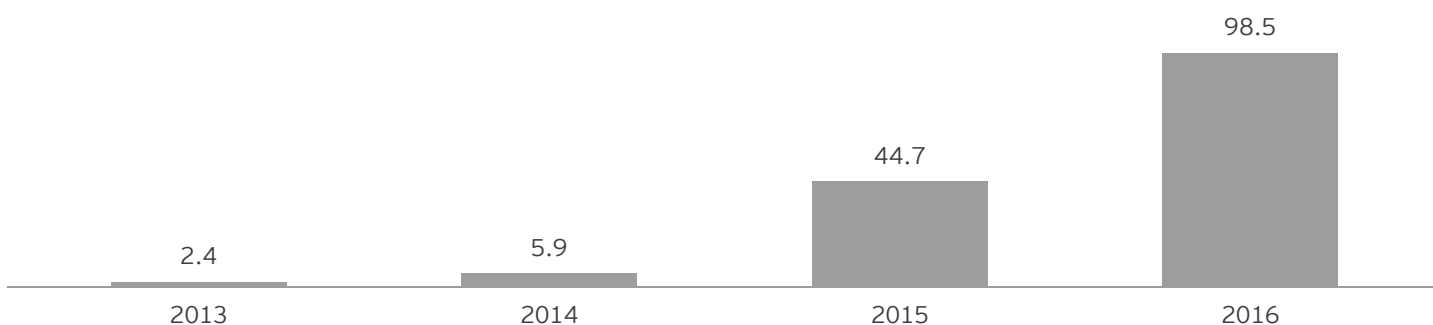
is that digital technology offers growing potential. Promoters should focus on:

- ▶ Leveraging the continuing global growth of robo-advisors, which often use ETFs to build low-cost portfolios (see Figure 10). The continuing growth of robos is expected to boost retail ETF adoption, with some estimates suggesting robo-advised assets could reach \$8t worldwide by 2020. As a result, ETF promoters are increasingly interested in partnering with robos, or acquiring them.
- ▶ Improving relationships with financial advisors and private wealth managers, helping intermediaries to build low-cost model portfolios for investors.
- ▶ Developing their ability to work both with "full robots" and with hybrid machine/human advisors.
- ▶ Enhancing their direct connections with retail investors, setting up online distribution platforms to get around the traditional dominance of bank distributors.
- ▶ Working with fund platforms to develop intraday trading, or to market ETFs to investors that don't require this feature.

Even so, it will take time, patience and a sustained effort on education to grow retail adoption, especially outside the US and Australia. Regulatory reforms such as MiFID II will provide long-term support, but the experience of the UK's RDR shows that they will not deliver an immediate boost. Even robo-advice will not be a game changer in the near future.

Figure 10 – AUM at US-based robo-advisors that target retail investors (in US\$ billions)

Source: EY





In contrast, institutional investors will remain the dominant source of global ETF inflows over the next few years. Our survey highlights wealth managers, private banks and investment funds as particularly promising areas for growth. In contrast, pension funds and insurers – while finding ETFs useful tools, especially for liquidity management – have more complex needs and are seen as more of a long-term growth opportunity.

“ETF growth will continue to be driven by ETFs not weighted by market capitalization, as well as by ETFs with ever-more granular or thematic exposures.”

François Millet
Head of ETF & Index Product Development,
Lyxor Asset Management

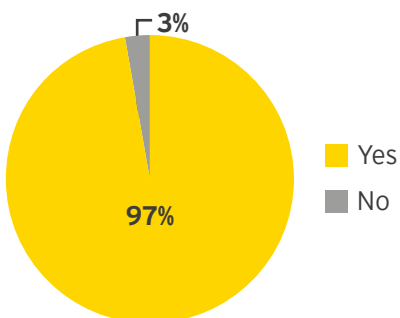
Our view – institutions will dominate ETF inflows for the foreseeable future

Our survey shows that 97% of interviewees expect institutional investors to remain the dominant source of ETF asset inflows over the next three years (see Figure 11). This not only holds true in Europe and Asia, but even in the US – the world’s largest retail ETF market. Given the challenges of generating significant retail growth, we expect institutions to remain the dominant force in ETF markets for the foreseeable future.

In our view, the ETF industry needs to do more to refine investor journeys for different groups of institutions. Most promoters do not currently seek to tailor the investing experience for different groups. In some cases this means that the industry may not be capitalizing on its full growth potential. Practical steps that promoters can take to refine investor journeys include:

Figure 11 – Will institutional investors continue to dominate investor flows into ETFs?

Source: EY



- ▶ Understanding and anticipating the long-term needs of different investor groups, and thinking about how ETFs can help them to achieve their specific desired outcomes.
- ▶ Developing local knowledge of how tax, regulation, accounting and other factors affect ETF investing for different institutions.
- ▶ Building up specialized sales teams that can apply this knowledge with potential investors.
- ▶ Directly addressing the concerns that may deter some institutions from investing in ETFs, for example, around secondary market trading and liquidity.
- ▶ Engaging with industry bodies and professional forums to educate different investor groups about the potential benefits of ETFs.

The opportunities that could flow from refining investor journeys are illustrated by focusing on one key investor group – insurers. In the US, the National Association of Insurance Commissioners (NAIC) has recently lowered the risk designation of fixed income ETFs, bringing capital charges for insurers into line with direct bond holdings. This will make it far easier for promoters to market fixed-income ETFs to insurers. In Europe, there is the potential for Solvency II to have a similar effect, but there seems to be limited awareness of this opportunity among promoters.

Our view – particular opportunities for insurers

European respondents see insurers as the least promising institutional segment, but they may not appreciate the rationale for insurers’ requests for data on underlying holdings, securities lending, synthetic exposures and other areas. These are driven by the “look through” requirements of Solvency II, without which ETFs carry an equity risk-weighting. Promoters that understand these requirements and can help insurers to reduce the costs of ETF investment could see a powerful boost in demand. Following the recent policy changes by NAIC, US promoters have already identified new opportunities with insurers.



Reducing investor costs





ETF providers around the world continue to face downward pressure on prices and profit margins. TERS have fallen from 29bps to 27bps since 2016, and 71% of our interviewees expect margins to fall further over the next three years (see Figure 12).

“ETFs are delivering better outcomes for investors as they offer easy access to low-cost investing. Investors are recognizing the negative impact of high fees on long-term returns.”

Mark Fitzgerald
Head of Equity Product Management Europe, Vanguard

It is not hard to see why. First, the majority of capital entering the sector heads for the cheapest funds in each asset class. Pricing remains a key driver of net inflows and an important source of differentiation. Second, fee pressure is strengthening in specialized areas such as smart beta, where 54% of respondents expect margins to fall. Third, 93% of our respondents expect more promoters to enter ETF markets (see Section I).

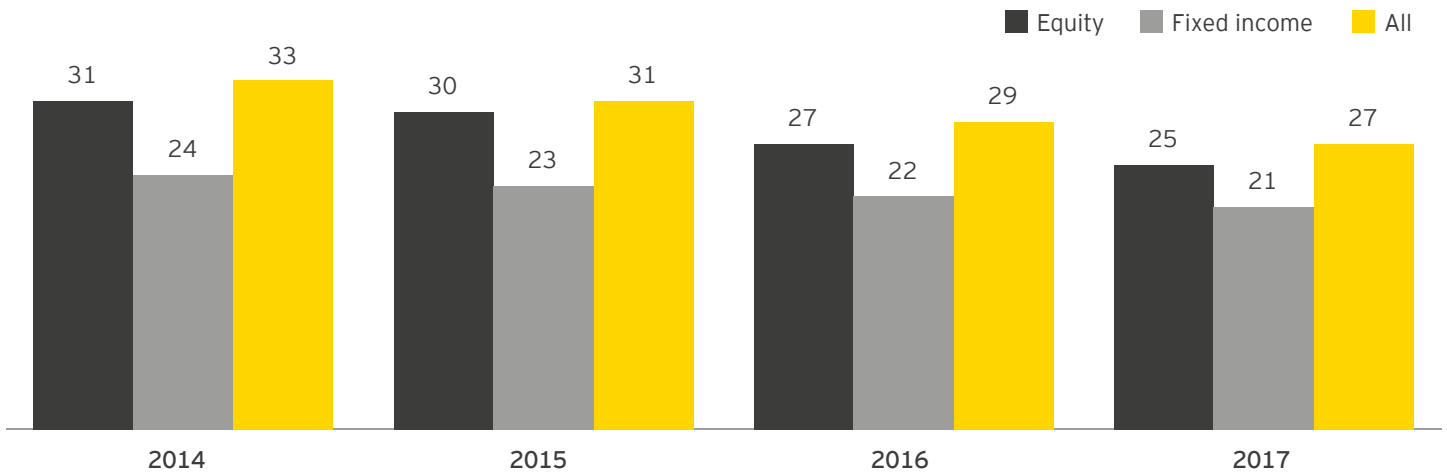
In our view, ETF promoters need to accept fee pressure as a permanent feature of the industry. But this does not mean that “zero-fee” ETFs will become the norm, even if several providers have already trialed such products. There is a limit to how fast promoters can reduce costs, and how low they can allow fees to fall. Questions over transparency may also limit investors’ appetite for zero-fee ETFs. Regional variations are another factor. Average Asian TERS, although declining from 46bps in September 2016 to 44bps in September 2017, remain well above global levels.

Our view – promoters should embrace perceptions of an “ETF price war”

Leading ETF promoters are understandably reluctant to talk publicly about “price wars.” But in reality, the importance of fees in attracting inflows means that most firms reduce charges whenever they can. Low fees and intense competition help ETFs to stand out in a crowded market and encourage regulators, legislators and the media to view the industry in a positive light.

Figure 12 – Reduction in TERS (in bps)

Source: EY



Reducing investor costs



In this environment of falling fees and margins, being a low-cost provider is becoming indispensable to survival. Scale or expertise will only deliver success when backed up by ruthless efficiency. ETF promoters are increasingly aware of the need to develop “future-proofed” operating models and of the importance of looking beyond TERs to reduce all costs of ownership. We see several emerging areas of improvement, including:

- ▶ **Indexing.** Nearly half of respondents (44%) feel there is insufficient competition between index providers (see Figure 13). In Europe, that figure rises to 57%. Promoters are frustrated that competitive pressures in ETF markets are not pushing down indexing costs. In response, 76% of respondents expect new index providers to enter the market – including from within the ETF industry itself (see Figure 14).

Our view – self-indexing by leading promoters will increase

Many ETF promoters would welcome more competition between index providers, with one exception. The industry in APAC felt that they have sufficient competition, and it’s also where the market share of the top three index providers has fallen from 60% to 50% over the past three years. As for more competition, barriers to entry are high, with investors typically preferring recognized brands with a reputation for accuracy. As a result, some of the industry’s largest promoters are becoming interested in the possibilities of self-indexing. We see this as a sign of promoters’ growing determination to reduce investor costs.

- ▶ **Best execution.** In Europe, Solvency II and MiFID II are putting asset managers under growing pressure to demonstrate best execution. Promoters are working more closely with request

for quote (RFQ) platforms, helping clients to trade significant blocks of ETFs with minimal market impact. RFQs provide instant quotes, rapid execution, anonymity and time stamps.

- ▶ **Life cycle management.** The continuing flow of product launches means that most ETFs still fail to reach a sustainable scale. In Europe, the average ETF has three listings and investors have a choice of 15 or 20 ETFs for every major equity index, making life cycle management increasingly vital. We see the willingness of leading ETF providers to close subscale funds as a sign of growing maturity and of a readiness to emulate other innovative industries by “failing fast.”
- ▶ **Innovative distribution.** We have already discussed the potential benefits of digital distribution for retail growth. Digital channels can also reduce the need for dedicated support staff and, as a result, can reduce certain associated distribution costs.
- ▶ **Stock lending.** The lending of investment holdings, and of ETF units themselves, is an increasingly important way for many providers to supplement the returns their products provide to investors.

“The ETF industry is growing at a relentless pace. Success will come from delivering better opportunities to investors, but the challenge is to do so in a more crowded market where consolidation is underway.”

Mark Weeks
CEO, ETF Securities

Figure 13 – Is there sufficient competition in the market for the index providers?

Source: EY

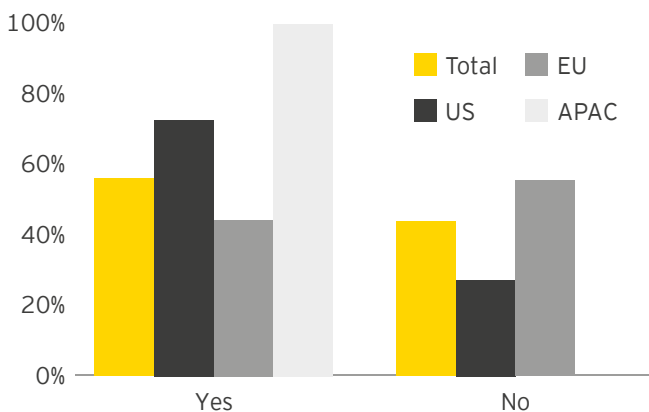
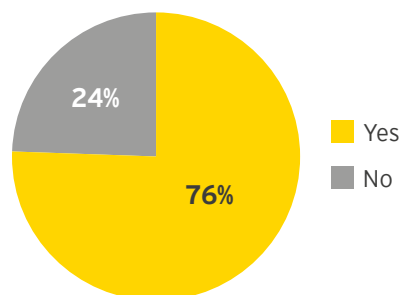


Figure 14 – Will more index providers enter the market in the future?

Source: EY





The need for ETF promoters to reduce investor costs means that it is more essential than ever for them to work closely with service providers. This dynamic will only strengthen as product evolution continues to push up costs.

Our view – growing product complexity will create new opportunities for service providers

As ETFs increase in complexity, development and operating costs are climbing and margin pressure is growing. This creates valuable opportunities for service providers that can support the industry's evolution. Asset servicers that can handle core ETF processes fast and reliably – while also supporting complex, tailored products – have a unique opportunity to benefit from the growth of ETFs.

“Expect increased interest from asset managers who have yet to successfully launch ETFs in Europe. This will lead to more innovation from service providers to assist in getting these ETFs off the ground.”

Anthony Ferguson
Vice President – Relationship Management, Northern Trust

Asset servicers have the most to gain from enabling ETF growth, especially in Europe and Asia. Very few asset servicers currently have specialized platforms to support the detailed regulatory, reporting and risk management requirements of ETFs. Developing these capabilities poses major challenges, including the need for

immediate connections to exchanges and authorized participants. Small errors can have a much greater impact than would be the case with conventional funds. We see huge potential for robotic automation and cognitive computing to create value. Several global custodians are investing heavily in their ETF capabilities, but the build-up of human and technology costs will present asset servicers with their own margin challenges.

White label providers offer an increasingly popular way for new entrants to overcome barriers, especially in Europe and Asia. White label providers allow new promoters to test the market while limiting their initial capital outlay. They can help with regulatory approval, seed capital, product development and listings, and provide introductions to market makers, authorized participants and other liquidity providers.

The importance of taxation on ETF investor behavior (see Section IV) emphasizes the important role that **professional advisors** can play in product development. The effective and efficient use of technology by auditors and other professionals can also help to reduce operational demands on promoters.

Ultimately, operating pressures will force many ETF providers – especially in the mid-tier – to consider strategic responses such as M&A. In the callout, we consider how the industry might be restructured over the next few years.



Potential restructuring in the ETF industry

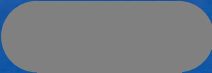
All ETF promoters will face an accelerating margin squeeze in coming years. At the top of the scale, the very largest players will find it easier than most to gather inflows and improve efficiency. At the other end of the spectrum, specialized promoters that can provide distinctive products and investor journeys will have more success in defending fees.

However, firms that lack either of these advantages will find themselves under increasing pressure. In the long term, those without a truly differentiated proposition could find their business models called into question. As a result, we expect the next two to three years to see:

- ▶ **A strong increase in M&A activity.** There will be an increasing number of strategic rationales for M&A among ETF promoters. In-market consolidation will realize operational and product range synergies. Cross-border acquisitions will provide a route to enter new markets, as seen in Invesco's acquisition of Source. And vertical integration will give promoters access to new distribution channels.
- ▶ **Growth in strategic partnerships.** Partnerships will be a vital way for promoters to deliver transformational change in ETF content or distribution. This could include collaborating with providers in different markets, or even in different industries; cooperating with authorized participants and RFQs to boost liquidity; or integrating with retail distributors such as robo-advisors.
- ▶ **Greater use of white label platforms.** (see left)
- ▶ **Increasing collaboration with FinTech.** As discussed in Section I, ETF providers will make increasing use of AI in smart beta and active products. Partnering with external developers is likely to become an increasingly important aspect of this strategy.
- ▶ **A handful of strategic withdrawals.** For some financial institutions that own ETF providers, exiting subscale market positions may prove to be an attractive option. The rapid growth of the ETF market means that we have seen comparatively few exits so far, but this could change. In a consolidating market, ready buyers could be plentiful. But the challenging economics of ETFs could mean that sellers find exit valuations disappointing.

The situation will be given added intensity by a rising tide of new entrants. The US and Europe will continue to see traditional asset managers entering ETF markets for a combination of offensive and defensive reasons. Our survey also shows that Asia-Pacific is a more important target for geographic expansion than ever, and we expect more Asian asset managers to launch their first ETFs. As discussed in last year's report, new entrants will follow a range of approaches, including leveraging established platforms, creating subadvised classes of mutual funds – and acquiring established ETF promoters.





Responding to regulation





The inherent strengths of the ETF vehicle – not least, transparency and low costs – mean that the industry sees little to fear from regulation. In fact, 70% of respondents think investors welcome regulatory scrutiny of ETFs (see Figure 15). And the global regulatory focus on transparency, suitability and value for money continues to work in favor of ETFs. Providers see initiatives such as FOFA in Australia, the UK's pension freedom reforms and MiFID II as providing tailwinds for growth, especially in the retail segment.

Even so, there are signs that the growing complexity of the ETF industry is making the regulatory landscape harder to navigate. In particular, major EU initiatives such as EMIR and MiFID II have created a combination of pluses and minuses for ETF promoters and investors. MiFID II, for example, is generally seen as favoring the industry but could also have unexpected effects on European markets.

Our view – MiFID II has key benefits for European ETFs, but is no “silver bullet”

MiFID II has many potentially beneficial effects for ETFs. Key areas include post-trade transparency (improving the visibility of liquidity); the ban on inducements (leveling the playing field vs. mutual funds); and trading frameworks (encouraging stock lending). However, MiFID II seems increasingly unlikely to improve on-exchange liquidity. Big institutions will continue to use RFQs to demonstrate best execution, only reporting on exchanges. It seems that greater awareness and education will be needed for the ETF industry to realize the full benefits of MiFID II.

Furthermore, the likelihood of ETF-specific regulation is increasing as the industry expands. This is a prospect that ETF providers once hoped to avoid, so it is surprising that 68% of respondents now

take a positive view of ETF-focused regulation. But a closer look shows significant variations. In the US, where the Department of Labor's Fiduciary Rule is seen as helping ETFs, views are much more positive than in Europe, where asset inflows and growth are attracting attention from regulators and the media. In 2017, the industry has seen the Central Bank of Ireland publish a discussion paper on ETFs, the Autorité des Marchés Financiers produce a paper examining ETFs and their associated risks, and ESMA announce a peer review on its guidance for UCITS ETFs and other UCITS-related Issues as part of its 2018 work program.

Debate over the impact of regulation on ETFs has traditionally focused on distribution. In fact – as already discussed – we think promoters could benefit from better understanding the potential benefits of regulatory changes.

Our view – regulation is having an increasingly positive effect on ETF distribution

The majority of our interviewees (61%) expect regulation to change the way ETFs are distributed (see Figure 16). The Department of Labor Fiduciary Rule, which places a legal fiduciary obligation on retirement advisors paid by commissions, is a prime example. In Europe, MiFID II will also restrict the inducements asset managers can pay to distributors. We expect ETFs to continue to benefit from the global regulatory focus on eliminating bias and improving transparency.

“MiFID II will be a game-changer in the European retail ETF market. Cost will become a much larger concern.”

Arne Scheehl
Director of Institutional Clients, ComStage

Figure 15 – Is ETF-specific regulation good for the industry?

Source: EY

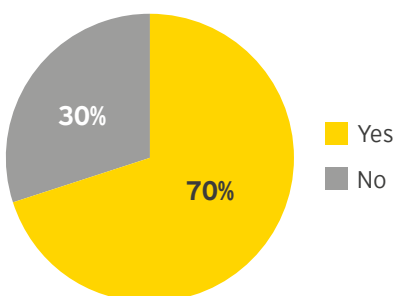
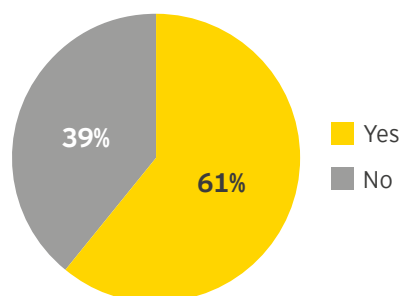


Figure 16 – Will changing regulation affect how ETFs are distributed?

Source: EY





But away from distribution, the impact of regulation may be less positive. There are signs of a growing regulatory focus on systemic risks, typified by the International Organization of Securities Commissions' (IOSCO) review of liquidity risks.

Conversations with promoters also show a growing awareness of how regulation can affect tracking error, and thus harm an ETF's investment performance. For example, margin rules introduced under EMIR, which apply to uncleared transactions such as forward foreign exchange contracts, may make it harder for currency-hedged ETFs to precisely track an index since funds are not 100% invested in underlying assets.

Nor is regulation the only external factor that can affect tracking error. So can any rule that creates a difference between the returns generated by an index fund and those generated by its constituent parts. Tax has a major effect on ETF investment. This is illustrated by the way that IFRIC 23 introduces the concept of accruing for uncertain tax liabilities, meaning that an ETF may have to create a tax liability that an investor would not face if they held the shares that make up the index. Different countries' approach to dividend withholding tax (DWT) rebates can also affect the performance of ETFs with international holdings, depending on the nature of double tax treaties.

Meanwhile in the accounting sphere, IFRS 9 could also create challenges for ETF providers, due to the changes that investors may need to make in how they account for ETF investments on their own balance sheets.

Not all of these issues are unique to ETFs. But as investors develop a more sophisticated view of ETF performance, it will become vital for promoters to limit any factors that can affect the quality of index tracking, and to be aware of the impact of rules and regulations in other areas.

In our view, ETF promoters need to be smart about ensuring that changes to regulation, tax and accounting do not affect their ability to create value for investors. This could involve:

- ▶ Combining local understanding and global insight, helping investors to understand the overall regulatory environment, as well as any relevant technicalities
- ▶ Identifying the potential opportunities created by regulatory change and leveraging them into product development and improved investor journeys
- ▶ Developing a detailed view of regulatory threats and being willing to retire products or strategies that underperform as a result

We believe that a smart approach to the complexities of regulation will, in turn, help providers to carry out the investor-centric improvements they need to make in terms of product innovation, journey design and cost management.

Conclusion: a renewed focus on the investor holds the key to lasting success

As ETFs continue their rapid growth, their influence on other parts of the investment industry is becoming ever more apparent. But convergence works both ways, and the challenges and opportunities of ETF providers increasingly resemble those confronting the wider industry.

One positive example is the increasing awareness of how digital technology can transform areas as varied as portfolio management, customer experience and back office processing. Another is the increasing importance of close, integrated relationships with market makers, securities servicers and other partner organizations. And a third, less positive factor is the strategic pressure facing mid-tier providers without a decisive advantage in scale or expertise.

However, the ETF industry also continues to face its own unique threats and opportunities. On the upside, the ETF structure remains ideally suited to innovative product development and could have been designed for the era of digital advice. On the downside, questions persist over the possible performance of ETFs in a financial crisis.

If individual firms – and the industry as a whole – are to sustain ETFs' remarkable track record of growth, these challenges must be addressed head-on. What has worked in the past won't necessarily continue to in the future.

In particular, we believe providers should renew their efforts to put investors at the center of their activities. In this report we have focused on the four vital areas of innovation, investor journeys, cost management and regulation. But these should not be seen as separate areas. Instead, they represent four pieces of a puzzle. Each needs to be in place if the industry is to sustain its remarkable achievements into the future.

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