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Executive summary

Buoyed by strong performance during the first half of 2020, the ETF industry expects to continue growing strongly over the next five years. It's not hard to see why — many of the structural changes reshaping the investment world continue to work in ETFs' favor.

EY research shows that ETF promoters' plans for growth between now and 2025 are based on a combination of product innovation, retail adoption and digital distribution. But those goals are not without their challenges. As it moves forward, the ETF industry must not only contend with slowing economic growth and political uncertainty but also with new entrants, falling fees and the need for greater scale at the fund level.

Given this outlook, we believe ETF providers need to focus on four key areas if they are to achieve their ambitious growth targets, and create sustainable value for investors and other stakeholders. These priorities, which we examine in detail in this report, are:

- Navigating the risks and opportunities of regulation
- Getting sustainable investing right
- Rethinking customer journeys and experiences
- Transforming business models with technology and data

Despite its success to date, the ETF industry needs to align its business models with the "new normal" as it charts its route to 2025 and beyond. Ever-increasing competitive pressures mean that promoters must look beyond business as usual and take the bold decisions needed to deliver clear and scalable growth strategies for a post-COVID world.

ETFs in 2020

The ETF industry continued to grow during 2020, breaching US$7t of global assets under management (AUM) in August.[1] But that, of course, is not the full story of this unusual year. COVID-19 brought disruption to ETF markets, just as it did to other investment vehicles. In particular, fixed-income ETFs experienced significant pricing dislocations during the volatility of March and April. For example, one large global bond ETF and one large US bond ETF traded at discounts to net asset value (NAV) of up to 6.17% and 4.43%, respectively, before spiking to premiums of 1.05% and 1.03% as the Federal Reserve announced credit market support.[2]

However, the way that these gaps were eliminated as underlying liquidity recovered suggests that ETFs had aided price discovery at a time when prices of many corporate bonds were hard to obtain.

In fact, data from the London Stock Exchange (LSE) shows that trading volumes for exchange-traded products (ETPs) experienced record highs in March 2020.[3] That seems to confirm the conclusions of a Financial Conduct Authority (FCA) research note from 2019, which found that, despite concentration in primary fixed income ETF markets, stress events were unlikely to see liquidity evaporate.[4]

In short, ETFs appear to have come through this testing time strongly. EY research shows that ETFs' performance in stressed conditions is seen as the greatest upside to emerge from COVID-19, and investors seem to agree — many individual ETFs enjoyed some of their strongest ever inflows during April 2020.

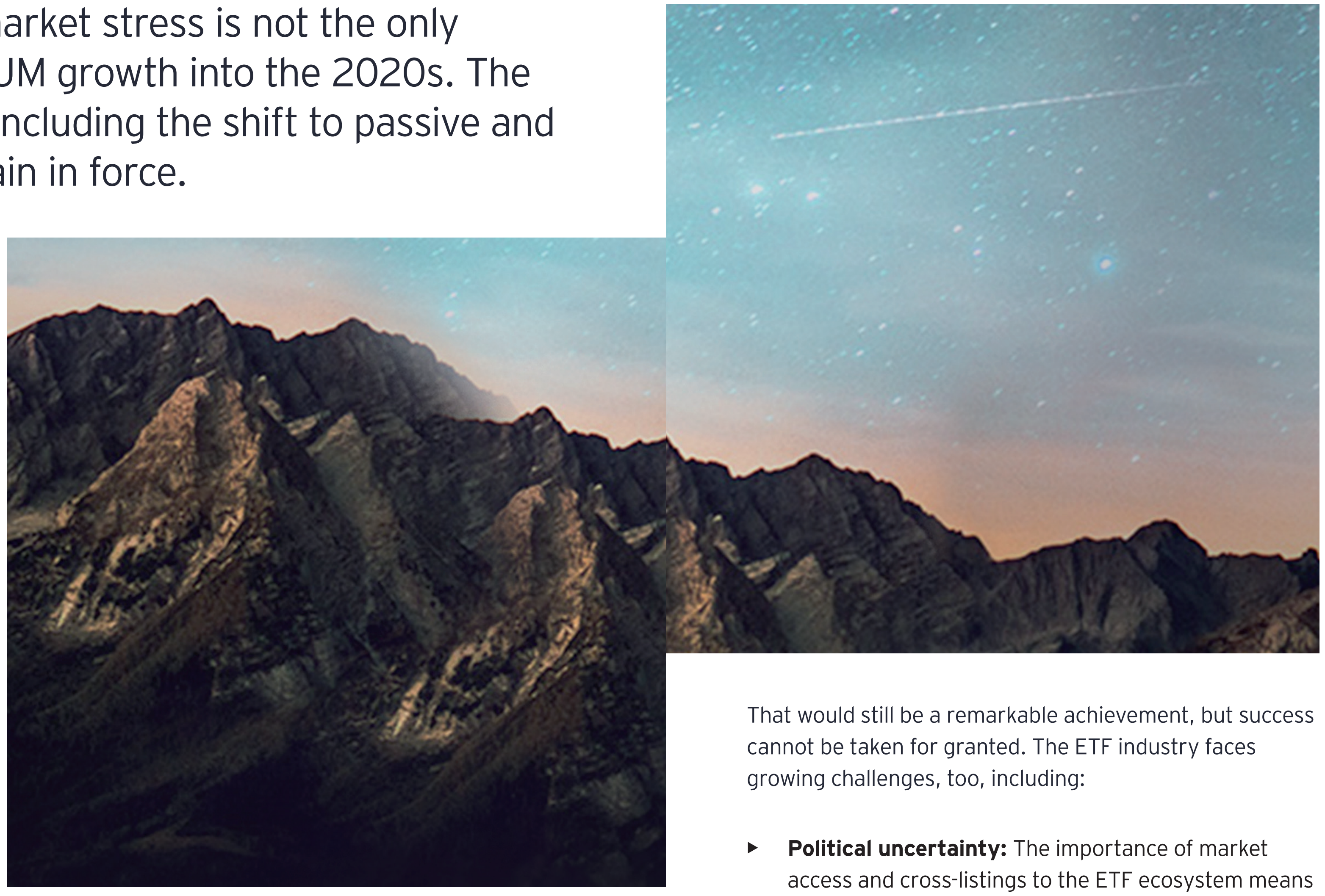
[1] "ETF assets reach $7tn milestone," Financial Times, 9 September 2020.
[2] EY analysis of market data.
[3] "How the ETF ecosystem has responded to coronavirus lockdown," ETF Stream, 9 April 2020.
[4] "Fixed income ETFs: primary market participation and resilience of liquidity during periods of stress," Financial Conduct Authority, August 2019.

The outlook: expectations and reality

The performance of ETFs during market stress is not the only factor that argues for continued AUM growth into the 2020s. The industry's historic growth drivers, including the shift to passive and the structural decline of fees, remain in force.

Other trends reshaping the investment industry — like the tendency of smart beta and factor investing to replace core active, the increasing demand for high standards of transparency, and the need for individuals to take more responsibility for long-term savings — should also favor ETFs.

This picture is backed up by EY research, which shows that ETF participants expect the next five years to see a cumulative average growth rate (CAGR) in AUM of 15% for ETFs in Europe, with 11% in the US and Asia-Pacific. Our own predictions are slightly less bullish, reflecting the global outlook for asset management — which we expect to feature slowing growth in AUM, revenues and net inflows. Our forecasts, which incorporate the likelihood of further market corrections and a slow W-shaped recovery, anticipate a CAGR of 10% in AUM for European ETFs over the next five years and expect global ETF assets to reach US$10t by 2025.



That would still be a remarkable achievement, but success cannot be taken for granted. The ETF industry faces growing challenges, too, including:

- **Political uncertainty:** The importance of market access and cross-listings to the ETF ecosystem means that the industry is potentially sensitive to political risks. Brexit represents a particular challenge, but the uncertainties caused by COVID-19 and global geopolitical rivalry also raise questions over international growth.
- **Increasing competition:** Rivalry among providers, slim margins and a steady flow of new entrants suggest that competition within the industry will only intensify. EY research shows that falling fees and margins are expected to be the leading challenges for ETF providers over the next three to five years. Profitability pressures also increase the risk that short-term cost cutting in areas, such as investor education, could harm the industry's long-term growth prospects.
- **Product proliferation:** Low margins mean that fund size is a crucial driver of ETF profitability — and yet, new products are seen as the leading source of growth. The result is that confidence in the success of fund launches has fallen from 57% in 2018 to 46%. The contradiction between the desire to launch new funds and the need for economies of scale will only become more acute as fees decline further.
- **Innovation risks:** Developing innovative new ETFs is central to growth, and "winner takes all" dynamics makes speed to market essential. But regulatory attention resulting from new products is expected to be the industry's number two challenge over the next three to five years. Reconciling rapid innovation with ever-growing stakeholder expectations for transparency, value and performance will be increasingly important during the 2020s.

Avenues for growth in the 2020s

So, what will drive the growth of ETF assets over the next five years? Experience suggests that flagship index-tracking funds will capture a large slice of inflows. But wafer-thin margins mean that this is not a sustainable growth strategy for new entrants. Nor will it help the bulk of ETF providers.

That view is confirmed by EY research, which shows that individual ETF promoters expect the key drivers of growth to be launching new products, reaching more investors and improving distribution networks. New entrants are also expected to drive the industry's expansion. But none of these four growth avenues will be straightforward.

New products: ETF professionals see developing new products for existing investors and current markets as the most important way for promoters to drive growth in an increasingly crowded market. EY research shows four main areas of focus for new product launches. They are as follows:

- **Environmental, social and governance (ESG) ETFs** are seen as the most important source of growth by market participants. Demand for sustainable investing is growing rapidly and providers see ETFs as an ideal vehicle, but ESG investing also presents significant challenges (see "Getting sustainable investment right").
- **Fixed-income ETFs** have been a key driver of ETF growth in recent years. The impact of COVID-19 on interest rates and debt markets, together with the strong performance of fixed-income ETFs during 2020, explain why many ETF professionals expect this to remain an important area of growth.
- **Active ETFs** will proliferate. Almost all ETF practitioners (98%) expect more active promoters to enter the market over the next three years, probably from the ranks of active mutual fund managers. Institutional investors are the key target, with the US offering the greatest potential growth (ETF professionals we surveyed, on average, expected a three-year CAGR of 11%), followed by Europe and Asia-Pacific (7%). Some investors question the efficiency of active ETFs. But the example of semitransparent actives, which charge an average fee of 48 bps (10-20 bps less than non-ETF equivalents), and which traded with average spreads of 12 bps and an average premium to NAV of 9 bps between June and September 2020, suggest that pricing is tight.[5]
- **Thematic ETFs,** which aim to give investors quick exposure to key sectors or investment themes, are seen as another significant growth area by promoters. EY research shows that climate change, clean energy, cybersecurity, cloud technology, artificial intelligence (AI) and robotics, and treatments for COVID-19 will be the most important themes of the coming year. First-mover advantage is key for thematic ETFs, but speed to market must be balanced with careful design.

New investors: Institutional investors, especially pension funds, are expected to remain the leading users of ETFs — both for core exposures and for tactical applications. Private banks are forecasted to remain an important market too. But it is retail investors that are predicted to deliver the strongest relative growth between 2020 and 2025. Many promoters expect the changes brought by COVID-19 to hasten adoption among self-directed investors, albeit that distribution networks will need to change significantly (see "Rethinking customer journeys and experiences").

Looking beyond Europe, ETF professionals identify South America and key Asian markets, such as China, as the most attractive markets for expansion — with the undertakings for collective investment in transferable securities (UCITS) label seen as a valuable hallmark for retail investors.

Better distribution: The proportion of ETF practitioners who see their current distribution models as sufficient for today, but not for the future, has grown from 12% in 2018 to 41% today. Promoters hope to take advantage of 2020's shift toward remote advice and online sales to scale up their digital distribution capabilities. But it remains to be seen whether issuers can provide sufficient transparency, disclosure and convenience to encourage greater take-up via channels such as robo-advisers and online fund platforms.

New providers: A large majority of ETF professionals (79%) expect more firms to enter their local markets in the coming two years. Furthermore, two-thirds see asset managers without an ETF track record as the most likely entrants. The fact that existing ETF promoters often focus less on semitransparent actives than other fund types could offer an opportunity for active managers. EY research supports this view, showing that 74% of market participants expect more promoters to launch semitransparent funds. Models, such as Precidian's ActiveShares, can be a useful wrapper for delivering existing strategies at low costs, although new entrants could find that even a strong product proposition is unlikely to succeed without access to a large investor base or distribution network.

[5] Market data, EY analysis.

Getting ready for the "new normal"

The increasing scale, complexity and reach of ETFs, together with the ways in which COVID-19 is accelerating change in the investment industry, mean that it's vital for all ETF providers to tailor their growth plans to the post-pandemic world. Delivering the right outcomes, to the right investors, in the right way, will be essential to the industry's ability to achieve sustainable growth. EY believes the ETF industry must focus on four key areas during the years ahead if it is to reach its ambitious targets for expansion.

1. Navigating the risks and opportunities of regulation

EY research shows that ETF professionals (74%) see regulation as the leading driver of change in operating models. This is about more than short-term compliance. The fast-changing political environment has major implications for the industry's plans for growth.

Needless to say, Brexit is the most urgent consideration for many ETF providers. Most are confident that they will be able to manage its associated risks, but the prospect of a "no-deal" outcome is still a major source of uncertainty given the UK's status as Europe's largest ETF market and as a portfolio management center for ETFs domiciled in Ireland or Luxembourg.

First, the end of "passporting" creates questions over the long-term feasibility of selling EU funds into the UK. This is not unique to ETFs, but any need to duplicate funds would pose a particular threat to the efficiency of the ETF model. The industry will be hoping that the UK's temporary permissions regime (TPR) could be in place for longer than its anticipated two to three years, and promoters that still need permissions should act immediately while the Financial Conduct Authority's notifications window remains open. However, it's unclear whether the TPR will also be available to new products launched after December 2020. If not, Brexit could have a major impact on the industry's plans for product innovation.

The delegation of portfolio management to Markets in Financial Instruments Directive (MiFID) entities carrying out investment activities in the UK is the second major area of uncertainty. Some ETF providers have established authorized investment management entities in the EU in case delegation to the UK is no longer possible. European Securities and Markets Authority (ESMA), and national supervisors, such as the Central Bank of Ireland (CBI) and US (CSSF), are already signaling that they will focus closely on the substance of those activities — something that promoters must be ready for.

Looking further ahead, Brexit raises questions about future regulatory equivalency between the UK and the EU. Divergence seems unlikely in the short-term, but any future loss of equivalence could have major implications for the ETF industry's infrastructure. Regulatory arbitrage might create opportunities for some, but the resulting duplication and inefficiencies could do lasting damage to the profitability of the whole ETF industry.

Brexit is not the only regulatory obstacle for ETF providers to negotiate. The importance of **ESG-themed** products as a driver of growth means that the rapid evolution of sustainable investment regulation poses a challenge of a very different sort — something we explore in the next section (see "Getting sustainable investment right").

Active ETFs are a third area where the industry's growth plans will be shaped by regulation. The Securities and Exchange Commission's approval of semitransparent fund structures has helped the US to become a hub for active ETF innovation, and its decision to allow periodic disclosures could prove influential. For example, EY research shows that the proportion of ETF professionals who believe actives should provide daily transparency has fallen from 73% to 51% in the past two years, with those advocating weekly or monthly disclosures growing from 15% to 29%. Over time, that could favor semitransparent fixed-income ETFs, given the fragmented nature of bond markets.

Lastly, the potential regulatory risks of ETPs are something for the ETF industry to monitor. ETPs are typically backed by commodities or precious metals, making them very different to the majority of ETFs — as was obvious in April 2020 when some West Texas Intermediate oil futures contracts briefly turned negative. ETPs may not be an area of specific regulatory focus, but the need for investor protection makes it vital for the ETF industry to provide investors with clear guidance on the differences between the two structures.

In summary: Promoters must ensure that regulatory awareness, compliance and flexibility are built into their culture, particularly around product development, and that ETFs continue to provide high standards of transparency over product holdings, structure and operations. They should also be alert to the conduct risks that could arise from increased online distribution.

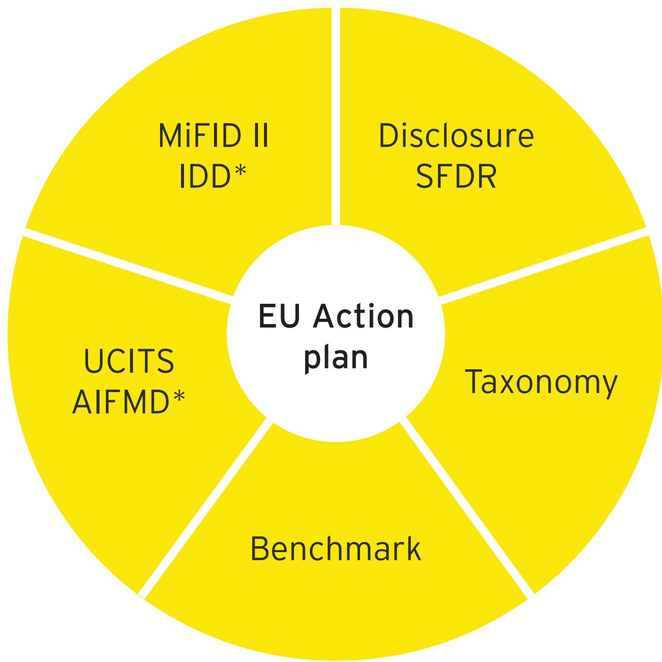
2. Getting sustainable investment right

Sustainable investing continues to grow rapidly around the world. ESG-themed ETFs were reported to have gathered US$38b in new money during the first seven months of 2020, reaching US$100b in AUM for the first time.[6] That followed the volatility of March 2020, when ESG-themed ETFs were found to have outperformed the wider market in the global, European and US large-cap categories.[7] COVID-19 is also adding to the awareness of global challenges among retail investors, further encouraging pension funds and other institutions to embrace sustainability.

Sustainable investment represents a particularly important opportunity for the ETF industry, given the increased focus on nonfinancial outcomes among all investor groups. EY research shows that providers see ESG funds as the leading source of future growth and the key focus of product development. That includes funds with an ESG-themed overlay as well as thematic ETFs, especially those focused on climate change factors.

Even so, it would be a mistake to see ESG-themed ETFs as a one-way bet for promoters. Demand for sustainable investment may be growing fast, but so too are stakeholder expectations.

Regulation represents a fast-growing hurdle for ESG-themed ETFs, especially the first two elements of the EU Action Plan on sustainable finance: Disclosure Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy (see figure below).



* AIFMD - Alternative Investment Fund Managers Directive
IDD - Insurance Distribution Directive

The Taxonomy regulation for sustainable investment often dominates the debate over the EU Action Plan. However, the Taxonomy regulation is not expected to be fully implemented until 2022 or 2023, and it is limited to environmental factors. EY research also shows 74% of ETF professionals expect common environmental standards to benefit the industry.

In contrast, it's the SFDR that poses the greatest compliance headaches for ETF providers today.

- The SFDR requires promoters to assess each ETF — a process involving detailed and potentially costly analysis of every investee company — to determine whether it can be classified under Article 8 (for funds promoting an environmental or social characteristic) or Article 9 (for funds with sustainable investment as an objective).
- Only funds that meet the criteria of one of the two articles can be marketed either as "an ESG ETF" or "a sustainable ETF." Promoters will need to reflect this in their pre-contractual fund prospectuses, key investor information documents (KIIDs), marketing documents, periodic reporting, website disclosures, and in all product- and entity-level disclosures.
- The scope of these requirements includes ETFs that track recognized ESG indices, but it remains to be seen whether promoters or index providers will shoulder the burden of verifying that benchmarks are consistent with their stated ESG characteristics.
- The SFDR also applies firm-level requirements. Promoters employing more than 500 staff will need to make detailed disclosures of the environmental and social "principal adverse impacts" of their investment decisions on their websites.

[6] "ESG surges as investors search for better corporate citizens," Financial Times, 14 September 2020.
[7] "How ESG ETFs have performed in the sell-off," Morningstar, 02 April 2020.

Level 2 compliance with the SFDR's full Regulatory Technical Standard (RTS) has recently been delayed, probably until 2022. But this is of little help to ETF promoters since the level 1 requirements, which set out the principles of the framework, will still apply from 10 March 2021. Without the RTS, firms must implement level 1 on a "best efforts" basis, which seems certain to lead to either insufficient or duplicative compliance work. For example, it's currently unclear whether ETFs using negative screening will be accepted as "ESG funds" under Article 8.

Regulation is not the only ESG-related hurdle for ETF promoters. Investors increasingly expect all investment managers — not only those focusing on ESG — to exercise long-term stewardship of their investments. This represents a particular challenge for index-tracking equity funds, which have no scope to vary their holdings. Can a passive vehicle provide effective stewardship? Three possible approaches already being trialed are:

- **Watchlists:** At least, one major promoter has created a watchlist of investee companies, identifying those seen as having insufficient disclosure. Watchlists are republished regularly, giving companies an incentive to improve their transparency.
- **Engagement:** One promoter has written to all its investee companies, naming those it sees as having good governance practices. Another has written to selected investee companies stating an expectation for greater ethnic diversity in the boardroom.
- **Voting:** Passive investment managers are increasingly willing to vote against directors at annual general meetings (AGMs), for example, on executive remuneration.

Lastly, the rapid evolution of stakeholder expectations means that ETF promoters looking to develop their ESG credentials should ask themselves if they want to target becoming a sustainable investment provider. For now, many ETF providers will consider this unnecessary if they can deliver strong performance via ESG-themed funds. But as investors' commitment to sustainability grows, we believe they will increasingly challenge firms to integrate their beliefs into their own operations and processes or into their entire product range. Promoters should also be prepared for any perceived shortfalls in conduct to provoke strong reactions, such as accusations of "greenwashing."

In summary: The compelling opportunities for ESG-themed ETFs need to be balanced against fast-growing expectations from regulators, investors and the public. It's vital for promoters to set out a coherent vision of sustainable investing and to clearly differentiate themselves, for example, by:

- Covering a broader range of environmental themes than climate change
- Launching a broad range of funds addressing environmental, social and governance themes
- Developing a distinctive approach to stewardship and engagement
- Building unique proprietary analytics that deliver empirical performance advantages
- Offering high-quality ESG education to investors and investee companies
- Embedding sustainability across the whole product range, including fixed-income ETFs
- Developing "impact investing" ETFs that harness private capital techniques of intentionality, additionality and measurability to achieve specific nonfinancial goals

3. Rethinking customer journeys and experiences

Investors of all types increasingly demand solutions that let them achieve their long-term objectives, not just relative performance. All investment managers are under pressure to deliver a transparent investment approach tailored to clients' financial needs — and their sustainability beliefs.

This shift in behavior presents opportunities and challenges for ETF providers. On the upside, the growing depth of ETF offerings means that the industry can provide a full range of investment styles and strategies, including core passive, factor investing, thematic investing and active management. Set against that, the industry's belief in the advantages of the ETF structure can make it hard to look beyond products and deliver compelling journeys oriented around investors.

The picture is further muddied by COVID-19, which has already transformed relationships between ETF providers and investors. It's obvious that face-to-face contact has declined permanently, and that sales and marketing experiences are unlikely to return to their pre-pandemic form. It's less clear what effect this will have on investor relationships. EY research shows that while 45% of ETF professionals expect personal relationships with investors to weaken in the future, the majority expect relationships to remain the same or even strengthen.

But how is this to be achieved? Our research identifies two key areas of focus:

- **Online distribution:** Plans to enhance ETF distribution are focused on selling through online platforms — for example, via partnerships with robo-advisers — and enhancing web disclosure of product data (61% each). In contrast, expanding distribution teams into new markets and growing sales teams are less popular than in 2018.

- **Self-directed investing:** EY research shows that 63% of ETF professionals expect COVID-19 to drive growth among self-directed investors doing their own research, with 71% expecting promoters to publish more detailed information on their websites.

These changes offer clear opportunities for ETF providers to harness their strengths in tradability, accessibility and value for money. But redesigning investor journeys will require a detailed understanding of the preferences of different investor types and the ability to reorient distribution resources accordingly. ETF promoters will need to reallocate staff, create virtual sales forces, and strengthen education and information sharing. New digital interfaces and investor portals will be crucial to the providers' ability to build direct investor relationships or to leverage intermediary data — and to disseminating detailed information on investment strategies, fund performance, fund holdings and investment operations quickly and clearly.

Aligning people, processes, partners and information in this way will make it easier for promoters to deliver investment solutions. One example could be helping robo-advisers to build ETF model portfolios tailored to the needs of specific investors. Another could be liaising with institutional investors to help them understand how ETFs can be used to achieve their goals for strategic allocations, tactical exposures or short-term liquidity management.

In summary: Effective use of data and high standards of transparency will be critical for building compelling journeys for ETF investors. Providers will need a tailored, evolving understanding of asset owners and their needs, while investors will expect simple, real-time reporting backed up by granular information on demand.

4. Transforming business models with technology and data

ETF professionals expect investments in technology and data to help them enhance a range of core activities, including customer analysis (according to 71%), investment analysis (68%), product development (63%) and cost reduction (63%). Common goals include:

- Reorienting around clients — including enhancements to digital distribution channels
- Strengthening investment propositions — including using AI and data analysis to improve ETF performance, and helping authorized participants to create and redeem fund units easily
- Investing in key areas of growth — including the development of ESG, smart beta, active and thematic ETFs
- Meeting regulatory expectations — including compliance with existing rules and adapting products and processes to future changes

These goals are also underpinned by another imperative — the need to improve operating efficiency. Margin pressure (55%) and competition (50%) are identified as two of the three leading drivers of change in operating models.

ETF promoters know that a strategic view of technology is crucial to developing scalable and sustainable business models. But real life and "winner takes all" dynamics often get in the way. Innovation is a key driver of inflows, making speed to market a vital component of success. This can lead to a disconnection between the long-term investments that providers want to make and the need for ad-hoc investments to help bring new products to market or comply with new regulation.

COVID-19 has only made it more difficult for ETF firms to take a strategic view of technology and data. Resources have been diverted to enable remote working, and the physical dispersal of teams makes it harder to visualize and implement change — although altered ways of working could give firms access to new resource pools.

A simple three-tier framework can help ETF providers to make sense of these conflicting dynamics, allowing them to develop a technology and data architecture that will be a sustainable source of competitive advantage.

The three levels of this framework are:

- **Strategy:** The strategy level will help providers decide what products to offer, which investors to target and how to reach them.

- **Structure:** The second level will help providers create the infrastructure needed to achieve the strategy. This means linking internal resources with third-party and fintech platforms, index providers, depositaries and white label providers, using portals and application programming interfaces (APIs) to exchange data.

- **Optimization:** The third level will guide ETF providers to invest in robotics, data analysis, AI and process optimization to maximize efficiency and effectiveness.

An integrated data infrastructure is also essential to making technological transformation work for ETF providers. In part, that reflects the data-intensive features of ETFs, such as the need to provide authorized participants with portfolio composition files. But it's also central to many of the industry's targeted areas of growth — such as the need for the managers of ESG-themed funds to access and analyze data from up to 60 external providers. As mentioned, effective data management will also be critical to ETF providers' ability to enhance their digital distribution.

In summary: A clear vision for technology platforms, closely aligned with strategic growth plans, is critical to building scalable and sustainable ETF business models. ETFs' complex construction, tight margins and need for tradability also make an integrated data infrastructure vital to success.

The road to 2025

Competition has always been strong in the ETF industry, and recent years have seen growing pressure on margins and profitability. COVID-19 has only strengthened these dynamics, making further downward pressure on fees and profitability seem inevitable.

EY research backs up this view. Although it shows that 50% of ETF professionals (up from 38% in 2018) believe ETFs have reached the minimum price point in traditional passives, 53% still predict a fee decrease of 1–2 bps over the next three to five years, and 95% see further scope for lower fees in active and smart beta ETFs. Fees may be nearing the bottom, but they're not there yet.

These pressures are making themselves felt. Recent months have seen several major ETF providers forced to make tough choices, such as exiting key markets. As they face the "new normal" of a post-COVID world, ETF providers, therefore, need to review their business models and their planned routes to 2025. Despite the ETF industry's undoubted strengths, what has worked in the past won't necessarily succeed in the future. If ETFs are to achieve their ambitious growth targets while navigating current disruption, the industry will need more than business as usual.

Clear, scalable growth strategies are vital, along with the willingness to make the bold changes required to implement them. That includes using cross-listings and closures to boost economies of scale at the fund level and applying inorganic tools – such as disposals, acquisitions and partnerships with nonfinancial firms – at the entity level.

At the same time, however, promoters need to ensure that ETFs continue to deliver on their core attributes, such as liquidity and value for money. The industry also needs to further elevate its purpose by helping to advance investor education and democratization. Intangible factors, such as transparency, flexibility and a focus on the investor, will just as be important to success as products, processes and technology.

ETF providers that can develop and deliver an effective strategy for growth in the post-COVID world will be better placed than ever to create sustainable value for investors and society at large and, in the process, for themselves.

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