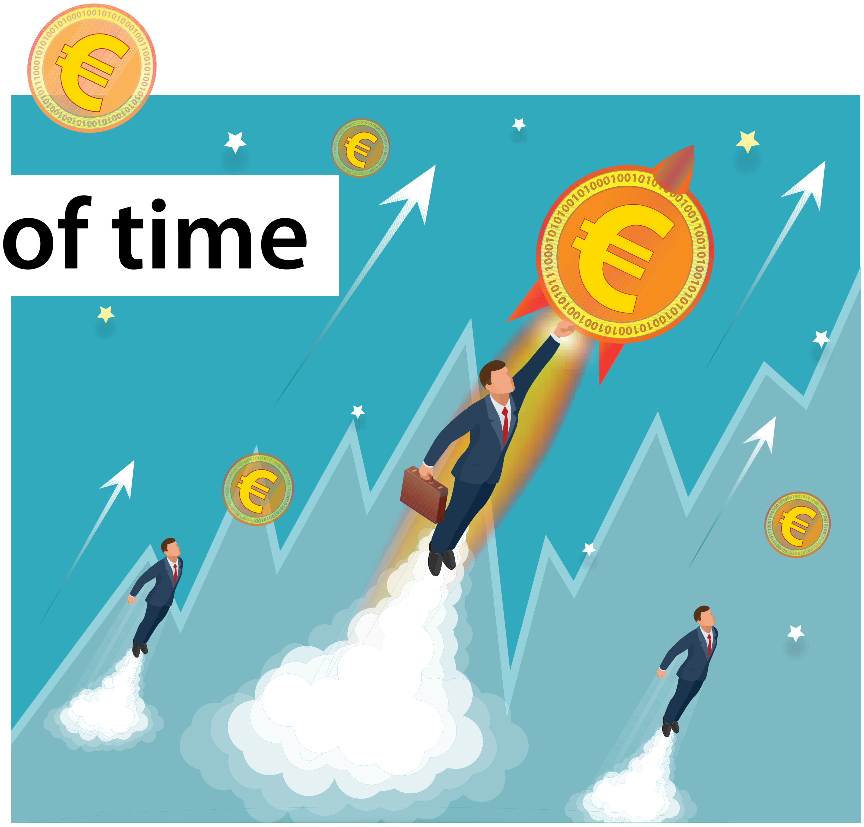
INVESTMENT

A matter of time



Lynn Strongin Dodds considers the reasons why European ETF fund use looks set to grow

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European institutional investors have warmed to exchange-traded funds (ETFs) but they still constitute a fraction of their overall assets under management (AUM). Cultural divisions, fragmentation and a preference for bonds have been major sticking points but industry participants believe that it is only a matter of time before they become a larger part of the investment framework.

The pace is certainly accelerating. A report earlier this year by Morningstar shows that AUM in European-domiciled ETFs have doubled over the past five years to around €550 billion at the end of December 2016, and this year figures from consultancy ETFGI showed ETFs domiciled in Europe chalking up $7.4 billion of inflows during September, marking the 36th consecutive month of increases. In the first nine months of the year, assets invested in Europe-listed ETFs leapt by 31 per cent to reach a new record of $751 billion.

However the region has still lagged behind the US, which accounts for over $3 trillion of the $4.5 trillion pie. One reason is that the US market is more established and is dominated by the retail investor. Moreover, it is a much more liquid market because ETF providers have to report transaction data and the majority of trading takes place on exchanges. Also, there is one central clearinghouse – the Depository Trust & Clearing Corp, according to a discussion paper published by the Central Bank of Ireland in May.

No uniformity

By contrast, Europe has multiple clearing and settlement systems and the market itself is much more opaque, with 70 per cent traded over the counter. As a result, pooled funds seem to be the preferred investment choice. As Mercer head of manager research Andy Barber says, generally pension funds use pooled funds rather than ETFs to obtain passive index tracking exposure – "historically this has been the cheaper way to gain exposure".

However, he adds that managers offering both ETFs and pooled funds are often reluctant to state a preference for one over the other as they both have a place. "For those institutional investors wanting liquidity and fast access to exposures, it seems from comments from managers, as well as the likes of the Greenwich survey, that ETFs have gained traction," he adds. "My sense is still though that sizeable institutions with a more buy and hold strategy can negotiate hard on fees for pooled funds, making this more cost effective."

The Greenwich survey on European institutional trends showed that although demand is growing, active managers still have the lion share. Institutional allocations to ETFs average 7.6 per cent, with registered investment advisers having the biggest chunk at around 24 per cent of total assets, followed by asset managers at 20 per cent. This is in contrast to the US market where institutions hold 21 per cent, followed by Asia at almost 18 per cent of total assets. Meanwhile, Canadian institutions are somewhere in the middle at 15 per cent.

"When looking at Europe, it is crucial to understand that unlike in the US, there is no uniformity," says ETF Securities Canvas CEO Howie

Li. “There are many different regional flavours.” For example, he points to the UK, where the majority of pension funds are intermediated by either a large investment consultancy or asset manager with their own solutions teams, while in Scandinavia the pension funds themselves have greater control of the investment strategies.”

Drivers of change

However, some market participants believe that the advent of the European Union’s Markets in Financial Instruments Directive (MiFID) II could be a game changer and increase European ETF fund AUM from $751 billion to $1 trillion within two years. In Europe, funds are smaller, less liquid and are traded more over-the-counter than on-exchange,” says Deutsche Asset Management’s head of ETF sales for Europe and Asia Simon Klein. “MiFID will increase the level of transparency on stock exchanges because trades have to be reported on a consolidated tape. This will boost the overall liquidity and should help pension funds better understand the benefits of ETFs.”

The other driver is the general industry move to passive from active management. Although this trend is more pronounced in the US than Europe – where active managers still comprise the majority of assets – research from Thomson Reuters Lipper shows that passive investments are gaining ground. They have risen from only 5 per cent of total European mutual fund AUM in 2004 to 12 per cent last year. In addition, the recent UK Financial Conduct Authority review on asset management has only served to heighten the discussion on costs.

“Ultimately it comes down to a case-by-case assessment of the ‘total cost of ownership’ i.e. not just the cost of holding (annual management charge//total expense ratio) but also the trading costs (eg bid/offer spreads for pooled funds versus creation/redemption costs, brokerage commissions and on-exchange spread of ETFS) as well as the tax situation of the investor,” says Barber. “Investors have more to think about than might be initially thought.”

Aside from greater cost pressures, other factors driving growth include the changing defined contribution landscape, a greater appetite to have more ESG (environmental, social and governance) investments and the increasing popularity of fiduciary management, according to vice president in BlackRock iShares indexing business Armit Bhambra.

Applications

He also notes that European institutions are using ETFs in a much more granular way, either to gain exposure to factors through smart beta ETFs or for risk management purposes. “For example, ETFs may be part of a trigger-based de-risking strategy because they can be more cost effective and can provide more immediate liquidity when compared to trying to access fixed-income markets through more traditional index mutual funds.”

This is supported by the Greenwich study, which showed that across asset classes, European institutions are deploying ETFs for a diverse set of applications, ranging from high-level strategic functions like obtaining core exposures and achieving portfolio diversification, to making tactical portfolio adjustments and executing short-term tasks. They are also continuing to use ETFs as a stop-gap parking place when moving from one fund to another in a transition management programme.

As in overall passive management, one of the most popular products is smart beta. The Greenwich study showed that last year approximately a quarter of institutional ETF investors were employing them, up from 21 per cent expecting to do so in 2015, while three quarters planned to increase their allocations. Moreover, it found that half expected to replace an existing equity futures position with ETFs in 2017, with 40 per cent expecting to evaluate futures positions for potential substitution. Currently they use a variety of derivatives to access beta, such as futures, swaps, and options.

European institutions are also increasingly being seen as an effective way to manage liquidity, inflation, or concentration risk. The one area that has been slower to take off is fixed income smart beta ETFs. Overall appetite has dwindled, with figures showing that year to date inflows were $23 billion, slightly less than the $27 billion seen over the same period in 2016.

“The trend into fixed-income smart beta is slower than equities because it is not a listed market and there is a lack of historical data,” says SPDR, State Street head of ETF strategy and research for EMEA Antoine Lesne. “Also there is more academic literature on equities than bonds.”

Looking ahead, J.P. Morgan international head of ETFs Bryon Lake believes that ETFs will be used more strategically, as well as tactically. “When I say ETF, I mean the wrapper and the investment is what goes in it, whether it be market cap or smart beta, which is a very thin slice of the pension market but one of the fastest-growing areas. This is because schemes are keen to deconstruct alpha returns by using factors. I also think we will see more hedge fund strategies such as managed futures or long/short in the wrapper.” ■