WHAT'S NEXT FOR FUNDS?

EXCHANGE-TRADED FUNDS AND FRAGMENTATION

A FUNDS EUROPE SURVEY IN CONJUNCTION WITH CLEARSTREAM

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Highlights from the report

Flexible, transparent and with low fees, exchange-traded funds (ETFs) have a broad appeal. But there are challenges involved with this kind of fund, which is why *Funds Europe*, in association with Clearstream, chose the subject for the second in a series of research reports, 'What's next for funds', about the future of the funds industry. Among the highlights of this survey:

- 52% of respondents think the investor category with most to gain from investing in ETFs is mass retail
- 56% believe low fees are the most important factor attracting ETF investors
- 68% believe the cost of investing in ETFs (such as operational costs and fees) will fall
- 55% believe Europe's ETF market, by being spread across many exchanges, is too fragmented
- 60% think ETFs are not appropriate for investing in illiquid assets such as real estate

A total of 124 funds professionals participated in the online survey. See 'survey methodology' for more information.

EXCHANGE-TRADED FUNDS AND FRAGMENTATION

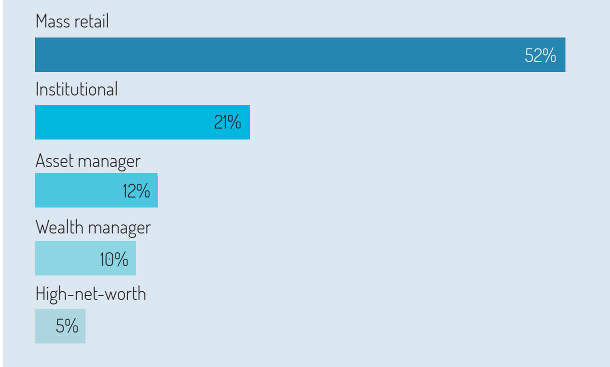
THE RISE OF ETFs HAS SHAKEN UP THE FUNDS INDUSTRY. A SURVEY BY *FUNDS EUROPE* AND CLEARSTREAM EXAMINED THIS POPULAR FUND TYPE.

IT IS WIDELY ACCEPTED that the first exchange-traded fund (ETF) was the State Street Global Advisors S&P 500 Depository Receipt, which began trading on January 1, 1993.

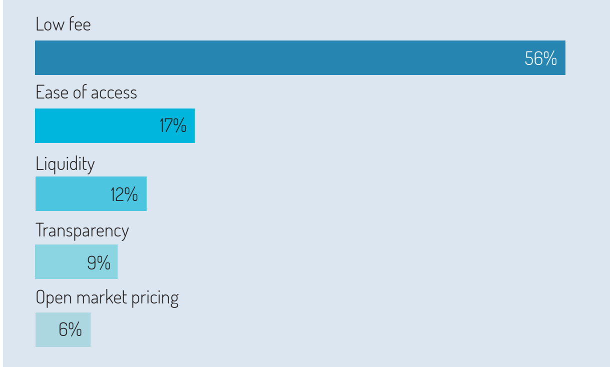
Index funds had existed since at least the early 1970s, but ETFs were novel because they could be bought and sold on an exchange, just like a stock. Unlike traditional index funds, which are typically valued no more than once a day, the value of an ETF can rise or fall during the day, allowing investors to see, almost in real time, what their fund is worth. Additional advantages are that ETFs tend to offer high liquidity and low fees.

Less than a quarter of a century after that first launch, ETFs have blossomed into a global industry worth about $4 trillion, according to ETFGI, a consultancy. Although the US dominates the world ETF market, assets in Europe are growing fast and may

1. WHICH TYPE OF INVESTOR HAS MOST TO GAIN BY USING ETFs?



2. WHAT IS THE MOST IMPORTANT FACTOR THAT ATTRACTS ETF INVESTORS?



soon account for a fifth of the world total. However, the apparent ease and simplicity of these instruments masks infrastructure and technical challenges.

Because European ETFs are listed across a number of stock exchanges, the European ETF market has been described by some as being too fragmented. What is the best solution to offer cross-border functionality for these funds?

"COST WILL BE THE NUMBER-ONE FACTOR FOR INVESTORS FOR A LONG TIME. AS A PROVIDER, WE'VE MADE 20 FEE CUTS THIS YEAR."

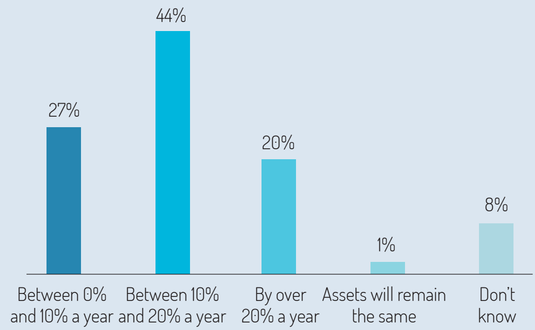
This report is the second in a series produced by *Funds Europe* in association with Clearstream. The aim of the series is to shed light on the future of the funds industry.

Easy access for many

One of the main selling points of ETFs is their accessibility. From a multi-billion-euro pension fund to a working mother with a small inheritance, anyone with the money can buy ETF units.

But which type of investor has most to gain from using them? We asked our respondents to name one investor type out of a list including mass retail investors, high-net-worth individuals, institutions, asset managers and wealth managers.

3. HOW QUICKLY WILL THE ETF MARKET GROW IN THE NEXT FIVE YEARS?



ADAM LAIRD

HEAD OF ETF STRATEGY, NORTHERN EUROPE, LYXOR

"Cost will be the number-one factor for investors for a long time. I know that from experience: as a provider, we've made 20 fee cuts this year so far.

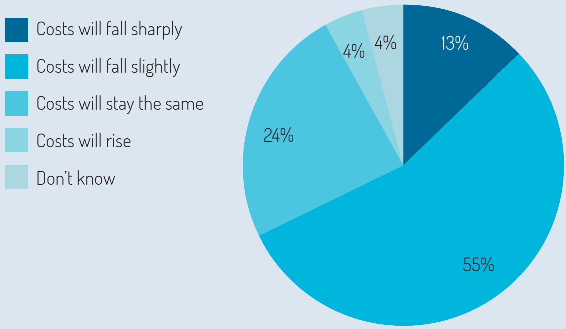
Investors feed back to us constantly that this is a major selection factor. There are some places where investors are happy to pay a premium in more niche strategies. But if you're investing in, say, broad European equities, a lot of people want it for under 0.1% TER [total expense ratio].

In terms of who uses ETFs, in our experience, the biggest users are asset managers and the biggest growth market is wealth managers and private banks. In other words, the biggest area for ETF use tends not to be individuals but active investment selectors who are simply using ETFs as the tool to execute their portfolio."

$686 BILLION

European ETF assets in June 2017, according to ETFGI

4. WHAT WILL HAPPEN TO COSTS RELATED TO INVESTING IN ETFs (TOTAL OPERATIONAL COSTS & FEES)?



The results were fairly clear: 52% of respondents said mass retail investors had most to gain (see figure 1). There seems to be a common view that ETFs are a democratic product: a fund for the people.

Clearly there are many reasons to invest in an ETF. Some use them for day trading, others to gain exposure to a broad asset class, such as US equities, in a quick and efficient manner. We asked our respondents: if they could pick only one factor that attracts ETF investors, what would it be? Among the options were: ease of access, liquidity, transparency and open-market pricing. The most popular result by a large margin, attracting 56% of responses, was 'low fee' (see figure 2). ETFs, to put it bluntly, have a reputation for being low on costs . And who doesn't love a bargain?

European ETF assets have grown rapidly in the past decade, increasing from $138 billion in 2007 to $686 billion as of June 2017, according to ETFGI. Given this rapid growth, it is natural to expect further inflows into these products. But how fast will this growth be? According to 44% of our

ANDREW WALSH

HEAD OF PASSIVE & ETF SPECIALIST SALES, UK AND IRELAND, UBS ASSET MANAGEMENT

"The ETF industry is already very efficient, similar to the car industry, for example. You're not going to get car prices dropping 20%.

People think if you charge 20 basis points you're making 20 basis points, but that's not the case. The index fees could be 4-5 basis points and then you have custodian fees and other fees. At ten basis points, you're already massively lean.

While, on the whole, I would expect fees to come down fractionally, there may be scope for a slight increase in pricing, on average. The thinking here is that not many people are launching funds tracking well-known indices any more. Instead, newly launched ETFs tend to track niche indices, with higher fees."

respondents, the ETF market will grow at between 10% and 20% a year in the next five years (see figure 3). This is a healthy rate. Growth of 10% a year would mean the European market would be worth $1.1 trillion by 2022. Growth of 20% a year would lead to $1.7 trillion of assets by that date. (A fifth of our respondents predicted that growth would actually exceed 20% a year.)

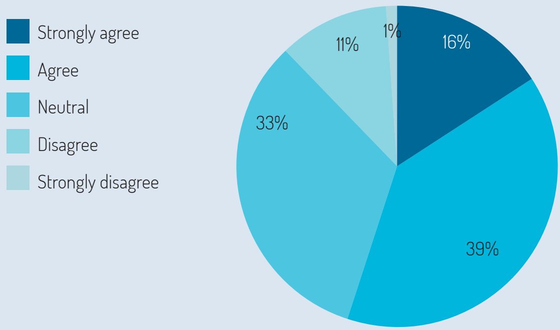
It is telling that only 1% of respondents judged that the assets in the ETF market would stay the same. As far as our respondents are concerned,

"PEOPLE THINK IF YOU CHARGE 20 BASIS POINTS YOU'RE MAKING 20 BASIS POINTS, BUT THAT'S NOT THE CASE."

ETF assets are only going one way: up.

But, just as assets are going up, costs are coming down. Only 4% of respondents expected the costs related to investing in ETFs (total operational costs and fees) to rise (see figure 4). In contrast, 68% thought costs would fall, of which 13% thought they would fall sharply.

5. 'THE EUROPEAN ETF MARKET, BY BEING SPREAD ACROSS MANY EXCHANGES, IS TOO FRAGMENTED.' DO YOU AGREE WITH THIS STATEMENT?



MANOOJ MISTRY

HEAD OF PASSIVE ASSET MANAGEMENT, EUROPE, MIDDLE EAST AND AFRICA, DEUTSCHE ASSET MANAGEMENT

"Although we have fund passporting in Europe, the different markets have different tax and distribution requirements. This is why there are something like three times as many mutual funds in Europe as the US and yet the US has three times as many assets.

There has been consolidation in market infrastructures: for example, the Euronext exchange. However, when stock exchanges in Paris, Amsterdam, Lisbon and so on trade under Euronext, they still have their individual settlements systems behind the trade. There has not been consolidation on the back end.

I would agree there is a lot of fragmentation in Europe, but whether it is an issue is another question."

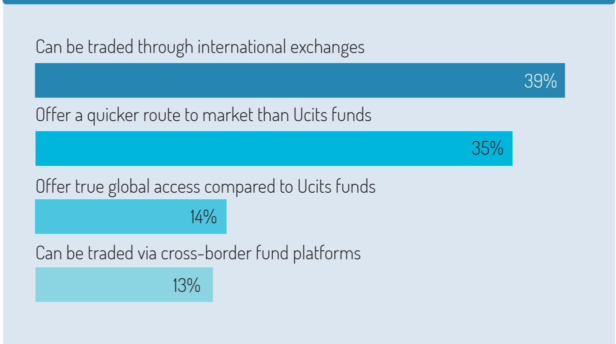
This is good news for investors, who can expect to give away less of their invested capital to fund managers, custodians and administrators. But this finding is, perhaps, a concern for the providers of ETFs, which have already slashed their costs in competition with one another for assets. At some point, the question will have to be asked, how low can costs go? Clearly, our respondents think there is room for more cost-cutting.

> **"I WOULD AGREE THERE IS A LOT OF FRAGMENTATION IN EUROPE, BUT WHETHER IT IS AN ISSUE IS ANOTHER QUESTION."**

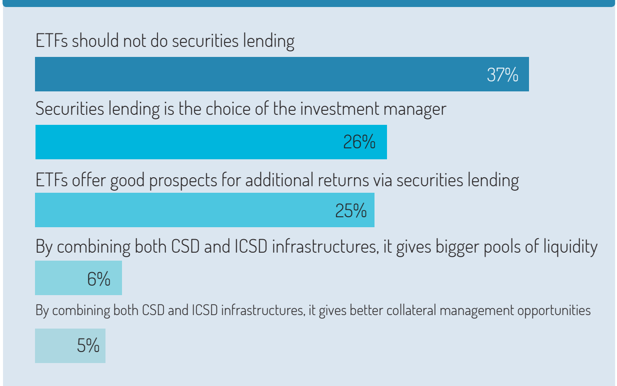
A need for harmonisation

One explanation for the strong growth of ETF assets in the US is that the American market is large and unified. Although Europe has achieved a high level of regulatory harmony, there are a large number of different exchanges operating on the continent. We asked our respondents if they thought the European ETF market, by being spread across many exchanges, was too fragmented. A majority (55%) agreed, of which 16% strongly agreed (see figure 5). Clearly, many respondents would like to see greater unification of Europe's ETF market.

6. HOW DO ETFs COMPARE WITH OTHER FUND TYPES IN TERMS OF ACCESS TO MARKET?



7. HOW DO YOU BELIEVE ETFs SHOULD OPERATE WITH SECURITIES LENDING AND COLLATERAL MANAGEMENT?



ETFs do have some accessibility benefits, however. We asked how ETFs compared with other fund types in terms of access to market. The most popular answer, attracting 39% of the responses, was that they 'can be traded through international exchanges' (see figure 6). Clearly, our respondents recognise that funds can both be exchange-traded and international. A close second was 'offer a quicker route to market than Ucits funds', attracting 35% of the responses. This finding suggests ETFs may sometimes be more appealing than conventional fund vehicles for asset

ANDREW WALSH

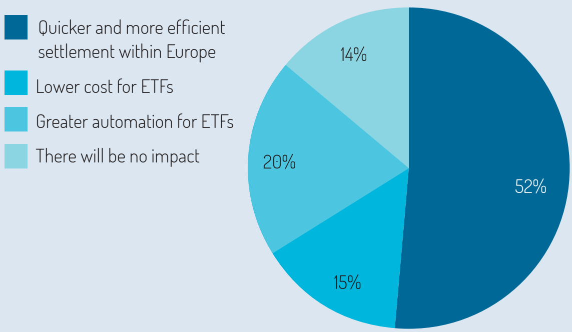
HEAD OF PASSIVE & ETF SPECIALIST SALES, UK AND IRELAND, UBS ASSET MANAGEMENT

"Five years ago, a fund could potentially gain 30 basis points of extra performance with securities lending. Nowadays, you might make three basis points. This has changed massively.

People tend to focus on ETFs as the bad guys even though the active management industry also does securities lending. The result is that ETFs have the spotlight on us and we as an industry have been at the forefront of improving transparency.

My view is that if you can enhance the performance of the fund, why wouldn't you do it? We only allow 50% of a fund's assets to be lent out at any time, though in practice, it's rarely more than 10%. A fund must be a certain size before you can do securities lending and we don't do it in fixed income or in our socially responsible investment (SRI) funds."

8. WHAT IS THE MAIN WAY THAT T2S, A SINGLE, PAN-EUROPEAN PLATFORM FOR SECURITIES SETTLEMENT, WILL AFFECT THE ETF MARKET?



managers hoping to launch products rapidly.

However, there are some controversies regarding what ETFs should be permitted to do. We asked how ETFs should operate with regard to securities lending and collateral management. The most popular answer, attracting 37% of the responses, was 'ETFs should not do securities lending' (see figure 7). It seems many respondents believe the structure of ETFs means they are inappropriate

"PEOPLE TEND TO FOCUS ON ETFs AS THE BAD GUYS."

for this kind of activity, despite the potential to increase returns for investors. This result was not unanimous, though. A quarter of respondents said ETFs offer good prospects for additional returns via securities lending, while 26% said the decision should lie with the investment manager.

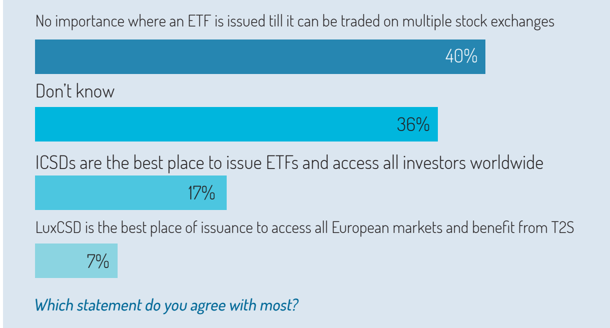
To return to the question of fragmentation, it should be noted that European authorities have embarked on various initiatives to make Europe's capital markets more interconnected. One such initiative is TARGET2-Securities, a single, pan-European platform for securities settlement. We asked our respondents what effect this scheme would have on ETFs and the most popular answer, with 52% of the responses, was 'quicker and more efficient settlement in Europe' (see figure 8). There is room for optimism among those

$1.7

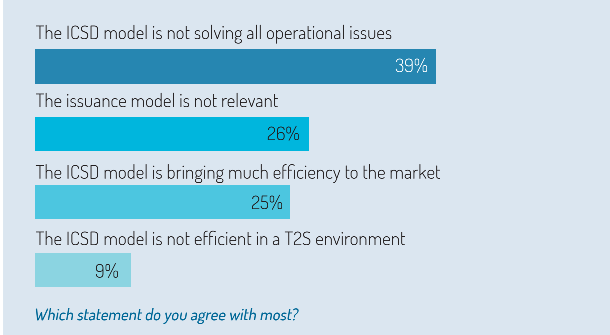
TRILLION

European ETF assets in 2022, assuming assets grow 20% a year

9. THROUGH CLEARSTREAM'S ISSUANCE OFFERING OF EUROPEAN DOMICILED ETFs, LUXEMBOURG CAN OFFER CROSS-BORDER FUNCTIONALITY FOR ETFs



10. THE NEW ICSD MODEL HAS BEEN RECENTLY CHOSEN BY SOME MAJOR ETF ISSUERS



who think ETF settlement could be improved.

TARGET2-Securities (T2S) by itself may not, however, be enough to solve all the challenges related to market fragmentation. Clearstream has solved some of these problems with their issuance offering, in which the Luxembourg-based market infrastructure provider offers cross-border functionality for ETFs via T2S and via its international central securities depositary (ICSD). The results of our survey suggest more needs to be done to explain the benefits of such schemes, however, with 40% of respondents stating there is 'no importance where an ETF is issued till it can be traded on multiple stock exchanges' (see figure 9). A similar proportion, 36%, said they didn't know how to answer this question. It would appear there is space for more education about the challenges connected to cross-border functionality of ETFs.

A similar result was obtained when we asked our respondents to consider the ICSD model, which has recently been chosen by some major ETF providers. The most popular result, with 39% of responses was, 'the ICSD is not solving all operational issues' (see figure 10). It would appear there is still more work to be done in this area.

Looking ahead

We have established that ETFs are growing in favour. But how popular will they get? Could they, perhaps, take over from traditional mutual funds as the most popular investment product in Europe? There was a lack of consensus on this question, with 31% of respondents withholding judgement (see figure 11). But more agreed (47%, including those who strongly agreed) than disagreed, suggesting there is a widespread view that ETFs could seize the position as the top investment product.

As they develop, what must ETFs do to improve? We wanted to know if ETFs should develop more as a tool for wealth managers or professional investors, or whether they should focus on offering access to sophisticated investments such as volatility. Our respondents gave a strong vote for the status quo, with 47% stating that ETFs should stay the same (see figure 12). In this changing world, perhaps it is only natural to desire some consistency.

That said, ETF providers cannot be accused of complacency. Many new asset classes are being launched within the ETF format. One area of development is fixed income ETFs. How do our respondents view these kinds of products? The findings indicate some scepticism here, with a fifth of respondents stating that fixed income 'is not a natural ETF

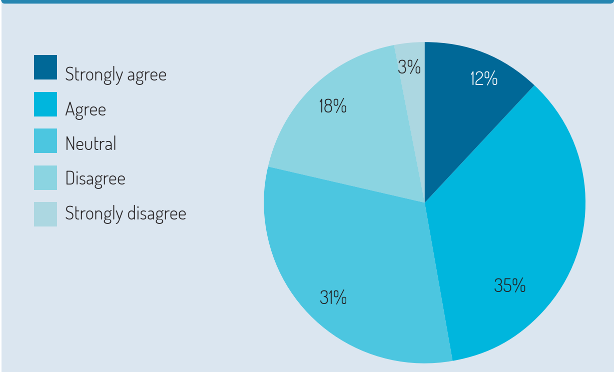
"THE BIGGEST POTENTIAL CHANGE IS MIFID II, WHEN ALL TRADING WILL BE ON EXCHANGE."

JAN VAN ECK
CHIEF EXECUTIVE, VANECK

"To me, the biggest potential change is MiFID II, when all trading will be on exchange. Yes, Europe is fragmented by country but the biggest fragmentation is between on-exchange ETF trading done by individuals and off-exchange trading done by institutions. If you're an individual German investor using an online broker, you're going to get on-exchange execution, which is less attractive than the kind of execution institutions are getting.

This change is positive. The fact that all ETF trading is visible in the US is a huge plus. At VanEck, we have far more assets from European investors in our US ETFs than we have in our Ucits ETFs and the reason, I think, is they are attracted by the liquidity they see in the US. If Europe can compete with that, that's tremendous for Europe."

11. 'ETFs WILL TAKE OVER FROM MUTUAL FUNDS AS THE MOST POPULAR INVESTMENT PRODUCT IN EUROPE'



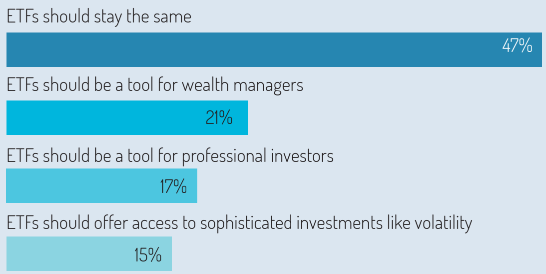
FANNIE WURTZ
MANAGING DIRECTOR, AMUNDI ETF, INDEXING & SMART BETA

"The retail market is a strong growth driver for the ETF industry, along with more traditional professional investors. The access to ETFs in Europe for retail investors will evolve thanks to the development of packaged solutions with ETFs as underlyings. Distribution networks are indeed seeking new offerings, and ETFs are a perfect tool.

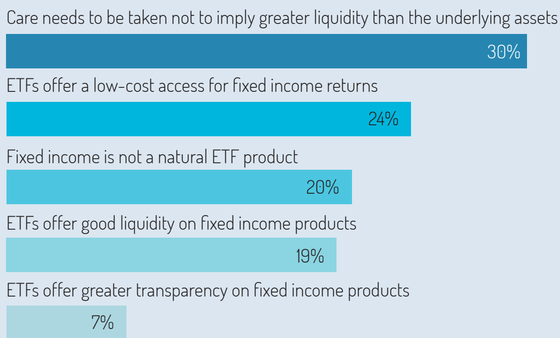
Cost is obviously a key selection criteria. In an environment characterised by high volatility and low yields, offering investment solutions at competitive pricing is crucial.

A new phase of development in the ETF world is fixed income. Investors are seeking granularity in asset allocation. ETFs, as they enable investors to access a market or segment in a single transaction, are an ideal candidate for such usages, though the provider must take care to monitor liquidity."

12. HOW DO YOU BELIEVE ETFs SHOULD DEVELOP?



13. WHICH STATEMENT ABOUT FIXED INCOME ETFs DO YOU AGREE WITH?



product' (see figure 13). The most popular response, with a 30% score, displayed a similar ambivalence in its statement that 'care needs to be taken not to imply greater liquidity than the underlying assets'. However, 24% of responses said that ETFs can offer low-cost access to fixed income returns.

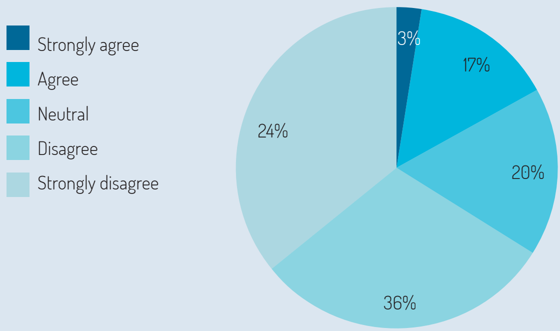
An even more controversial question is how illiquid assets, such as real estate, should be handled within the ETF structure. Our respondents gave a fairly clear response here. The majority (60%) said ETFs are not appropriate for investing in illiquid assets – with 24% expressing their opinion strongly (see figure 14). Only a fifth of respondents said ETFs were appropriate for illiquid asset investment. This result seems to suggest a limit to ETF growth. Some of the most attractive areas for development in asset management today are in alternatives, yet many alternative assets are illiquid. Apparently, this puts them outside the proper scope of ETFs.

"A FRENCH INVESTOR CAN BUY INTO A GERMAN-LISTED ETF AND SELL IT ON THE UK STOCK EXCHANGE SEAMLESSLY."

This finding indicates one of the central features of ETFs. Although they have many benefits and are tipped for strong growth in the years ahead, there are still doubts about their applicability to a wide range of asset classes.

Funds Europe plans further surveys to examine these and other issues facing the funds industry, in the hope of discovering what the future holds for the world of funds.

14. ARE ETFs APPROPRIATE FOR INVESTING IN ILLIQUID ASSETS SUCH AS REAL ESTATE?



PHILIPPE SEYLL

CO-CHIEF EXECUTIVE OFFICER, CLEARSTREAM BANKING

"ETFs are likely to be troubled by market fragmentation problems, which is why Clearstream has expanded its cross-border fund processing platform into multi-listed ETFs. The platform allows, for example, a French investor to buy into a German-listed ETF and sell it on the UK stock exchange seamlessly. Although fund units are custodised in the countries where they are listed and sold, Clearstream creates a mirror of transactions in its international central securities depository (ICSD) in Luxembourg. The service allows for transactions in ETFs listed in multiple exchanges, without complexity for the client.

As an ICSD, Clearstream also offers issuance models for ETFs which have been adopted by some major issuers, improving liquidity, reducing cost and speeding up realignments within Europe. ETFs benefit from Clearstream's direct access to the Eurosystem's settlement platform Target2-Securities and to the international distribution network."

SURVEY METHODOLOGY

A total of 124 professionals drawn from Funds Europe's readership, who work in various positions across the funds industry, participated in the survey that was conducted online between May 18 and July 7, 2017. For some questions, the number of responses was less than the total because of drop-outs. The occupations of the respondents were as follows:

Asset manager: 48%
Custodian or transfer agent: 9%
Wealth manager: 8%
Fund distributor: 5%
Institutional investor: 4%
Other: 26%

Expert panel

We consulted a panel of experts on the ETF industry to put the survey findings in context and add their opinions. On the panel were:

Jan van Eck, chief executive, VanEck
Adam Laird, head of ETF strategy, northern Europe, Lyxor
Manooj Mistry, head of passive asset management, Europe, Middle East and Africa, Deutsche Asset Management
Philippe Seyll, co-chief executive officer, Clearstream Banking
Andrew Walsh, head of passive & ETF specialist sales, UK and Ireland, UBS Asset Management
Fannie Wurtz, managing director, Amundi ETF, Indexing and Smart Beta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