



Extending the ETF frontiers

Institutions are finding new ways to use ETFs

Growing institutional adoption of exchange-traded funds (ETFs) has been an undeniable trend over the past few years. In this article, [Hong Kong Exchanges and Clearing \(HKEX\)](#) explains why institutions are increasingly using ETFs to gain targeted exposure, generate alpha, manage liquidity and reduce tax

A world of opportunities in one trade

Behind the rise of exchange-traded funds (ETFs) is the wide variety of features they boast in a single package – and, perhaps most importantly, the ability to diversify using a highly liquid instrument at a lower cost.

Investing in ETFs is often cheaper than investing in mutual funds, thanks to lower management fees and a simpler structure. In addition, ETFs tracking major market indexes often contain more securities than actively managed mutual funds, allowing a higher degree of diversification while providing the added benefit of convenient trading.

A bridge to less accessible markets

In a recent survey carried out by Greenwich Associates,¹ 54% of respondents listed international diversification as the primary reason for using ETFs, not least because ETFs make it easier to invest in markets with trading restrictions. ETFs can thus be the go-to product for managers seeking exposure to certain markets – such as emerging markets – where market proxies are not readily available.

The ability to sidestep trade barriers is a compelling feature of ETFs – especially in Asia, where free-market access is still at a developing stage. One Singapore institutional fund featured in the survey said that investing directly in securities in India would require engaging a tax agent. However, this could be avoided using an ETF. Similarly, in Hong Kong, A-share ETFs are one of the few preferred channels for international investors to gain exposure to China – a market where capital flows are still restricted.

A new way to generate alpha

Once regarded as a passive vehicle, ETFs are increasingly traded for alpha generation. They can be used to target specific sectors or factors – such as technology, or for momentum investing targeting stocks with further upside potentials – in a single cost-effective trade.

“Investors used to concentrate their attentions on country-specific ETFs,” says Andy Wong, chief investment strategist at Harris Fraser. “Now, more and more investors are tapping the potential of factor ETFs to gain targeted exposure. They are increasingly adopting ‘momentum’ strategies, such as sector rotation, to generate alpha.”

The drive to achieve above-market returns has fuelled the growth of smart beta strategies – a hybrid of active and passive investing that tracks factor-based indexes. Global assets under management invested in smart beta ETFs has grown to \$687 billion at the end of September 2018, a 6.7% increase from a year ago.



Andy Wong, Harris Fraser

Investors will have more ways to generate alpha using ETFs as actively managed ETFs gain momentum. For example, in Hong Kong, applications for the listing of active ETFs will be accepted from January 2, 2019 onwards.

An effective tool for liquidity management

ETFs have also grown in importance for key strategic portfolio functions, such as liquidity management. The Greenwich Associates report found that, over the past 12 months, the share of study participants using ETFs in liquidity

management almost doubled to 40%, and the proportion of respondents using ETFs in risk management increased to 20% in 2017 from 13% in 2016.

Liquidity management through ETFs can be achieved using so-called ‘liquidity sleeves’ to absorb effects of cash flows on the portfolio. For example, to meet fund redemption demands, asset managers can park extra cash in ETFs in advance, creating the liquidity sleeve to capture interim beta and avoid the outright sale of portfolio holdings in times of net fund outflows.

Additionally, the use of ETFs during market distress is a big draw. Bouts of liquidity shortages in the equity or bond markets often create an environment of low volumes and wide spreads, but because ETF shares can be created and redeemed to satisfy market demand, asset managers can execute their trades in a more efficient and cost-effective way through ETFs.

Hong Kong-listed ETFs – A matter of tax efficiency

Institutional investors in Asia are also drawn to ETFs because of tax benefits. According to a tax study by EY,² a Hong Kong investor would retain up to 30% after tax returns for dividends by investing in Hong Kong-domiciled funds rather than US mutual funds. For a Taiwan-based investor, the figure is over 20%, while for a mainland Chinese or a Singaporean investor, this is around 10%.

The diverse range of ways ETFs can be deployed and their ease of trading are turning them into a cornerstone strategy for institutions in Asia. As such, their use is only expected to grow.

¹ Greenwich Associates, ETFs: Versatile vehicles for Asian institutions, Q2 2018, <https://bit.ly/2UPAWNT>
² EY and HKEX, ETF taxation report for Hong Kong investors 2018, <https://bit.ly/2UPGB6v>