ETFs in 2019: Flows in the Fast Lane, Technology Driving Growth

By Ryan Sullivan

Exchange-traded funds (ETFs) had a banner year in 2018. Global inflows to the vehicles surpassed $516 billion, pushing the global ETF market to more than $5.1 trillion.[1] ETF issuance was also robust: more than 650 new ETFs entered the market globally,[2] many of which built upon recent innovations such as smart beta, ESG, thematic, and factor-based methodologies. Some analysts believe ETF growth may just be getting started and predict the market will swell to $7.6 trillion by 2020, equivalent to a two-year CAGR of about 18%.[3] As we look at the year ahead, there's a lot in store for ETFs – new regulations, technology, and products are driving the market to new, uncharted territory. Here are five themes we believe will shape the ETF market in 2019:

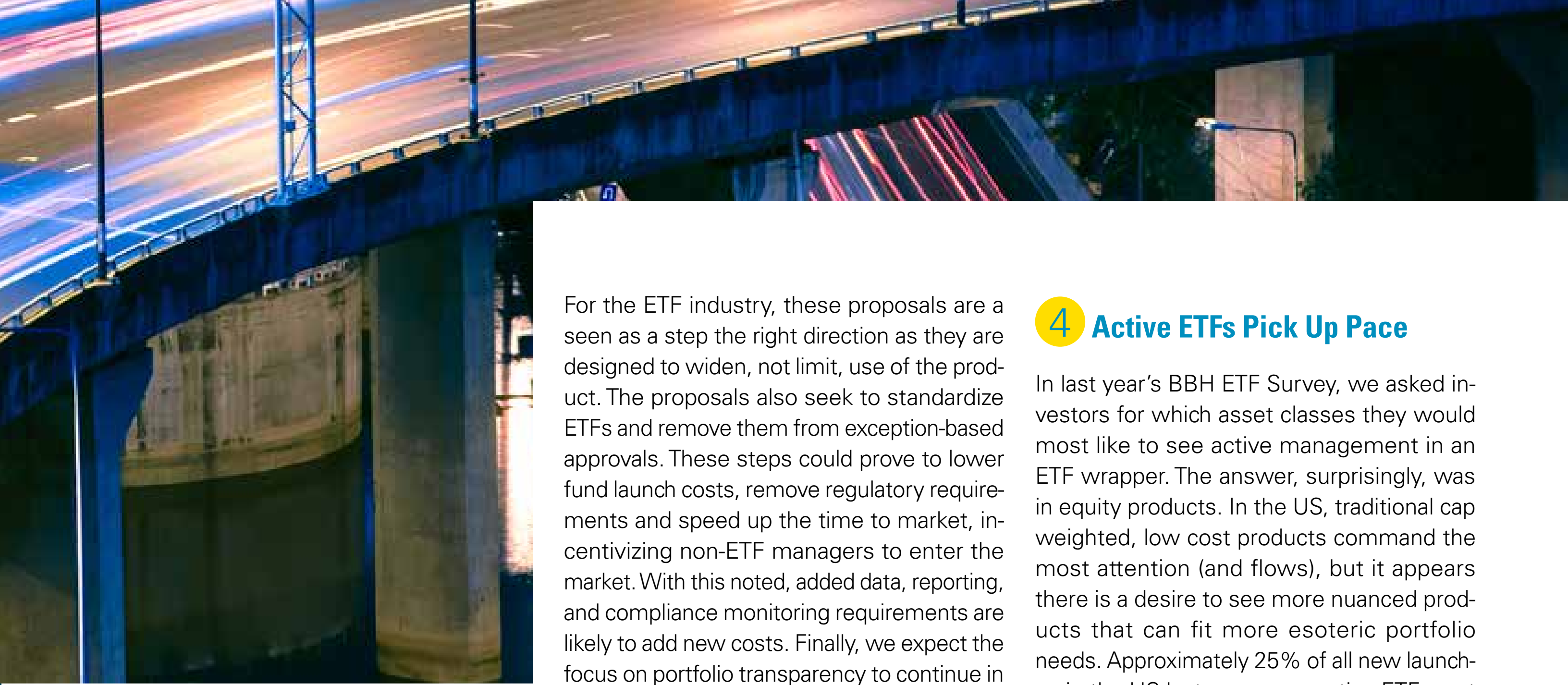
1 Want Flows? Bring Your Own Assets

What defines success for a newly launched ETF? Scale, as measured by assets under management (AUM), is perhaps one of the most critical survival metrics. In the past 18 months, BBH has witnessed a common theme among the most successful ETF launches as large asset managers have entered the ETF market: early asset growth often comes from within.

Self-seeding, bringing your own assets, self-funding – whichever the preferred term — is the practice of an asset manager (or insurer, broker-dealer, or other institutional-caliber brand) entering the ETF arena and using its own customers and captive distribution channels. Some may work with existing institutional investors, large RIAs, or third party model portfolio allocators to provide early assets to a new ETF just after launch. Others work with "captive" channels and gain early investment through converting assets from internal separately managed accounts (SMA), adding the new ETFs to a proprietary fund-of-fund range or other products and accounts via an affiliated broker-dealer or insurance arm. In some cases, self-seeded ETFs can come out of the gate with $25-50 million in assets within the first couple of weeks. This leg up is a potential spring-board to coveted shelf space on other distribution channels (think retail trading platforms) and goes a long way to legitimizing a new product. In 2019, we expect this trend to continue, as large global asset managers with affiliated distribution channels enter the ETF market. Conversely, new ETF issuers face a pronounced competitive disadvantage if they go to market without a captive distribution channel to kickstart their new ETF. One seed strategy, however, is fading in the rear-view mirror: seeding an ETF from a market maker and launching a fund with little capital has diminished in recent years.

2 Regulations Become Reality

2018 was a pivotal year for ETF regulation. In June, the US Securities and Exchange Commission (SEC) released a set of proposals to create a specific regulatory framework for ETFs. The rules would allow asset managers to bring certain types of ETFs to market without first obtaining what's known as "exemptive relief." It would also rescind



all exemptive relief that has been granted to certain existing ETFs, requiring them to comply with the new rules as well. In a move long sought by many in the ETF market, the SEC included provisions that would permit qualified ETFs to accept custom baskets from Authorized Participants (APs).

In September, the Central Bank of Ireland (CBI) proposed new rules for ETFs under a "feedback statement" which was well-received by the industry. The CBI indicated a change in their policy on the co-mingling of listed (ETFs) and unlisted (mutual funds) share classes in a single fund structure. It said it would also permit different dealing cut-offs for hedged and unhedged share-classes within the same sub-fund. Following the release of guidance, sponsors can expect that the CBI will accept new product submissions under these new policies. The feedback statement touched on many other topics, including public disclosure of APs and remuneration, direct redemptions, risk due to multiple counterparties, and ETF liquidity. The CBI will continue to review many of these themes and will also engage in discussions with the European and international regulatory forums.

In December, Hong Kong's Securities and Futures Commission (SFC), provided clarity on a few important topics pertaining to mutual funds and ETFs. Their changes to the Code on Unit Trusts and Mutual Funds (UT Code) aim to update the rules to bolster market development, increase investor protection in Hong Kong, and align with international standards. Key changes include allowing for active ETFs and the comingling of listed and unlisted share classes.

For the ETF industry, these proposals are a seen as a step the right direction as they are designed to widen, not limit, use of the product. The proposals also seek to standardize ETFs and remove them from exception-based approvals. These steps could prove to lower fund launch costs, remove regulatory requirements and speed up the time to market, incentivizing non-ETF managers to enter the market. With this noted, added data, reporting, and compliance monitoring requirements are likely to add new costs. Finally, we expect the focus on portfolio transparency to continue in 2019, particularly in Europe with groups such as IOSCO reviewing ETFs under a number of headings including market arbitrage and investor and conduct related issues.

3 Technology Turns Up the Volume

The importance of technology can't be understated. This is as true in product development as it is in the back office. In the ETF space, the primary market's move toward open architecture is transforming order taking. APs must currently place orders either with the ETF's custodian or distributor. Ideally, APs would send the transfer agent (TA) a standard trade file. But until we see more regulation in that area, APs will rely on technology to help drive their volume.

Whether through large clients, or new entrants to the space, APs have said they expect to see double or even triple-digit growth in the volume of trades they have. Therefore, they need to spend less time per order to speed up their process and their order takers can help ease that burden.

Some of the larger firms in the AP space are making a case to regulators that technological development in the ETF space needs more uniformity. The current environment is supported by varying capabilities, processes, and players, but APs and sponsors are looking for consistency. In 2019, we expect to see many other parts of the ETF ecosystem leverage technology to accommodate an industry that is evolving rapidly.

4 Active ETFs Pick Up Pace

In last year's BBH ETF Survey, we asked investors for which asset classes they would most like to see active management in an ETF wrapper. The answer, surprisingly, was in equity products. In the US, traditional cap weighted, low cost products command the most attention (and flows), but it appears there is a desire to see more nuanced products that can fit more esoteric portfolio needs. Approximately 25% of all new launches in the US last year were active ETFs, yet there are still only 272 active ETFs listed in the US. Globally, there are 592 active ETFs (as of December 31, 2018) with total assets of $106 billion.[4] On the fixed income side, active management will continue to play an integral role, and we're keeping an eye on whether more issuers explore fixed income ETF launches in 2019.

5 Robo Rising

In the US, digital advice platforms have emerged in recent years as important tools for a wide range of retail and institutional investors. Composed primarily of low-cost funds, robo-advisors, are starting to gain momentum in Europe and Hong Kong, too. As more investors become familiar with these platforms, many are looking to them to fill investing needs beyond purely passive index strategies.

Cue robo 2.0: The next wave of robo platforms may include hybrid-portfolios, made up of a combination of indexed ETFs, actively-managed ETFs, smart-beta ETFs, and/or mutual funds. While robo-advisors have benefitted from the extended bull market, this new iteration comes amid increased volatility and market uncertainty. Some suspect the inclusion of actively managed products in robo funds – either through an ETF wrapper or mutual fund – is a better bet than a passive ETF robo portolio in combating prolonged periods of volatility.

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[1] *ETFGI*
[2] *ETFGI*
[3] *EY: Reshaping Around the Investor, Global ETF survey 2017*
[4] *ETFGI*

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