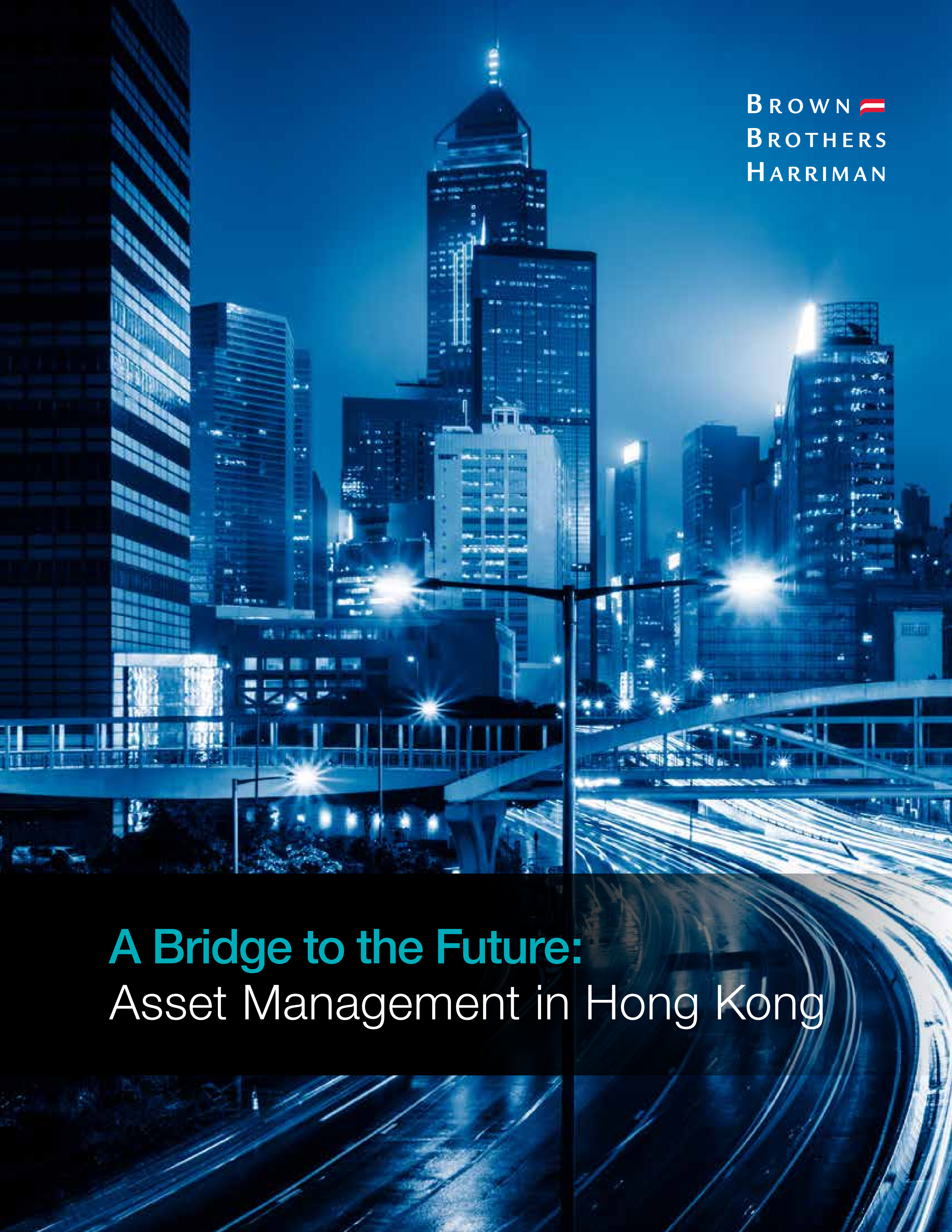


BROWN BROTHERS HARRIMAN

A Bridge to the Future: Asset Management in Hong Kong

BBH INSIGHTS

Right now, Asia is a red-hot center for asset growth. The asset management market in Asia brought in nearly 45% of global flows between 2012 and 2017* and shows no signs of slowing. Assets under management (AUM) in China are expected to grow over 17% by 2022. With increasing access channels available to foreign firms, China presents a rare opportunity for asset managers to gain entry to a large domestic market.

China's liberalization will undoubtedly bring opportunity, but fortune will favor those with commitment and a long term vision of building a brand, developing relationships, and navigating the regulatory landscape. In this paper, we explore some recent developments and hot topics to assist you in navigating your strategy in the Greater China region.

** McKinsey, October 2018*

Hong Kong Funds: New Structures and New Friends

By: Gabriel Cheung and Scott McLaren

"Now with over 800 Hong Kong-domiciled funds, the work of the SFC has had the desired effect in attracting more managers to Hong Kong and making it increasingly attractive for raising assets across borders."

Hong Kong has taken notable steps this year to realize its ambition as a asset management hub for the Greater China region: introducing a new globally accepted corporate fund structure in July and signing its fourth mutual fund recognition agreement in October.

As of July 30, asset managers in Hong Kong can now establish investment funds in corporate form as an Open-ended Fund Company (OFC), in addition to the already available unit trust regime. The OFC is a corporate vehicle, which is more generally accepted and recognized for collective investment across the globe, and is crucial for cross border fund passporting, such as Mutual Recognition of Funds (MRF). The industry expects the OFC to be more marketable internationally and therefore deliver growth opportunities to the domicile.

Mutual Recognition of Funds

The MRF scheme between Hong Kong and other countries represents a large future growth opportunity for asset managers. With the addition of the UK-Hong Kong MRF in October, the industry expects that Hong Kong domiciled funds (and especially OFC when added to the MRF arrangement) will extend Hong Kong's reach and relevance, particularly in light of Brexit.

The UK and Hong Kong have a long and storied relationship that includes equivalent legal systems, political relationships, and a similarly modeled and regulated asset management industry. More than 300 UK-based companies have regional headquarters or offices in Hong Kong. Together with the OFC, the industry expects that Hong Kong funds will tend to passport better on a cross-border basis. The corporate structure serves to further grease the wheels of a streamlined authorization process for recognition in the UK – a market familiar with such vehicles through the use of UCITS and OEICs.

Now the fourth such arrangement of its kind for Hong Kong, the Securities and Futures Commission (SFC) previously implement similar MRF arrangements with China, Switzerland, and France. Many believe the UK arrangement has a better chance for success because the UK and Hong Kong are already so interconnected. (So far, demand has been minimal for the France and Switzerland MRF.) This arrangement is also indicative of the UK's desire to foster financial services partnerships beyond the EU as Brexit negotiations continue to play out. The loss of certain EU fund passports, such as UCITS, is inevitable post-Brexit, but no impediment exists preventing the UK – as a non-EU third country – from striking a similar deal with Ireland and Luxembourg.

Further Updates to the Mutual Fund Code

Early next year, the SFC is expected to issue its conclusion on proposed amendments to the Code on Unit Trusts and Mutual Funds. The proposed amendments include:

- Strengthening requirements of key operators of funds, including management companies, trustees, custodians, and their delegates
- Streamlining existing fund types and introducing new fund types, such as active ETFs
- Enhancing safeguards for funds' investment activities as well as the oversight and monitoring performed by the trustees/custodians

The above proposals place Hong Kong in a position to better align with international best practices, thereby offering further comfort to overseas investors that they would be protected appropriately through strong governance.

For global asset managers in the process of building out a Greater China and/or European strategy, a Hong Kong domiciled fund range now offers access to Hong Kong, Mainland China, France, Switzerland, the UK and additional jurisdictions in the future. Now with over 800 Hong Kong-domiciled funds, the work of the SFC has had the desired effect in attracting more managers to Hong Kong and making it increasingly attractive for raising assets across borders.

How Currency-Hedged Share Classes Tear Down Distribution Barriers

By: Albert Chan and Jay Moore

Share classes are a tool that not only deliver a common investment strategy to a range of investors, but also help asset managers expand globally. While some share classes are straight forward, foreign currency share classes expose investors to FX risk. Here's what Hong Kong asset managers need to know as they embark on the race for assets:

Hong Kong is in the middle of a transformation from a local mutual fund market to a cross border fund center for Greater China. The Hong Kong regulatory agenda is a driving force for this evolution as the Mutual Recognition of Funds (MRF) program continues to expand and following the recent introduction of the Open-Ended Fund Company (OFC). With this transformation, asset managers need to design products with features that enable cross border distribution. One of those key product features is the ability to offer share classes denominated in currencies that are attractive to investors in their home market.

Whether through Dublin and Luxembourg UCITS, or Cayman funds sold into Asia, investment managers looking to expand their global footprint have been using currency-hedged share classes as a key component of their cross-border distribution strategies for years. Today, currency-hedged share classes have become standard practice for globally-minded firms launching new products and a robust automated hedging program is key for fund performance and distribution.

As of July 2018, 12 of the 15[1] approved Hong Kong funds sold to Chinese investors via the MRF scheme have launched currency hedged share classes, that enable investors to access fund performance without introducing currency risk. Asset managers use share classes to deliver a common investment strategy to a broad range of investors. Class types include retail or institutional, income reinvesting or distributing, varying fee structures, and share classes denominated in foreign currencies. It's the final category that presents a unique risk that the other class types do not: Foreign Exchange (FX) risk. Investing in an unhedged class of a fund that is denominated in a currency other than the base currency of the investment strategy exposes the investor to cross-border translation risk, resulting in potentially significant return differences.

Take, for example, an investment manager in Hong Kong managing a fund with a base currency of USD, but offering share classes to investors who prefer to purchase units in currencies such as SGD, CNH, JPY or AUD. The historical investment performance of the fund has been realized and published in dollar terms, yet the investor's returns will reflect both the USD-based strategy performance and the translation to the relevant share class currency. Without hedging the currency risk, investors may fear USD weakening or, more likely, have no expectation of currency performance at all, and may prefer to avoid the unknown risk by choosing not to purchase the fund at all.

Alternatively, if the manager offers investors non-base currency share classes on a fully hedged basis, the investors can access the intended investment performance without the unwanted FX risk. Simply put, the hedged share class is designed to mitigate the FX risk by including FX forward contracts to "hedge," or offset, the FX translation risk of the class relative to the base. The net result is:

Hedged Return = Base Strategy Performance +/- Currency Translation Effect +/- FX Forward P&L

The effectiveness of the hedge will depend on how accurately and consistently the gains or losses from the FX Forwards will offset the Currency Translation Effect. If that US manager performed the function properly, the hedged return should yield relative performance in line with the base strategy, subject to the effect of implementation, market, or accounting related factors, but that's not always the case. To meet today's demands for implementation, calibration, oversight, and transparency, the manager may wish to outsource these functions to improve efficiency and cost effectiveness.

[1] *"China MRF Approvals Surpass 2017 Total." Ignites Asia, 2017*

How a hedging program could impact fund performance

The consistency of relative performance is measured as "tracking error," which is defined as the uncertainty, or standard deviation, of return differences between the fund in base currency terms and the currency-hedged share class. The lower the tracking error, the more closely share class performance aligns with the underlying fund strategy.

Defining a hedging program to produce optimal performance can be complex and varies according to the characteristics of the investment strategy and share class currency. Several implementation and accounting-related factors influence share class performance, including rebalance frequency, hedge ratio filters, treatment of investor flows, and class specific accruals and fees. If the manager properly calibrates these factors, they can be managed for ideal performance; however, poorly defined programs can produce suboptimal returns and hurt investor confidence.

Beyond the operational parameters of a hedging program, the two primary drivers of the performance of a well-calibrated and operationally sound program are typically interest rate differential and execution slippage.

Interest rate differentials

Forward FX contracts must account for the difference in local risk-free interest rates between the two currencies traded – known as the interest rate differential. In an efficient market, investors cannot borrow in a low interest rate country (based on local risk-free rates), convert their cash to another currency where they can then invest at higher local risk-free rates, and hedge the FX risk to net a risk-free return. Therefore, forward FX rates must include "forward points" that account for this interest rate differential. This represents an economic certainty built into the performance of FX-hedged products. While interest rate differentials are a component of hedge performance, managers must take into account several considerations when selecting FX Forward tenor.

Execution slippage

With fluid regulatory demands, newly defined reporting requirements, and investor scrutiny around transparency, asset managers are focusing on the trade execution process related to share class hedging programs more than ever. Poor execution quality can be a drag on performance, and inconsistent execution timing can create tracking error.

The managers' ability to demonstrate an execution process that aligns with both the hedging objectives and their definition of best execution is essential. This may include limiting tracking error by aligning investor flows with the fund's valuation rates and avoiding unnecessary execution latency while minimizing cost through netting and competitive dealing with multiple banks.

A particular challenge in evaluating execution quality is the complexity of measuring costs in the FX forward markets. Forwards are highly customized, bilateral over-the-counter (OTC) trades with little in the way of standardized benchmark data. While Transaction Cost Analytics (TCA) for FX forwards is improving, demonstrating a well-designed execution process with sound oversight remains a top priority.

How to do it: DIY or hire a professional?

Due to the complexities of implementing, maintaining, and demonstrating an effective hedging program, asset managers should ask themselves:

1. Do we approach hedging as a core competency or treat it as an operational burden that introduces uncompensated risks?

2. Are we equipped to provide our internal and external clients with the level of transparency and detail required to validate the effectiveness of our hedging program in a world of increased scrutiny on cost and performance?

3. Do we have the scale to grow and the tools to evolve our process as the market changes?

After careful consideration, many managers agree that they are better served to direct their valuable resources to strategy performance, their true differentiator. Even for those managers who have successfully implemented an in-house hedging program, many are reevaluating their ability to adapt to regulatory changes or meet the demanding requirements to demonstrate oversight and control in a transparent manner.

Many Hong Kong managers seek out specialists to manage their hedging program to help them reduce their operational risk and relieve the burden of manual calculation and execution. Managers must ensure that their hedging providers not only meet operational requirements, but also provide robust oversight tools, detailed performance insights, and transparent execution reporting on an easily accessible platform. This will give managers all the tools they need to handle the ongoing discussions with investors, regulators, and fund boards around appropriate investor performance and cost.

A comprehensive understanding of the broad array of factors that influence performance of share class hedging programs can be the difference between a well-oiled machine and a disaster waiting to happen. The ability to measure and validate results is essential to improving the process, gaining the trust of end investors, and satisfying regulatory demands. These considerations can be the edge in setting investment products apart in a market where competition is fierce and standards are rising. A well-implemented program can tear down cross-border distribution barriers and arm sales teams with an arsenal of highly effective and transparent investment choices for potential investors across the world.

Look Before You Leap Into Private Debt Funds: A How-To Guide

By: Andrew Ritchie and Michael Schuster

Stemming from the contraction in bank lending since the 2008 global financial crisis, there was a shift from traditional lending models to alternative lenders looking to provide capital to mid-market borrowers. Stimulated further by an ongoing low-interest rate environment and the search for yield, institutional investors such as pensions and endowments are now more willing to invest in long term credit assets. Private debt funds managed approximately $640 billion[1] in direct lending in June 2017 and this trend is likely to continue as many corporate CFO's now view private debt lending as an increasingly important tool in their tool kit.

For asset managers looking to set up a private debt fund, the domicile of the fund, operational complexities of originating loans, and data reporting and transparency procedures should all be evaluated as part of their entry strategy into the market.

Choosing the Domicile

The fast-growing private debt industry is expected to hit ¤1 trillion by 2020.[2] The US is the largest private debt market, accounting for more than 60 percent of the new money raised globally in 2017.[3] The European market accounts for the remainder, while Asia is largely undeveloped and even restricted in certain jurisdictions.

While the US is the largest market, the direct lending opportunity in Europe is significant. It's a local, fragmented market with thousands of investable companies, most of which are serviced by long-standing banking relationships. However, accessing the European market presents its own challenges including significant language barriers and bankruptcy and security enforcement laws that are unique to each country.

If managers decide to enter the private debt market in Europe, they can choose various structuring options as both Ireland and Luxembourg offer credible product solutions. Luxembourg has a robust and well established closed-ended fund regime allowing for flexible asset mixing and concentration limits, which meets the needs of a private loan strategy. Ireland has recently enhanced its direct lending code, revising and relaxing direct lending criteria, making it easier for managers to mix asset types and borrowers. Ireland is also in the process of upgrading its partnership legislation to compete more directly with that of Luxembourg.

Navigating Operational Complexities

Understanding the asset is key to the success of both the manager and its providers. Private debt is more than broad, syndicated loans for mature companies; growing companies that require complex financing solutions will also be part of the universe of potential borrowers.

Asset Types

Managers need to recognize the nuances between asset types and leverage their existing operations where possible, however, they must be prepared to adjust and modify their back office as needed to accommodate the new product type. The manager should gain a thorough understanding of the typical behavior or process flows of the asset and ensure they have internal systems and controls to support the loan type. For example, the move from syndicated loans into private loans will reveal many differences in the lifecycle of a transaction between the two loan types and managers need to have addressed any operational gaps prior to trade initiation.

Technology Strategy

Managers should assess their technology strategy and whether they have the infrastructure to support a new asset class. Often managers face loan administration challenges because they do not have appropriate loan tracking and reporting systems. Loans are complex instruments with myriad technical elements and it may be more efficient to outsource some of these tasks to a third-party who can provide specialist expertise as well as the technology infrastructure.

[1] 2018 Preqin Global Private Debt Report

[2] Alternative Credit Council

[3] 2018 Preqin Global Private Debt Report

> *Whether due to regulation or pressure from boards and stakeholders, the push for transparency is growing. Managers should evaluate which data they are required to report and how they plan to do so before setting up a private debt fund."*

Advances in the use of technology over the next three to five years will radically transform the loan market. We expect to see increased straight-through-processing (STP) from new technologies such as financial products markup language (FpML) and distributed ledger technology (DLT). Leading technology platforms will drive the standard in advancing repetitive operational processes and investment managers will need to embrace these new technology developments. However, some may face significant challenges as they assess the best way to integrate with their existing systems.

Closely linked to technology, data presents another operational complexity. Accurate data drives all processes and can cause confusion or error if not properly gathered, stored, secured, delivered, and reported.

Credit Agreements

Credit agreements are not standardized – certain provisions can be interpretive, and often documents are more than one hundred pages long. Managers are instrumental in establishing bespoke loan documentation recording processes which would provide the administrator and agent with the information necessary to process, record, and control the cashflows and economic value of private loan. Inaccurate loan set-up by the manager could result in errors and omissions across the trading and reporting cycle.

Managers should ask themselves whether they need a loan agent. For deals with some form of syndication, it could be money well spent. Ongoing asset servicing is a key challenge and the largest operational strain for most managers. Many providers offer turnkey solutions that they can white label as needed.

Fund Administration

The final functional consideration is whether a fund administrator has the global footprint to support a manager's activities. In some markets, immediate funding may be required at the time a deal closes and so an administrator and custodian with appropriate market coverage is required to enable the manager's investment activities. Adding market specific counterparties will add complexity to the operating model.

Whether due to regulation or pressure from boards and stakeholders, the push for transparency is growing. Managers should evaluate which data they are required to report and how they plan to do so before setting up a private debt fund. For example, deal specific data such as loan ratings may be hard to obtain due to confidentiality provisions in the structuring of the facility, and there is now greater emphasis on ESG reporting. Managers need to consider all current reporting requirements for regulators and investors, and also prepare for enhanced disclosure requirements in the future.

Exploring Entry Strategy

Many managers entering the private debt market come from a position of deep experience in a different sector, such as corporate bonds. This means they are already skilled in credit analysis and now wish to expand their business model to the private debt strategy. When creating this new product, managers typically approach execution in one of three ways: build, buy, or borrow.

Some managers build teams in-house, expanding their core skill to incorporate a direct lending product. For example, a fixed income manager already understands credit risk, and will understand balance sheets, cash flows, and other considerations in private debt lending. Private equity managers often choose this strategy as the lending activity complements their deep analytical expertise and long-term investment goals.

Other managers choose to buy the capability – buying the skills and experience required by acquiring another manager or team and folding them into their own outfit to run the new product. Finally, some managers borrow the expertise by outsourcing the investment management process to a firm that already has experience with the strategy.

All three strategies have their own merits and challenges and we have seen managers develop new lending products via all of these routes.

On the Horizon

As with any maturing market, the global direct lending sector is constantly changing and presents both opportunities and challenges. One side-effect of the popularity of the sector is that demand is currently outpacing supply leading to growing pools of uninvested capital, otherwise known as dry powder. In an attempt to put money to work, managers have changed fund and loan terms and net returns have fallen but there are still areas of opportunity.

In Europe, infrastructure debt is attracting much attention – the world needs it, and private investors are willing to provide the finance thanks to the long term returns from the asset. Cashflows from the underlying asset produce an income stream and the long-term nature of the loan aligns with the long-term requirements of the pension fund and insurance company investors.

Demand for private debt is strong and managers are responding with new fund launches and product strategies. Given the inherent illiquidity of the loans, investors need to understand the long-term commitments they are making when choosing the asset class and managers need to demonstrate robust risk management expertise. The asset servicer is the synapse that connects the investor and the manager and brings together accounting, valuation, safekeeping and oversight. As asset complexity increases, the role of the administrator and custodian with deep understanding of the asset class as well as strong risk mitigation protocols is essential to the successful operation of a private debt fund.

APIs: A Driving Force for Asset Managers

By: Michael McGovern

The financial sector may be predicated on investments, deposits, and lending, but without data there wouldn't be an industry at all. Every day, copious amounts of data flow from one place to another – some is captured and harnessed to the advantage of the institution, and some is floating in cyberspace. However, thanks to application program interface (API) technology, institutions can not only organize the data they desire, but receive it faster than ever before. Today, APIs provide the digital roadways on which electronic information rides.

For the last 15 years, APIs have helped software programs quickly exchange information within the e-commerce space, but the need for faster access to data is just as critical in asset management: firms with better data can offer better investment decision making and service to their clients.

After a slow start, the API economy has expanded into institutional financial services over the last few years. Asset managers' middle and back offices have been especially ripe for technological change, including via the use of APIs as a facilitator of real time information delivery across operating platforms and data sources.

The Supply Chain

APIs create the ability for system-to-system integration between asset managers and their service and technology providers. This integration is seamless and light weight, compared to heavier traditional file and message-based transfers of the past. APIs allow firms to employ best-of-breed capabilities for every activity in their investment management supply chain.

When Henry Ford manufactured his Model T a century ago, his only factory inputs were steel, coal, rubber, and black paint. Today, through a multi-tier, technology-enabled network manufacturing process and supply chain, Ford can integrate components, made by their pick of suppliers all over the world, into a single vehicle.

The emergent institutional API economy will permit managers to achieve a similar transformation through efficient, service-oriented architecture applied to internal business processes. While the automotive supply chain process evolved over decades, the analogous process in asset management should happen much more quickly because the manufacturing of investment products is all about easily digitized data.

Know Before You Go

To realize the full promise of APIs and other emerging technologies, asset managers and service providers need to invest in data governance, quality, security, lineage, real time transformation, and provisioning capabilities. Data should be flexible, fit-for-purpose, and asset managers should know exactly when they need it.

Data is the new currency, with accuracy and consistency as the core measures of its value. The key to unlocking that value is data timeliness and alignment with client process. Asset managers should have a solid understanding of what data they have and what data investors need in their own unique process. To achieve this, data must be aligned to process, role, and context.

The best way to give global managers the options they need is a modular approach to investment operations. They should be able to choose tools that support the full scope of middle and back office operational needs across trade management, cash administration, collateral management, settlement, reconciliation, corporate actions and IBOR data distribution. Each tool should be optional and linked via APIs, leveraging common data standards.

The New Economy Car: Horsepower AND Efficiency

How might an asset manager use APIs? A firm that wants to get valuations updated every time it processes a trade would use this technology to receive that information in real-time rather than wait for a file that might be sent at the end of the day. The faster they can get the valuation data, the better their investment models and risk assessments can be. Firms can also tap into other information, such as real-time economic data from the Federal Reserve and settlement instructions from the Depository Trust and Clearing Corporation to enhance their own reporting.

> *“Today, APIs provide the digital roadways on which electronic information rides.”*

Now imagine two organizations that exchange dozens of trade status emails every day. If an asset manager links their trade management platform directly to an API framework and mapping service, it can allow employees to request encrypted, secure real-time access to trade information. This would replace hundreds of trade status query emails every month. Most importantly, the service could be built in just weeks using APIs to natively integrate into running processes, without requiring restructuring of existing applications, separate user interfaces, or major control environment impact. This is lighter from a change management perspective, and delivers material process improvement impact.

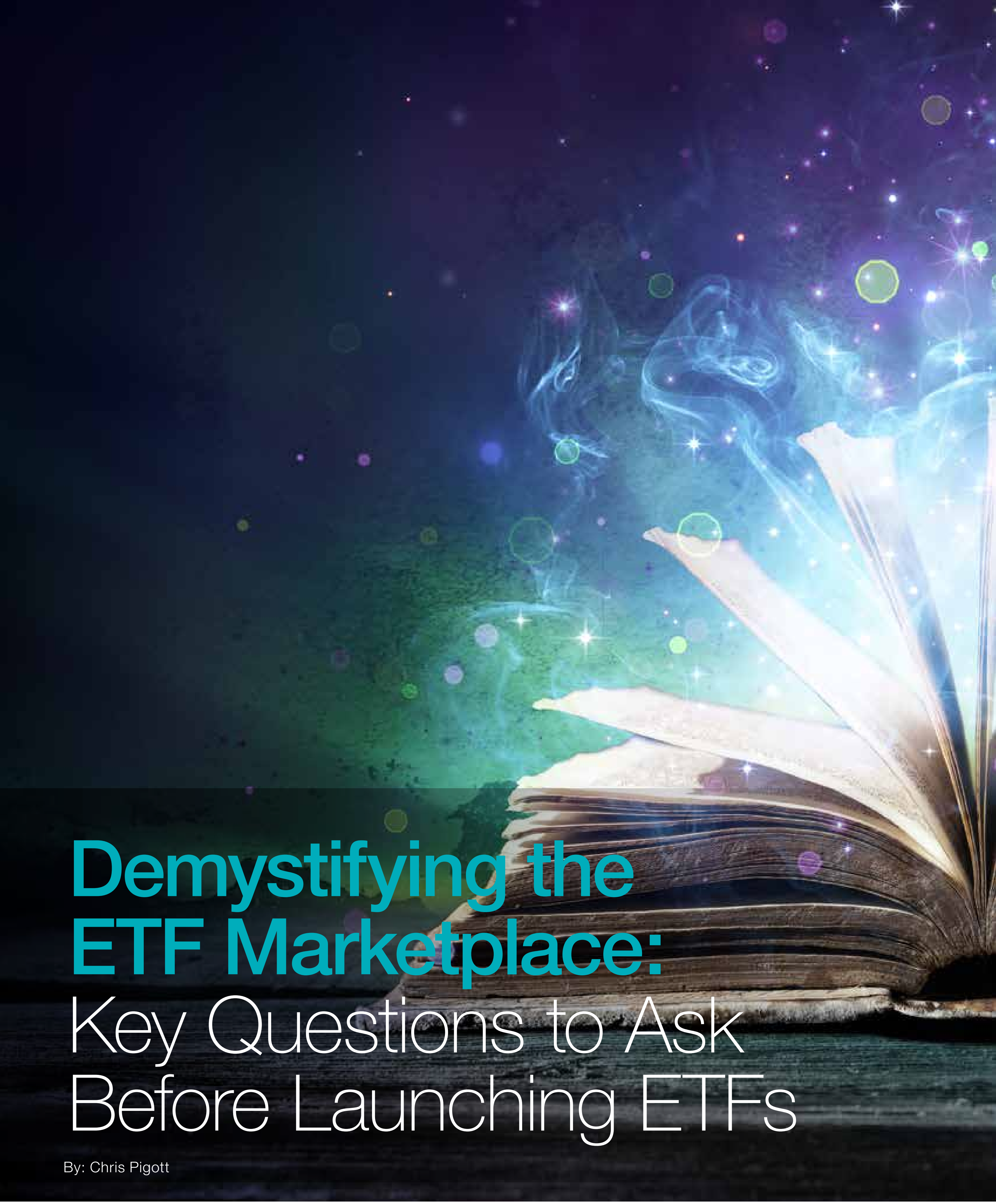
Fortunately, incorporating APIs isn't difficult to do. Firms are already developing technology that facilitates the exchange of information between various programs. In fact, the retail arms of many financial institutions are already using APIs, and developers familiar with the technology can apply it to the institutional side of the business. This allows outdated legacy systems to use APIs to get information they otherwise couldn't.

A Smooth Ride

When a manager implements several use cases across key business processes in the middle and back office it creates a scaling effect where the potential for efficiency gains and savings are dramatic. More importantly, the provisioning of real-time information is driving the next frontier of accuracy for better decision making and insights. There is an opportunity for hundreds of these use cases across a substantial enterprise – such as cash projections, corporate actions confirmations, income payment notifications, and reference data changes. Crucially, the use of the framework, once configured, is easily repeatable and data services components are reusable. Once a manager implements one API, it gets progressively easier to implement subsequent use cases.

Asset managers can leverage these technologies without having to completely retool the automation ecosystem they have in place today. Having quicker and easier access to more data sets helps firms become more competitive, efficient, and flexible. Staff who may have been gathering data by hand can now deploy their brainpower elsewhere, while investment and risk models can reflect real-time market conditions. Driven by competition and powered by technology and information exchange standards, firms that aren't taking advantage of APIs risk being left in the dust.

Think of APIs as an interconnected highway system. City streets can take you to certain locations, but a highway will get you to anywhere you want to go – and usually faster, too.



Demystifying the ETF Marketplace:

Key Questions to Ask Before Launching ETFs

By: Chris Pigott

In recent years, Exchange-Traded Funds (ETFs) have emerged as the passive vehicle of choice for a wide range of institutional and retail investors. Global ETF assets grew from just $417 billion in 2005 to over $5 trillion in August 2018,[1] representing annualized growth of 21%.[2] The popularity of ETFs is not surprising: ETFs come with low expense ratios, trade like a stock, and offer intra-day liquidity. With more than 5,600 ETFs available today, there is no shortage of options for investors to choose from.[3]

While ETFs have been around for more than 25 years, originally they were built to track broad indexes — like the S&P 500 — and were deployed by investors as passive strategies. But ETFs have evolved in recent years to include actively managed strategies, more sophisticated smart beta methodologies, thematic vehicles, and factor-based approaches. As ETF demand continues to rise for retail and institutional investors, many asset managers are adding ETFs as a core part of their product strategy to either retain assets or drive flows across existing or new distribution channels.

For asset managers new to the ETF market, the products' operating model may look familiar. By our assessment, roughly 80% of the ETF workflows resemble that of a mutual fund. Hence, the real question: How do you handle the 20% that is new and different to your business?

EVALUATING ETFS

As you're assessing what ETF products to launch, it's important to understand that the strategy playbook for market entry is not universal. For instance, some asset managers have launched ETFs to retain cost-minded investors who are moving some of their holdings from mutual funds to lower-cost ETFs. Others have deployed ETFs as a defense against a competitor's product or to pursue new distribution channels. While the reason for launching will depend on your own unique circumstances, a good place to start is by asking if ETFs will complement or detract from your overall product suite. Rigorous analysis of product trends, peer offerings, flows, and investor demand can help narrow the field of potential ETF types, but careful consideration is necessary to ensure a newly launched ETF enhances your existing product offering.

After you conduct a thorough evaluation and decide to take the leap, there are a multitude of factors that you should consider prior to the launch. Here are four that stand out.

1 How Can You Differentiate Your ETF Product Offering?

In recent years, ETFs have emerged as core products for large scale asset managers. In fact, out of the top 20 largest asset managers globally (based on AUM), 18 offer proprietary ETFs.[4] This leaves new entrants with the challenge of differentiating their ETF products in a crowded marketplace. Managers can do this through investment strategy, cost, and brand awareness.

Investment Strategy

Given the widespread availability of established core-index ETFs – which are dominated by a handful of incumbent ETF providers – there isn't much shelf space for new products that mirror these strategies. In recent years, some new entrants have turned to smart beta and active strategies to launch new, differentiated ETFs. ETFGI reports that the 5-year CAGR for smart beta ETFs globally is 33% and more than 20% for active ETFs. Esoteric sectors and nuanced strategies have also become increasingly popular targets for new issuance, including thematic, currency hedging, and environmental, social, and governance (ESG) ETFs. No matter the strategy, delivering an ETF that solves the needs of an investor segment is imperative for competing successfully.

Cost

Cost can also be an effective way to differentiate. A common misconception is that all ETFs are low-cost and therefore will cannibalize existing higher-fee products (e.g. active mutual funds) rather than complement them, but a look beyond the total expense ratios (TER) of certain core index products shows this is often untrue. On an asset-weighted basis, the global average TER for an ETF is 23 basis points (bps).[5] The TER increases, however, depending on the level of product innovation and complexity. For active ETFs, the sponsor generally needs to commit more technical and human resources when compared to passive index strategies.

Globally, average TERs for active ETF strategies is 56bps but can extend well north of 70bps. Investors, for now, are willing to pay a premium for active strategies that look to outperform the index. For managers, cost is a delicate balancing act: ETF success is largely defined by the ability to scale quickly (i.e. AUM). And to gain AUM, an ETF needs to not only have a differentiated strategy but must also have a competitive TER against peer products.

Brand Awareness

Managers who can capitalize on an existing brand will be at a significant advantage in building assets in the initial post-launch phase, particularly when combined with a unique strategy. Research indicates that building a brand in ETFs may hinge more on educating investors through thought leadership than targeting them through traditional advertising.[6] Findings from our 2018 Greater China ETF investor survey underpin the need for education as over 40% of respondents said their lack of understanding ETFs is keeping them from increasing their use.

2 How Will ETFs Affect Your Operational Infrastructure?

Most of the functional elements managers must address to support stand-alone ETFs will likely overlap with mutual funds, but nuances and outright differences arise in operational areas such as portfolio management, distribution, fund accounting, and transfer agency. While attracting ETF talent can be challenging, especially in Europe and Asia, operations staff must be well-trained to understand these distinctions. There are additional support functions required to run an ETF such as a Capital Markets team who manage the relationship between the Portfolio Management team and the Authorized Participants (APs).

> *Research indicates that building a brand in ETFs may hinge more on educating investors through thought leadership than targeting them through traditional advertising"*

Shareholder servicing costs for ETFs are substantially less than for mutual funds due to the lower volume of order activity (but higher order values) from fewer primary market investors (APs) as most of the buying and selling is on the secondary market. In addition, the sub custody transaction charges as a result of order activity is generally paid by the AP. Both of these items contribute to lower costs for the sponsor.

Another key difference is that ETFs must publish a portfolio composition file (PCF) on a T-1 basis (minimum). This is used for both creation and redemption purposes, as well as indicative net asset value (iNAV) calculation. Generally, the administrator, custodian, or a third-party servicer will provide these files. However, an asset manager will need to build the capability from both a technology and personnel perspective to accommodate this process into their work flow.

Choosing Your Fund Structure

Asset managers should also consider the fund structure, as the operational workflows can vary significantly. Typical structures for ETFs include:

Stand-alone

The most common structure used to launch ETFs is a stand-alone legal entity. Stand-alone examples include 40 Acts in the US, UCITS in Europe, Investment Trusts in Japan, and Unit Trusts or OFCs in Hong Kong. The entity can have multiple sub-funds each with segregated liability. Each sub-fund can track different indexes and can have different investment objectives.

Master-feeder

The master-feeder structure also leverages common portfolio management and reporting expenditures, but the ETF is a separate legal entity. Master-feeder funds are formed when the assets of a mutual fund are transferred to a newly established master fund, making the existing mutual fund a "feeder fund" to the master. This structure, however, has been slow to take off given that converting to such a structure may present tax, legal, and operational hurdles, incurring costs for the manager and investor.

Share-class

Asset managers in Europe have shown interest in the share-class model, but it has not yet become a prevalent approach. However, that could change as the Central Bank of Ireland (CBI) recently indicated in a "Feedback Statement" that it intends to revise its policy to allow co-mingling of listed (ETFs) and unlisted (mutual funds) share classes in a single fund structure. The full CBI guidance will be released in the coming weeks, but sponsors can expect that the CBI will accept submissions that permit the establishment of listed and unlisted share classes within the same UCITS sub-fund.

Hong Kong has recently introduced the opportunity to add listed share classes to unlisted funds and vice versa. Local issuers are reviewing this option as a means to help scale their ETF business by adding a listed share class to existing mutual funds that have been successful in raising assets. The share-class structure reduces many complexities but also introduces new challenges. Challenges lie in treating all shareholders equally in areas such as taxation and trading of shares.

3 What is Your Distribution Strategy?

The ETF marketplace is a crowded space with more than 5,600 ETFs globally.[7] In order to survive, ETFs must quickly grow assets at the outset and carry that momentum through the early stages of the ETF launch lifecycle. Identifying the right distribution strategy is perhaps the most important aspect in building AUM. This starts by firmly establishing a comprehensive distribution plan pre-launch and training sales and distribution personnel on the features and nuances of the ETFs so they can make an impact immediately. Those who wait to initiate this process post-launch stand to delay asset growth in perhaps the most critical time.

In an industry increasingly defined by scale, some managers may look to distribute in channels where they already have a significant client base. If they can successfully onboard existing clients by transferring assets from pre-existing funds to the newly-launched ETFs, the sooner they can attain critical scale (i.e. AUM).

Strategy	Passive Index ETF	Smart Beta	Active	Currency /Leveraged
TERs	There are 386 ETFs with a TER of <10bps	Average TERs for smart beta is 28bps	Average TERs for Active Strategies is 56bps	Average TERs are >90bps

Source: ETFGI Global ETF and ETTP industry insights July 2018

From a marketing perspective, emerging technologies such as digital platforms, social media, and robo advisors are transforming the ways in which many investors learn about ETFs. Understanding and harnessing these technologies will become increasingly important for asset managers as they look to promote their products.

As asset managers look to distribute in new regions, it's important to recognize that not all markets are created equal. For this reason, asset managers should consider leveraging local expertise or potentially setting up a regional shop.

Opportunities in Asia

Fragmentation is an even greater issue in Asia than in Europe and ETF adoption is still in a nascent stage in comparison to the rest of the world. ETFs face headwinds in retail channels where they compete with mutual funds that pay high commissions to distributors. Japan has the largest ETF market in Asia with $311 billion in assets[8] and the industry has been a significant beneficiary of the Bank of Japan's Quantitative Easing program. Hong Kong and Korea are starting to position themselves as regional trading hubs for ETFs as well, with 7.4% and 7.0% of market share respectively.

Hong Kong may have an advantage as an access channel to Mainland China if ETFs are included in the Stock Connect program. Including "eligible ETFs" in the program would allow Mainland investors to access Hong Kong listed ETFs and international investors to access ETFs listed in Shanghai and Shenzhen. While there are a number of open questions as to how the program will operate (which ETFs will be allowed, will there be quota restrictions, will there be domicile requirements on the ETF or manager), it could be a great way for asset managers to access investors in Mainland China. It should expand the range of investment opportunities for Mainland investors beyond the ETFs currently available in Mainland China. The industry believes that the SFC (Hong Kong regulator) will provide some clarification regarding the requirements in 2019.

Channels and Platforms in the US

Institutional channels in the US are evolving in their ETF usage. Non-401(k) channels, like pension plans, endowments, insurers, and hedge funds have purchased ETFs from a handful of issuers in the past, but these were typically in fixed-income asset classes for cash equalization strategies. However, given the low cost of most ETFs, many of these channels are now using ETFs in core asset classes, including domestic and global equity strategies — often at the expense of active managers. Smart-beta demand has been a key driver of some of this product growth, as institutional investors gain access to multi-factor,

low volatility, and equal weight strategies at a low cost. Insurance companies have also entered the ETF fray. Blackrock believes that $300 billion of bond ETFs will be purchased by insurers by 2021.[9]

As for the retail channels, RIAs were the earliest adopters of ETFs and allocate the highest percentage to ETFs (23%) when compared to other channels.[10] Not surprisingly, in 2018, 87% of financial advisors said they used or recommended ETFs with their client portfolios — the most popular investment vehicle among 19 listed options. This is a pronounced leap compared to 2006 when ETFs were only recommended 40% of the time.[11]

Fragmentation in Europe

With over €694 billion in ETF assets,[12] Europe is the second largest market globally. Encompassing 28 countries, 25 exchanges, and 14 currencies, the fragmented nature of the market adds additional layers of operational complexity and presents unique distribution challenges for both mutual funds and ETFs. This is especially pertinent for managers outside of Europe who may not have experience distributing product within the EU.

Distribution in Europe tends to be bank driven, however each market has its own financial advisory channels, which is expected to drive the next phase of growth for retail ETF investors in Europe. While approximately 80% of ETF assets are currently held by institutional investors, many believe retail adoption will continue to accelerate as issuers increase their focus on financial advisors.

The majority of European ETFs are domiciled in Ireland (55%) or Luxembourg (22%)[13] and follow the UCITS framework, enabling managers to distribute ETFs cross-border through a fund passport. The UK is a major ETF consumer and the UCITS passporting rules may be disrupted when the UK leaves the EU. It is difficult to predict what type of access the UK and EU will have to each market post-Brexit, but asset managers should keep a watchful eye on the ongoing negotiations.

4 Ways to Enter the ETF Space

Asset managers ready to make the leap to launch their own ETF essentially have three options: Buy, build, or rent.

Buy: The first option is to acquire an existing ETF business through the purchase of an established company. This approach comes with pre-baked regulatory approval, an existing distribution network, and immediate ETF expertise and sales experience, not to mention live products with track records and AUM. These advantages, however, may be tempered by potentially higher upfront costs—monetary, time, and labor—as well as potential complexities integrating a new workforce.

Build: The second approach is to develop ETFs from the ground up. While creating a bespoke ETF allows firms to align new products with core investment expertise, scale staff over time, and tailor their marketing and distribution plan, drawbacks do exist. New funds lack track records, may require staff additions, and a product with a nuanced, carefully-crafted strategy can take many months to gain regulatory approval. Since the ETFs are being created from scratch, asset managers may also have to build out additional operational functions, which may inhibit speed to market.

Rent: Lastly, managers can create an ETF through a third-party platform. These providers offer a turnkey service, handling some or all aspects of the development, launch, and ongoing management of the ETFs. Additionally, in the US, these platforms offer the benefit of tapping into existing trust and exemptive relief (for now), freeing the manager to focus on product and distribution strategy. While this route offers one of the quickest ways to enter the market, managers must consider that revenue may be split with the platform and they may have to contend with sharing shelf space with other issuers using the same platform. The rent option has seen limited uptake in Europe, but there are still a number of providers offering solutions to asset managers looking to take this route.

ARE YOU READY?

The ETF market appears perched to accelerate its development pace and provide asset managers with a new array of fund types to satisfy increased investor demand. Since 2013, the global ETF market more than doubled in size from $2.2 trillion to over $5 trillion, as of August 2018.[14] The 10-year CAGR is 18.9%. Some analysts predict the ETF market can grow to $7.6 trillion by 2020, equivalent to a conservative CAGR of approximately 18%.[15]

Asset managers are embracing ETFs as an opportunity to distribute their investment strategy in a new wrapper, rather than writing them off as a threat to their existing business. Like with any new product, adding ETFs to an investment menu can be disruptive, especially in light of their unique structure and distribution nuances. Managers must assess several factors when evaluating how ETFs can complement their business. Top-down commitment by management is essential. Growing an ETF business is a long-term venture and as such, needs the framework of ample resources and capital to be successful. However, given the growth to date and future growth projections, it is clear why so many managers have decided to enter the ETF marketplace.

[1] *ETFGI*
[2] *EY: Reshaping Around the Investor, Global ETF survey 2017*
[3] *ETFGI*
[4] *BBH*
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Albert Chan
Head of Hong Kong Foreign Exchange
+852.3756.1787
albert.chan@bbh.com

Gabriel Cheung
Head of Hong Kong Trustee
+852.3756.1675
gabriel.cheung@bbh.com

Scott McLaren
Head of Hong Kong Office
+852.3756.1667
scott.mclaren@bbh.com

Philip Chiang
Hong Kong Relationship Manager
+852.3756.1692
philip.chiang@bbh.com

Chris Pigott
Head of Hong Kong ETF Services
+852.3756.1749
chris.pigott@bbh.com

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