THE GROWTH OF ETFs IN EUROPE
The European Exchange-Traded Fund (ETF) industry continues to build on the significant growth over the last 10 years. Promoters for ETFs are developing new products by expanding the nature of ETFs in the market and the assets under management (AuM). As of September 2016, the industry had enjoyed a decade of growth, averaging 20.4 percent per annum in the number of ETFs in Europe and average growth of AuM 20.1 percent per annum.\(^1\) This achievement has been driven by post-credit crisis quantitative easing bull run in the financial markets.

\(\text{Figure 1}\)

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\(^1\) Data sourced from ETFGI
As at the end of September 2016, the European ETF industry had 1,556 products, with AuM of US$536bn from 49 providers and listed on 24 exchanges across Europe. The top five countries where ETFs are listed are: UK with 731 ETFs, Germany with 626 ETFs, France with 330 ETFs, Switzerland with 295 ETFs and Italy with 143 ETFs. The top 5 countries account for US$527bn of the US$536bn of assets in the European market.

The growth in ETFs has resulted in them becoming the barometer for investor sentiment. By watching the flows into ETF asset classes, distributors can gauge investor risk appetite on a daily basis.

Figure 2
Key Drivers
In this environment of significant growth, we see the key drivers for asset accumulation in the industry to be as follows:

- Low Cost
- Liquidity
- Transparency

Low Cost
As with any investment, operating costs vary among ETFs. The last few years have seen a material repricing of ETFs. New entrants have resulted in aggressive market share plays based on low total expense ratios (TER). The weighted average expense ratio for ETF strategies in Europe is 31 bps. The cheapest products track fixed income indices averaging 26 bps, while the most expensive are alternative ETFs averaging 77 bps.

There are a number of ETFs with an expense ratio less than 10 bps. The pressure of lower fees and the lower risk profile for investors is a reason for the significant inflows into fixed income strategies. In the fixed income strategies, the top three promoters, are iShares; with an average TER 25bps, DB has an average TER 20bps and Lyxor has an average TER 17bps.

The market for low TER, bluechip index tracking ETFs is saturated. New entrants can now only compete on bespoke index/factor products or in the smart beta/actively managed ETF space.

In the UK the Financial Conduct Authority (FCA) plans to shake up the funds industry. The FCA published the Asset Management Market Study Interim Report in November 2016 and the key theme coming from the report is that actively managed funds are underperforming their benchmarks after costs are deducted. The UK’s asset management industry will need to start to offer investors an “all-in” fee as part of sweeping measures unveiled by the FCA in their report to try to kick-start competition and reduce costs for investors. Any regulation that will be implemented will see a significant amount of flows going the ETF industry.

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**Figure 3**

<table>
<thead>
<tr>
<th>TER (bps)</th>
<th>0-10</th>
<th>10-20</th>
<th>20-30</th>
<th>30-40</th>
<th>40-50</th>
<th>50-60</th>
<th>60-70</th>
<th>70-80</th>
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<td>399</td>
<td>262</td>
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<td>144</td>
<td>101</td>
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<td>43</td>
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<tr>
<td>EFT assets (US$ Bn)</td>
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<td>83</td>
<td>94</td>
<td>63</td>
<td>28</td>
<td>15</td>
<td>11</td>
<td>3</td>
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</tbody>
</table>

As of 12/2016, there were 3397 ETFs, with 56% in equities, 26% in fixed income, 44% in commodities, 77% in alternatives, 65% in mixed, 34% in active, 37% in inverse, 46% in leveraged, 42% in leveraged inverse, and 31% in all.

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<table>
<thead>
<tr>
<th>Asset class</th>
<th>ETFs</th>
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<tr>
<td>Equity</td>
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<tr>
<td>Fixed income</td>
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<td>Commodities</td>
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<td>Alternative</td>
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<td>Mixed</td>
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<td>Active</td>
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<tr>
<td>Leveraged Inverse</td>
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<tr>
<td>All</td>
<td>31</td>
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Over the last decade, ETFs have become an investment of choice compared to mutual funds (passive and active). This is due to investors believing ETFs are extremely liquid investments as they are traded on the main regulated market exchange. As ETFs are traded during market hours, investors can execute trading strategies to help achieve their investment objectives. However, stock market circuit breakers can cause pricing and liquidity issues for ETFs. This has been exasperated by the record flows into ETFs, particularly, fixed income ETFs. Regulators are concerned about the "liquidity illusion," while others believe ETFs, as very large owners of fixed income bonds, should be better placed to deal with a potential decline in liquidity.
**Transparency**

As ETFs are listed on the main regulated market exchange, all their information is publicly available and they generally track a benchmark. The vast majority of ETF investors are still institutional, but there is a shift to retail investors investing into ETFs. When analyzing an ETF you are able to see the NAV (Net Asset Value) price trade during the trading day. This transparency is unlike traditional open-end mutual funds, which do not price their funds until day’s end. The investor may not know how much they made or lost with traditional open-end mutual funds. ETF transparency sets a high standard for fund managers or promotors. One is able to see the entire holdings of an ETF on the fund company’s website, which is updated daily. One can also see the expense ratio clearly publicized at most research websites such as Morningstar.

Some fund managers have launched a variety of new products that trade on exchanges that are also referred to as ETFs. However, some of these new products may provide less transparency than traditional ETFs that hold physical securities and may inadvertently introduce additional risk for the investor arising from the management, construction, and performance characteristics of these products. Some of these ETFs may be synthetic ETFs that could be highly leveraged, which generates additional risk for investors. As investors look to smart beta and active products, the promotors are finding it harder to create and test new products in the market while achieving speed to the market. These new products will ultimately support the growth of the industry. Smart beta ETFs make up most of the new product launches in 2016, attracting strong inflows from investors seeking greater returns and diversification at a lower cost than actively managed funds. Inflows are particularly strong in Europe, with investors favoring dividend or equity related products.

While there are new products being launched, the regulators are looking for clearer labelling of product structure and investment objectives, more frequent and timely disclosure for all holdings and financial exposures, clear standards for diversifying counterparties and quality of collateral and disclosure of all fees and costs paid, including those to counterparties. This is to allow investors to make investment decisions while understanding all of the risks associated with the ETFs.

**Growth in Product Strategies**

The promotors are keen to anticipate the needs of investors and continue to create new products for investments. The key ETF strategies are as follows:

![Figure 3](image-url)
Fixed income
Fixed income strategies dominated the ETF inflows with over US$26bn and the launch of 40 new products in the first nine months of 2016. Corporate bond ETFs gathered the largest net inflows year to date (YTD) with US$14.2bn, followed by emerging market bond ETFs with US$7.9bn, and high yield ETFs with US$2.9bn, while government bond ETFs experienced the largest net outflows YTD with US$2.4bn. There are newer ETFs in the mortgage and credit spreads strategy that create higher risk for investors.

Commodities
The commodities strategy has generated the second largest inflows in European ETFs with US$12.1bn and ten new product launches in 2016. Precious metals ETFs gathered the largest net inflows YTD with US$10.2bn, followed by broad commodity ETFs with US$1.8bn and industrial metals ETFs with US$0.2bn, while ETFs providing exposure to energy experienced the largest net outflows YTD with US$0.03bn. Physical ETFs like gold gather the largest net inflow in relation to precious metals, followed by silver with US$9.8bn and US$0.4bn respectively.

Equity
Equity ETFs have generated the bulk of new product launches so far in 2016 with over 87 new products. Conversely, Equity ETFs have had significant outflows in AuM up to July 2016 but it has since picked up inflows between August and September to get back to US$0.8bn of net inflows during the year. European equity ETFs experienced the largest net outflows YTD with US$14.7bn, followed by developed Asia Pacific equity ETFs with US$3.4bn, while North American equity ETFs gathered the largest net inflows YTD with US$7.9bn, followed by Emerging ETFs with US$6.7bn and Global ETFs with US$4.3bn.

The five largest promoters of ETFs are iShares, db xdb ETC, Lyxor AM, UBS ETFs, and Amundi ETF. Combined they have 963 ETFs with AuM of US$433bn, representing 76.1 percent of the market. In 2016, the top five promoters have launched 50 new products.

Despite numerous challenges, the market for ETFs will grow substantially over the coming years. The significant inflows over the last few years has shown the growth in ETF products and the benefits will allow investors to have access to ETF products with lower costs, liquidity and transparency. More investor segments will embrace ETFs in a growing number of markets and new firms/promoters will develop new products to enter the market.
The Future of ETFs
We expect ETF assets to continue to grow, and we predict that the industry AuM will reach US$3trillion by the end of 2020. We also expect ETF inflows to be significantly more than mutual funds (actively managed and passive). Innovation is crucial to the ability of ETFs to meet an ever growing range of needs, and attract an ever wider range of investors. As the industry grows, it is becoming progressively harder for promoters to deliver new products at a lower cost model. There are new threats to current promoters with new market entrants entering the market and there is a need to invest in new technology that will allow for the lower cost model. Some of the opportunities to innovate in the ETF industry are:

Stock Lending
With the lower cost model, promoters are finding it more difficult to generate income. Stock lending is one example where promoters are able to generate additional income. Most managers see stock lending as a positive function. The majority of investors welcome the resulting reduction in cost, and stock lending has great potential to increase the liquidity of ETFs in Europe. Stock lending can reduce the transparency of returns as it could increase the tracking error in ETFs and give physical ETFs some of the features of synthetic ones. If promoters want investors to continue supporting stock lending, they need to be as transparent as possible about lending limits, average lending levels, and revenue sharing policies between the ETF and the promoter and provide details of collateral received by funds.

Distribution Model
One of the key areas that the industry has been slow to be innovative is around distribution models. ETF promoters face the same distribution challenges as all fund providers, in addition the need to educate investors about ETFs and the advantages over mutual funds. The emergence of robo-advisers as an accessible retail channel could overturn this picture. The most obvious application for robo-advisers is direct sales to retail investors. Wealthfront and Betterment’s are two robo-advisers in the US. Wealthfront charges a flat fee of 0.25 percent that applies only to investment amounts above US$10,000. If you are investing under that amount, you can open an account with Wealthfront and put your money in ETFs for no cost. Betterment’s fee structure ranges from 0.35 percent for small balances to only 0.15 percent for balances greater than US$100,000. No matter which robo-adviser you choose, your TER comes out to much less than it would for an actively managed fund.

Robo-advisers are a golden opportunity, but there has not been significant uptake or development in robo-adviser technology in Europe. The development of platforms to use robo-advisers could take years to reach their potential in many markets. Promoters need to be innovative and consider investor preferences by either buying or launching their own robo-advisers in the markets.

Brexit
There are concerns among promoters and investors on Brexit, which brings a number of challenges to the ETF industry. Currently there is lack of clarity over Brexit and when the UK will actually leave the European Union, and whether agreements will be put in place to allow the UK to have access to the single market. This provides passporting challenges for the promoters based in the UK and also for the distribution of UCITS into the UK investors. There are 731 ETFs listed on the London Stock Exchange that could be affected given that most of those ETFs are not domiciled in the UK. Overall, Brexit may have a negative impact on the ETF market, but this creates more opportunities in other locations for either relocation of promoters or listing the ETF on additional exchanges.

The ETF industry’s track record of growth is fascinating. There are so many new mutual fund providers entering the ETF market, which is increasing the competition for ETFs. The increase in passive funds threatens the distinctiveness that has served the ETF industry so well. If ETF providers want to continue growing, we believe that technology, adapting to changing markets, and innovation will be the keys to success.

To the point:
• The European ETF industry continues to build on the significant growth over the last 10 years. Promoters for ETFs have continued to develop new products by expanding the nature of ETFs in the market and the assets under management.
• Key drivers in this environment of significant growth are low cost, liquidity, and transparency.
• We expect ETF assets to continue to grow, and we predict that the industry’s AuM will reach US$3,000bn by the end of 2020.