Five Big Disruptors in the Exchange-Traded Fund Industry

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Little did we know, when the first exchange-traded fund (ETF) hit U.S. markets a quarter of a century ago, that this nifty investment tool would forever change the way we invest. As the ETF industry matures and evolves, new ideas and innovations keep coming, and these new developments eventually could be equally disruptive.

Among recent disruptions are factor, rules-based, enhanced, strategic beta, and smart beta ETF strategies that stick to customized indexing methodologies and have quickly gained popularity. For example, smart beta ETFs adhere to a passive indexing methodology but also screen for specific factors or risk premia, similar to how traditional active managers would handle investment decisions. Through a combined active investment strategy and passive indexing methodology, more investors are taking a different approach to diversifying market exposure to potentially enhance returns and diminish downside risks.

ETFs are poised to step into the future with five major trends developing in the industry, including: (1) socially responsible investing; (2) smart beta fixed income strategies. (3) nontransparent actively managed exchange-traded products; (4) blockchain and cryptocurrency; and (5) the race to zero fees. Each trend presents a potential for additional innovative disruption in the ETF industry.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE
The socially responsible ETF that tracks or screens for environmental, social, and governance (ESG) principles may become a disruptive addition to the U.S. investment ecosystem.

As more investors look for opportunities to align their investment choices with their values, many retail investors, institutional investors, pension funds, and money managers have adopted ESG-related investments in recent years. The push to incorporate ESG factors into investment practices has been championed by the United Nations Principles for Responsible Investment (UNPRI), and the number of signatories jumped to 2,205 in December 2018, compared to just 63 in April 2006. The United Nations Joint Staff Pension Fund also has worked with MSCI Inc., State Street Global Advisors, and BlackRock to launch low carbon target ETFs that address carbon exposure by overweighting companies with low carbon emissions relative to sales and per dollar of market capitalization.

However, the majority of assets held in socially responsible ESG-related funds remain largely concentrated among European institutions and investors. According to the Global Sustainable Investment Alliance, $22.89 trillion in assets in 2016 were being managed under responsible investment strategies globally, or a 25-percent increase from 2014, and European assets made up $12.04 trillion.1

Considering the size and scope of the U.S. markets compared to the European markets, U.S. investors are falling behind. About $8.7 trillion, or 21 percent of all managed assets in the United States, has some element of ESG consideration as part of the process; this figure represents a tripling between 2012 and 2016.2 Compared to Europe where more than 50 percent of all managed assets have a sustainable investing attribute, the United States has more room to run. This leaves a large opportunity for ETF providers to fill in the gap with ESG-related strategies. According to Create Research, 36 percent of pension fund assets are invested in ESG strategies and 61 percent anticipate an increase in ESG-related allocations in the next three years.3

Potential investors needn’t fear that ESG is a gimmicky or feel-good investment that puts the investor on higher moral ground with little else to show. A number of studies over the years suggest that ESG investments add value for a diversified investment portfolio. For instance, Boston Consulting Group found that companies using an ethical approach were likely more profitable and more highly valued than companies that eschewed ESG principles.4 A study from UNPRI and MSCI revealed that portfolios optimized around ESG momentum or an improvement in ESG scores would have contributed to an 18-percent cumulative outperformance and portfolios with ESG tilt or a best-in-class approach would have contributed to a 10-percent cumulative outperformance for the 10-year period ending June 2017.5 After combing through 10,000 mutual funds over a seven-year period, Morgan Stanley concluded that sustainable funds exhibited slightly higher returns and lower volatility than traditional fund strategies.6 Mutual funds and separately managed accounts categorized as
sustainable investments have met or exceeded broad market performance, both on an absolute and a risk-adjusted basis, across asset classes and over time.

The results also are backed by sensible economic rationale. From a risk perspective, investments that ignore ESG factors can miss capturing information beyond financial statements that mark higher risk exposure. Looking at the returns side, as ESG strategies continue to propagate, a virtuous cycle could develop where investors reward companies with good ESG ratings, which would motivate others toward beneficial corporate governance.

SMART BETA FIXED INCOME
 Adding to the smart beta ETF theme, some providers have come out with various equity ETF strategies that implement factor screens. But there is a dearth of smart beta options in fixed income, which opens another opportunity for the ETF industry to disrupt the status quo.

Bond investors have been coasting for many years, but good times are coming to an end. After a three-decade-long bull run in the fixed income market that has pushed yields to record lows, we are now heading toward a rising-rate environment, leaving many bond investors to take a hard look at their holdings. Many may find that the risk-reward profile of their core bond positions has changed.

Components of the Bloomberg Barclays U.S. Aggregate Bond Index, a widely observed benchmark used to measure many core bond holdings, have shifted over time, altering the index’s risk-reward profile. Such alteration is especially evident in a rising-rate environment. Based on the benchmark, investors now are overexposed to interest-rate risk due to higher duration, and they are receiving less yield for the higher risk.7

Similar to actively managed bond funds in the traditional fund space, smart beta bond ETFs could implement targeted screens to enhance diversification potential. At the most basic level, a smart beta methodology for fixed income could eschew traditional market-capitalization weights or not allocate component holdings based on which issuer has the most outstanding debt.

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ETF providers also could bring factors from the equity space to fixed income—factors such as momentum, a well-documented investment style that has worked in equities, currencies, commodities, and bonds.8 Studies have documented significant momentum effects in corporate bond returns and momentum profits have increased over time along with the growth of the segment.9

There are many other ways to add value through risk factors to help build a quantitative strategy for fixed income. For example, Goldman Sachs’ Access ETFs aim to improve risk-adjusted returns for fixed income investors by using liquidity, technical, or fundamental criteria, which include operating margin, leverage ratio, debt service, money supply, and the government’s current account.10

Nevertheless, the smart beta bond ETF category may face an uphill battle. Most ETF investment assets remain concentrated in the equity asset class, with a disproportionately small amount allocated to fixed income ETFs when compared to the trillions invested in debt securities and bond-related mutual funds. As of November 2018, there were 2,217 U.S.-listed ETFs with $3.6 trillion in assets under management but only 373 fixed income-related ETFs with $604 billion in assets and 52 enhanced or alternative index-based bond ETFs with $6.2 billion in assets.11

NONTRANSPARENT ACTIVELY MANAGED EXCHANGE-TRADED PRODUCTS
 With more traditional active mutual fund managers eyeing the ETF space but loath to give up their secret sauce under the transparent nature of the ETF investment vehicle, many are looking into nontransparent exchange-traded products as a way to combine the best of two worlds.

Many asset management firms already have filed with the U.S. Securities and Exchange Commission (SEC) seeking exemptive relief to launch actively managed funds under a nontransparent product structure. However, only two of these nontransparent structures—Vanguard’s patented fund structure and Eaton Vance’s NextShares exchange-traded managed funds or ETMFs—have gained SEC approval so far. Over the past couple years, institutions have outlined increasingly divergent approaches to fulfill SEC concerns related to these nontransparent ETF offerings, including varying terminology in differentiating the levels of transparency within their products.12

Vanguard Group entered the ETF space in 2001 under the radar. As the industry matured and observers examined Vanguard’s offerings, they found that Vanguard’s ETFs are a “share class” of a Vanguard index mutual fund and rely on an “opaque” transparency where holdings are revealed on a month-end basis with a 15-day lag.13

More recently, the Eaton Vance NextShares ETMF is another available SEC-approved nontransparent actively
managed exchange-traded product. Potential investors should be aware that these ETMFs are not to be confused with ETFs, because they are designated as a completely separate investment class. NextShares funds trade on an exchange and are bought and sold at the next end of day net asset value (NAV) plus or minus the best bid or offer. More importantly for the fund sponsor, because NextShares funds are not required to disclose full holdings on a daily basis, the portfolio managers are able to maintain confidentiality of their proprietary methodology.

The following are proposed nontransparent actively managed ETF products that are under SEC review at this time:

Precidian ActiveShares is a strong contender to NextShares and incorporates a proposed “AP Representative” structure where the authorized participant (AP) will direct creations and redemptions through a trustee without knowing the identity of portfolio securities. The structure also will provide a verified intraday indicative value on one-second intervals throughout the trading day. This makes the ActiveShares model unlike any active managed ETF on the market today.

Blue Tractor Group (BTG) Shielded Alpha ETF does not disclose specific weights but it does show which securities are held, so the structure may be seen as a nearly transparent investment tool. The daily published basket would disclose 100 percent of the stock names in the portfolio and have a minimum 90 percent overlap in asset value with the portfolio. BTG developed a proprietary algorithm to help shield the alpha generation strategy for potential fund managers.

Fidelity Actively Managed Exchange Traded Active Fund (AMETF) is based on a closed-end fund management design and utilizes a “tracking basket.” The structure includes a proposed tracking basket that would comprise the fund’s recently disclosed portfolio holdings and representative ETFs. Additionally, it would utilize a mathematical optimization process to minimize deviations in the return of the tracking basket relative to the fund.

T. Rowe Price Hedged Portfolios is based on a hedged portfolio to closely track the NAV. The money manager proposes the daily disclosure of a hedge portfolio, the value of which is expected to closely track the underlying NAV of the fund. “[E]ach fund will consistently invest such that at least 80 percent of its total assets at the time of purchase (including borrowings for investment purposes) will overlap with the portfolio weightings of its identified Hedge Portfolio.”

These digital units represent a new form of information transfer that allows anyone to exchange a unit of currency over an open public network.

NYSE/Natixis Periodically-Disclosed Active ETFs generate a proxy portfolio with different composition and weighting than the fund’s actual holdings by utilizing lagged holdings. The proxy portfolio will, according to the application: “(1) allow for effective hedging by market makers that will have the effect of keeping share bid/ask spreads within a narrow range that will foster liquid share markets, and (2) support arbitrage activities by Authorized Participants and other arbitrageurs that will have the effect of keeping Fund share trading prices reasonably aligned with Fund NAV per share.” These various nontransparent products have some similarities and some differences. An obvious difference among them is their intraday pricing and daily disclosures to the AP. The SEC takes issue with these features, leading to bumps and stalls in the regulatory vetting process.

**BLOCKCHAIN AND CRYPTOCURRENCY**

The cryptocurrency hype has spilled over to the ETF industry. Although no cryptocurrency-backed ETFs are available now, blockchain-related ETFs have made their way to market, allowing investors to gain indirect exposure to the technology that powers the cryptocurrency industry. Blockchain is a decentralized database shared across all users that facilitates recording transactions and tracking assets. This foundational technology is expected to pave the way for significant disruptions across many industries.

Cryptocurrencies act like digital tokens or units earned by computer operators for processing transactions on public blockchains. Each blockchain would have a unique digital unit or cryptocurrency. These digital units represent a new form of information transfer that allows anyone to exchange a unit of currency over an open public network. The units are accessible, secure, fast, and borderless, operating independently of any traditional banking or government influence.

Although no cryptocurrency-specific ETFs are listed on the markets, a theoretical cryptocurrency ETF offering would own the underlying assets it tracks and sell shares of these assets on the secondary market. At this time, cryptocurrency ETFs are stuck in red tape because the SEC already has rejected many bitcoin ETF proposals. According to the SEC, the products did not comply with the requirements of “Exchange Act Section 6(b)(5), in particular the requirement that a national securities exchange’s rules be designed to prevent fraudulent and manipulative acts and practices.”
ETF providers, though, have not given up. In November 2018, BlackRock Chief Executive Officer Larry Fink said at the New York Times Dealbook Conference in Manhattan that a cryptocurrency ETF is not off the table, but added that BlackRock is waiting until the industry becomes “legitimate” under the government laws and regulations.

Other asset managers and Wall Street chief executive officers have expressed interest in blockchain technology and its potential applications. The emerging technology is potentially relevant to more than 30 industries in multiple economic sectors, including ride share, global shipping, creative rights, intellectual property, real estate, insurance, health care, and commodities. A handful of blockchain-specific ETFs already are trading on the market. These ETFs cover companies that are committing material resources to developing, researching, supporting, innovating, or utilizing blockchain technology for their proprietary use or for use by others.

**THE ETF FEE WAR: A RACE TO ZERO FEES**

In the face of increasing competition, the ETF space and broader fund industry is expected to continue its interminable fee war, pushing investment costs closer to zero. As the fee war has intensified, its aftereffects have bled into the fund industry as a whole.

Long-term mutual fund expense ratios have on average declined substantially for more than two decades. In 1996, equity mutual fund expense ratios averaged 1.04 percent, falling to 0.59 percent in 2017. Hybrid mutual fund expense ratios averaged 0.95 percent in 1996, dipping to 0.7 percent in 2017. Bond mutual fund expense ratios averaged 0.84 percent in 1996, compared to 0.48 percent in 2017. Furthermore, the expense ratios of index equity ETFs fell from 0.34 percent in 2009 to 0.21 percent in 2017, and expense ratios of index bond ETFs went from 0.26 percent in 2013 to 0.18 percent in 2017. The Investment Company Institute attributed the push toward lower fees to rising investment demand for lower-cost equity funds in both actively managed and index funds, along with asset growth and economies of scale.

According to PwC, management fees for traditional mutual funds are projected to fall by nearly 20 percent by 2025, lowering the global asset-weighted average of 44 basis points (bps) at the end of 2017 to 36 bps. The pressure on fund fees is attributed to increased pressure from investors for better value as well as heightened regulatory scrutiny.

Competition is expected to be most intense in the passive fund space, where ETF managers already are locked in a price war to see who can bring fees closest to zero. Five U.S.-listed passive, beta-index ETFs now trade on the market with a 0.03-percent expense ratio. However, the ETF industry technically already has offered a 0-percent expense ratio ETF; iShares Treasury Floating Rate Bond ETF (TFLO) may have a 0.15-percent expense ratio, but it used to have a fee waiver of 0.15 percent that resulted in a 0.00-percent expense ratio. Note also that the mutual fund industry’s Fidelity now offers zero management fees on two of its mutual funds.

The fee war has moved into the global markets as well. Fees for passive funds in Europe are expected to slip from 23 bps to 15 bps by 2025. In the United States, where passive funds already have a prominent position in investor portfolios, fees are anticipated to fall from an average of 13 bps to 11 bps by 2025.

Active managers likely will have it worse off. PwC expects fees for actively managed funds in Europe to plunge by about 26 percent, from 78 bps to 58 bps. Meanwhile, actively managed funds in the United States, which have experienced large outflows in recent years, are predicted to fall from an average of 43 bps to an average of 38 bps.

The fee war already is exposing casualties in the fund space. As the end investor looks at cheap passive index-based funds, many actively managed funds are losing steam or calling it quits altogether. In the developed markets, up to 25 percent of all mutual funds are projected to close and ETFs are expected to continue to grow significantly; up to 20 percent of firms in developed markets are expected to be eliminated through competition or acquisitions by 2025, according to PwC.

**SUMMARY**

As the ETF industry grows and matures, the ETF sector is revealing an ongoing desire to innovate in a bid to attract more investment assets. There are at least five obvious ways the ETF industry may continue to drive asset growth and disrupt the status quo: the lowly populated socially responsible investment category, smart beta fixed income, nontransparent actively managed exchange-traded products, cryptocurrency, and low management fees. Each of these trends presents a potential for additional innovation and growth in the ETF industry.

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**ENDNOTES**


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