



Achieving sustainable
growth through
exchange-traded fund
(ETF) product innovation

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ETFs have grown at an astonishing pace over the past decade. They accounted for no less than US\$5.7t of assets at the end of August 2019, with European ETFs making up US\$890b of the total.

Despite market volatility, year-to-date compound annual growth rates are running at 16% in Europe and 17% worldwide, according to September 2019 data published by independent research consultancy ETFGI. This exceptional growth not only reflects the global shift to passive investing – a trend ETFs helped to create – but also ETFs' tradability and flexibility. Even so, the ETF industry can't afford to ignore the global economic situation. Growth is slowing in key markets, such as China and Germany, as geopolitical uncertainty throws a shadow over financial markets. August 2019 was the first month in years to see net global outflows from ETFs. Despite their strong track record, ETF providers can't assume that what has worked well to date will guarantee future success.

This means that ETF product innovation, always central to the industry's story, is more important than ever for growth. In an increasingly crowded market, innovation also allows new entrants and second-tier firms to compete with the industry's leaders. In this paper, we look at two key ETF growth markets and suggest actions firms could take if innovation is to deliver sustainable benefits for investors – and for themselves.



Fixed-income ETFs – onward and upward

Bond ETFs have grown rapidly into the mainstream and look poised to move up another gear

Fixed-income ETFs have dramatically shrugged off their “niche” label in recent years. Global bond market ETFs recently exceeded the US\$1t mark – quite a milestone for a product created in 2002, which accounted for less than US\$50b of assets in 2008. The fixed-income ETF universe has grown from 114 products, in 2007, to over 1,300 in late 2019. Globally, in the first eight months of 2019, fixed-income ETF inflows exceeded those to equity ETFs by US\$148b to US\$89b. However, in Europe, bond ETF inflows beat equity ETFs by US\$42b over the same period, according to research consultancy ETFGI.

Even allowing for investors’ global shift into fixed income, it’s an impressive track record. But what about the future?

The future will see more innovative uses of ETFs by investors ...

In the short-term, there are certain potential headwinds for bond ETFs:

- Slowing economic growth may reduce the capital that investors have to invest.
- Although interest rates are unlikely to rise in the immediate future given the economic outlook, were central banks to increase rates, this will have the effect of reducing bond prices.
- Investors and supervisors also have concerns about liquidity risks, given the reduction in bond inventories held by primary dealers over the past decade.

EY ETF team expects bond ETFs – which represent less than 1% of global bond markets – to continue their strong growth.

Even so, we expect fixed-income ETFs to continue their strong growth. After all, they still account for a tiny slice of global bond markets – less than 1% in 2019, and the industry agrees, with some promoters predicting that fixed-income funds will double in size to US\$2t by 2024.

“Investors’ growing familiarity with the diversification and flexibility of fixed-income ETFs will be one key growth driver,” explains EY EMEA ETF leader Lisa Kealy. As well as using ETFs for strategic and tactical asset allocation, institutions will increasingly use fixed-income ETFs for portfolio management functions, including cash management, active liquidity management and portfolio transitions. The adoption of bond ETFs by institutional, high-net-worth and retail investors will receive a further boost from three other factors:

1. Developments in portfolio construction, such as active managers using ETFs alongside individual securities or to build short positions.
2. The spread of model portfolios using ETFs among wealth advisors, robo-advisors and other intermediaries serving retail and high-net-worth investors.
3. Improvements in bond market efficiency, such as electronic bond trading platforms that connect buyers and sellers directly without relying on traditional market makers.



... and more innovative design by ETF promoters

Looking further ahead, we also expect continuing product innovation to play a key role in driving greater inflows to fixed-income ETFs. Future areas of innovation will include:

- ▶ A greater range of maturity profiles, including target date funds, to help institutional investors meet liability commitments and to facilitate drawdown by retail investors.
- ▶ More smart beta products, introducing style factors, such as quality or momentum into fixed-income ETFs and helping investors to tailor their holdings around their desired outcomes.
- ▶ Incorporating environmental, social and governance (ESG) techniques into fixed-income ETFs:
 - ▶ The need to rollover debt will help ETF investors to wield growing influence on ESG topics.
 - ▶ Van Eck and iShares are two promoters to have issued Green Bond ETFs, and Nuveen has recently launched a high-yield corporate bond ESG ETF.
- ▶ Greater geographical choice for fixed-income investors:
 - ▶ Many bond markets remain difficult for foreign investors to access – mainland China being an obvious example.

Are ETFs and ESG a match made in heaven?

Combining ETFs with ESG offers huge growth potential – if the two concepts can be grafted together

The market for ESG-themed ETFs – funds that use ESG factors in their strategies – is far less mature than the bond ETF market. Investment research provider Morningstar reported that ESG ETFs had global assets of £13.5b at the end of August 2019 – around a quarter of 1% of all ETF assets. It's not an asset class, but an investment philosophy, which is comparatively new to many investors and relies heavily on qualitative judgments.

At their present rate of growth, ESG-themed ETFs could attract £500b during the 2020s.

So, why look at ESG ETFs at all? The answer is simple: they're growing very fast, albeit from a low base. Global assets under management (AUM) increased by 50% in 2018 and during the first eight months of 2019, AUM again increased by 36%, according to Morningstar data. At this rate, ESG ETFs could attract US\$500b within a decade, but many firms feel that even this may underestimate their potential. Demand is soaring among European pension funds and other institutions, and this appetite will only increase as millennial investors receive an unprecedented financial inheritance. The Global Sustainable Investment Alliance reports that there are now US\$22.9t (€19.2t) of assets managed under responsible investment strategies worldwide; ETFs currently represent less than 0.1% of that total.

"We see huge opportunities for promoters that can match the benefits of ETFs with the growing demand for ESG investing," says Lisa Kealy. But there's a long way to go to achieve that goal. For now, ESG investing poses potential challenges for ETF promoters. Some of the most obvious pitfalls are:

- ▶ The lack of agreed definitions over the elements of ESG. Even climate change, a hugely complex investment problem, is only one of many environmental factors.
- ▶ The misunderstanding of many investors that ESG investing does not put "values above value," but focuses on how ESG factors can affect financial risks and returns, especially in the long-term.
- ▶ The absence of proven quantitative investment techniques for modeling ESG-related risks and returns.
- ▶ The inconsistency of ESG-related disclosures among "asset creators –" the companies that issue securities. Despite global initiatives, such as the Task Force on Climate-related Financial Disclosure and the EU's efforts to develop ESG investing standards, international agreement over ESG disclosures remains a very long way off.

These are problems for all investment providers, but they may be particularly challenging for ETF providers who are used to rules-based investment strategies. ESG might take ETF promoters into more judgmental areas than they are used to.

Promoters should ask four key questions before launching ESG ETFs

Can ETF providers incorporate ESG into their products without compromising on transparency and tradability? We think ETF issuers should ask themselves the following four questions before launching ESG-themed ETFs:

1. Which ESG investing techniques are best suited to fixed-income, equity and other classes of ETF?
2. Negative screening can be built into ETF strategies, but how quickly can index providers remove an individual stock that suffers an "ESG incident" and how fast can we as an ETF manager divest it?
3. How can qualitative ESG techniques, such as positive screening, "best-in-class" or thematic investment, be incorporated into rules-based investment criteria?
4. Can we clearly explain to investors how the ESG-related decisions we take will affect a fund's composition, volatility, concentration risks, yield and growth?

Innovative solutions to the challenges of ESG are evolving

Of course, every challenge brings an opportunity. Several providers have already issued ETFs that track high-profile ESG-themed indices. They believe that developing proprietary approaches to ESG will create lasting competitive advantages. We expect innovative solutions to the challenges posed by ESG-themed ETFs to include:

- ▶ Using smart beta techniques to implement ESG: ETF promoters and authorized participants have extensive experience of developing and trading multi-factor funds, and these techniques should help to incorporate different ESG approaches into ETF structures.
- ▶ Developing tailored solutions that meet the needs of anchor investors: One recent example is a new ESG-themed ETF developed by Finnish pensions insurer Varma in collaboration with Legal & General Investment Management and indexing specialist Foxberry. Another comes from BNP Paribas, which is considering creating proprietary ESG indices for its ETFs.
- ▶ Implementing ESG strategies through actively managed funds: Active ETFs are a small but growing subset of the ETF universe and give managers greater discretion over investment decisions than most passive or semi-passive funds allow.
- ▶ Making greater use of ETF managers' ability to vote investors' proxies on their behalf: Some of the world's largest ETF providers have received public criticism for underutilizing this potential source of leverage to address ESG-related issues.

Implementing a structured approach, such as the EY responsible investment framework, will help ETF providers to innovate sustainably. "Robust product development processes will help ensure that promoters fully understand the implications of their decisions and that these are communicated clearly to investors," explains Lisa Kealy. In time, this kind of framework will also make it easier for ETF providers to incorporate ESG considerations across their investments. BNP Paribas is one example of an ETF promoter planning to develop such an enterprise-wide approach.

So, what does smart ETF innovation look like?

A clear focus on the risks and rewards for investors holds the key to sustainable, successful innovation

Innovation will help ETF providers to grow their fixed-income and ESG inflows, but it is not a panacea. These will not be markets in which every firm can succeed. Leaders will need to keep innovating to stay ahead, while challengers and new entrants will need a distinctive, compelling advantage if they're to compete. We expect future growth in fixed-income and ESG ETFs to be accompanied by:

- Increasing competitive pressures, as existing players and new entrants vie for a slice of growth.
- Lower fees and additional competition on price, leading to margin pressure and – for firms unable to achieve economies of scale – falling profitability.
- Growing disparity between those firms with the scale or expertise to succeed in specific product areas and those struggling to remain competitive.

Firms that want to overcome these competitive challenges need to be mindful of the risks of innovation – and keep a clear focus on the needs of their investors.

ETF providers must keep an eye on potential risks ...

ETF providers must also be aware of the potential risks that can flow from careless innovation. On the fixed-income side, we expect investors and regulators to increase their focus on the potential downsides of further growth. Fixed-income ETFs create tradability in the secondary market, but this depends on a degree of underlying liquidity. So far, regulators do not appear to have specific concerns over financial stability impact of fixed-income ETFs, but recent comments from the UK Prudential Regulation Authority (PRA) and the European Securities and Markets Authority (ESMA) suggest that

supervisors will continue to monitor the roles that different parties play in providing a market for ETFs. There may also be a risk that growing demand for higher yielding bond exposures will distort risk pricing.

In contrast, ESG ETFs are currently far too small to create any systemic concerns. The greater risks here lie in the potential for investors to misunderstand the details of individual ETFs' risk-return profiles. These products have very limited track records, so it remains to be seen how well providers can incorporate ESG considerations into reliable, scalable ETF structures. Given the rapid evolution of ESG investment techniques, this is an area that firms must monitor closely.

... and ensure they stay focused on investor needs

With the above factors in mind, we believe it's vital for ETF providers to remember that innovation per se will not deliver sustainable growth unless it takes place in the context of delivering outstanding investor experiences and value for money.

This means that innovation must always be driven by a clear-sighted focus on **meeting investor needs**. Investor suitability has played a key role in the growth of fixed-income ETFs, and many recent innovations in the ESG space have been built around the needs of anchor investors. Providers need to maintain this investor-oriented approach, especially as industry thinking on ESG investing evolves.

It's equally important that innovation occurs within business models that are fit for the future. In particular:

- ▶ ETF providers should encourage growth in **retail adoption**, especially in Europe where the shift to passive has further to run. That might include developing direct-to-customer sales; engaging with Defined Contribution or group personal pension providers; and working with distribution

partners, such as online platforms, robo-advisors and traditional wealth managers.

- ▶ Firms must aim to provide the best possible **user experiences** in terms of reporting, education and digital interfaces, supporting demand across a range of investor types.
- ▶ Third, ETF issuers should upgrade existing **operating models**, in order to support the changes detailed above; to handle greater scale; to execute at lower cost; and to remain competitive against mutual funds, other ETF providers and new entrants. Important elements are likely to include:
 - ▶ Using emerging technology, including artificial intelligence (AI) to automate and optimize client onboarding, back-office processing, risk reporting, and portfolio management.
 - ▶ Using external providers – such as securities servicers, fund administrators, software vendors and cloud providers – to supplement the ETF operating model.
 - ▶ Partnering on innovation and distribution with a range of specialized third parties, including FinTechs, index providers, digital platforms, sustainability consultants and academics.
 - ▶ Developing a talented workforce that's not only able to make the most of technology and data, but can also add value in sensitive areas, such as innovation or regulatory engagement.
- ▶ Finally, firms must address any potential **supervisory concerns** by focusing on suitability and risk management, and by engaging constructively with regulators and lawmakers.



Conclusion

Get innovation right now to accelerate ETFs into the 2020s

Product innovation is central to the ETF industry's plans to build on the rapid growth of the past decade. In our view, fixed-income and ESG ETFs stand out for their potential to create sustainable demand. But the EY ETF team doesn't believe that "more of the same" will be enough to steer ETF

markets toward continued expansion. ETF providers need to pursue smart, continuous improvement if they're to accelerate in an increasingly competitive market – and change investing for the better.



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In our wealth and asset management work today, not everything is innovation; a lot of it is evolution. And it's important to know the difference. FinTech disruptors continue to shift the rules, newer investors aren't flocking to older channels and cost pressure is relentless. From data and AI, to tech platforms and partners, the questions have never been bigger, and the stakes never higher.

We help clients re-think everything from pricing and operating models to competition and convergence. We bring critical questions into focus, which lead to bolder strategies, simplified operations and sustainable growth. Our sharp understanding of the state of play allows us to shift discussion from reacting to change, to helping shape it. Ultimately, we work with clients not just to stay competitive, but to change investing for the better.

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