



Exchange-Traded Products: Emerging as an Increasingly Important Global Asset Class

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The exchange-traded product (ETP) industry—including exchange-traded funds and related exchange-traded vehicles—has recently reached two remarkable milestones: more than 1,000 funds with over \$1 trillion AUM. Since the introduction of the **S&P 500 Depository Receipt** (SPDR) ETF in 1993, the marketplace has seen steadily increasing popularity, with an accelerating growth rate in recent years.

According to the **National Stock Exchange**, there were 672 ETFs in 2006, 875 in 2008, 924 in 2009 and 1,099 last year. Over the same period, AUM have likewise grown: from \$433 billion in 2006 to \$1.01 trillion at year-end 2010. This growth of AUM has been sparked both by cash inflows into existing ETFs and by a steady stream of innovative products. In 2010, 223 new ETFs were launched—compared to 100 in 2009—enabling investors to access a wide variety of regions, asset classes and investment strategies.

ETFs and ETVs can take many forms. With the significant increase in the number of funds and their total net assets, we have seen a corresponding emergence of innovation and diversification in their investment areas and structures. There are now ETPs that track virtually every recognizable stock market index, many bond market indexes, and as mentioned, even commodities and currencies.

Launch Considerations

Since the first product was introduced in 1993, the evolution and growth of the ETF/ETP industry has consisted

of hours of product development. This effort has served a remarkable purpose: It has brought products to market that not only fill the needs of institutional investors, but bring retail investors into an institutional space in terms of ETFs' competitive pricing and efficiencies as investment vehicles. These are the stages that asset managers should keep in mind when issuing ETFs:

Stage 1: Landscape

Before you even get to the drawing board in terms of your product's design, it is important to gauge the investment interest landscape. Are there interested investors? What is the level of product demand? Who are the current competitors? What are the barriers to entry? Most importantly, will you create a product that meets the needs of your current investors?

Stage 2: Product Structure

ETFs and ETPs are not uniformly structured. There are ETFs in the form of unit investment trusts, such as SPDRs, as well as open-end funds, such as iShares. Currently, there are ETPs structured as grantor trusts and those that use a limited partnership structure. The structure of the fund depends on factors such as the fund's investment portfolio and is a decision of the fund sponsor.

Stage 3: Investment Strategy

Not all ETFs aim to replicate an index. For more traditional passive products, index selection can be important to a product's success. Many well-known indexes have already entered into a restric-

tive or exclusive licensing agreement with fund managers, and therefore are not available.

Absent available well-known indices, some ETF sponsors have sought to create an index that is unique—utilizing a specific alpha or quantitative model with proven market performance. Market niche indexes have been steadily growing in popularity.

If products are planned to be constructed as active, relevant considerations can be a manager's reputation and track record; thinking through the interconnectivity between the ability to provide daily transparency into the ETF's holdings relating to a fund's ability to be fairly priced and traded on the secondary market. Since active ETFs remain in an immature state of innovation, it is important to seek the advice of experts including legal counsel, market makers and primary market liquidity agents. Currently, regulators have only approved products that offer investors full daily transparency into fund holdings. Any deviation is subject to regulatory approval.

Stage 4: Exchange

Shares of ETFs and ETPs trade intraday, thus requiring the product to be listed with a primary exchange. Key considerations include product support, reputation, liquidity, trading volume and cross-listing arrangements.

Stage 5: Service Providers

The role of service providers has grown in importance in recent years; for example, portfolio valuation and NAV

accuracy have undergone increased scrutiny to ensure investor protection. Settlement, back-office and clearing procedures may also be looked at closely by regulators. As ETFs continue to demonstrate increased innovation, an asset manager can benefit by establishing a partnership with a firm that can offer solutions spanning pre-to-post trade, including back and middle office, primary and secondary market trading, liquidity solutions and connectivity with major global trading exchanges.

Stage 6: Distributor

One role of the distributor is to take the orders from the Authorized Participants (APs) and, often, to act as the liaison between the ETF's transfer agent (TA) and the APs. The distributor passes the order information to the TA, who either creates or redeems the shares in creation units with the local depository.

Stage 7: APs

ETFs and ETPs operate both in a primary and a secondary market environment. Apart from the fact that the portfolio assets of an ETF or ETP can appreciate or depreciate due to market events, creation/redemption orders for shares entered by APs have a direct impact on the assets underlying an ETF or ETP. APs are the large institutional counterparties that enter into an agreement with the ETF or ETP, which permits them to participate in the creation/redemption process.

Stage 8: Registration

Asset managers will need to retain an attorney to help prepare and file the registration statement (including the prospectus and exhibits) with the SEC (or appropriate home-domicile regulatory agency) for review and comment. Counsel will also negotiate with the SEC and file amendments to the statement, as well as finalize the prospectus and other materials.

2011 and Beyond

The ETF/ETP space will continue to expand on its long-standing trends—asset growth, product innovation, global expansion—in 2011 and thereafter. In particular, we see:

Growing Institutional Interest

Although ETFs are commonly thought of as a retail product, institutional investors are finding that they can be helpful tools in such portfolio management tasks as cash equitization, transition management, rebalancing, and obtaining hard-to-achieve exposures. ETF use among U.S. pension funds, endowments and foundations has grown to about 14%, according to **Greenwich Associates**. Despite that relatively modest share, institutions actually represent roughly half the assets invested in ETFs in the United States.

The future looks bright for ETFs in the institutional market. Almost 55% of institutions currently employing ETFs expect their usage to increase in the next three years, including nearly 20% that expect the amount of assets dedicated to ETFs to grow by 5% to 10% in that period. Money managers are slightly more likely to predict an increase in use: 65% expect to be devoting more assets to ETFs in the next 12 months, compared with half of plan sponsors.

Changes in Distribution

To gain share from traditional mutual funds, several fund complexes have introduced zero-commission trades on ETFs. **Schwab** offers free trades for 11 of its proprietary ETFs, **Fidelity** on 25 iShares ETFs, **Vanguard** on more than 60 and **TD Ameritrade** on more than 100 commission-free ETFs.

In the UK, the impact of changing distribution practices can be seen through the retail distribution review (RDR). A major component of the RDR initiative is putting more constraints on how shareholder servicing fees are dis-

closed to make them more transparent.

Popularity Among Fee-Based Advisers

Some believe that ETFs will continue to be embraced by fee-based financial advisers, something that may help support their popularity. If regulators tighten up on potential conflicts of interest in the brokerage and advisory industry, more advisers are expected to move toward business models based on fees from clients rather than sales commissions on products. Fee-based advisers tend to have their own investment strategies and disciplines, and the use of easily traded, relatively low-cost ETFs may be popular, because they provide excellent liquidity and are an efficient tool to dictate asset allocation.

Products Launched Outside N.A.

As leading issuers look to extend their footprint outside their home domicile, prospects for growth are especially strong in the Europe, Asia and Latin American markets. At the same time, products domiciled in Hong Kong are flourishing and are being offered throughout Asia. And regulators in local jurisdictions around the world may adjust their policies to promote ETF creation, trading and domiciliation. Promoting global access, the industry is increasingly looking at ways to streamline liquidity in fragmented markets and promote and create global access products tied to ETFs.

Now and In the Future

In 2011 and beyond, we expect that ETFs and their related products will continue to evolve into very important, increasingly mainstream vehicles within the investment community's allocation tools. Broadening investment demand and product innovation on a global scale could open up new avenues for growth for the asset class for years to come.