Global ETF Survey
A new era of growth and innovation
January 2014
Foreword

The global exchange-traded fund (ETF) industry continues to grow, as investors and traders around the world become more familiar with the unique features of ETFs. At the end of October 2013, the Global ETF/ETP industry had 5,042 ETFs/ETPs, with 10,053 listings, assets of US$2.3 trillion, from 215 providers on 58 exchanges.

In response, EY has expanded the scope of our annual ETF survey to cover the United States, Europe and Asia Pacific. The latest survey builds on last year’s by interviewing more than 60 promoters, market makers, investors and service providers in 21 cities and 13 markets, including promoters representing 87% of the industry’s global assets.

This report summarizes what we have been told. It analyzes the quantitative responses to the survey, along with qualitative commentary gathered from our interviewees. It also draws on the international series of roadshows held by EY during October and November 2013. These events saw the survey’s initial findings presented to, and debated by, a range of leading figures from the ETF industry in Europe and Asia.

As a firm we are committed to improving the understanding of ETF markets, and our own ability to support the industry. We would like to put on record our great appreciation for the time and thought contributed by our interviewees. We hope that they, and the wider industry, will be interested in the insights this paper contains, and that it will make a modest contribution to the development of this vibrant, fast-growing and fascinating sector.

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1. Source: ETFGI LLP
Executive Summary

ETF assets continue to grow rapidly, and we expect this to continue into the future. We predict annual growth rates of 15%-30% around the globe over the coming five years, and believe the ETF industry could surpass the hedge fund industry in assets under management during the next 12-18 months. We expect this growth to come from more widespread users of, and uses for, ETFs. This will be achieved through greater innovation, and by taking market share from active and other passive competitors.

Despite this rapid growth, we believe the survey shows increasing signs of maturity in the ETF industry. Competition remains intense, but competitive dynamics are becoming more sophisticated as the industry grows in size and complexity. There is also greater understanding of the importance of liquidity, accuracy and innovation, and of the mutual reliance between promoters, market makers and administrators. Promoters are giving increasing thought to their long-term distribution needs, and the industry as a whole appears to be taking a more measured attitude to regulation. We see an increasing desire to not only pursue asset growth, but also to secure the industry’s future by making ETFs work better for investors. We examine the defining themes of the global ETF industry in more detail in our Key findings.

The broader scope of this edition of the survey – which is now global, rather than purely European – has also given us a fuller appreciation of the shape of the industry. In some respects, the industry is fragmented along regional lines. The US is the world’s most mature ETF market, and enjoys strong retail take-up. Europe is comparatively sophisticated, but geographically fragmented, and carrying a particularly heavy burden of regulation. Meanwhile ETF markets in Asia – outside Japan – are dominated by institutional capital and are comparatively small and shallow. However, the rapid development of Asian markets suggests that they could leapfrog ahead of Europe in future.

Despite these differences, we have also gained a better understanding of just how globally connected the ETF industry can be. This is evident not only in the comparability of products and strategies, or in the global reach of many leading promoters, market makers and service providers. It is also apparent from statistics and anecdotes showing the importance of cross-border capital flows in institutional ETF markets.

Overall, we remain strong believers in the “ETF story.” This not only means that we expect the low costs, liquidity, transparency and convenience of ETFs to allow the industry to continue to outgrow the wider asset management sector. It also means that we believe successful ETF markets have the potential to deliver benefits to economies and societies at large.

However, this success and these benefits cannot be taken for granted. If the industry is to fulfil its undoubted potential for long-term growth, it needs to ensure that the right building blocks are in place. These include better educated customers, better informed regulators, effective distribution and robust pre- and post-trade infrastructures. In our recommendations, we highlight some areas which we believe merit particular attention from the industry.

We also caution the industry against taking its current rapid growth for granted. To be clear, we detect no hint of complacency among ETF promoters, traders or administrators. In fact, the ETF industry in many markets is characterized by a refreshingly collegiate atmosphere. Even so, we feel that the ETF industry’s reputation – still in its formative years – could be permanently damaged by a well-publicized scandal.

The remarkable success of ETFs is a tribute to the product itself, and to the companies and individuals that make up the industry. Investment and vigilance will be crucial to ensuring that ETFs continue to enjoy a bright future.
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Key findings

1. ETFs continue to grow rapidly, but few markets will follow the US model.

The size, longevity and stability of the ETF industry in the United States mean that it is often referred to as a mature market. US ETF assets represent more than 70% of the global total. But while annual growth may have slowed from its ten year average of more than 25%, the US market is still expected to expand by more than 15% annually – hardly a sign of maturity. It is also notable that a significant proportion of US ETF inflows represent inward investment from Europe, Asia and elsewhere.

In comparison to the US, ETFs in many developing markets are still in their infancy. Growth rates in Asia Pacific are among the highest in the world, with assets expected to continue expanding at 20-30% per annum. Even so, the region is highly fragmented and there are significant local variations. Japan is the region’s largest and best established market, while Hong Kong continues to be the region’s largest hub for offshore investment and Korea has an increasingly innovative domestic ETF market where leveraged products are very popular. Most other markets in the region are at an earlier stage of development, with rival promoters occasionally co-operating to build awareness of the benefits of ETFs.

In contrast, the European ETF industry is something of a hybrid. As a region, many of our respondents expect it to continue growing at 15-20% a year. In many ways it is as sophisticated as the US market, especially in the institutional arena. But while it enjoys some common standards, it is far more fragmented than the US market, and retail take-up is far lower. As we shall see, European ETF players would love to iron out these differences.

So while ETFs are out-growing the wider asset management industry in every region, it is important to remember that cross-border flows of capital play a significant role. It is also increasingly obvious that every market will follow its own development path. Nonetheless, there is global recognition that ETF growth can only be achieved with the right supporting circumstances and infrastructure. In the rest of this section, we explore these issues in greater detail.

2. The industry’s success depends on delivering liquidity – in good times and bad.

Although low costs and flexibility remain crucial to the appeal of ETFs, liquidity is increasingly seen as the most distinctive and important feature of the industry. Liquidity is particularly important to winning the confidence of institutional investors, so achieving and maintaining liquidity is essential to growth and profitability. Lack of liquidity is the most frequent reason that fund launches fail, and most respondents view US$50m, or even US$100m, as the minimum viable size for a typical ETF.

Our conversations with interviewees show how complex the links between liquidity, size and investor confidence can be. One important aspect is the way that institutional investors’ internal concentration limits prevent them from investing in anything but the largest ETFs. The need for liquidity also underlines the vital role that market makers play in the development of ETF markets. In the case of emerging markets, lack of liquidity is cited as a particular obstacle to building the industry’s profile. In many cases, this can have the effect of driving local capital into more liquid US or European-listed ETFs, artificially depressing the size of Asian ETF markets.

With this in mind, it is interesting that promoters and broker-dealers often view liquidity through different prisms. Promoters tend to see size and bid-offer spreads as key measures of liquidity, while market makers put more weight on trading volumes, the ability to offer funds as collateral and the liquidity of indices’ underlying constituents.

All of these features mean that liquidity often operates like a virtuous circle. The more liquid a fund, the more assets it is likely to attract. Of course these self-reinforcing characteristics can also work in reverse. Although most participants are convinced of the liquidity benefits of ETFs, there are some concerns that weak liquidity at a time of wider market volatility could pose a reputational threat to the industry.
3. Efficient centralized settlement would be a game changer in Europe — if it can be achieved.

In Europe, the need for liquidity faces a huge challenge from the region’s fragmented markets and the resulting importance of over the counter (OTC) trading volumes. Europe will never be a single market like the US, but promoters and market makers are crying out for better cross-border coordination. The combination of widespread cross-listings with numerous local venues and processes for trading, clearing and settlement means that price discovery and best execution remain elusive in the European ETF market.

Our survey respondents believe centralized European settlement would have a game-changing effect on liquidity and investor confidence. It would also achieve huge cost reductions for investors; cross-border settlement in Europe can cost four to six times as much as in the domestic US market. In short, centralized settlement offers the potential to unlock huge latent growth in the European ETF market.

Identifying this goal is one thing, achieving it another. The improvements in post-trade reporting promised by T2S could provide the necessary stimulus, but T2S is not expected to be fully implemented until late 2017 at the earliest. MiFID II’s requirement for all ETF trades to be reported in formalized venues with open access to prices would reveal a lot of hidden liquidity, but this too will not happen overnight. Greater co-operation and recognition between Europe’s biggest exchanges and other electronic markets would be a welcome step, but that is a long way from the optimal outcome of achieving a single “virtual” European trading venue.

For now, it looks as though innovation from within the industry may offer the best chance of success. Most of our interviewees would support consolidated tape — a continuous feed of ETF price and volume data — but many are sceptical whether the necessary level of co-operation can be achieved, given the dominance of OTC trading. In the meantime, initiatives such as BlackRock’s recent cross-border settlement partnership with Euroclear will be closely watched by other promoters and market makers. If this proves to be successful, then other market participants may wish to join. Network effects could hold the key to taking European ETFs to the next level of success.

4. Innovation is vital to successful fund launches, but needs to be handled with care.

The survey shows that new products remain at the center of most promoters’ business models. Apart from the obvious chance to gather fresh assets, new launches fill gaps in product ranges, build brand awareness and help issuers to enter new markets. However, achieving scale and liquidity remain a leading obstacle to success, and there is an expectation that fund closures will accelerate.

Going forward, large promoters may be able to consolidate sub-scale funds, particularly where cross-listings are involved.

It follows that there is no longer any room for “me too” in today’s ETF markets. Every launch needs to offer something new to investors. Pricing remains important to every fund’s appeal, but price alone is an increasingly unsustainable route to success, especially in the US and Europe. Instead, issuers are putting much more effort into their pre-launch preparation. This is not just about seeding. It also means doing more due diligence into potential demand, rather than developing products on the basis of investor queries. So while promoters are launching fewer funds, they are expect to achieve a much better hit rate than in prior years.

As a result of these trends, fund strategies continue to get more sophisticated. Nowhere is this truer than in the US, where fixed income funds – particularly high yield products – are a major area of focus. Fixed income funds are also gaining ground in Europe. Interviewees across every region predict growth in foreign currency share classes, fund of fund ETFs, new emerging market funds and commodity ETFs. Looking further ahead, active ETFs also show potential – many attributes of ETFs are not restricted to passive products. Active ETFs could also draw traditional investment managers into the ETF arena. In the US, these are already marketed alongside mutual funds, but it could be a long time before a secondary market develops in Europe.

Smart, enhanced or alternative beta ETFs are another major focus of innovation. Promoters are broadening their range of outcome oriented products for institutional investors looking to pep up low-yielding portfolios. At the same time, these products are causing a few alarm bells to ring. ETFs are an access vehicle for other investments, and there are concerns that the whole industry’s reputation could be damaged if highly leveraged ETFs end up in the wrong hands, if exotic ETFs fail to track their benchmarks at moments of market stress or if the line between active and passive funds becomes blurred. New products may be vital to growth, but the industry should be wary of incautious innovation.
5. Attitudes to pricing are becoming more sophisticated as ETF markets develop.

Price competition in ETF markets remains intense, particularly in the US where mainstream index funds are at their most efficient and leading promoters compete heavily on price. Even so, there are some signs that attitudes to pricing are changing as the ETF industry matures. Globally, management fees are seen as a slightly less important differentiator than last year, and as only the fourth most important overall. The fact that charges remain the leading driver of preference in Asia Pacific suggests that management fees may become less important as investors become more familiar with ETFs. Conversations with industry experts also provide anecdotal evidence that the largest promoters in the US and Europe are moving away from using pricing as a standalone strategy. Instead of price wars, the industry may be shifting toward localized “price skirmishes.”

Another sign of greater pricing sophistication comes from investors’ growing awareness that management fees do not always reflect the full cost of ETF investment. Many of those we surveyed talked of the growing importance investors attach to other costs of investment. In particular, investors are increasingly factoring tracking error and difference into their assessments of cost. Promoters are responding with an increased focus on this area, and by highlighting low tracking error in their marketing efforts.

The survey allows us to roughly quantify respondents’ pricing predictions. Even though new entrants are expected to keep up competitive pressure, the outlook for management fees remains broadly stable. Almost all of our respondents expect fees to remain static or experience only a modest decline of two-five basis points. This reflects a range of factors, not least the fact that profit margins are already extremely tight. There is also the likelihood that most new entrants will pursue niche strategies rather than launching a head-on challenge to incumbent market leaders. Whether the forecast for stable prices proves correct may depend on the industry’s rate of expansion. Issuers will not need to take market share from each other if they can continue to grow their overall levels of ETF assets.

6. Big incumbents remain dominant, but competitive dynamics are heating up in many markets.

The large majority of our interviewees expect the market shares of leading players to remain stable, almost double last year’s figure. The prospect of further gains by the big beasts of the ETF jungle may be falling, but there is no question that the “Big 3” will continue their dominance, particularly in the US. In all markets, they and other firms with established positions will continue to benefit from the advantages of scale and liquidity. But tight profitability is likely to dissuade even the largest players from trying to cannibalize each other’s customers.

Instead, the focus of large firms will increasingly switch to entering new markets and launching new products. Asia Pacific remains the most attractive target for established US and European promoters, reflecting the region’s huge growth potential and a lack of dominant local incumbents. Latin America is also the subject of a growing wave of interest, especially among US issuers. But foreign entrants will not have it all their own way. Limited market knowledge, sparse distribution options and the skepticism of local regulators mean that in-market entrants will provide real competition. Korea and Japan are two major markets where local providers already occupy dominant market positions.

Developed ETF markets are much more likely to see new entrants in the form of niche players with specialized product ranges. The chances of an established asset manager entering the ETF market are considered fairly small, although a large bank-owned firm could still make a significant splash. However, most asset managers would prefer to gain ETF exposure through asset allocation than by becoming issuers in their own right.
Mirroring these developments, predictions of consolidation at the promoter level have declined since last year. Instead there is an expectation that sub-scale players will form alliances, or simply choose to exit the market. This is especially true in Europe, where the need for cross-listings represents an additional burden. Issuers may consider US$50–US$100m to be the viable threshold for a typical fund, but informal conversations suggest that many promoters need at least US$10b in ETF assets to achieve standalone profitability.

Looking further ahead, the industry's competitive dynamics are harder to predict. If ETF assets continue to grow, more of the world's largest asset managers may decide to enter the market. This would make up for the withdrawal of any of today's second- and third-tier players. It could also strengthen the industry's long-term outlook by giving investors a broader choice of ETF promoters.

7. Improving distribution is crucial to the next phase of growth, especially in retail.

Today's regulatory mood-music means that, like any financial products, ETFs need to be promoted and sold without detriment to the end investor. This is illustrated by the effort that promoters in Asia Pacific are making to convince investors of the benefits of ETFs. Strikingly though, the survey shows that more than 90% of respondents around the world believe their distribution models will need to be improved sooner or later.

In the long term, institutional investors are seen as the most important users of ETFs. Institutions already represent the majority of global ETF assets, although education remains a priority in developing markets. Promoters hope that innovation will continue to stimulate demand and help them to capture a greater share of pension fund assets.

In the meantime, issuers and market makers in the US and Europe are focusing their efforts on asset managers and private wealth managers. Many of those surveyed believe that ETFs should have larger allocations in many high-net-worth portfolios. Understandably, promoters with in-house wealth managers see this as a particularly valuable distribution channel.

Retail business represents a more complex challenge. Retail investors are seen as a source of long-term growth, but there is increasing recognition that every retail market has its own unique features. Few will emulate the success of the US, where promoters use a range of channels including proprietary sales teams and independent brokers. In most markets, seismic changes will be needed to unlock the kind of retail growth promoters are hoping for. Education alone will not be enough to create a culture of retail ETF investment. Nor is regulation likely to be a game-changer. This is illustrated by the UK’s Retail Distribution Review, which shows some signs of boosting demand for ETFs, but which many issuers view as having been a disappointment so far.

The role of independent advisors and investment platforms will be crucial to unlocking retail growth. Online platforms have a particularly important role to play, and this could prove to be a critical dependency in countries without developed bank-assurance models. But ETFs are struggling to gain traction with platforms and supermarkets set up for mutual funds. Limited budgets for brand building are also an obstacle for many promoters. We feel that issuers need to engage much more proactively with platforms to explain the benefits of ETFs to retail investors.
Growing acceptance of regulation is balanced against its increasing complexity.

Europe continues to feel the greatest burden of ETF regulation, but the survey shows that tensions have eased slightly since last year. A welcome reduction in the average number of hours spent on regulatory matters reflects the greater clarity over several initiatives, particularly ESMA’s proposals for European ETF regulation.

We also detect a growing sense that the industry should have nothing to fear from regulation, and that closer scrutiny arising from greater transparency may actually boost investor confidence in the industry. As already discussed, promoters and market makers are increasingly seeing the potential upside of changes, such as last year’s RDR in the UK, or in future, MiFID II. In Hong Kong, the RQFII scheme offers a major opportunity for growth among approved managers, and Hong Kong’s appeal is further underpinned by the potential for mutual fund recognition with China. The recent memorandum of understanding for an ASEAN fund passport signed by Singapore, Thailand and Malaysia is another illustration of the potential benefits that can flow from regulation.

Even so, the prospect of an eventual split in the UCITS eligibility regime in the shape of UCITS VI is proving controversial. Promoters without complex ETFs are comparatively relaxed about the idea. Others are vehemently opposed, seeing a split as an unnecessary complication that could damage the UCITS brand. Alternative approaches might be to reduce asset eligibility, or to restrict certain UCITS to professional investors. In the longer term, AIF structures might prove to be an internationally accepted vehicle for riskier products and strategies.

Finally, there is no question that ETFs continue to suffer cross-effects and unintended consequences from regulatory initiatives aimed at other targets. The potentially conflicting effects of EMIR and a future UCITS VI or Shadow Banking Regulation on synthetic ETFs illustrate this point, though we note that most survey respondents believe swap-based products will always have a role to play. Even index regulation, which could strengthen the industry’s credibility, is a source of uncertainty. However, some interviewees, concerned about reputational risk to the industry, would like to see exchange-traded products and leveraged ETFs come under regulatory supervision.

Although European respondents are more concerned about regulatory disruption than their counterparts in the US or Asia Pacific, the growing internationalization of ETFs suggests that many promoters’ regulatory challenges will only grow more complex.
9. The industry needs to take a proactive approach to managing its growing tax risks.

Tax remains an issue that the ETF industry engages with from necessity, not choice. Unfortunately, it is a rapidly growing area of concern. In Europe, this owes a lot to the Financial Transactions Tax (FTT) and the likelihood of introducing a directive which could affect the 11 “enhanced co-operation” EU states as early as the start of 2015. This prospect is alarming our interviewees more than any other regulatory initiative. Even if implemented in a “light” form, the FTT is expected to increase costs, widen spreads and reduce liquidity across many European markets. It could also have a highly selective impact on funds, promoters and market makers, depending on their domiciles, trading locations and settlement venues.

Considering the potentially far-reaching effects of the FTT, survey respondents show a striking range of awareness. Some are sufficiently worried to consider re-domiciling their funds, but others are barely aware of the possible impact. The FTT may not be introduced as currently proposed, but it will not go away entirely. In our view, firms should join their voices to demand sensible carve-outs for the ETF industry.

The FTT may be grabbing the headlines, but is not the only factor driving tax up the agenda. As the ETF industry grows in complexity, so too do a range of tax related issues. Even before the arrival of the FTT, the management of fund-level investment taxes, such as stamp duty and withholding tax, is seen as a growing challenge, particularly for complex or innovative ETFs. Another pressing issue is tax reporting. Again, this issue is a particular concern in Europe where national requirements vary and so much cross-border investment takes place.

ETF promoters and market makers often seek to outsource tax headaches like these to administrators or custodians. However our conversations with interviewees leave us feeling that the industry should take a more proactive approach to tax. At a firm level, this means putting more formal tax management frameworks in place and engaging more closely with service providers over tax issues. The industry needs to stay on top of tax if it wants to avoid a gradual rise in tax-related costs.
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Key findings
10. Better understanding and engagement with service providers would benefit the whole industry.

Service providers are integral to the ETF industry, supplying the infrastructure that promoters and traders need to make good on their promises to investors. Asset servicers are also expected to act as enablers for the further development of ETF markets. This is not just a question of supporting growing volumes of business. Market participants expect service providers to help lower costs and improve liquidity, as well as meet increasingly complex tax and regulatory reporting requirements.

With this in mind, it is striking that promoters in most markets feel service providers are not doing enough to support innovation in the ETF industry. This implies that market share gains could be made by asset providers able to offer tailored support to ETF issuers. Set against that, promoters continue to identify low fees as the most important differentiating factor when selecting an asset servicer. This is a natural response to price competition, but it is hard to reconcile a focus on lowest cost with a desire for greater innovation and expertise.

This is particularly true given the challenges that ETFs present to service providers. The liquidity of ETFs and the degree of automated trading in the market are just two features that contribute to the technological complexity of ETF support. Cross-listings are a further complication in Europe, while local regulations in Asia Pacific often require service providers to develop separate systems in every market.

Bottlenecks like these are frustrating to market participants, but the harsh truth is that they will not disappear overnight. Promoters and market makers also need to recognize that developing a new fund is often quicker and easier than developing the administrative platforms it will require. In our view, better communication is the key to co-ordinating expectations and ensuring that when money is invested, it is targeted in the right areas.

Recommendations

If the industry is to fulfil its undoubted potential for long-term growth, it needs to ensure that the right building blocks are in place in terms of sentiment and infrastructure. We, therefore, believe that the ETF industry should focus on:

- **Education.** Make further efforts to educate investors of the benefits of ETFs. Boosting adoption by institutional investors in Asia will be particularly important to developing the region’s ETF markets.
- **Distribution.** Work with platforms and other retail channels to increase their ability to market ETFs. This will mean engaging with a range of partners to develop the right distribution infrastructure.
- **Cooperation.** Make a new effort to achieve cross-border settlement in Europe, giving the industry a platform for stronger growth. This might mean building on regulatory or market-led initiatives.
- **Communication.** Speak with one voice when communicating with regulators, legislators, tax authorities and other external stakeholders.
- **Innovation.** Continue to develop ETFs’ innovative vibrancy, but ensure that new fund strategies or structures do not expose the industry to systemic or reputational risks.
- **Conduct.** Remain fully alert to potential conduct or mis-selling risks. As the adoption of ETFs grows, so does the chance of the wrong products being sold to the wrong investors.
- **Control.** Take a more structured approach to the management of regulatory and tax issues, as products grow in complexity and the industry becomes more internationalized.
- **Collaboration.** Engage with service providers to develop the industry’s efficiency and effectiveness. Areas of focus might include better support for innovation, growth, reporting and compliance.
- **Unity.** Consider the creation of a professional industry body dedicated to devising shared approaches to common ETF issues.
Liquidity and reputation

What is the minimum size of a fund for it to be viable?
- Overall, more than 90% of those surveyed view US$50m as the minimum size for an ETF to be viable
- More than a third see US$100m as the cut off point for success
- In Asia’s developing ETF markets, more respondents believe that smaller funds are viable
- In contrast, no US respondents believe funds smaller than US$50m can be successful

How do you measure adequate liquidity?
- Measures of liquidity vary significantly between regions
- The depth of secondary markets in the US mean that tight spreads are seen as the most important measure
- In Asia, turnover is seen as the key metric
- In Europe, respondents look at a combination of both factors

What are the most important criteria for investors choosing between competing promoters?
- Investors’ selection criteria have not changed hugely since last year
- However, it is notable that liquidity has gained the most ground
- Promoter reputation, which is closely bound up with liquidity has also advanced slightly
- Management fees are seen as having become slightly less important to investors, but the US is the strong exception to this rule
Will more promoters enter the market over the next two years?

- 83% of all respondents – even more than last year – expect more promoters to enter the market over the next two years
- In the US and Asia, this figure reaches 100%

If so, how will they enter?

- Views have changed significantly over likely entry routes
- Start-up entry appears to be the most popular option, but this reflects greater enthusiasm for organic growth in Asia (70%) than in Europe (22%) or the US (23%)
- Strategic alliances have become a much more favored option, driven by the views of US and especially European respondents
- Niche entry is seen as a less attractive route than before, but US respondents are still comparatively keen, reflecting the sophistication of the US market

What are the barriers to entry?

- Achieving scale remains the leading overall barrier to entry, and is seen as an even greater challenge than before
- The importance of liquidity and its close link with scale continues to act in a self-reinforcing way
- As a result, new entrants are finding it increasingly difficult to compete directly with the industry’s largest players
- Asia is the major exception; here the large players are less well-established, instead differentiation is seen as a greater barrier to entry
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Survey results

What effect will new entrants have on the industry?
- New entrants are expected to have an additive effect on industry dynamics
- The entry of new players will continue to boost competition and pricing pressure
- Consolidation among promoters is only now anticipated by a small minority of respondents
- Instead, more expect to see withdrawals by managers failing to achieve scale
- Innovation remains a crucial factor — both as an entry strategy and as a side effect of greater promoter diversity

Do you plan to increase or decrease the number of products you offer over the next two years?
- The survey shows that while most promoters continue to expand their product range, the rate of growth is slowing
- The number of respondents anticipating to launch more than 10 products has fallen, with plans for lower numbers of launches making up for the decline
- Only a small minority of those surveyed expect to see product ranges shrink

Will the success ratio of new launches improve in the future?
- The flipside of launching fewer products is that promoters are investing more time and money in areas, such as design, due diligence and seeding
- As a result, the anticipated success rate of new launches has almost doubled since last year, while the anticipated failure rate has almost halved
- Greater pre-launch effort reflects promoters’ increasing focus on innovation products and strategies
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Competition and market forces

Which products do you see as growth areas?

- Fixed income products are identified as the leading focus for growth. US enthusiasm is surprisingly low, given the growing success of these funds.
- Instead, US respondents are keenest on more innovative products, including active funds, commodity funds, enhanced beta and termination date products.
- Within fixed income, emerging market and high yield funds generate the greatest enthusiasm.

Are retail investors key to future growth?

- Expectations of retail growth have become much more upbeat.
- In part, this reflects the attitude of Asian respondents, who see strong potential for retail take up of ETFs.
- However European respondents – and promoters in particular – are also positive about retail growth.
- US respondents also predict growth, but take a more balanced view. Retail investors already make up a large proportion of US ETF assets.

Will there be consolidation among promoters?

- As already discussed, expectations for consolidation among promoters have fallen markedly since last year.
- In contrast, there has been an increase in the number of respondents expecting to see promoters withdrawing from the industry.
- There has also been a slight increase in expectations for partnerships and joint ventures.
The large majority of those surveyed expect the industry’s three largest promoters to maintain, rather than improve, their market share — and is broadly consistent across Europe, Asia and the US. Of the remainder of respondents, the balance of views is still toward market share gains.

Will margins (management fees) for promoters tighten in the future?
- It is no surprise to find that respondents see the outlook for management fees as veering toward the downside.
- The numbers of respondents expecting a strong decrease far outweigh those predicting a strong improvement.
- Even so, nearly half of those surveyed expect fees to remain virtually static.

Do you expect to see more promoters leaving the market over the next 2 years?
- This finding illustrates a growing view in the US and Europe that sub-scale promoters will begin to withdraw from the ETF market in greater numbers.
- The prevailing wisdom is reversed in the growing markets of Asia — where funds are typically seen as being viable at a smaller size.
Very few of those surveyed see their current distribution models as everything that they could be. This is particularly true in Asia, where many promoters are finding distribution challenging. In the more developed markets of the US and Europe, the majority of those surveyed see room for improvement. If European goals for retail growth are to be realized, promoters will need to do more to sell via platforms.

Asian respondents are purely focused on intra-regional growth (including Japan), while European and US respondents are more outward looking. Latin America has become more popular, especially in Europe. US promoters are heavily focused not only on Asia but also on Eastern Europe.

In Europe, concern about the impact of the AIFM Directive on the ETF industry has receded significantly since last year. This issue is also not on the radar of US or Asian players. In contrast, the EU Financial Transactions Tax has jumped up the agenda – largely, but not uniquely, in Europe. European regulation, such as UCITS and ESMA guidelines, is creating a degree of concern in Asia, but not in the US.
Which future regulatory developments give you most opportunity?

- The UK’s RDR is generally seen as having failed to trigger a mini-boom in retail sales – so far at least
- Even so, the RDR and similar European and Asian regulations to open up retail investment markets are seen as opportunity for the future
- There are also signs that promoters see potential upside from other regulatory changes, such as MiFID II

How much time do you spend dealing with new regulation and regulatory responsibilities?

- Receding concern about the impact of the AIFMD and ESMA guidelines has contributed to a welcome reduction in the regulatory burden for many respondents
- Even so, a minority see their compliance workload as having increased over the past year

Is there a future for swaps-based UCITS ETFs?

- Despite a recent history of regulatory focus on synthetic ETFs, respondents clearly believe that swap-based products have a role to play
How would the regulation of index providers help ultimate investors in ETFs?

- The majority of those surveyed identify improvements in clarity and transparency as the major benefits that might flow from regulation of index providers.

Where should regulators focus their attention in future?

- Leveraged ETFs and other emerging products are a leading source of concern among those surveyed.
- This is an interesting finding, given that many respondents either offer or are developing these products themselves.
- It suggests a concern that “someone else’s mistake” could damage the industry’s reputation.
- ETPs are seen as the other major source of risk to the exchange-traded world.

Taxation

To what extent is the EU FTT a significant issue for the industry as a whole?

- The EU Financial Transactions Tax (FTT) has leaped onto the ETF industry’s agenda.
- Not surprisingly, it is the European respondents who are by far the most concerned about the impact of the FTT on the industry.
- Most European respondents expect the costs of the FTT to be passed on to investors.
What are the leading tax issues for the ETFs you manage or support?

- Globally, the FTT ranks as the second biggest tax issue facing ETF players
- Investment taxes are seen as a leading challenge in every region
- FATCA is seen as a leading issue not only in the US, but is also a concern for many Asian respondents

Service providers

Do service providers do enough for the industry in terms of innovation? (Promoter responses only)?

- Promoters across Europe, Asia and the US feel that service providers could be doing more to support their innovative efforts
- Dissatisfaction is greatest in Europe, but in the US, there is a much more even balance of views

Do you expect more administrators to enter the ETF market?

- A strong majority of those surveyed do not expect to see more administrators enter the ETF market
- This implies that the advantages of scale already available to the largest service providers will only increase in future
- Where new entrants are expected, this typically refers to new geographic markets – not to entirely new service providers entering the ETF space
Exchange-traded funds
A new era of growth and innovation
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