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The evolution of the ETF industry

By Greg Tusar

The explosion in ETF assets — to $2.9 trillion in 2015 from $204.3 billion in 2003 — is evidence of a broad shift in the way investors approach asset allocation. No longer content to build a generic 60/40 stock/bond portfolio, investors are looking for any edge they can find to increase performance and lower volatility.

The exchange-traded funds industry has helped fill this void by providing investors with a simple way to gain investment exposure to virtually any asset class, geography or sector. According to research and consultancy firm ETFGI, there are now almost 2,000 ETF and exchange-traded notes products listed on U.S. exchanges, and more than 6,000 around the world, each with a distinct approach. Cerulli Associates estimates the total size of the market today is $3 trillion, and projects ETF assets to double by 2020.

The vast majority of these assets are controlled by the three largest ETF issuers: BlackRock (BLK) Inc. (BLK), State Street Corp. (STT) and Vanguard Group Inc. These market leaders account for approximately 90% of ETF daily trading volume occurring in a collective 1,200 funds.

While these firms have played a major role in pushing the ETF industry to its current heights, we believe the next evolution in the industry will be driven by smaller firms and new entrants. These firms, which include hundreds of small and midsize asset managers turned ETF providers, will drive growth and fuel product innovation.

Here is what's driving the next phase of growth in the ETF market and what it means for 2017.

Structural advantages

Exchange-traded funds have become an increasingly attractive investment vehicle as more investors — both institutional and

retail — realize the advantages of using these products to diversify portfolios and provide much-needed liquidity to help navigate today's volatile markets. With trading more globalized than ever, ETFs also greatly reduce the barrier of entry to new markets and asset classes. Instead of trying to invest in an area in which they might lack expertise, investors can save time and money by allocating to an ETF with exposure to the region or asset class.

Meeting this increased investor demand are dozens of new entrants, who specialize in everything from emerging market bond funds to esoteric commodity option funds. Even though asset sizes and trading volumes for these funds can be small, they play an important role in the overall market by providing investors with exposure to and, importantly, liquidity in virtually every sector and asset class imaginable.

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Cyclical advantages

The most successful and innovative smaller ETF providers are now being acquired by larger asset managers, providing an added incentive for launching new funds. A significant amount of new investments going into robo-advisers and retail advisers are being invested in ETFs. The planned DOL fiduciary rule rollout is expected to continue these flows. Further, many established funds are starting to realize this trend. Some are repackaging parts of their existing product range and adding ETFs, while others acquire successful smaller providers.

For example, Hartford Funds acquired Lattice Strategies in 2015 and Janus Capital, which since has merged with Henderson Global, started to increase its presence in the rules-based and active ETF space with the 2014 acquisition of VelocityShares, a boutique firm known for launching sophisticated products designed to manage market volatility. Backed by the scale and resources of these larger fund managers, the acquired ETF specialists stand to benefit from greater distribution and the flexibility to create innovative products, which will drive further growth.

Challenges

As with any other industry, rapid growth presents a series of possible hurdles. According to a study from the University of Mississippi and the University of Alabama, an increase in the number of ETFs in certain areas of the market, particularly niche sectors, could raise trading costs and lead to "degradation of market quality" and "lower overall market depth." The researchers argue traders will have a difficult time accurately pricing ETFs, especially those with low trading volumes.

However, we believe investors ultimately benefit from having more investment options. Increased competition raises the standard for what can be considered a successful ETF product, and also tends to bring down management fees, helping to compensate for potentially higher trading costs. Market makers also play an important role in creating successful ETFs, providing liquidity so that trades are done as efficiently and cost effectively as possible. Over time, as low-quality ETFs are shut down (either because of poor performance or low assets), the overall industry will mature.

Policy outlook

This next year should be a watershed moment for the industry. A number of regulations could give the industry a major boost.

- The Department of Labor's fiduciary rule: If implemented as it stands, we expect more financial advisers and broker-dealers to allocate to ETFs as opposed to more expensive options like traditional mutual funds, hedge funds and other alternative investment vehicles.
- 401(k)s: Currently, some ETFs are approved for inclusion in defined contribution plans in Canada. If a similar regulation is passed in the United States, we foresee this as a paradigm-changing trend as ETFs might capture market share from other traditional retirement-oriented investment vehicles, driving further asset growth.
- NextShares: Many traditional mutual fund managers have said they will launch these active non-transparent funds and several already have (e.g., Eaton Vance Management (EV), GAMCO Investors (GBL) Inc., etc.), with more expected over the next year.

The current market environment also offers opportunities for ETF providers and innovators, particularly in the following areas:

- Low-volatility funds: Recent market shocks (Brexit, the U.S. presidential election, etc.) have shown the importance of having the ability to weather volatile periods, particularly with liquid investment vehicles.
- Bond ETFs: Given the rising rate environment, investors might prefer to reallocate the bond portions of their portfolios via ETFs to help react to market changes more quickly.
- Smart beta: Smart beta and other quasi-active mutual fund replacement products should continue to grow in popularity as investors look to customize their portfolios via specific risk/exposure parameters.

In conclusion, asset allocation can oftentimes be more art than science, and ETFs vastly expand the artistic tools that investors can use to create their Picasso portfolio.

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