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ETF Assets Set To Double Over Next Five Years

Exchange-traded funds have had a helluva run since they hit the scene in 1993, and according to a report from McKinsey & Company there should be plenty more where that came from.

During the last decade, assets under management in the exchange-traded products universe grew by more than 30% per annum versus 5% to 6% annual asset growth for mutual funds, says McKinsey, a global consultancy. And the firm expects worldwide ETP assets to grow from more than $1.5 trillion today to between $3.1 trillion and $4.7 trillion during the next five years (the vast majority of those assets are in ETFs; exchange-traded notes remain a small slice of the overall market).

In the U.S., the industry's growth has been fueled in part by the trend toward fee-based financial advisory models where advisors get paid on a percentage of assets under management rather than on commission.That encourages them put client money in low-cost vehicles such as ETFs.

At the same time, ETFs have enabled advisors to hone their tactical allocation across a range of asset classes, enabling clients to get exposure to assets classes that were previously too expensive or impractical to own such as commodities, currencies and foreign debt.

McKinsey believes the ETF industry has reached an inflection point and is entering the next stage in its evolution that will be marked by even more product proliferation and specialization, intense price competition, and more actively-managed funds.

"There's an ever-expanding array of choice, and generally that's a good thing for advisors," says Ogden Hammond, an associate principal at McKinsey and one of the lead authors of the report, *The Second Act Begins for ETFs: A Disruptive Investment Vehicle Vies for Center Stage in Asset Management*.

But as the ETF industry becomes more granular and increasingly rolls out niche market products, the number of options can be overwhelming. "The challenge for advisors is sorting through all of the products on the shelf and trying to find the one that's right for their client," Hammond says. "I think manufacturers will be more focused on how to better service the financial advisor and educate them on how these products are applicable to their clients."

Act II
The first phase of ETF industry growth was built around passive funds aimed at tracking underlying indexes. But that space is saturated, and competitors are seeking market share by slashing fees—in some cases as low as five basis points. Sounds great for investors, but McKinsey warns that ETF purveyors should carefully consider the pros and cons of engaging in price wars because there isn't a clear connection between rock bottom ETF prices and asset flows.

Competition for ETF assets should also heat up if and when established asset managers in the mutual fund space—worried that ETFs might be eating their lunch—start rolling out their own ETF products. This much-anticipated scenario has been all talk and little action to this point, with one notable exception being Pimco's launch in March of the ETF version of its popular Total Return mutual fund.

Part of the holdup for traditional managers is finding ways to convert existing their mutual funds into ETFs. Jeff Tjornehoj, a research manager at Lipper, believes mutual fund companies might have legal problems when it comes to translating their traditional open-end portfolios into accompanying ETFs because Vanguard has patented the method for taking a mutual fund and creating an alternate ETF share class that trades on an exchange.

But ETF sponsors are working on ways to circumvent that. “There’s been a lot of discussion and active work going on in the industry on this topic,” Hammond says. “There are ways where you can take a traditional 40 Act mutual fund and convert it in its entirety into an ETF.”

More Active

As part of the expected trend of more mutual fund companies entering the ETF space, McKinsey also expects to see a greater number of actively-managed ETFs. Pimco’s Total Return ETF made a big splash in that the area, joining such players as AdvisorShares, Columbia Management Investment Advisers, Wisdom Tree and PowerShares.

McKinsey sees active ETFs evolving from “smart beta” products based on so-called intelligent indexes to pure actively-managed products with human discretion generating alpha.

Initially, the trend toward active ETFs has been on the fixed income side where there’s less concern about protecting an asset manager’s trading strategies in transparent ETF vehicles against front-running by institutional traders.

Not A Smooth Ride

The ETF industry’s phenomenal growth is starting to hit some roadblocks. Product proliferation has created an excess number of passive products and too many narrowly-defined niche products that haven’t gained traction with investors, causing a dramatic uptick in fund closures.

According to McKinsey, just 10 ETFs closed between 2000 and 2007. That number jumped to more than 150 in the following three years, and the number of fund closures keep coming. “I think there’s a natural limit beyond which some funds are getting so granular and are appealing to such a narrow base of addressable assets that they’re probably uneconomical,” Hammond says.

But Hammond expects ETF providers will roll out new offerings that will have greater investor appeal and generate more sustainable asset levels, particularly as mutual fund companies enter space. And that should more than overcome fund closures.

And Hammond says the increased use of ETFs in defined contribution plans could be a growth catalyst. “Some companies are talking about introducing all-ETF defined contribution platforms,” he notes.
—Jeff Schlegel

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