STATE STREET

Speaking of Alpha

Modernizing ETF Management

A conversation with Anna Bernasek, Frank Koudelka, Ciarán Fitzpatrick and Jeff Sardinha

This year, State Street is celebrating the thirtieth anniversary of the ETF, having launched the first US listed exchange traded fund in 1993 to offer investors broader, more efficient access to capital markets. Since then, ETFs have transformed the investment landscape for both institutional and retail investors by democratizing access to low cost, liquid and performant investments across nearly every asset class globally.

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Driving continued innovation in the space, we recently announced the launch of State Street Alpha® for ETF Issuers, the industry's first end-to-end asset servicing platform designed to support the unique and complex requirements of ETF managers.

In this Speaking of Alpha article, **Anna Bernasek** discusses the survey results, industry trends and our Alpha platform with **Frank Koudelka, Ciarán Fitzpatrick** and **Jeff Sardinha.**

Anna: Let's start with the 2023 ETF Outlook where you make several predictions - active ETFs will have outsized growth, fixed income will stand out, and ETF growth will accelerate in Europe. How are those predictions turning out?

Frank: Active ETFs have accounted for **25%** of global ETF inflows through the first 4 months of the year. In 2022 that number was **14%**. While their market share is growing, AUM levels for active ETFs is only **5.5%** globally. The regulatory environment has become more accommodating to active ETFs and investors and their advisors have seen the benefit of investment products packaged in an ETF wrapper.

The firms that have entered the marketplace in the last 3 years are among the largest asset managers, including **Alliance Bernstein, Capital Group, DFA, Federated, Neuberger Berman, Putnam, T. Rowe Price and Double Line.**

Our second prediction on the fixed income front has been realized as investors are capitalizing on the rising rate environment and finally getting "fixed income" after a decade of near zero rates, which is conducive to the growth of these offerings.

The third prediction was accurate as well. Europe is on the pace to double the flows of last year, driven by growing retail adoption of ETFs. Europe has traditionally been a mostly institutional market with **80%** of asset share, so having a growing retail component is a good sign of growth. On the manufacturing side, the ETF issuers entering the European space are many of the global active managers I mentioned previously.

The EU just released its retail investment directive, and it does place restrictions on inducements and forces more transparency. This levels the playing field for ETFs as an investment wrapper which is very supportive for future growth.

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Anna: Jeff, in your new article The Unlimited Potential of Actively Managed ETFs, you make the case for why actively managed ETFs play to the strengths of the US market. Can you elaborate?

Jeff: We make the case that the popularity of actively managed ETFs comes down to growing supply of actively managed ETFs and corresponding demand from investors. That dynamic is coming together to the benefit of the ETF industry. ETFs have several distinct advantages. They're inexpensive, tax efficient, and they compete on performance.

In the early days of the ETF, there was a limited supply of active strategies. From a cost perspective there was no regulatory guidance to support a streamlined path to launching an active ETF until **2019 when ETF Rule 6c-11 was codified**.

Early adopter firms had to go it alone with regulators on a fund-by-fund basis. All of that work and cost increased the breakeven point for most fund families resulting in higher expense ratios. This kept many of the large ETF managers on the sidelines.

Regulatory guard rails slowed adoption. For example, an active ETF couldn't use derivatives. They couldn't even hold an international equity until 2015. The only actively managed ETF with significant assets was a total return fixed income product. Once regulators loosened those reins, we saw 750+ active ETFs launched within 3 years, with assets increasing to about $400B.

From a demand perspective, investor actions and expectations have changed over time. **Factset published data showing that 80% of all cash flows went** to products below the industry average expense ratio, which was 44 basis points at that time.

Average active equity ETF expense ratios have been cut in half since 2019, currently its about 38 basis points. Investors are looking for inexpensive, tax efficient performance and alpha. In contrast, mutual fund investors in taxable accounts can face more adverse tax treatment when compared to a similar ETF in most cases. With ETFs, any small flows are likely taking place on exchange, consisting of individuals selling and buying shares. That has no impact on the fund whatsoever.

When inventory management is done and firms are redeeming on the fund, the ETF can transact much of that in-kind at scale. That minimizes the need to sell securities to meet investor redemptions, which should reduce the amount of capital gains realized by the funds, and ultimately the tax burden that ETF investors would find. ETFs are a more efficient way to offer investors what they're demanding. Last year, the gap between mutual fund outflows and ETF inflows was the largest on record, nearly a trillion and a half dollars. We don't see it slowing down.

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Anna: Can you explain how product and tech innovation goes hand in hand with the growth of actively managed ETFs?

Frank: We're seeing a lot of innovation in active ETFs. After the 2019 rule came into effect, we had to launch a semi-transparent ETF for issuers who wanted to protect their IP by disclosing holdings on the same frequency as their mutual funds. Semi-transparent ETFs ensure that issuers don't have to publish holdings on a daily basis.

Then in **2021, the wholesale conversion of mutual funds into ETFs began**, followed by separately managed account (SMA) and private fund conversions. This enables an issuer to come to the market at scale. Finally, in Australia they created a dual registry model enabling active managers to create a listed version of their mutual funds as an ETF. Together, these innovations have led to more active managers entering the marketplace.

Pivoting to the tech side, we recently expanded State Street Alpha, our front to back asset servicing platform, to address the specialized needs of ETF issuers.

An active manager needs intraday flow information so they can update their positions and put investable cash to work. That's the essence of **Alpha for ETF Issuers** – delivering timely and accurate back-office data to front office decision makers by combining our basket creation capabilities, the orders that are coming in from authorized participants, and flow data. Portfolio managers can see real time flow information along with cash and position updates throughout the day. We know that the ETF market transacts in a significant way through the in-kind mechanism. But there is also a cash component. Our platform enables active managers to play a more significant role in the ETF market by putting that cash to work quickly.

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Anna: Give us an overview of actively managed funds in the EU, and what's the outlook?

Ciarán: In the EU, we're seeing a huge growth opportunity for active ETFs. For perspective, the overall European ETF market is close to **$1.5T**, and active ETFs are only **$25B**. The European passive market is dominated by large incumbents, so a new issuer entering the ETF market is not going to survive. To compete, they need to launch differentiated products leveraging their expertise.

Most of our clients, either new entrants or existing mutual fund managers are considering active strategies, typically by creating ETF wrappers around existing mutual fund strategies. In Europe there is a transparency requirement for exchange-related funds to publish the holdings on a daily basis, a rule which doesn't have to be adhered to by a UCITS mutual fund. Even though an ETF is a UCITS product, it's held to a higher standard when it comes to transparency. That raised a legitimate concern about divulging IP by publishing holdings of a successful mutual fund strategy if they package it into an ETF. That has slowed the transition into active, and there's been a lot of engagement with different regulators to remove some of the daily transparency requirements.

Publishing your holdings today for what you held in your fund last night isn't giving too much away. IP comes from your research and the knowledge you have in your mutual fund strategy and wrapping that in an ETF.

The active structure allows you to adjust your portfolio intraday, because a true active strategy isn't tracking a benchmark. There is a reference benchmark for the product, but managers don't have to adhere to an index strategy. If there's something happening in the market, they can drop or add to their portfolio intraday without having to wait for an index to be updated.

Anna: What are the growth drivers in the EU, and what role is regulation playing?

Ciarán: Transparency on the daily disclosure has resulted in lots of discussions with regulators. Fund managers are getting comfortable with the transparency from an active ETF perspective. because it means we can grow that market.

Secondly, retail investing is starting to take off in Europe. Increasingly, people are managing their own money, with Germany in the lead. The larger managers are offering ETFs on their own platform, and every one of our clients now has a digital platform strategy.

Packaging these products as ETF savings plan makes it more palatable at the retail level. The total expense ratios are lower, and investors will likely get better performance from these products over a period of time. Industry observers forecast that by 2027 there'll be another **20 million** retail accounts open across Germany alone, and the UK is also seeing robust growth.

Anna: What trends are you seeing in the growth of fixed income ETFs?

Jeff: Fixed income ETFs can now compete without zero interest rate policy hanging over it. We expected an increased percentage of flows to fixed income products and that's exactly what's happening. Frank mentioned **50%** of the flows end of April were into fixed income ETFs. But that's only **18%** of the overall market, so they are definitely taking in an outsized share year-to-date.

Active fixed income could gain a leg up with investors who are looking for yield, liquidity and ease of access. It can take a complex strategy and turn it into a very simple wrapper. Fixed income ETFs democratize access to complex investments, and the active part of this can be nimbler in many cases. Actively managed products can take advantage of yield when and wherever it is available, in a very timely fashion, which isn't the case for most passive products.

Anna: What countries are leading innovation in the ETF space?

Jeff: The Canadians got it right when they drafted their initial regulations. They didn't differentiate mutual funds from ETFs in many of their rule sets. Canada was at the forefront on issues such as transparency and allowing ETF series of a mutual fund.

Both exist in the US but took numerous filings and years of work. Semi-transparent actives are still limited to North American equities for the most part and ETF series are still limited to passively managed ETFs.

I don't think there's any shortage of innovation in the US, driven by expansion into new asset classes and fund types. It's making innovative use of the wrapper to respond to the advisor community and how they want to use ETFs.

ETFs are fantastic building blocks. We've seen some success with single stock ETFs and managed futures for example. Finally, conversions of mutual funds to ETFs continue at a brisk pace, we've seen about 46 of these to date.

Anna: Was there anything in the survey that surprised you?

Jeff: Most notable was that **80%** of respondents stated that they would be more inclined to invest in an active strategy if it was packaged as an ETF rather than a mutual fund. The main reason was low fees, followed by ease of trading and tax efficiency. When asked how much of their portfolio is invested in actively managed ETFs, respondents with zero active exposure have dropped three years in a row, and now sits at about 30%.

The reasons given for not investing in actives were a limited range of products and lack of track record. I believe that fee compression, longer track records, the mutual fund to ETF conversion trend and the increased number of active launches will accelerate adoption of actives. 64% of US-based ETF launches State Street participated in last year were actively managed.

Anna: What's the next big innovation in ETFs?

Frank: In the US market, ETFs have lagged in the retirement space. That's been a mitigating factor to more mutual fund ETF conversions. If you run a big defined contribution program, it's hard to make the case that you should be converting it to an ETF. Fractional shares and intraday trading aren't important, you only need end of day NAV for most of these record keeping platforms.

Tax efficiency is an important consideration. I predict there will be conversions of mutual funds into ETFs for taxable accounts, and the rest will go into a collective investment trust (CIT) or similar structure. You need to do the full conversion and at the same time you can move assets into the most cost-effective vehicle. When that innovation takes place, it will accelerate flows into the ETF marketplace and CITs.

Ciarán: In Europe, we're having a lot of discussions around digital assets. Not just from crypto specialists but traditional managers as well. That's why crypto ETPs are quite a popular strategy in Europe. We've also fielded a lot of questions around share class tokenisation. Germany announced the approval of a digital security, and while it's limited, it's raising the appetite amongst newer ETF managers to enter that market. There's a new generation of digital natives investing through platforms or digitisation, and they may want to invest in a token on the blockchain as opposed to the traditional methods. The blockchain also provides an innovative way to modernize trade settlement.

Jeff: Capital markets could derive significant benefits if participants transacted on a blockchain and had access to information at the exact same time. Currently, assets have to be converted to a common unit of measure and then back into their native currency. Tokenization does away with that. The token itself is the common unit of measure. There's no FX trading, and a significant reduction in latency. While there are a lot of benefits, much remains to be done operationally and technology-wise.

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