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ETF 2.0

SIX TRENDS

Shaping the Next Generation

Just 20 years ago, exchange-traded funds (ETFs) were novelties. Now, after two decades of explosive growth, they are firmly entrenched in the asset management landscape. Total U.S.-listed ETF assets reached a record-setting $2.0 trillion at the end of 2014, up from $1.7 trillion a year earlier, and inflows totaled $244 billion for the year.[1] European ETFs also saw record flows in 2014; they attracted $61.4 billion in new assets, more than three times the 2013 total.[2]

It's certainly true that even in the U.S., ETFs are a long way from eclipsing open-end mutual funds, which have about $14 trillion in assets.[3] Still, ETFs' growth in both assets and products has been impressive, to say the least. The industry tally shows 1,664 products at the end of November 2014, and an average of 150 new funds have been launched each year over the past decade.[4]

Industry analysts expect ETFs to gain even greater momentum in the years ahead, with some projecting a rise to $5 trillion in total assets by 2020.[5] ETFs are not only growing, but also rapidly evolving as new product types and marketing approaches emerge. And they continue to broaden their reach as they penetrate new investor segments, distribution channels and geographic markets. Welcome to ETF 2.0.

Six key market trends are shaping and fueling the opportunity in ETFs

1) Active ETFs—As regulators address major transparency issues, active ETFs are finally moving from concept to reality.

2) Ongoing convergence—The mutual fund and ETF worlds increasingly intersect as new types of ETFs emerge, investment organizations look to package their strategies in a variety of ways, and investors build portfolios using both structures side by side.

3) Widening appeal—Institutions and hedge funds were early ETF adopters, followed by advisors and intermediaries; retail investors are the next big wave.

4) Strategists and robo-advisors—New players are altering the ETF distribution landscape, creating new business models and shifting the economics of the business.

5) Marketing through education— As ETFs go mainstream and evolve into different forms, it becomes even more important that investors understand how—and how not—to use them. New distribution structures will further expand educational needs.

6) Global opportunity—Adoption is accelerating outside the U.S., especially in Europe, where ETFs are rebounding after a slow period, and in Asia, where some long-standing barriers are coming down.

1 Active ETFs

Over the past 20 years, ETFs have been virtually synonymous with indexing. That is changing. Now that most indexes are tracked by one or more index-based ETFs, providers will need to find growth and innovation elsewhere. While we expect index-based ETFs to contribute meaningfully to asset growth in the coming years, the highest rates of growth will likely come from other types of funds.

ETFs that bridge passive and active strategies are an important and fast-growing product type. Variously called smart beta, strategic beta, fundamental indexing and factor-based indexing, these products aim to enhance returns by tracking indexes that are weighted by criteria other than market capitalization. ETF sponsors try to increase return potential by filtering the securities in an existing index based on factors, such as volatility, dividend yield, price momentum or whatever criteria they may choose. In some cases, they may even create their own indexes. The number of smart beta funds has doubled over the past five years, and their transparent, rule-based approach has attracted strong flows.[6]

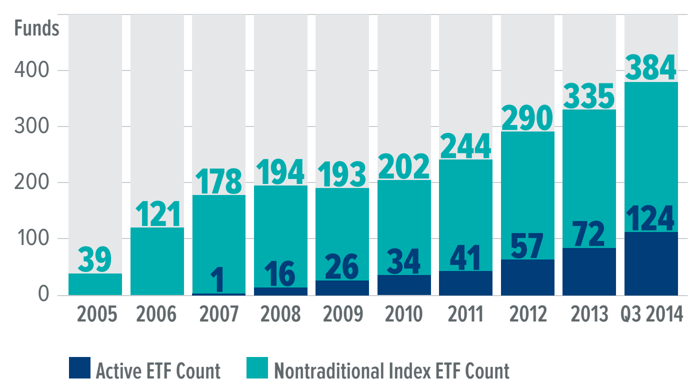
There are actively managed ETFs, which after years of anticipation have finally gone from vaporware to reality. Moreover, they are quickly becoming a force to be reckoned with. With 124 actively managed ETFs available in the U.S. alone, assets climbed to $18.4 billion by November 2014, a 25% jump from a year earlier.[7] However, growth has not been a given. The two active ETF sponsors that ranked highest in AUM at the end of 2013 suffered major outflows in 2014.[8] At the same time, nine new providers jumped into the ring this past year, bringing the number of firms with active ETF offerings in the U.S. market to 25.[9]

More entrants are waiting in the wings as regulatory issues are addressed, transparency being the main sticking point. While daily disclosure of holdings is not an issue for index funds, sponsors of active funds understandably have been more reluctant to lift the veil on their portfolios.

The way forward became clearer toward the end of 2014. While rejecting some proposals for non-transparent ETFs, the SEC approved Eaton Vance's exchange-traded managed funds (ETMF) concept, which relies on a new type of "NAV plus or minus" order pricing. This novel approach could be a game-changer, but more competition may be just around the corner. After losing their initial bid to introduce nontransparent ETFs, Precidian Investments refiled its exemptive relief application in December, proposing to use blind trusts as a way to deal with the transparency issue.[10] Meanwhile, BlackRock, American Funds, Invesco, State Street and Cohen & Steers have all licensed Precidian's concept. The upshot is that investors may soon be offered a much wider array of active investment strategies in ETF form.

The future will no doubt bring new variations on these concepts, and perhaps groundbreaking new approaches. In the meantime, these new product types will help fuel the growth of ETFs going forward.

FIGURE 1 **Number of active and nontraditional[11] index ETFs in U.S. market**



Source: Strategic Insight.

Addressing the **Operational Challenges**

The emergence of active ETFs puts a spotlight on the industry's distinct infrastructure needs. The ways that ETFs differ from mutual funds translate into operational demands that many operating platforms may not be equipped to meet, especially where active ETFs are concerned.

- A fundamental difference is that investors have the ability to transact directly with mutual funds via a primary exchange, while ETFs can only be transacted through an intermediary that is an authorized participant. When authorized participants want to create or redeem units of an ETF, they are typically delivering or receiving securities in kind — a transaction that immediately affects the ETF's holdings. Thus, the share balances of the underlying securities within an ETF move based on the actions of other market participants. Mutual funds, on the other hand, simply receive or deliver cash when investors buy or redeem fund shares, and the fund's security holdings are unaffected.
- Mutual fund managers have no requirement to disclose their holdings on a daily basis. In contrast, ETF managers must fully update their portfolio management systems at the end of the day and publish their holdings through the DTCC data repository. If they don't, they will be out of SEC compliance. Most critically, they will frustrate the market-makers and other authorized participants who must have accurate portfolio information to make competitive markets in the fund the next day. If that happens, it can trigger cascading effects, including widening spreads and higher transaction costs.
- In the mutual fund world, in-kind purchases and redemptions are rare, and it may take several weeks to fully process them. In the ETF world, such transactions happen and must be accounted for on a daily basis.

In sum, ETF sponsors live in a world of daily, real-time data management, in which portfolio holdings must be continually updated. Passive ETF managers who expand into active funds must deal with some escalation in operating demands, such as the need to rebalance daily rather than quarterly. For active mutual fund managers who want to move into the ETF world, the operational differences and challenges are far greater. In both cases, it's critical to have an operating platform that can smoothly handle the order-taking, daily accounting and basket data capabilities that ETFs demand.

2 Ongoing Convergence

The rapid growth of ETFs has set off alarm bells in the mutual fund industry, which has often viewed the ETF industry as an upstart and a threat to its franchise. But that mindset is rapidly becoming outdated. Innovation-minded asset managers recognize that intermediaries and investors now call the shots on product design. To be competitive, their product lines must be responsive to rapidly evolving preferences. This means investment organizations must increasingly package their expertise in different formats to meet varying needs.

Just as hedge fund and mutual fund strategies have converged over the past decade, producing the new category of liquid alternatives, mutual fund and ETF strategies are converging, too, with active ETFs being one result.

As is often pointed out on both sides of the divide, ETFs and mutual funds are different animals with distinct advantages and purposes. But the areas of overlap are growing. For example, many mutual funds now use ETFs to help implement their strategies. At the same time, large, sophisticated investment organizations are already moving to establish their presence in both worlds.

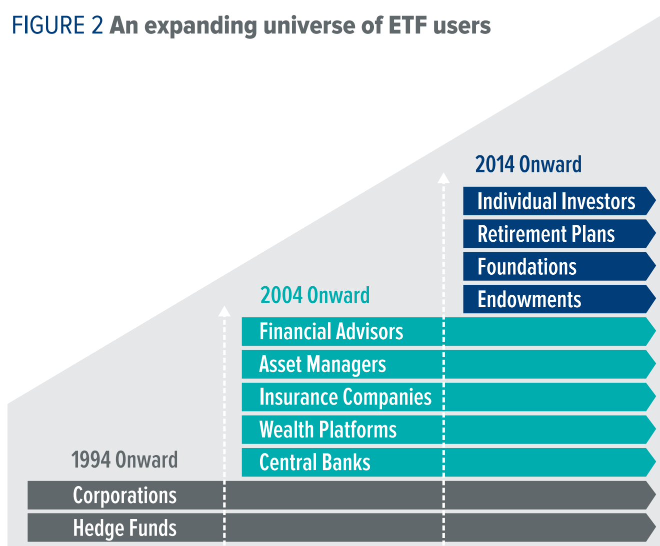
It's also clear that investors have good reasons to use both vehicles, often tapping index-based ETFs for low-cost passive exposure and mutual funds for the pursuit of alpha and other outcomes. The new generation of active and so-called "smart beta" ETFs is shifting that equation, providing new ways to deliver advice in the process. In the realm of ETF 2.0, mutual funds and ETFs may co-exist and cross-fertilize as much as they compete.

3 Widening Appeal

Sophisticated institutional investors were the first to take advantage of the low cost and liquidity of ETFs. Hedge funds used them to execute complicated trading strategies and corporations found them to be useful cash management tools.

Now a wide range of institutional investors employ ETFs in an assortment of ways. Insurance companies are using them both as sub-accounts for annuities and as balance-sheet assets. After some initial resistance, retirement plans are beginning to incorporate ETFs, a trend abetted by the introduction of target-date and target-risk funds. Central banks are building them into asset purchase programs. Foundations and endowments have been relative latecomers, but are also finding ways to integrate ETFs into their portfolios. The embrace of ETFs by retail investors and their advisors may give ETFs their biggest push yet. They are particularly well suited to the fee-based advice environment, enabling advisors to focus on asset allocation decisions rather than security selection. Their adoption is being accelerated by the emergence of new distribution channels serving individual investors and advisors, such as ETF strategists and robo-advisors. Thus far, retail adoption has been focused in North America, but the prospects in other markets are promising (see Global Opportunity, page 8).

FIGURE 2 **An expanding universe of ETF users**



Source: Alphahut.

4 Strategists and Robo-Advisors

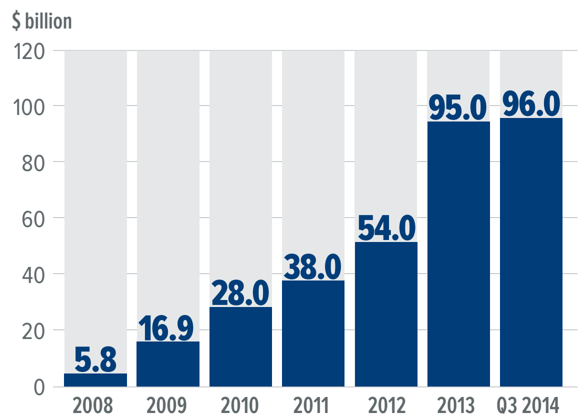
Now that ETFs can provide exposure to so many facets of the global financial markets, new types of services have sprung up to help investors access and manage the possibilities. ETF strategists are a prime example. Practically invisible before the financial crisis, these firms now manage close to $100 billion in the U.S. market alone.[12] They offer managed accounts, but, in a bid to execute strategies more efficiently and cost effectively, use ETFs in place of the securities or mutual funds on which similar offerings may have relied in the past. ETF strategists construct portfolios geared to outperformance, risk management, or a combination of the two. Promising active management at a relatively low cost, they appeal to advisors who might prefer to outsource this aspect of portfolio management, freeing time for client service and practice development.

Sales by ETF strategists slowed in 2014, due in part to performance concerns and the SEC's action to sanction one of the largest firms in this category, but are expected to regain momentum in time. Meanwhile, strategists have begun selling the algorithms behind ETF-managed accounts for use by other advisors, asset managers and institutional investors. Thus, the influence of ETF strategists may extend considerably beyond what their still relatively modest asset levels would indicate.

Another new set of actors in the ETF arena are the so-called robo-advisors, which bring an unprecedented level of automation to financial planning and asset allocation. These online advisory firms automatically invest client assets in a diversified mix of investment strategies based on systematic assessments of an investor's risk/reward profile. Firms of this type had less than $20 billion of assets as of December 2014,[13] but have been growing rapidly, with a 65% jump in AUM from April to the end of the year.

Both ETF strategists and robo-advisors have the potential to alter the asset management industry's dynamics. Having squeezed manufacturers' fees for some time, traditional distributors may now find themselves challenged by newer players. Technology and asset management are converging to spawn entirely new ways of managing money and communicating to investors, and ETFs may well sit right in the middle of these trends.

FIGURE 3 **AUM growth of ETF-managed accounts**



Source: BlackRock, Morningstar.

5 Marketing Through Education

Education always plays an important role in the marketing of new investment vehicles and strategies. This is particularly true in the case of ETFs, both because they can be used in many ways by many types of investors and because their potential for misuse is high. The liquidity and low cost of ETFs make it is easy to view them as short-term trading vehicles rather than long-term investments. There is nothing inherently wrong with this if ETFs are being used by sophisticated investors, such as hedge funds, to execute carefully constructed strategies. It becomes more problematic if inexperienced or unsophisticated retail investors are tempted to use them as speculative vehicles. The risk of misuse is compounded by the availability of leveraged and inverse ETFs, which are designed for institutional use but available to anyone.

ETF sponsors may need to address common misconceptions. Failed trades and tracking error, for example, have been noted by some as areas of concern. But neither is a particularly significant risk, and the former concern is based on a misunderstanding of how ETFs operate.

It will also be important to familiarize investors with newer types of indexing and how they perform. For example, as more factor-based approaches are introduced, returns will naturally begin to disperse. That means ETFs in the same category or asset class may for the first time begin to exhibit very different performance characteristics. This is a result for which investors need to be prepared. Beyond that, it has yet to be determined how intermediary platforms are going to incorporate active ETFs. This will raise additional educational needs as answers emerge.

Of course, some markets are more informed than others. But as a general principle, it behooves ETF sponsors everywhere to make investor education a cornerstone of their marketing efforts. Gaining and keeping the trust of prospective ETF investors will be critical if the industry wants to attract new asset flows. Investor education could be particularly beneficial to asset and revenue growth in the newer markets of Europe and Asia, where retail distribution is only now taking hold. Strong educational campaigns in these markets could significantly bolster brand-building efforts.

FIGURE 4 **Key topics for investor education and content marketing**

- **Alternative strategies**
- **Liquidity**
- **Nontransparency**
- **Leverage**
- **Self-indexing**
- **Nontraditional indexing**
- **Failed trades**
- **Infrastructure**
- **Tracking error**

Source: Alphahut.

6 Global Opportunity

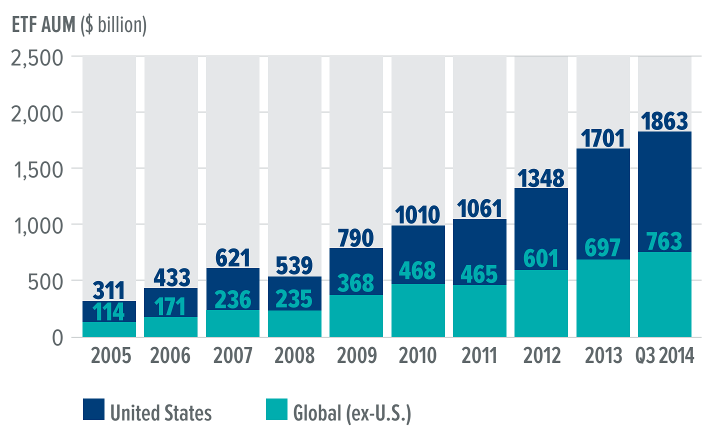
North America led the way in developing and adopting ETFs, but most markets in the rest of the world are catching up. ETFs and ETPs in non-U.S. markets now account for more than $760 billion under management, 29% of the global total.[14]

ETFs in Europe have followed a similar growth trajectory to those in the U.S. over the past decade, but market penetration still lags. This may change in the wake of upcoming regulatory changes. New EU rules as well as those enacted by individual countries are quickly transforming the business of advice to a fee-driven model rather than one dependent on commissions. This development alone could significantly boost retail adoption of ETFs. The introduction of more cross-border funds with centralized settlement may further encourage adoption. So will the move toward what are termed physical ETFs, which directly track or replicate an index, and away from synthetic versions, which use derivatives to mimic the behavior of an ETF. The latter have been popular in Europe, where they were first introduced, but are beginning to lose favor.

Asia offers outstanding growth prospects. Even with Japan included, Asia's ETF assets still total less than half of those in Europe, indicating plenty of room for expansion.[15] Considering the rapid accumulation of wealth and lowering of barriers within the region, it would be reasonable to expect higher rates of growth than in more mature markets. Even Japan, Asia's largest market, has seen rapidly accelerating ETF adoption despite the significant structural and cultural barriers in that nation.

What about other markets? ETF assets in Latin America grew through 2012, but retreated as regional economies faltered.[16] ETFs are available in Africa, but barely register on a global scale. Still, all of these markets offer growth potential. After all, the qualities that make ETFs attractive to investors in developed markets hold just as true elsewhere. Recognizing the opportunity, both local firms and global players are positioning themselves to ride the next wave of growth. South Africa alone has scores of ETFs and ETNs available to its investors, many of which are nontraditional products.[17] It would appear that ETFs are a truly global product with almost universal appeal.

FIGURE 5 **Gaining traction on a global scale**



Source: ETFGI.

Challenges Along the Way

ETF 2.0 promises to be a landscape of abundant opportunity, but those aspiring to establish or expand an ETF business will certainly encounter obstacles. Those stumbling blocks will be especially jarring to investment organizations that are new to ETFs.

For one thing, ETFs present unique distribution challenges. Information is not as granular as it is in the mutual fund world, and can be more difficult to come by. That said, experienced service providers can help new ETF sponsors collect and make sense of the data necessary to optimize their distribution efforts.

New entrants will also need to adapt to the presence of market makers and authorized participants. Dedicating resources to proactively establish and maintain relationships with these entities is crucial to any successful ETF sales effort.

To compete effectively, investment organizations will also need operating infrastructure tailored to ETFs' specific and complex operational demands. Only if they have the right systems and processes in place can ETF sponsors aggregate and distribute data in ways that meet the needs of portfolio managers, risk officers, and compliance professionals. Beyond that, sponsors need access to specialized expertise in ETF compliance, legal and tax issues. In light of the rapid and profound changes ETF markets are undergoing, fund providers will need operating partners who not only understand the evolving competitive arena, but are also flexible and nimble enough to adapt to their needs.

Twenty years ago, it would have been impossible to foresee the trajectory that has brought ETFs to their position in the industry today. While we can see the outlines of the future from here, we can only imagine where the paths to ETF 3.0 will lead.

About SEI

SEI (NASDAQ:SEIC) is a leading global provider of investment processing, investment management, and investment operations solutions that help corporations, financial institutions, financial advisors, and ultra-high-net-worth families create and manage wealth. As of September 30, 2014, through its subsidiaries and partnerships in which the company has a significant interest, SEI manages or administers $612 billion in mutual fund and pooled or separately managed assets, including $249 billion in assets under management and $363 billion in client assets under administration. For more information, visit seic.com.

About SEI's Investment Manager Services Division

Investment Manager Services supplies investment organizations of all types with the advanced operating infrastructure they must have to evolve and compete in a landscape of escalating business challenges. SEI's award-winning global operating platform provides a full set of capabilities that are integrated across a wide range of investment vehicles, strategies and jurisdictions. Our customizable services enable investment managers to gain scale and efficiency, keep pace with marketplace demands, and run their businesses more strategically. SEI presently partners with more than 300 traditional, alternative and sovereign wealth managers representing $13 trillion in assets, including 28 of the top 100 managers worldwide.

SEI was among the first to provide outsourced ETF order-taking capabilities, and has been a pioneer in advancing automation of the process. Beyond giving ETF sponsors the sophisticated, real-time data management they need, we provide deep expertise in distribution, tax, legal, and compliance dimensions of the business. We specialize in helping clients efficiently launch and distribute complex products, enter challenging markets, and meet ambitious time-to-market objectives. We currently provide order processing, accounting, administration, and distribution services to ETF sponsors representing a total of more than 630 funds.

SEI Knowledge Partnership

The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI's investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing best practices and develop more competitive business strategies. The SEI Knowledge Partnership is a service of the Investment Manager Services unit, an internal business unit of SEI Investments Company.

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[1] ETF.com, “2014 ETF Flows Blow Through 2013 Record,” December 31, 2014.

[2] Ignites Europe, “European ETF inflows treble in 2014,” January 7, 2015.

[3] Strategic Insight, SimfundMF, November 30, 2014.

[4] Ibid.

[5] Pricewaterhouse Coopers, “The Next Generation of ETFs,” November 2013.

[6] Strategic Insight, SimFundMF, November 30, 2014.

[7] Ibid.

[8] Ibid.

[9] Ibid.

[10] http://www.sec.gov/Archives/edgar/data/1396289/000114420414075294/v397161_40-app.htm

[11] Nontraditional indexes shown in Figure 1 are defined as strategies tracking indexes that do not weight components based on market capitalization.

[12] Morningstar, “ETF Managed Portfolios Landscape, Q3 2014,” November 19, 2014.

[13] Corporate Insight, http://www.businessinsider.com/robo-adviser-growth-2014-12, 2014.

[14] ETFGI, www.etfgi.com, January 13, 2015.

[15] Ibid.

[16] Ibid.

[17] ETFSA, www.etfsa.co.za, January 13, 2015.

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