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A World of Opportunity for Exchange-Traded Funds 3.0

As head of global exchange-traded fund services at BNY Mellon, Joe Keenan has a front-row seat on developments in the exchange-traded fund industry. As such, Keenan fully expects ETFs to continue their incredible success story. *Money Management Executive* Editor Lee Barney recently spoke with Keenan on the drivers of ETF growth.

MME: What developments in the exchange-traded funds coming to market strike you as the most interesting?

Joe Keenan: There certainly have been an extraordinary number of innovations in the ETF space, most notably the ever-increasing interest among established asset managers to develop their own exchange-traded funds across all asset classes—including passive and actively managed products. This is exciting for us because we think there is long-term potential, for the next several years at a minimum, for even more clients and prospective customers to enter the ETF space.

But in order for new entrants to successfully jump into the fray, they can't simply plan to launch another S&P 500 fund. A "me-too" approach really is not going to be the cornerstone of a successful business plan, be they a large, established asset manager or a start-up.

Instead, new players first need to assess what is unique about their expertise. Do they have a lock on a particular distribution channel? Are they renowned in the fixed income or equities area? Are they best known as a stock picker, and thus able to parlay this expertise into actively managed products?

These firms also have to decide whether they are going to slowly enter the ETF market with a toe in the water—or whether they are going to be more aggressive and go wholesale across their entire family of traditional mutual funds. The best example of this



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is PIMCO and their leap into the ETF space with the announcement of plans to extend their franchise with a new product that will seek to replicate their famous PIMCO Total Return Bond Fund.

Take a look at what Vanguard has done. Historically, they have been viewed as the indexer for retail products.

The emergence of iShares' competition has prompted Vanguard to respond with a call to arms—and they have been extremely aggressive with regards to competing on total expense ratio for these products.

There has been continued willingness among large and small asset managers, as well as discount brokers, to compete on price to the point of lowering index-based ETF fees to as low as five basis points. Even for a \$100,000 investment in an ETF, the difference between these fees is more about optics than true expense, so at some point, the industry will reach a tipping point on this pricing battle where it is no longer viable for firms to launch ETFs with such low fees, or what we are calling "cheap beta products." On top of this, some brokers, Schwab, Fidelity and TD Ameritrade, for instance, are offering ETFs with zero commissions.

MME: In terms of specific products, what new ETF sectors do you find interesting?

Keenan: Certainly, there has been a continued focus on commodities. At BNY Mellon we support nearly 600 ETFs globally, 475 of which are in the United States. In terms of total assets, we administer have \$240 billion, of which \$75 billion is in commodities products alone. For instance, we are the trustee for BlackRock's iShares Gold ETF (IAU) and iShares Silver Trust (SLV). We also support commodities products for ETF Securities, WisdomTree, Deutsche Bank, GreenHaven and Teucrium, just to name a few. We have continued to see growth not only in these funds, but we have been in an active dialogue with firms seeking to capitalize on this interest in commodities, both in terms of their performance as well as the ever-increasing interest among investors to place their money in assets that are not correlated to stocks and bonds.

This tight correlation between stocks and bonds has been pushing investors into specific, targeted commodities asset classes, such as precious metals—or into broad-based commodities products.

As proof of this, we recently engaged the leading consulting and market research firm Strategic Insight to do a study for us, "ETFs 2.0: The Next Wave of Growth in the U.S. Market." It validated two things. First, our growth expectations: the ETF servicing business is one of the fastest-growing areas at BNY Mellon. In another recent study, McKinsey & Co. projects global ETF assets will exceed \$3.7 trillion by 2015.

Second, we expect the next wave of ETF growth to be in more innovative and novel products, whether they are passive, fundamentally weighted, based on novel benchmarks or tied to a very focused, tactical segment of the market, such as our client First Trust's Smartphone Index Fund ETF.



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Looking even further out, ETFs 3.0 will move into truly active funds. To date, there have been a number of currency and fixed income active ETFs to hit the market. The actively managed ETF investment advisor **Grail Partners**, for instance, was recently acquired by **Columbia Management**. We see this type of merger and acquisition activity as a harbinger of the likely future consolidation within the industry and recognition of the extraordinary asset gathering potential of these products.

Our client **Invesco** was very prescient in 2006 in its acquisition of **PowerShares Capital Management**. Invesco (formerly **Amvescap**) was a well-established global asset manager, that further strengthened its franchise in 2010 with the acquisition of the **Van Kampen Investments** mutual fund and unit investment trust businesses from **Morgan Stanley**. BlackRock, of course, succeeded in the largest ETF acquisition to date, with its purchase of iShares in 2009.

Large, established asset managers are realizing that they need to at least take a serious look at the ETF market and determine whether there is opportunity to participate in the exponential growth of the segment.

MME: Are you seeing any further developments in the ETF industry?

Keenan: We are very fortunate in that we have 30 clients globally, with a number in the pipeline. I think we will see further consolidation. The natural evolution, or survival of the fittest, will begin to take place. Firms will also start to close ETFs products that have not resonated with investors.

And I certainly think that we will continue to see the launch of additional products. Almost every new product that we are talking to our clients about is unique.

In addition, we have been working to help them extend their franchises globally, particularly into Europe, Asia and Latin America. The globalization of our

business, and theirs, is fast becoming the top priority.

MME: Are there any ETFs structured as Undertakings for Collective Investments in Transferable Securities (UCITS)?

Keenan: Yes, in fact there are a number of ETFs structured as UCITS in Europe, and we are assisting a number of customers interested in cross-listing their ETFs with their business plans or risk/reward analysis. These clients are trying to determine whether a locally registered product, or a cross-listed product, will resonate with both regulators and local investors.

MME: Do you have a sense whether ETF growth will be driven by institutional or retail investors, or both?

Keenan: Both. Growth has certainly shifted to retail investors, clamoring for low-fee products in this diminished return environment. We also expect to see more growth of ETFs within 401(k) programs as investors continue to demand access to products they can purchase in their discount brokerage accounts.

However, institutions, particularly large pension funds, have also begun using ETFs for rebalancing and transitioning from one asset manager to another.

Another area of growth is the increasing use of ETFs to gain access to the emerging and frontier markets. Both iShares and Vanguard have gathered significant assets in products offering exposure to these markets, and this is a trend that further demonstrates both the broad institutional and retail appeal of ETFs as products that allow investors to be fully invested in any given region or market.

By comparison, if you are a futures investor, you must hold about 10% of your assets in cash as collateral. There are also times when futures migrate away from the underlying benchmark, known as contango or convexity.

Thus, ETFs that are able to rely upon hard assets, such as precious metals or

currencies, or local shares or depository receipts as opposed to futures contracts to achieve their exposure, are growing in popularity among institutional investors because of their predictability in terms of performance and the potential to fully invest in the market or asset class.

There has also been a tremendous surge in volume in ETF trading at hedge funds and large broker-dealers that engage in arbitrage, especially given the recent volatility in the markets.

MME: What developments in ETF regulation are you witnessing?

Keenan: There has been heightened scrutiny, particularly in Europe, on ETFs that rely exclusively or primarily on derivatives to deliver their performance. In the volatile market environment that we live in, regulators have become increasingly concerned about derivatives and their impact on the markets. Asset managers are also concerned about counterparty risk from an investment bank offering a derivatives or a swap to deliver the performance to the portfolio.

In essence, this is an extension of the scrutiny that the double and triple leveraged long and short ETFs here in the U.S. have come under. Our client, **Direxion**, for instance offers an entire family of such funds. Regulators want to ensure that the end investor is sophisticated enough to understand how these products work and that they are not suitable for buy-and-hold investors. The sponsors of these products have done an admirable job educating the end-users of these products to ensure that they are not used by investors as simple "buy and hold" investments.

One thing is clear, as ETFs continue to their double digit march toward \$2 trillion or more in assets, the obligation of issuers, their service partners, the exchanges and other market participants to educate investors and regulators alike will become even more important to the continued success of this exciting segment of the global funds industry.