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Q&A

Two leaders in the exchange-traded fund industry—**Joseph Keenan**, managing director and head of global ETF services at **BNY Mellon Asset Servicing**, and **Deborah Fuhr**, partner and co-founder of **ETFGI LLP**—share their views on the trends and challenges facing the marketplace.

Q: *Debbie, as an award-winning authority on the global exchange-traded fund and product marketplace, would you provide a quick summary on the ETF industry, including the number of products and what type of growth rate we have seen during 2012?*

FUHR: If we look at the global ETF and ETP industry based on our end-of-July report, the total industry had 4,722 products with 9,597 listings and assets of \$1.72 trillion. There are 202 providers with ETFs listed on 54 exchanges.

The global growth rate has reached 26.5% compounded over the past 10 years, and is 12.9% year-to-date with \$130 billion of net new assets. When you look at growth, it's important to remember that asset growth is influenced by net new assets, as well as whether the markets have seen positive moves in a particular year compared with previous years.

The U.S. segment is the biggest, with \$1.2 trillion in assets out of the global industry's \$1.72 trillion. The U.S. has seen growth of 25.9% on a 10-year compounded annual growth rate, and year-to-date it's up 14%, slightly more than what we've seen globally this year.

It's also useful to consider the

money going into ETFs versus other products. According to Strategic Insight, active mutual funds saw net outflows of \$62.5 billion during the first half of 2012, while our data shows ETFs and ETPs had net inflows of \$76.5 billion in the same period.

One challenge for the industry's growth is uncertainty from the political and market perspectives, with investors concerned about the Euro zone, among many other issues. On the retail side, investors have put money into their banks, but if the environment improves, we would see money move back into the market and ETFs.

We find globally that most products provide exposure to equities, with 67% of assets in equity ETFs. Fixed-income ETFs represent 17% of assets, while commodities are at 12%. Active ETFs are 0.5% of global assets. There are also levered, inverse and currency funds, which are smaller segments.

Q: *Asset flows and growth of the global ETF/ETP industry have slowed somewhat from the exponential 25-35% annual rate we have seen during the last few years. Joe and Debbie, do you agree with some analyst reports that suggest we are entering a new phase of slower growth or do you believe this is a*

temporary phenomenon driven primarily by the volatility in the global capital markets?

KEENAN: With ETFs, there is typically a whipsaw effect. If the S&P is down 5%, we could see our assets under administration down 7%. If there is a rally, we could see our assets come back faster than other products, because of their popularity as short-term trading vehicles. If we can get out of this good news/bad news cycle the markets seem to be stuck in, I believe we could see a significant shift back to the higher growth rates the industry has historically enjoyed.

FUHR: Given the market environment, you are seeing ETFs being used by many long-term strategic institutional investors who feel they need to adjust their tactical allocations. ETFs allow investors to tailor where they want to over- or underweight, and they can use the products to express their views of where they want to put their money.

The flows that we look at three days after the end of the month reflect investors' reactions to the news. We'll see money moving out of the U.S. and into Europe when people want to get into Europe,



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with money moving to Germany because that's seen as a safer haven, for example.

Investors also want income, so dividend products have been popular. Fixed income has seen strong flows, with \$41 billion of net new money. At this time last year, we only had \$18 billion flowing into fixed income.

If you dive into the numbers, you see people doing risk on/risk off trades. These numbers are good indicators from smart investors. ETFs are unique in that they are one of the few financial products that appeal to both large institutions and retail investors.

Q: Joe, given that BNY Mellon has been at the leading edge of the ETF space for more than 15 years, what new developments are you seeing, both in terms of demand from the investors and new products in development by your clients?

KEENAN: I would break the industry into three buckets: the traditional passive index-based funds; active ETFs; and a middle ground of fundamentally weighted or customized indices. We're seeing different things in each of these buckets.

In the traditional index space, there continues to be stiff competition among the top three providers: State Street Global Advisors, Vanguard and BlackRock, with its iShares products. They are able to compete on price because their franchises have each achieved critical mass, which creates an even more difficult environment for smaller firms, because they are not only competing against a leading brand, but are also competing against cost with firms that have the scale to offer fees

below the industry average.

Combined with a trend toward cheap beta products from firms such as Charles Schwab, which have launched very low total expense products, some entrants are looking beyond the traditional passive space to carve their niche.

We see a lot of interest in the active space. PIMCO's entrance with its Total Return ETF (NYSE: BOND) has been a shot across the bow of the traditional fixed income managers. Not only has PIMCO been successful in quickly gathering assets, but they have woken up traditional active managers who were content to marginalize ETFs as passive-only products.

We've seen a material uptick in our dialogue with clients who had previously said they didn't think the ETF space was for them, but now are concerned they need a response to PIMCO and other traditional fund managers that are starting to find success in the ETF industry.

Lastly, we're seeing a lot of innovation in products that provide access to commodities or products that are designed to behave in a certain way, such as low volatility ETFs or dividend-weighted funds designed to deliver income. For instance, we have an Exchange Traded Product (ETP) client, Teucrium, whose Teucrium Corn Fund (NYSE: CORN) is a commodity pool that offers exposure to a basket of three different corn futures.

These products can potentially be used both as short term trading and long term investment vehicles, and they can provide access to strategies and assets that previously were difficult to tap. That's where I believe we'll see continued growth in the near term, especially among thematic

investors and asset allocators using ETFs as tools for portfolio construction.

Q: There seems to be a "big get bigger" trend in the ETF industry, with the top three providers managing the bulk of assets under management in the industry. Debbie, your firm's most recent report notes that the top three providers—iShares, State Street and Vanguard—grabbed the largest net inflows YTD. How should newer entrants to the ETF industry approach this landscape when rolling out new funds?

KEENAN: There are many products in the U.S. that still have very small asset bases, and we have seen clients launch products even if they are uncertain if there will be demand for them in the marketplace. If new products are launched but don't gather assets, then they'll eventually be closed. Over the long run, an ETF really needs \$50 million to \$100 million in assets before it covers all of its operating expenses.

Yet the focus on the "big three" doesn't mean there won't be smaller successful firms. Everyone struggles with this question of what's the definition of a successful franchise. A number of clients we support have achieved success on a smaller scale when compared to the behemoths, like Van Eck, WisdomTree and First Trust. While they might be a smaller percentage of the overall market, they are very successful.

FUHR: It comes back to making sure you have a good and solid business plan when you come to market with the right price point and the right benchmark. If you do your homework, you can be successful.



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Q: The industry has come under fire lately on a number of fronts, including from regulators and the media. What's behind the scrutiny and what is the ETF industry doing to address the concerns that have been raised?

FUHR: Part of the challenge is that ETFs have been among the most transparent financial products by many measures. They provide transparency into the securities they are holding and use of securities lending, for example.

By providing much more information, it has allowed people to ask questions. It's important to keep in perspective that what ETFs are doing in the U.S. is the same as traditional mutual funds. They are in general following the 40 Act guidelines in the U.S., while in Europe they are similar to what other UCITs are doing. Many people forget that if they have criticisms, it's not an ETF-specific issue but about how all funds work.

KEENAN: The ETF acronym has emerged as a catchall for many different products. While many fall under the 40 Act or UCITs guidelines in Europe, there are a number of products that are very different.

If you are buying an exchange-traded note, for example, you have an element of counter-party risk. Those vehicles are only as good as the guarantee that the underlying sponsor can deliver, and post-Lehman, there's an increased awareness by investors for this added level of risk.

Levered and inverse products have also been made available to retail investors, but some were confused about how those would behave. If you held them for more than one day, you might not enjoy the performance of the underlying benchmark.

Non-fund products using the limited partnership or grantor trust structure may also encounter taxation implications. You may need a K-1 or grantor letter, so it may be more cumbersome and expensive to file your taxes.

Products that use futures can have issues with contango and might not always perform like the underlying asset they are meant to replicate.

So, just like with any investment decision, it is imperative that you know what you are buying and how it might behave during periods of market uncertainty. Just because you are investing in an ETF doesn't mean you get to ignore the age-old principle of caveat emptor.

Q: Along those lines, last year the ETF industry heard suggestions that funds should be labeled differently, making it clearer to investors what types of funds they are buying. Do you expect ETF providers will eventually adopt these changes?

FUHR: The debate is one that's being raised globally. A regulator in Hong Kong has required products with derivatives place an asterisk after their names. In Europe, ESMA issued guidelines so that any exchange-traded fund will have that in its name.

ETCs (exchange-traded commodities) are a great example of the debate: some say an ETC is only backed by a physical commodity, others say it is Exchange Traded Currencies. Regardless, the structure is typically not a fund.

I expect there may be industry guidance, with perhaps Investment Company Institute recommending how the terms should be used, rather than regulations.

KEENAN: The Securities and

Exchange Commission might not specifically step in to mandate guidelines, but it's in the interest of the industry broadly to develop a nomenclature that drives home to investors the unique features and risks of the products they are buying.

Q: What other types of challenges are facing the ETF industry, specifically when looking at the broader structure of how issuers, service providers, market makers and investors interact to support the marketplace?

KEENAN: There is a lot of discussion around one of the key market makers, Knight Capital, and what the negative impact would have been had they gone into bankruptcy or closed up shop because of the losses caused by issues with their high frequency trading software.

We tend to focus on the capital strength of the sponsors, on the disclosure of products and the regulatory environment, but all ETF products are contingent on a robust underlying liquidity infrastructure—yet there are fewer and fewer market makers in the space.

One of the concerns I have as the industry grows is whether the trading structures underlying the market will support it, or if we'll be tapped out because there won't be additional market makers to support the demands of this growing industry.

FUHR: You need to have the exchanges working properly and to have good rules. Some investors might not realize how much work it is for market makers and authorized participants (APs) to support the ETFs and properly price them—for instance to make sure the indicative



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NAV is working properly or to understand holidays globally if you have a global product.

A lot of people are involved to make sure the process is working properly. It's a big challenge to make sure an ETF will be liquid and tradable.

KEENAN: This could constrain new entrants. It's not the early days of ETF industry, when small start-up firms could enter and get the support they need from market constituents. As the space gets more crowded and there's more pressure on APs and market makers, that will continue to drive consolidation in the industry.

Q: *With the ETF industry approaching its 20th anniversary since the debut of the SPDR S&P 500 ETF, what are your thoughts on what may drive the next stage of the market's growth?*

FUHR: I expect the industry to continue to grow in AUM based on the use of ETFs continuing to expand in the institutional, financial advisor and retail segments of the market globally. The number of investors will increase as will the ways ETFs are used, the types, the size of investment and the holding period.

The challenge is to educate investors so they feel knowledgeable enough to make their first trade. Once investors try them once, they tend to use them in more ways, in larger sizes and hold them for longer periods.

KEENAN: At BNY Mellon we are very bullish on the long-term potential of the industry, so I couldn't agree more, and as is always the case with Debbie, couldn't have said it better, either.



**Joseph F. Keenan, Managing Director
BNY Mellon Asset Servicing**

Joe is the head of our Global Exchange Traded Fund (ETF) Services business which encompasses all services offered to the rapidly evolving ETF industry and includes those services we provide to Unit Investment Trust and Closed-End Funds as part of the Structured Products Services business in the United States.

Joe is also a segment executive within the Global Financial Institutions (GFI) sector of BNY Mellon Asset Servicing and oversees a portfolio of the company's most important franchise clients. Since 2008 he has also acted as president of BNY Mellon Illinois Trust Company.

Joe has over twenty seven years experience in the financial services industry. He joined The Bank of New York in 1985 in a customer service capacity for our mutual fund and unit investment trust company clients. Joe later served as the business manager for Mutual Fund Services in San Francisco, and in 1998 returned to the Wall Street headquarters to spearhead sales and marketing efforts for Global Fund Services.

In early 2000, he was named global product manager of ETF Services, responsible for all sales and marketing of the Bank's specialized services to meet the dynamic needs of the Exchange Traded Fund marketplace. At the time of The Bank of New Company, Inc. and Mellon Financial Corporation merger in 2007, he led North American Asset Servicing Sales and oversaw Relationship Management for our Financial Institution clients.

In his role as the head of the Global ETF Services business, Joe has been interviewed by leading financial publications and websites including: The Wall Street Journal, Financial Times, The New York Times, American Banker, Institutional Investor, Pensions and Investments, Global Finance, Business 2.0, Forbes.com, IndexFunds.com, and Morningstar.com.

Joe has a B.A. in English Literature and Communications from the University of Michigan, and an M.B.A. in Finance from New York University's Stern School of Business.



**Deborah A. Fuhr, Partner & Co-founder
ETFGLL**

Deborah Fuhr is a partner and co-founder of ETFGL, an independent research and consultancy firm established in early 2012 aimed at providing services to the rapidly expanding global Exchange Traded Fund (ETF) industry and investors. The firm is focused on providing thought leadership, publishing independent research on the industry, products, applications, competitor analysis,

providing education and assistance to investors on product comparison, asset allocation implementation and offering customised research.

Previously she was the Global Head of ETF Research and Implementation Strategy and a Managing Director at BlackRock/BGI from Sept 2008 – Oct 2011. Under Ms Fuhr's guidance the team was responsible for advising clients on the implementation of asset allocation strategies using ETFs, producing analysis and guidebooks on the global ETF industry. The team won a number of awards. Previously she was an Associate at Greenwich Associates the premier strategic consulting and research source for providers and users of financial services worldwide.

She has an MBA from the J.L. Kellogg Graduate School of Management, Northwestern University, and Bachelor of Science from the University of Connecticut.