

Investors Cozy Up to Exchange Traded Funds (ETFs)

A panel of ETF industry experts met with Institutional Investor and offered their insights on the rapidly evolving ETF market. Participating in the discussion were Kathleen Cuocolo, managing director for US funds and ETF services at BNY Mellon Asset Servicing; Edward McGann, managing director at BNY Mellon Asset Servicing; and Mitchell Bell, director of product management and development at Pershing. Ernest McCrary, publisher and editor of special projects at Institutional Investor, served as moderator.

Moderator: What has been the growth rate of your ETF business? How has that affected the servicing side of the company?

Kathleen Cuocolo: Last year saw an extreme growth rate for our ETF business, the highest in the history of ETF's. We had a 63 percent growth in assets, and a 116 percent growth in number of funds. It is always a challenge to keep up with this kind of growth, but we have a great partnership with the industry. In fact, BNY Mellon Asset Servicing recently received the "2007 Best US Provider of ETF Services in the Industry" award from Exchangetradedfunds.com. We take great pride in that.

In addition, the commitment of our organization to research and development is truly unparalleled. For this particular product, we offer full-service to our customers, including a "pre-launch service," where we talk to an organization that is looking to enter the business or looking to expand into a new fund type. We work alongside the client during the registration phase. That gives the servicing side an advantage, because we're very well prepared when the product goes live.



"Last year saw an extreme growth rate for our ETF business, the highest in the history of ETFs. We had a 63 percent growth in assets, and a 116 percent growth in number of funds."

**Kathleen Cuocolo,
BNY Mellon Asset
Servicing**

Edward McGann: In addition, the insight that we get from our clients, the exchanges and other market participants during the early stage has given us an advantage in developing the technology needed to support our business. We are able to provide tools to the sponsors, managers and ourselves to be more efficient and help the industry grow. BNY Mellon Asset Servicing has played a leading role in the development of procedures and systems integral to some of the first and most innovative products of the ETF industry, including the Powershares QQQ Trust, the MidCap SPDRs and BLDRS.

Suppose I have an idea for a new ETF. How would you work with me to get started?

McGann: One thing we do from the beginning is try to understand the product. So if it were an index-based product, we would work with you to understand the index, work with your index provider and try to do some consulting as to whether we think the composition of the index and the composition of the portfolio would meet the needs of the marketplace. We would introduce you to various people who can help get the fund started.

Cuocolo: The portfolio composition is critical to having a successful product. We are interested in finding out how the product will be funded. How are they going to create interest in the product? You can have seed capital and still not generate market interest. That is why the distribution and marketing plan is very important.

Mitchell Bell: We represent the distribution side of the business, and that entails every market segment out there – from independent financial planners to private client groups. We have seen consistent growth year after year in those different market segments and in the investment professionals. To give you an example: In 2005, we had \$3 billion in ETF assets, and today we're approaching \$30 billion.

We're seeing extraordinary growth in distribution. We see many of the ETF providers focusing more frequently on the registered investment adviser marketplace and finding different ways to incorporate ETFs into products that weren't traditionally used, such as 401ks and 529 plans.

How risky is it to launch a new ETF? And how long is that process going to take?

Cuocolo: How long it's going to take really depends on how creative your product is going to be. The SEC has proposed a specific '40 Act rule change that will allow for a speedier approval process to the extent that a product conforms to specific parameters. This should expedite the process significantly. Until the changes are adopted, it could still take at least nine months to get approved.

Bell: On our platform, what we see is that more than 70 percent of the assets have an adviser in front of the decision to invest. One of the ways in which product manufacturers and innovators can increase the likelihood of a successful product is to reach out to those financial advisers, get indications of interest and talk to them.

Many of the providers, particularly those that have been in this business since its inception, are doing exactly that, and they're surveying financial advisers. Having advisers contribute to product development can improve your success rate before you even go to market.

Would you say that the current volatile market favors the ETF business?

McGann: In a volatile market such as this, a lot of investors would tend to stick with indexes, under the assumption that they could do no worse. The advantage that ETFs bring to that kind of scenario is that it's got the attributes of an index mutual fund, but at the same time, you can trade it intraday. You can do options and futures, which gives advisers and financial people the best of both worlds. Investors can be in and out when they want to be as opposed to typical mutual funds.



“We see many of the ETF providers focusing more frequently on the registered investment adviser marketplace and finding different ways to incorporate ETFs into products that weren’t traditionally used.”

**Mitchell Bell,
Pershing**

Bell: Advisers are more and more comfortable with ETFs, and they know them well enough to determine how they fit into a portfolio. They are also utilizing advanced and more complex models. Many of the largest providers have approached the entire industry with an effort to educate, particularly financial advisers, on the use of the products. That has gone on for many years but has taken effect more in the past five years.

Is there enough of room in the marketplace for traditional mutual funds and similar exchange-traded funds?

McGann: There is plenty of room because they are targeted at different investor types, and even the same investor can be in both sides of the equation. You're starting to see it now with the active interest in ETFs. Many of the traditional mutual fund companies are seriously looking at them, and not as a replacement, but as an additional product that can sit alongside the mutual fund.

Cuocolo: I agree with Ed. ETFs are another investment vehicle through which investment managers can reach the US and global markets. Fund firms have been, and continue to be involved in the innovation, from Vanguard with their ETF classes of shares to Invesco's Powershares push into listings in foreign ETF markets. We have seen significant movement of sponsors going into the European and Asian markets, and our service model supports all those domiciles in an exceptional way. We are continuing

to invest heavily in these services.

Bell: There's advanced product development, increased adoption and utilization of the product and a higher comfort level among financial advisers. The opportunity for ETFs is based largely on the expanded pool of assets to draw from: fixed income, equities, mutual funds and even money markets. The pool of investable assets is growing and advisers are seeking efficient investment vehicles on behalf of their clients, and ETFs have largely benefited from that.

How has the investor base evolved in the last two or three years?

McGann: The adviser marketplace – registered investment advisers and financial planners – have really continued to expand. You see fewer and fewer self-directed players now because the market has turned, and it's harder to make money, so there's a tendency to hire an investment adviser even at the retail level. The comfort that the advisers have with the product, and the familiarity that the investor has with the product is the perfect confluence of events to keep driving this into the retail market.

To what extent has this market been internationalized in terms of assets in the funds and ETFs set up outside the US?

McGann: Many US sponsors are looking at Europe as the next stage for their products. There is also a lot of interest in Asia, a geographically diverse marketplace. And then there's the whole concept, too, of just being able to have products listed on the various exchanges and available to investors. That is a



“BNY Mellon Asset Servicing has played a leading role in the development of procedures and systems integral to some of the first and most innovative products of the ETF industry.”

**Edward McGann,
BNY Mellon Asset
Servicing**

phenomenon that is really starting to take hold, especially when you see the New York Stock Exchange and Euronext coming together and being able to cross-list the products. There is a tremendous amount of interest outside the US for this product. It has given the broad global investor marketplace a lot of choice and asset classes that many investors would typically not be able to participate in. ●