

A Modern Day Galapagos

BNY Mellon chronicles the rapid evolution of exchange-traded funds

By Joseph F. Keenan

MARKED BY SLOW GROWTH and limited appeal in their earliest days to today's period of unprecedented differentiation and exponential asset gathering, exchange-traded fund (ETFs) offer perhaps the finest example of how the forces of evolution can impact the financial marketplace. Not unlike Charles Darwin's finches, ETFs have morphed into the widest array of conceivable variations; some will surely prosper and flourish in the years ahead, while others are destined to become only a tiny footnote in the ever-changing history of the capital markets. So join us aboard our virtual *HMS Beagle* for a journey of discovery designed to provide a detailed appreciation for the rapid evolution of the U.S. ETF industry.

Originally developed as unit investment trusts (UITs), U.S. ETFs and their brethren, exchange-traded products (ETPs), are now based upon a number of registered formats. Today, the open-end mutual fund, grantor trust, limited partnership and structured note all serve as a wrapper around a basket of securities or even a single asset class such as precious metals and currencies.

While many point to the launch of the S&P 500 SPDR in 1993 as the first ETF, the truth is there were a number of products developed prior to this seminal event that all could be argued to fall under a broad definition of 'exchange-traded fund.' Some pundits suggest that the first true exchange-traded fund (or trust) to be found in the fossil record is the Equity Investor Fund, First Exchange Series - AT&T Shares (ATF), formed in 1983 under the guidelines of the Investment Company Act of 1940 by Merrill Lynch and others as sponsors and The Bank of New York as trustee.

The ATF Fund was created to permit an investor in common shares of the pre-divestiture AT&T to hold a single investment in AT&T and the seven regional holding companies created by the mandated break-up of Ma Bell in the form of units of beneficial interest of the fund. This product, launched a full 10 years before the S&P 500 SPDR and still trading today, was the precursor to the HOLDRS products launched by Merrill Lynch beginning in 1998. While considered 'trust issued receipts' based upon fixed baskets of securities, they behave in much the same way as ETFs based upon benchmarks whose portfolios change in tandem with the rebalancing of the underlying index.

Listed instruments based upon indices had their genesis in 1989 with index participation shares (IPS), a proxy for the S&P 500 and other indices that traded on the American Stock Exchange (Amex) and the Philadelphia Stock Exchange. IPS were short-lived, however, after a lawsuit by the Chicago Mercantile Exchange (CME) and the Commodities Futures Trading Commission (CFTC) successfully stopped sales by charging that these products were in essence futures contracts, not listed securities, and therefore required to trade on a futures exchange. Not surprisingly, a federal court in Chicago ruled in the CME's favor and these products were cast to the pile of extinction through litigation.

Toronto Index Participation Shares (TIPS) started trading north of the border in Canada on the Toronto Stock Exchange (TSE) in 1990. The TIPS, which tracked the TSE 35 and later the TSE 100 stocks, also proved to be popular trading vehicles and gained early momentum among the institutional community as an alternative to futures contracts.

Whether you believe that ETFs started with trust receipt structures developed in the 1980s or migrated to the U.S. from Canada in the early 1990s, the archaeological record is clear - diversified and regulated financial products available for trading throughout the business day on a recognized securities exchange offered the potential for great success.

The Rise of the ETF

The rest of the 1990s proved to be fertile early ground for the emerging ETF structure. After seeking regulatory approval for more than five years, the Amex launched the most successful

ETF to date - the S&P 500 SPDR - in January 1993 using State Street Bank as the trustee. In 1995, this time working with The Bank of New York, the Amex launched the second U.S. index-based ETF, the MidCap SPDR, with the S&P 400 MidCap index as its underlying benchmark.

Morgan Stanley entered the fray in 1996 with their World Equity Benchmark Shares (WEBS), which were managed by Barclays Global Investors (BGI). WEBS were particularly innovative because they gave casual investors easy access to foreign markets, and the WEBS were set up as open-end mutual funds - the first of their kind and an important innovation in the evolution timeline.

In 1998, Merrill Lynch introduced the Select Sector SPDRs, which follow the nine sectors of the S&P 500, with State Street Global Advisors (SSgA) acting as sub-advisor. This was the beginning of a trend to dissect major institutional benchmarks into component parts, including sectors and styles, and in turn develop futures contracts, mutual funds and ETFs with these newly developed indices. The Amex brought its third ETF, the Diamonds Trust (DIA) - based upon the Dow Industrials price-weighted index - to market that year as well.

To close out the decade, the launch of the NASDAQ 100 Trust (QQQ) in March 1999 proved to be an event that would demonstrate the asset accumulating power of the ETF structure. Launched with 300,000 shares equaling just under \$15 million in seed capital, the QQQ quickly became the de facto proxy for the technology market. Not only were retail investors buying shares in droves, institutional arbitrageurs and hedge funds quickly made the QQQ the most actively traded equity security in the world. Levering off of the inherent volatility of the benchmark and the belief that at some point the tech bubble was certain to burst, short positions regularly exceeded 35% of shares outstanding during the first two years of the product.

Perhaps most astounding was the exponential growth in assets the NASDAQ 100 Trust enjoyed. At the end of its first year, assets exceeded \$11 billion on more than 100 million shares outstanding and, in spite of the bursting of the tech bubble, total shares outstanding increased almost six times in its second year (driven primarily by institutional desire to cover short positions) to 581 million shares and the assets doubled again to more than \$22 billion. Even with the muted performance of the benchmark since 2001, the now rebranded PowerShares QQQQ still has total assets approaching \$20 billion and remains the leading choice for retail and institutional investors seeking exposure to the Top 100 non-financial stocks trading on the NASDAQ Stock Market. The surprising success of the QQQ may have put ETFs on the map to stay, but it would still take another year for the launch of Barclays Global Investors' iShares to cause the mutual fund industry to take notice of these upstarts and begin to appreciate to competitive threat that ETFs present to their business.

Evolution of the ETF Business

In their brief and dramatic history many of the exciting innovations within the ETF arena went largely unnoticed by asset managers, who were content to marginalize them as simple institutional index products that could never compete against the well established mutual fund industry. With a short list of 30 funds and a bit more than \$30 billion in assets at the beginning of the new millennium, it was unclear if ETFs would ever live up to their promise as the new, new thing or continue to be marginalized on the periphery of the mutual fund industry.

That changed in March 2000 when BGI launched its first ETFs, the iShares. With the capital of a large global parent firmly behind the initiative, the iShares team brought an unprecedented level of passion and commitment to their plans to become the world's leading provider of ETFs. In the early days, BGI believed that the mutual fund business had gone through a fundamental change, driven largely by the growth of discount brokerage and the tendency of individual investors to make their own investment decisions. BGI's initial business plan was primarily focused on developing products that would simply compete on price, as they believed that with the lowest

Not content to sit idly by, and in spite of John Bogle's buy and hold driven protestation that ETFs are simply day trading vehicles akin to "giving gasoline to pyromaniacs," Vanguard quickly recognized the competitive threat posed by BGI's price competition strategy and began working on its own offering in the ETF business, the creation of share classes for its existing sector, style and international index funds. Originally called Vanguard Index Participation Equity Receipts (VIPERs), Vanguard recently rebranded its offering as Exchange Traded Shares (ETS) as they began to roll out products for fixed-income and other asset classes. With an impressive array of 37 separate ETS products now available, including the Total Market ETS (VTI) with just under \$11 billion in assets, Vanguard is clearly committed to defending its position as a leading provider of low-cost and tax efficient index-based funds by offering its clients a choice between their traditional funds and the ETS class structure.

State Street Global Advisors continues to be the second largest sponsor of ETFs in terms of assets under management with more than \$100 billion. Failing to gain traction in the market with their original StreetTracks brand, SSgA is now leveraging

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cost investors would beat a path to the iShares door. In fact, prior to the launch of the iShares S&P 500 ETF with a nine basis point total expense ratio, the cheapest funds on the market were the Vanguard 500 institutional share class priced at 19 basis points and the SPDR at 20 basis points.

In some ways, the timing couldn't have been worse for BGI as they officially entered the ETF business the same month as the peak of the NASDAQ. With the collapse of the tech market, the next two years would prove to very difficult indeed for the index business. To BGI's credit, when they realized that their initial strategy was flawed, they completely retooled their plans and developed a sales and marketing machine that is now the industry standard for ETF wholesaling. Not only did BGI position their franchise to capture inflows when the markets turned around, they also blazed a trail for other ETF issuers to follow in the wake of their multi-million dollar advertising and education blitz for these products. Today, BGI's iShares account for a staggering 53.3% market share in the U.S. with more than \$325 billion in assets under management and nearly 160 funds. In just a few short years, BGI has grown to become the fifth largest mutual fund management company. Not bad at all for an upstart on the periphery of the mature mutual fund business!

the SPDR brand - a license SSgA purchased from the Amex and S&P in tandem with a distribution arrangement for the Amex-sponsored ETFs - and have begun to pick up steam through the launch of ETFs branded with the SPDR moniker.

A Period of Explosive Growth

The first few years of the millennium were marked by diminished stock market returns, and only a handful of successful new entrants beyond the Big Three of indexing - BGI, SSgA and Vanguard. Several ETFs were launched in 2002 and 2003 with limited success, including a single product by Fidelity Investments via its ONEQ; the FITRs fixed-income funds, which closed several months after their launch; and UBS' Fresco Funds, which were successful in Europe but failed to garner interest in the U.S. and eventually were sold to State Street. Much greater success was enjoyed by The World Gold Council with its StreetTracks GLD ETF, the first of many PowerShares (now a unit of Invesco) and the first product to be based upon custom indices - the Intellidexes. The NASDAQ entered the ETF listing business via the BLDR family of ETFs (now also sponsored by PowerShares), which included both the first ETFs based solely on ADRs and the first product offering exposure to the emerging markets.

The general malaise of the markets began to finally turn around in 2004 and 2005, and ETFs were launched in droves. Improving index returns, coupled with the regulatory maelstrom engulfing the mutual fund industry, created the perfect environment for a number of would-be ETFs issuers who previously had been languishing in 'the queue' at the SEC, seeking approval from regulators distracted by market timing issues, Eliot Spitzer and preferred hedge fund distribution arrangements in exchange for sticky assets.

Since the beginning of 2005, more than 500 ETFs have been launched and an astounding number of new sponsors have entered the marketplace, including WisdomTree, Van Eck, First Trust, Claymore, Rydex, Deutsche Bank, London & Capital and HealthShares, just to name a few. Last year was the peak year for ETF issuance with more than 270 funds launched and nearly \$150 billion in additional asset flows, up from 150 new funds and \$62 billion in total asset flows in 2006. This year, however, new product release has slowed somewhat from last year's record levels - with just 41 new ETFs through April - due to volatility of the stock market, the scarcity of seed capital and the rapid closure of natural open spaces within the ever-crowding ETF domain.

Perhaps the most remarkable story of the last two years is the extraordinary success of ProShares. After seeking SEC approval to launch their unique products for seven long years, they have grown to become the fifth largest ETF sponsor with 60 funds and nearly \$17 billion in assets in just two short years. These double leveraged ETFs, designed to match two times the performance of their benchmark up or down, have proven to be very popular with hedge funds and sophisticated investors making bets for and against the market, even intra-day.

Most recently, the first actively managed fixed-income, equity and currency ETFs have come to market, launched by Bear Stearns, PowerShares and Dreyfus WisdomTree, respectively. With others expected to follow, these active products will need to demonstrate that their performance (net of total expenses) exceeds the return of reference benchmarks in order to truly compete with the active mutual fund industry.

The Road Ahead

Where are ETFs headed next you ask? Sponsors have already begun to experiment with new ideas designed to leverage off the exchange traded mechanism to deliver access to previously untapped asset classes. The ETF acronym has morphed into a catch-all that includes a wide range of diversified and undiversified offerings in both fund and trust structures - some with different tax treatments and trading limitations. In this frenzied period of growth, surely some of these new ideas will fail while others will exceed everyone's expectations. ETFs offer the best long-term potential in markets that are just beginning to mature in Asia and Europe, where investors have only recently

begun to face the pressures of planning for their own retirements in a reduced interest rate environment. As true equity cultures begin to emerge in these offshore markets and captive distribution channels begin to erode, ETFs will enjoy a significant percentage of the growth in assets during the years ahead.

The SEC recently asked the industry to comment on a sweeping proposal that would fast track the approval process for ETFs. New funds from existing sponsors and new firms are a certainty, and it seems that more choice is ahead and possibly more investor confusion along with it. Finally, with more than \$2 trillion in mutual fund assets, leading ETF sponsors are in pursuit of partnerships with 401k recordkeepers to find ways to better penetrate the ultimate buy-and-hold investor channel, U.S. retirement programs.

Whether you embrace active or passive investing, believe that ETFs are a panacea to cure all investing ills, use them as a relatively cheap and transparent tool for portfolio construction or find ETFs simply too mundane to raise your heart rate, one thing is clear: these newfangled beasts are here to stay.

About the Author:



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About the Firm:

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