

HANetf Commentary: The Case for Non-Transparent Active ETFs

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Active Etf's In Europe

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active etfs in europe

Growth in the ETF industry is sustained, long-term and global - at the time of writing, there have been 51 months of consecutive net inflows to the industry.¹ This expansion is being sustained by both internal innovation and external mega-trends. The previous HANetf paper "Win the Future" described the external influences that are fuelling the unprecedented growth of the global ETF industry – automation, technology, focus on fees and regulatory initiatives – but the ETF industry is also seizing the opportunity to rapidly innovate and drive growth from the inside: creating, marketing and distributing new investment propositions that go far beyond the scope of what the original ETF pioneers could have imagined.

"ETFs are just better 'tech' – the iPhone to the mutual fund's Filofax."

At HANetf we believe that ETFs are simply a wrapper and should not be defined by the strategy they follow. ETFs are just better 'tech' – the iPhone to the mutual fund's Filofax. It is our view that in 15 years all new funds will be ETFs that can be traded throughout the day and any remaining mutual funds will need to look and feel more like ETFs in order to survive and retain legacy assets.

Active ETFs in particular are one of the most significant growth opportunities but are a segment of the market that is controversial, poorly understood and, in Europe, subject to inconsistent regulatory treatment.

Active ETFs are a small portion of the existing ETF markets in both North America and Europe – data supplied by IHS Markit shows that only 1% of AUM (US\$49 Billion), is invested in Active ETFs compared to an overall market of US\$4.5 Trillion. While the assets are small, the growth is strong. Active ETF AUM grew by 57% between January 2017 and June 2018 with 91 new active ETFs coming to market in the same period.



57%

Growth in Active ETF AUM

January 2017 – June 2018

Source: IHS Markit

ETFs have won the war for basic index exposure. Tomorrow's battle grounds are thematic, smart beta and ultimately active strategies. It's clear that the supply of transparent ETFs is growing. However, it is also clear the industry needs a solution for non-transparent ETFs to allow the active equity ETF world to flourish.

¹ <https://www.etfexpress.com/2018/05/14/264182/global-etfs-mark-51-months-consecutive-inflows>

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favouring fixed income

A significant proportion of active ETF launches have focussed on fixed income strategies. This is unsurprising given under existing rules ETFs must publish their full portfolio holdings and weights every day and this is generally less of a concern for fixed income strategies. Active equity managers are concerned about the risk of front-running eroding their edge and destroying the value of their investment strategy and hence the requirement to publish full holdings on a daily basis represents a significant challenge to them.

Fixed income, where there are potentially many different bonds for a given company, all trading over-the-counter, carries a far lower risk of front running and has been more rapidly embraced by active managers with an ETF shaped twinkle in their eye.

This imbalance in issuance of active equity and fixed income strategies reveals a tension at the heart of the industry which, if resolved, could fuel the next wave of ETF market growth, competition and product innovation. It all comes down to disclosure requirements vs secret sauces. The value proposition of an active manager is that they have unique and specialist insight into certain markets or asset classes which enables them to outperform the market – the infamous “secret sauce”. In return for outperformance the asset manager can charge a premium fee. If the manager is forced to reveal the recipe and ingredients to their secret sauce, then their value may disappear along with their business. Ultimately as an industry we are duty bound to extend the ETF revolution beyond passives and bring our efficiencies to the active management world.

We believe this unresolved tension is inhibiting growth in the European ETF markets, reducing competition and unnecessarily limiting investor choice. In the next article, HANetf will examine a potential solution already being offered to US and Canadian investors: the Non-Transparent Active ETF.

¹ <https://www.etfexpress.com/2018/05/14/264182/global-etfs-mark-51-months-consecutive-inflows>

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addressing the purists

In the previous article, HANetf looked at the potential for Active ETFs in Europe. While some ETF issuers have launched active fixed income ETFs, the equivalent innovation in equities is being hampered by concerns about transparency. To address these issues and encourage the next wave of European ETF growth, HANetf proposes the introduction of non-transparent active ETFs.

Many ETF purists will be clutching their pearls at the thought. After all, we've been told for so long that ETFs are simple, transparent, index tracking funds. Isn't the very idea of a non-transparent ETF anathema against everything that ETFs are supposed to stand for? No.

Far from being an almost treacherously revolutionary concept, the introduction of NTAEs should be viewed as a natural, healthy and desirable development in the evolution of a European ETF industry – an industry which has a proud track record of embracing the future, supporting innovation and encouraging experimentation.

"ETFs are a technology that is highly effective in the distribution of investment ideas..."

First generation ETFs provided exposure to mainstream capitalization weighted indexes, but there was nothing to fix this as a limit to their potential. ETFs quickly evolved away from tracking vanilla indexes to cover a huge range of smart beta and multi-factor approaches that mimicked popular active management strategies.

The rapid growth of these new approaches demonstrated that ETFs are a technology that is highly effective in the distribution of investment ideas, rather than being an index or asset class specific proposition. The fact that the first ideas that were effectively distributed as ETFs were index portfolios is almost entirely irrelevant.

Why are ETFs Transparent?

Go to any ETF conference and you will hear a speaker extolling the well-established benefits of ETFs – cost efficiency, liquidity, diversification and transparency. Daily disclosure of portfolio holdings and weights is rightly touted as an attractive feature of ETFs, but it is more of a happy side-effect than a deliberate design decision.

ETFs are transparent due to the mechanics of intra-day ETF trading – a market maker wants to provide the tightest spreads on a given ETF. To do that, they need to be able to accurately price the fund, with confidence. Therefore, they need to know the exact composition of the fund, hence full holdings including cash and weights were required every day in the Portfolio Composition File (PCF) – anything less means a market maker needs to widen their spreads to adjust for the uncertainty. The PCF as a tool is rarely asked for or provided to end clients which demonstrates the point that this disclosure tool is not used for transparency by end investors.

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is transparency important?

Transparency was never designed to be a market disclosure service, but the consensus is that investors nonetheless value transparency of ETFs. This may be true, but in more than 15 years of building ETF businesses, I have only ever had five clients ask me for a PCF file. I sent it to them and they never asked twice. Transparency is only useful if you are going to do something with it and many investors don't know what to do with transparency once they have it. Perhaps the idea of transparency is more important than the transparency itself?

Most European mutual funds, active or passive, tend to disclose only their top 10 holdings on a monthly basis and no one bemoans that. The additional transparency that is currently required for ETFs does not seem to be used in making investment decisions by end investors.

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Limited disclosure has been the norm for the majority of mutual funds sold to institutional and retail investors across Europe under UCITS and has never curtailed the funds ability to raise assets or satisfy regulatory requirements. As ETFs are UCITS, why should they be held to different standards than any other UCITS fund?

Why Active Asset Managers are "Active-ating" their ETF Strategies.

Creating an ETF strategy is among the highest priorities for many asset managers – 67% of respondents to the EY Global ETF Survey¹ expected a majority of asset managers to have an ETF offering in the near future. Asset managers are recognising the business opportunity of participating in an industry that saw growth of over 40% in 2017 and are seeking to develop an ETF range which they can offer alongside other structures like mutual funds, structured products, separate managed accounts or investment trusts, providing an alternative channel through which their investment ideas can be bought.

Just as a coffee company can sell their product as beans, ground coffee, pods, instant powder or pre-mixed iced coffee, so can an asset manager add to their distribution firepower by adding an ETF category to their product range. Many will already offer multiple wrappers including mutual funds, hedge funds, structured products and so on. Adding ETFs is simply extending this foot print.

¹ <http://www.ey.com/gl/en/industries/financial-services/asset-management/ey-global-etf-survey-2017>

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Re-imagining a product range to include ETFs enables asset managers to position themselves to benefit from the ever-increasing number of ETF-focussed platforms and distributors: there are now over 100 robo advisers in Europe² and many retail brokerages, wealth managers and banks are now offering ETF-based model portfolios.

ETFs allow access into this space and as importantly, provide a much smoother path to enter foreign countries that may be key to long-term business growth. For example, UK, Germany, France, Italy, Spain, Nordics and Holland all have strong domestic ETF markets and the ability to list ETFs domestically.

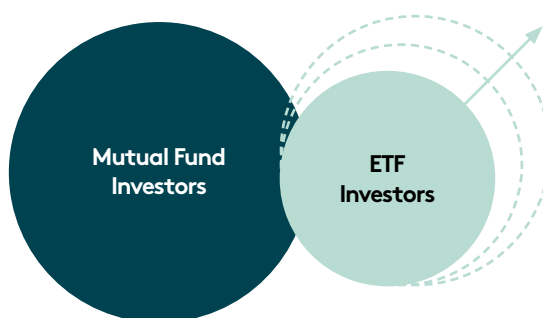


Illustration: As the number of ETF-only investors and distributors increases, asset managers without an ETF proposition stand to lose out on future growth

Without an ETF range, asset managers risk being excluded from these important distribution channels and will be at a significant competitive disadvantage to managers who recognised the distribution potential of ETFs earlier on.

The creation of non-transparent active ETFs could unleash a wave of innovation and growth within the ETF industry, but more importantly, there are also tremendous benefits for the end investors across Europe. In the final article in this series, HANetf explores how investors could be the biggest beneficiaries of this change and how concerns around disclosure and transparency can be addressed.

² www.techfluence.eu/investtech.html

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the value of choice

ETFs have frequently been described as 'democratic' investment tools – institutional and retail investors have access to the same products, the same information and the trading flexibility. Investors have been the big winners from ETFs – being able to create highly diversified portfolio at extremely low costs.

The tremendous growth of ETFs, and the variety of new ideas coming to market demonstrates that advisers, model portfolio managers and end investors want a wide variety of tools, **both active and passive**, to help them meet their investment objectives, and they want them in an ETF format.

“The well-recognised benefits of ETFs – intra-day trading, shortability, lendability...low entry costs and diversification can be retained in a nontransparent structure.”

Many ETF investors and professional fund selectors prefer ETFs over mutual funds due to the ease of onboarding, automatability of processes and simplicity of comparisons. During a recent lunch, a fund selector at a well-known UK private bank described with frustration the manual, error prone and antiquated process to add a new mutual fund to their platform.

“We still get [mutual fund] information by fax.” He said with a degree of resigned bafflement. “ETFs are just easier- they're on exchange, you don't need to fill in a ton of forms, you know what you're doing and you can hit it at any time.”

If investors and fund selectors want active ETFs but asset managers are uncomfortable creating them due to fears of front-running then the whole market loses out: investors don't have the ability to get exposure to the great managers they want in the format they prefer; fund selectors face hurdles adding attractive strategies to their platforms; the market becomes less diverse and competitive and asset managers have one less option to expand their businesses.

The lessons from the last two decades of ETF development provide a strong investor-led argument to support the introduction of non-transparent active ETFs – **value**.

Over just a few years, ETFs have dramatically driven down the cost of creating a portfolio. By using ETFs, investors can now construct a diverse, multi-asset portfolio at a fraction of the cost of using equivalent mutual funds and, via fractional trading, can start investing with a very modest sum of money. On the reasonable assumption that the same price pressure could be brought to bear on active strategies, the cost savings to the end investor will run into the billions over time. The well-recognised advantages of ETFs – intra-day trading, shortability, lendability, having an ETF portfolio held in one venue, portability of positions between trading venues, low entry costs and diversification – can be retained in a non-transparent structure, meaning investors stand to benefit from more features, more choice and more flexibility for less cost and less complexity.

The price of any Shares or the value of an investment in ETP's may go up or down and an investor may not get back the amount invested.

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convergence

When we discuss ETFs and active management, we cannot avoid the so-called “active-passive debate” – the idea that most active managers don’t consistently outperform their benchmark.

We think this debate is focusing on the wrong issues. Far from being a world of opposites, where “passive good, active bad” we are seeing convergence of trends across the range of investment management activity - human **and** machine, automation **and** customization, discretionary **and** systematic, active and passive, scale **and** personalization.

Giving investors the option to gain exposure to the same active investment strategies they already own via an ETF wrapper has the potential to offer significant improvements to their current experience. Non-transparent ETFs are a great example of how the European ETF industry could extract the attractive features of active and passive and combine them into one innovative solution that solves a real need for investors and asset managers.

Addressing The Disclosure Issue

Regulators and stock exchanges across Europe have not yet grappled with the issue of non-transparent ETFs, and in fact there is little consistency in approaches towards conventional active ETF disclosure – for example London Stock Exchange and Borsa Italiana, both part of the same group have opposite approaches, full daily disclosure in Milan but not in London.

Regulators are also grappling with the issues around disclosure. There is a fear that the role of the Authorised Participant (AP) means they get privileged information through the PCF and there is a risk of market abuse. In my view, there is a relatively simple solution here. To be an AP you need to sign a detailed contract with the issuer and the terms and conditions cover off these risks.

Regardless of the contract, the APs themselves are highly regulated (most notably MiFID 2 and the Transaction Reporting regime) and this has provided the regulators with far more data so they can analyse and catch any entities that are engaging in market abusive behaviour. APs receive confidential information regularly and have strong internal controls and processes to deal with such information. Part of the solution is also to redefine the role of the AP for non-transparent ETFs to include acting as a market maker. This would then allow APs to avail of the market making exemption within MiFID. This solution also allows issuers to control the flow of information by limiting its availability to essential trading counterparties. However, we would advise there should be at least a minimum of two APs for any ETF.

Exchanges stand to be one of the main beneficiaries of the next stage of the ETF revolution – active ETFs – but must play a proactive role in addressing the concerns of asset managers who want to leverage the disruptive distribution power of ETFs without sacrificing their investment IP.

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about han etf

The Best of Both Worlds

ETFs have driven down the cost of index investing, made it easier to construct portfolios and made it more convenient to take short-term positions on a theme, sector, market or strategy and allowed forwardthinking asset managers to build tremendous businesses. It's time to bring these benefits to the active management space, creating more choice and more opportunity for both institutional and retail investors.

HANetf and Active Asset Managers

Active asset managers who are creating their ETF approach may only want to launch a small number of funds that represent their core strategies, but do not want to face the cost and complexity of building an in-house ETF capability.

White-label ETF platforms, like HANetf, provide the operational, regulatory and distribution infrastructure needed to successfully launch UCITS ETFs in Europe, reducing costs, increasing speed to market and lowering barriers to entry for traditional and alternative asset managers while still allowing the asset managers to retain control of their IP and build their ETF capabilities in a time and cost-efficient manner. With HANetf you could be just 12 weeks away from launching your first ETF – vanilla, thematic, smart beta or active.

www.hanetf.com

Hector McNeil

Co-Founder & co-CEO of HANetf



Hector is a veteran of the ETF industry, being instrumental in establishing Susquehanna's ETF desk in Europe as Head of Business Development. Hector then joined ETF Securities as Joint Managing Partner and co-Founder, before going on to found BoostETP with Nik Bienkowski in 2011.

BoostETP was purchased by US ETF provider WisdomTree in 2014 and following the completion of this buyout in 2016 Hector stepped down as Co-CEO of WisdomTree Europe.

Hector established HANetf, Europe's first independent 'white label' ETF platform, with business partner Nik Bienkowski, to provide asset managers with a fully managed solution to enter the European ETF market.

Hector, a Fellow of the Securities Institute, holds a BA in Economics and received an MBA from Warwick Business School. HANetf is Europe's first independent white-label ETF provider. HANetf has been established to provide.

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