Few complaints from the users

First meeting of the ETF Users Group suggests that there is little to grumble about

There have been numerous and substantial developments in the European exchange traded funds industry over the last few years, as subscribers to this publication are well aware. Given what is going on IFI has decided to start an ETF Users Group. The objective of the Users Group is to allow investors and intermediaries with an interest in ETFs to meet with promoters of these products in order to discuss issues that have arisen as a result of the industry's expansion. The ETF Users Group will meet on an occasional basis in different locations around Europe in order to have 'thought leader' discussions that will be recorded for publication in IFI. The objective of the Users Group is to develop an ongoing dialogue between users and issuers of ETFs across Europe.

The first meeting of the ETF Users Group took place in London in mid July. Attending the meeting were: Nigel Baynes from iFunds; Pablo Carbajal from Cross Border Capital; Dan Draper from Lyxor; Manooj Mistry from Deutsche Bank and Alex Scott from Seven Investment Management. Following are highlights of the discussion.

"I think that the product range on offer is bigger than the market," said Alex Scott of Seven Investment Management. But he added that he thinks this is how it has to be. He claimed that the experience Seven Investment Management "was that the tool box wasn't full," at least until recently. Up until last year "there were still huge gaps in the range." So for investors like Seven Investment Management, who wanted to use ETFs for asset allocation purposes, there were difficulties. He added that ETF providers have done the right thing by issuing products that are ahead of their time - even if they are small and unprofitable for a while because "you can't wait for the market to ask you for it; by then it is probably too late." "The tool box needs to be full so by the time that the asset manager wants to make the trade it is there on the shelf." Until a year ago, for example, there wasn't a single ETF on the UK gilt market.

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> Alex Scott

Pablo Carbajal of Cross Border Capital said that, from his perspective, "the tool box is now full, but we now need some consolidation." He made the analogy of going to a supermarket and being confronted by numerous versions of the same product and therefore not knowing which one to chose. The same thing has happened with ETFs. "Too much brand for same type of beta is not good."

Nigel Baynes of iFunds made the point that the ETF market in the US has developed to the point where it is getting "a little polluted." He said that new entrants are coming into the market dreaming up new ranges of indexes to launch products on. He thinks that this phenomenon will continue until there is a major shake-out in the markets. In Europe the nearest equivalent is the growth of multiple versions of the index. The same index is often offered by different issuers. Alex Scott said that a challenge that intermediaries using ETFs such as he are having to get to grip with. Making the distinction between different promoters of ETFs on the same index, and explaining the benefits to clients of being in one rather than another, is a real issue.

In response Dan Draper of Lyxor said that there are often tax and regulatory reasons for multiple ETF issuance on the same index. One of the reasons why Lyxor brought out a duplicate of range of FTSE ETFs was for one specific set of investors. "So on the surface (certain ETFs) may look identical but if you crawl underneath there is a real need there." With regard to the US market Dan Draper made the point that we are now moving to an environment of synthetic replication and people are questioning whether market cap ETFs are the best alternative. It will be several market cycles before that it is decided but what is interesting is that different theories are being tested.

Manooj Mistry of Deutsche Bank made that the point that much of the recent ETF expansion has been into new markets and asset classes (rather than replicating an existing index), and "this is good for the market". And when there is an additional product that is launched on the same index he said that it is up to issuers such as him to explain why this has been done.

The ETF promoters at the meeting were asked if the fragmentation of Europe in some senses made it easier for them to issue ETFs into various niches than in the US, which is one large homogenous market. Dan Draper responded by saying this was true but that there is a bad side to this as well, which is the inverse of the US where so much volume is on exchange. He added that he would almost like to spend the majority of his marketing budget buying on exchange liquidity as this is his best form of advertising he could get. "We do tend to fragment liquidity across Europe". ETFs are competing with Delta 1 and other derivative products. "Somehow we have to commit to a price on a screen or on an exchange." If people feel that there is liquidity they will be able to sort out what is worth investing in and what is not, he added.

"We do tend to fragment liquidity across Europe,"
Dan Draper

Deutsche Bank recently launched an ETF covering credit default swaps. Manooj Mistry was asked to describe the thinking that a promoter of ETFs, like Deutsche Bank, goes through when it decides to issue a new product. He said that there is a combination of reasons for launching an ETF such as this. He made the point that Deutsche Bank came into the ETF market relatively late so, in addition to having a range of standard products, it wanted to be able to differentiate itself from its competitors. Although relatively new to issuing ETFs, Manooj Mistry added that Deutsche Bank has been broking ETFs for a while so they are able to see where demand is coming from. He said clients are asking for ETFs on credit default swap indices, on emerging market bonds etc. Based on the principle "if you build it they will come" Deutsche Bank decided to add three ETFs on the iTraxx CDS indices to its product range.

An ETF is really a wrapper but it is also a portal, said Dan Draper. It absorbs liquidity from a lot of different places and "as you move into alternative beta you start thinking about the world differently". As an example of what he was referring to he made the point that the

Pablo Carbajal & Alex Scott

silver market was shaken up when the first ETF was issued on that commodity. This was because retail investors were suddenly able to invest in silver and the market dynamics consequently changed. Manooj Mistry added that Deutsche Bank recently launched a ETF shorting the performances of the DAX and the EuroStoxx 50 which has been a great success with German retail investors. Average trading volumes are approximately €15 million a day, which is good by European standards.

Alex Scott says that he sees two different strands of development in the ETF industry at the moment: one is mainstream exposure to sectors, thematic baskets, countries etc and the other is the ETF as an "accessibility tool" for investors where they would not otherwise be able to gain exposure. It is not just retail investors that are gaining from the ability to go short for the first time but also discretionary wealth managers and perhaps long only fund of funds managers.

Nigel Baynes was asked what types of ETFs are of most interest to his clients. He said that that these are funds focussing upon global markets or sectors, such as banks, media or insurance, for example. And the development of the ETF market place within the total return space "has been fantastic," he added. It allows iFunds to almost construct a hedge type strategy for clients in that they can, for example, now short the EuroStoxx 50 but go long the sectors that they like. "So you can now create, even though it is not an actual hedge fund, strategies to give yourself absolute returns". But he added that he has problems with the structure of some of the sector funds that can be dominated by one two stocks. The technology index, for example, might be 40% Nokia or the energy index might be 40% Total. So there are diversification problems that need to be dealt with at sector level. He therefore suggested that an equal weighted index often has more attractions to someone like him than a cap weighted index.

In response Dan Draper said that the cynic might say that if you are going down the equal weighted route why not just overweight small and mid caps. The problem with fundamental indices is that there is a "black box" element to them, he added. Investors need transparency and therefore the processes that fundamental indexes are based upon have to be published in fund prospectuses. And as there are many billions of dollars already invested in index arbitrage and "if the black box is exposed to the world how long will it continue to outperform?"

FUNDAMENTAL INDICES

Alex Scott asked what the role of fundamental indices is. "Are they to be used as benchmarks against which investors manage their portfolios or are they are quantitative model designed to outperform a traditional index?" If it is the latter it should be called a quant strategy, not a fundamental index, he said. Pablo Carbajal added that he would not trade an ETF that he did not how it would behave as there would be risks that he would not be able to understand entirely. But if fundamental indices are all about just excluding stocks with certain PE ratios that is different. But Manooj Mistry said that most of the money that is flowing into ETFs today is still going into what he called mainstream products, rather than those based on fundamental indices.

Dan Draper

> "A bout of volatility will likely lead to underperformance on the active side which will play right into the hands of ETFs," Nigel Baynes

The discussion moved on from fundamental versus cap weighted indexes to the subject of alternative beta. Dan Draper said that one can almost see how alpha has a shelf life and he hopes that it will end up being captured in ETF portfolios. Nigel Baynes added that, as a prospective user of these funds, it is vital that he has the historical data for the index that the ETF is based on. "We need to know when that risk, return characteristic changes." He added that he cannot use ETFs based on a "black box" process, which are "artificially" constructed. Nigel Baynes made the point that he is not able to get hold of sufficient information on the methodology of these indexes to satisfy him. For example fundamental index providers do not provide historic time series data. And Pablo Carbajal suggested that if you are issuing a fund that is seeking to provide alpha you should be set up as an active fund.

With the advent of UCITS III Manooj Mistry said that ETFs can now compete on a level playing field with innovation in other areas of the market, such as certificates. He added that the European institutional market, in his experience, is unlikely to use certificates on a large scale.

LIQUIDITY

The issue of the liquidity with regard to at least some parts of the ETF market was raised several times during the discussion. With regard to the creation and redemption process Alex Scott that there is "an awkward middle ground." Some ETFs he deals with are a little too big for what is on the market but a little too small for a creation basket. Whilst it doesn't happen often it nevertheless can leave you "stuck in no man's land." Dan Draper added that the market still needs more active traders to use ETFs, such as hedge funds. Active investors need a price immediately and therefore need a commitment from a market maker to do just that. "We have to do something to get the more sophisticated investors in now." Closing the gap between the bid and ask spreads is the key to this, added Pablo Carbajal, "it is the best marketing that you can do".

Dan Draper made the point that in the US there is in effect syndicated liquidity but he finds that in Europe with a lot of the broker-dealers much of the execution remains on Delta 1 and ETFs may not be their main concern, as they are doing other things like certificates. "ETFs have something of a low priority" for market makers. They may be making more money on swaps or certificates, for example. One of the biggest priorities the ETF industry should have is to find ways to incentivise brokers to share liquidity. Specialist ETF brokers have done well in Europe and he suggested that the market needs more of them.

Manooj Mistry added that it is still difficult to execute large size ETF trades on exchange and a lot of Deutsche Bank's clients are still trading OTC with them. He also mentioned that at a recent conference a market maker mentioned that 70 percent of the ETF trades that they do are OTC. Across Europe as a whole Manooj Mistry estimated about the half the traded volume is OTC.

With regard to liquidity Nigel Baynes said that he is concerned that the ETF market has not been stressed tested yet. There has not yet been a situation that has tested out some of the new entrants. When that happens "it is probably inevitable that there will be some bad press." But a bout of volatility will likely lead to underperformance on the active side as well which will "play right into the hands of ETFs."

Alex Scott & Nigel Baynes

COSTS

Some of the largest institutions that IFI has researched over the years have complained about the costs associated with using ETFs. Alex Scott made the point that the largest of the large can afford to do it themselves; the cost of an ETF is an issue in that decision making process. But for smaller institutions, or even large ones looking to make small allocations, the costs of an ETF should not be an issue.

Nigel Baynes suggested that the costs of ETFs "have been one of the prime drivers for us using these vehicles: they are so significantly lower than actively managed funds."

"The tool box is now full, but we now need some consolidation,"
Pablo Carbajal

WHAT DO THE USERS WANT?

"I would like more tools in the tool box," said Alex Scott, adding that by more tools he doesn't mean another EuroStoxx ETF. He wants ETFs covering global thematic plays such as timber or shipping stocks. Nigel Baynes said that he would like to see more ETF development in the UK fixed interest market by duration. He added that he would the ETF providers to help promote these products to the IFA market. ■