The ETF (Exchange Traded Fund) market is growing at a rapid pace. ETFs are no longer considered a niche product and a growing number of organisations are likely to enter this market in the future. To help asset managers prepare to compete in this fast changing environment, we have considered the ongoing evolution, barriers to growth and the opportunities that lie ahead, and how they can plan for 2020.

ETF 2020
Preparing for a new horizon

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Executive summary

Since their introduction only two decades ago, Exchange Traded Funds (ETFs) have been undeniably successful. Growing far beyond their initial function of tracking large liquid indices in developed markets, ETFs now hold over $2.6 trillion of assets globally.[1] ETFs are listed on an ever growing number of exchanges and are being used by investors in a growing number of markets. New investor segments continue to integrate ETFs into their portfolios and fund sponsors continue to introduce new products.

The proliferation of ETFs was identified in our AM 2020 publication as one of the six game changers in the asset management (AM) industry. ETFs are no longer a niche product, and their impact will continue to be felt much more widely than imagined. As such, all financial services firms should consider developing an ETF strategy. This may be an obvious choice for firms planning to manage, service, or distribute ETFs, but it is also important for firms that will be competing in an environment that is increasingly shaped by ETFs.

In 2013, PwC explored the rise of ETFs in depth in 'The next generation of ETFs'. Based on the history of ETFs and a close examination of recent developments, this paper identified key trends, highlighted potential obstacles to growth and articulated how industry players might formulate coherent strategies to deal with ETFs. Since then, we have gone on to survey asset managers, service providers and other industry participants around the world in an effort to better understand regional developments in ETFs and use their expertise as a sounding board for our own perspectives.

This report leverages the results of our global survey and our insights to paint a picture of how the ETF business is likely to evolve globally over the next six years.

About the survey

PwC surveyed executives from approximately 60 firms around the world in 2014 using a combination of structured questionnaires and in-depth interviews. Two-thirds of the participants were ETF managers or sponsors, with the remaining participants divided between asset managers not currently offering ETFs and service providers. Participating firms account for more than 70% of global ETF assets.

1 BlackRock, 'ETP Landscape: Industry Highlights', 30 June 2014

Ongoing evolution

We begin by looking at the growing global footprint of ETFs. The U.S. market has led the way to date, but other markets demonstrate significant growth potential. These opportunities are accompanied by regional differences in market dynamics, investor preferences and regulations, so global aspirations will need to be supplemented with additional regional resources and expertise.

We next examine the increasingly complicated segmentation of the ETF market. Institutional use continues to drive assets as a growing variety of firms find uses for ETFs. The advisor market continues to evolve quickly, with ETF strategists playing a growing role in the U.S. market and now emerging in Europe. Segment and channel trends are largely driven by local considerations, so regional differences abound.

The flood of new ETFs has slowed in some regions (i.e. the U.S.) and proliferated in other regions (e.g. Europe and Asia) since the financial crisis in 2008. Non-traditional indexing is an important trend in most markets, while active ETFs are on the verge of radically changing the AM industry in the U.S.

Operational service providers are likely to play an increasingly important role in ETF markets as fee pressures mount and an ever more competitive environment cause fund managers to look for effective and efficient means of bringing products to market. Such firms could also serve as catalysts for further growth by offering turnkey platforms that minimize the barriers to entry facing prospective new market entrants, particularly smaller, less established firms and those looking to gain access to geographies beyond their current footprint.

Fee pressure may be mounting, but ETF sponsors remain relatively optimistic about their financial picture, with more than half of those in the survey predicting increased profitability and only one in five expecting a decline in profits. Asset growth will most likely continue to boost top-line revenue, but a variety of factors may conspire to pressure the bottom line going forward.

Regulations have the power to encourage as well as limit growth. Most near-term rule changes are seen as likely to improve the regulatory environment for ETFs, but there is still much that could be done, particularly in markets like Japan where distribution efforts are hobbled by the continued practice of sales' commissions on mutual fund sales.

On 21 October 2014, the Securities and Exchange Commission (SEC) denied requests for exemptive relief for two firms seeking approval to launch non-transparent active ETFs, which would provide less than the current daily transparency of the portfolio holdings using a blind trust. In early November 2014, the SEC approved the request for another firm to launch a different type of non-transparent active investment product referred to exchange-traded managed funds. This development has generated a lot of interest by current and prospective ETF sponsors. We expect that firms will continue to seek regulatory approval to launch non-transparent active ETFs, which could provide another phase of growth and innovation in the coming years.

Impediments to growth

The popularity of ETFs is unlikely to abate, but there will be challenges in the coming years. Among these are changing demographics, which will have asset managers increasingly tasked with designing

As more types of investment strategies become operationally feasible and are permitted by regulators, a growing number of firms are likely to enter the ETF market.

solutions suitable for a rapidly ageing population. Technology could also challenge ETF firms, with its power to radically alter the way investment advice and products are evaluated and consumed. Regulatory constraints and distribution dynamics favouring other types of investments may slow growth in some markets. A further complication in the U.S. is an increasingly saturated marketplace, crowded with firms eager to share some of the assets flowing into this fast-growing corner of the industry.

Opportunities ahead

Despite myriad challenges, opportunities abound for existing ETF firms as well as others willing to develop a thoughtful and informed strategy as they prepare to address this market.

As more types of investment strategies become operationally feasible and are permitted by regulators, a growing number of firms are likely to enter the ETF market. As the market becomes more crowded, product differentiation will become increasingly critical (and difficult). Brand building is important, but doing it effectively may hinge more on educating investors with thought leadership than traditional advertising.

Shifts in the regulatory environment will produce opportunities that may favour firms with local market knowledge.

The ability to transform ETFs into effective solutions that address the needs of specific investor segments may be a particularly important factor in competing successfully.

Deep expertise, differentiated products, brand awareness, investor education, regulatory savvy and the ability to craft innovative solutions are all pointless without effective distribution.

The ETF market is a fast-growing business with many appealing qualities. It is also undergoing some transformative changes that will make it much bigger and more competitive within a few years. There is no single approach that is likely to work for firms looking to take part in this business. Each firm will have to evaluate the considerations outlined in this paper and formulate their plan, based on their own capabilities and objectives.

We are grateful to everyone who contributed to this paper and to those who participated in our global survey. It is our sincere hope that it proves useful as you put together your ETF strategy.

ETFs in 2020

Despite lukewarm economic growth in much of the world, the AM industry remains a vibrant growth business. Having doubled over the past decade to approximately $70 trillion, we project professionally managed financial investments to grow at 6% per annum to approximately $100 trillion by 2020.[2] Some of this growth is expected to come from market appreciation, but strong new asset flows are also likely to contribute significantly.

ETFs will play an increasingly prominent role in this growth, accounting for an increasing proportion of asset flows in many markets and investor segments. ETFs now hold approximately $2.6 trillion of assets globally.[3] Their rapid rise can largely be attributed to the growing acceptance of indexing, but ETFs are likely to get an additional boost in the coming years from greater penetration of global markets, growing acceptance among more types of investors and the introduction of a wider variety of investment strategies. ETFs are widely expected to continue growing. More than three out of four survey participants said they expect ETF assets to at least double, reaching $5 trillion or more by 2020. Others are not so sure, predicting more modest growth rates or a gradual slowdown as market penetration reaches its limit.

Growing global footprint

With more than 5,400 products listed on 60 exchanges by 222 fund sponsors, ETFs are already a global phenomenon.[4] Assets are still heavily concentrated in certain markets, but globalisation will continue as ETFs proliferate and address a growing number of niche asset classes, a scenario that has played out in more mature markets and is likely to be repeated in newer markets as well.

In absolute terms, asset flows in the developed markets of the U.S. and Europe will dominate the global ETF landscape, but the highest rates of growth are likely to be found in less mature markets. Asian investors have had access to ETFs for some time, but are only now adopting them in greater numbers. Currently accounting for 7% of global ETF assets,[5] the sheer number of investors in the region combined with economic growth, rapid wealth creation and a quickly evolving financial services landscape mean that Asia is likely to contribute significantly to the growth of ETFs in the coming years.[6] Capital flows will accelerate further with the likely internationalisation of the Chinese renminbi, which will open up what will become one of the world's most important AM markets.

Investors in Latin America, the Middle East and Africa have been introduced to ETFs even more recently. The fact that they currently account for only 2% of global ETF assets only serves to illustrate the potential for growth in these markets as investors familiarise themselves with the benefits of ETFs.[7]

There is no consensus on whether the North American and European ETF markets are mature. It is quite possible that growth in these markets will slow, but it is not unreasonable to think that certain developments could reinvigorate demand and actually cause asset growth to accelerate in these markets. Even if Asia becomes the linchpin for growth in ETF assets, sufficient demand there could easily cause assets to climb past the $5 trillion mark by 2020.

More segments adopt

ETFs appeal to a diverse array of investors and intermediaries. Everyone from financial planners to hedge fund managers, insurance executives and central bankers can find something to like about ETFs.

A survey participant pointed out that ETFs give institutional and retail investors the ability to express and execute investment views in an efficient, low-cost and transparent way – something that was not previously available in the local market.

As ETFs become more global, they will find their way into the portfolios of a wider array of investors. Having led the way in most markets, advisors to individual investors will continue to drive demand for ETFs. The ease of use, low cost and liquidity of ETFs has made them a favourite among advisors, who in many cases are taking on more of a portfolio management role as the emphasis shifts from security selection to asset allocation. The growing ranks of affluent investors in Asia and elsewhere mean demand from advisors will almost certainly expand.

It is institutional investors, however, that are widely expected to be the primary growth driver in coming years. Insurance companies, pension plans and hedge funds in particular are projected to be significant sources of demand for ETFs. Insurers are increasingly looking to ETFs as sub-account options for increasingly sophisticated tactical strategies.[8] Defined benefit plans have already started using ETFs in greater numbers, and defined contribution plans may well follow with the introduction of more target date and target risk ETFs. Having long used ETFs in a variety of strategic and tactical roles, hedge funds are unlikely to turn away from an investment vehicle that has proven so useful in the past. Wealth management platforms, central banks, foundations and endowments are also expected to use ETFs in greater numbers.

"ETFs give institutional and retail investors the ability to express and execute investment views in an efficient, low-cost and transparent way – something that was not previously available…"

Segment and channel dynamics can vary from one region to another, and differences can sometimes be striking. The benefits inherent in the ETF as an investment vehicle are almost universally seen as the key drivers of their growth to date. But demand has come from different types of investors, depending on the market. In the U.S., retail demand is more likely to have been seen as a significant growth driver to date. Outside of the U.S., institutional

2 PwC, 'Asset Management 2020: A Brave New World', 2013
3 BlackRock, 'ETP Landscape: Industry Highlights', 30 June 2014
4 ETFGI, 'ETFGI Monthly Newsletter, July 2014', 7 August 2014
5 BlackRock, 'ETP Landscape: Industry Highlights', 30 June 2014
6 BlackRock, 'ETP Landscape: Industry Highlights', 30 June 2014
7 See footnote 6 above
8 PwC, 'The Next Generation of ETFs', 2013

investors are more likely to be credited with having driven asset growth in a meaningful way (Figure 1).

Figure 1: Significant growth drivers to date (more than one response provided)

Source: PwC Global ETF Survey, September 2014

There is no consensus on the retirement market. Some fund sponsors see it as a major opportunity, while others dismiss it as a dead end where ETFs cannot compete effectively.

Looking forward, financial advisors, retail investors and wealth management platforms are expected to be the top three segments driving demand in the U.S. market. While the retail business is not inconsequential outside of the U.S., demand will most likely come from different sources. Insurance companies, retirement plans and hedge funds are expected by Asian firms in the survey to be the biggest sources of demand in the next few years. Meanwhile, private banks and wealth management platforms are widely seen by European firms as a significant source of future demand for ETFs (Figure 2).

ETF sponsors are considering every avenue. Sovereign wealth funds are seen by some as a potentially major source of demand. Others are targeting local banks and financial institutions.

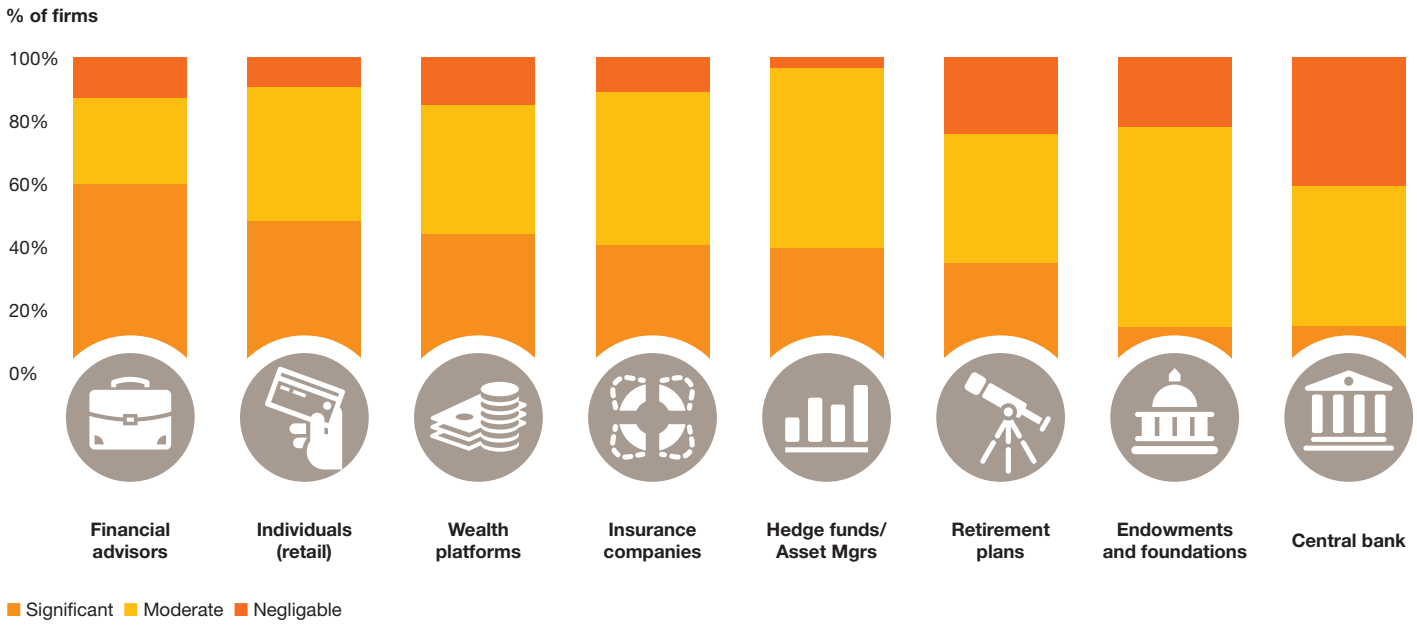
There is no consensus on the retirement market. Some fund sponsors see it as a major opportunity, while others dismiss it as a dead end where ETFs cannot compete effectively.

The insurance market is seen by some as potentially one of the biggest untapped opportunities for ETFs. ETFs have not yet penetrated very deeply into this massive pool of assets, but opportunities abound for their use, not only as building blocks in packaged products, but also as assets on insurer's balance sheets.

One important area of change in the ongoing evolution of the AM business is the role of intermediaries, who are increasingly acting in advisory capacities rather than simply acting as brokers. As a part of this shift, these intermediaries are being compensated differently, with fee-oriented models becoming prevalent in many markets. Asset-based fees create a powerful incentive to use lower cost investment vehicles in order to maximise profitability. This incentive is made even stronger by the higher turnover associated with tactical asset allocation models increasingly used by advisors.

The shift towards fee-based models is being reinforced by global regulatory developments, with authorities in many jurisdictions aiming to better align the interests of advisors with those of their clients. Regulations like the UK Retail Distribution Review (RDR) and Markets in Financial Instruments Directive (MiFID) II in Europe are likely to lead to interest in cheaper and more cost-effective vehicles. Similar regulations on fee models and related disclosures would have a comparable effect on other markets, underscoring the advantages of ETFs and potentially boosting their share of retail asset flows.

Figure 2: Investor segments projected to generate significant demand (more than one response provided)



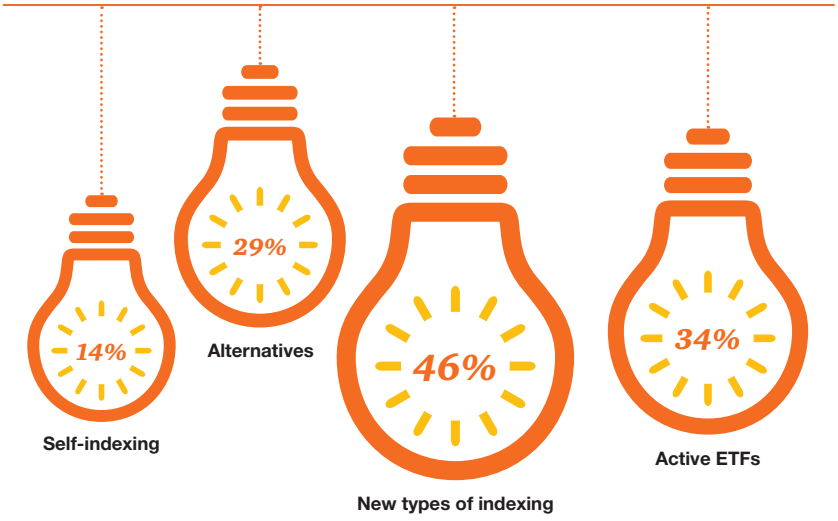
Source: PwC Global ETF Survey, September 2014

Products proliferate

Demand for ETFs is growing as more investors become familiar with them. Although new ETFs are not being launched at the same pace of a few years ago, fund managers and sponsors continue to do everything they can to meet the needs of key investor groups. Rather than designing products and hoping they attract interest, they are meeting with ETF strategists, investment advisors and others to ensure they understand the needs of their core users.

New types of indexing (also referred to as 'smart beta') represent one hotbed of product development activity, with 46% of all survey participants identifying this as the most important area of innovation (Figure 3). Among non-U.S. firms, it ranks first. As they evolve beyond their roots, non-traditionally indexed ETFs are attracting significant attention, with a growing number of investors opting for index weightings, based on factors other than market capitalisation, which can lead to overly concentrated exposure to certain markets, sectors, or securities. Their vehicle of choice is an ETF with holdings weighted by corporate fundamentals (e.g. profits or dividends), momentum, or some other factor.

Figure 3: Most important area of innovation (more than one response provided)



Source: PwC Global ETF Survey, September 2014

Scalability doesn't appear to be a major concern. About three in four ETF firms in the survey claim that their current operational infrastructure is sufficiently scalable.

"It is necessary to consider the profit model and how to deal with losses before product launch… costs are high and ETFs do not necessarily generate returns in the short term."

ETF executive on product strategy

There is an ongoing debate over whether these funds reflect 'active' or 'passive' approaches, but whatever the verdict on the nomenclature, these ETFs are generating considerable interest, with growth rates topping those of traditional index ETFs and $92 billion of assets in the U.S. market alone by mid-2014.[9] Almost half of the firms in the survey consider new types of indexing to be a key growth area going forward (Figure 4).

- U.S. respondents are particularly keen on non-traditional indexing, but they are even more enthusiastic about new developments in active ETFs.
- Alternatives are viewed by some as an important area for innovation.
- A significant number of fund sponsors are already waiting in the wings to launch actively managed ETFs. This is particularly true in the U.S., where the regulatory approval of non-transparent active strategies may eventually bring a growing number of active managers into the ETF market.
- Non-U.S. firms recognise the long-term potential of active ETFs, but are quick to point out the many structural barriers that need to be dismantled before active or alternative ETFs contribute meaningfully to growth.

Figure 4: Growth opportunities (more than one response provided)

Source: PwC Global ETF Survey, September 2014

Service providers evolve

With assets expected to double in the next five to six years, it is critical that the ETF business is supported by an efficient and scalable operating infrastructure. Scalability doesn't appear to be a major concern. About three in four ETF firms in the survey claim that their current operational infrastructure is sufficiently scalable.

- Slightly more than half of the ETF firms in the survey pronounced themselves either satisfied or very satisfied with quality of outsourced services (Figure 5).
- Some dissatisfaction may stem in part from a lack of automation, particularly for service providers located outside of the U.S., which is a more mature market.
- High fees are another source of dissatisfaction, with indexing companies most commonly cited as the offending party. Several ETF firms also say a lack of flexibility on the part of operating partners leaves them unsatisfied.

9 Strategic Insight, SimfundMF database, 30 June 2014

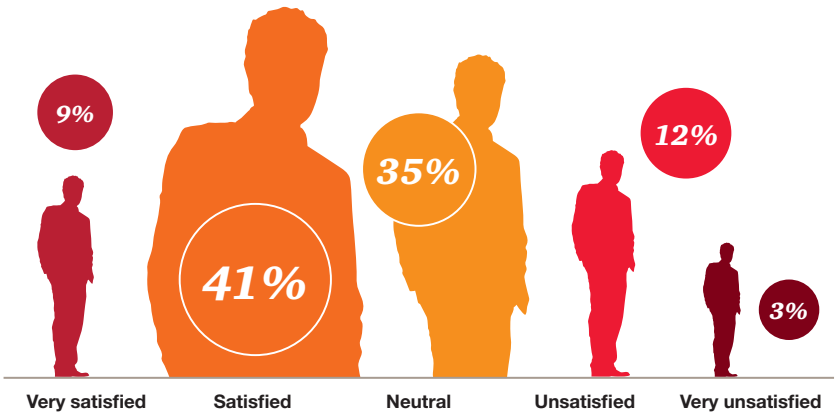
- 90% of the service providers say their firms have changed their business model by changing terms or adding resources, streamlining processes, introducing more automation, globalising operations and upgrading technology.
- Competition is also putting pressure on fees. Almost two out of three service providers in the survey stated that fees are an issue with which they are grappling.
- In many cases, their service offerings are integrated and offered in the form of 'platforms'. This is business as usual for many firms used to the mutual fund industry, where fund services are a mature business.

Optimistic economic outlook

ETF sponsors are rather more bullish on their financial prospects, with 59% saying they expect their ETF businesses to become more profitable this year (Figure 6). Meanwhile, only 14% say profits are likely to fall in that time. Much of this optimism has its roots in the nearly universal belief that the market will grow organically, generating additional income. Asset growth is likely to be propelled by growing demand as well as market appreciation. Some fee pressure is anticipated, but it is not expected to overwhelm revenue growth from a rapidly growing asset base.

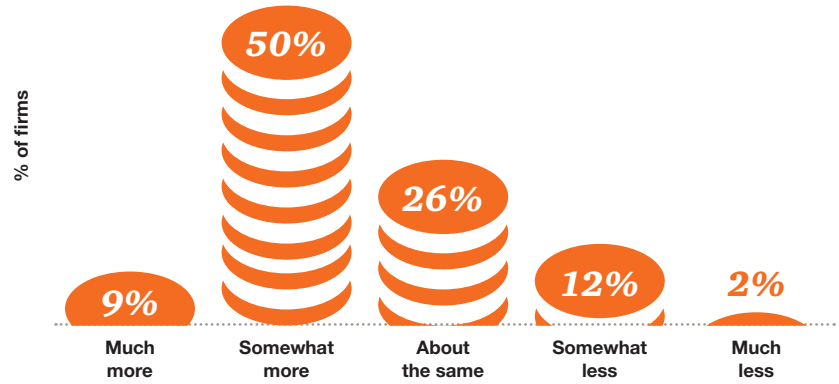
Non-traditional index ETFs (so-called smart beta funds) are already generating significant interest and asset flows, and boosting revenues for a growing number of firms. Non-transparent (also known as periodically disclosed) active ETFs are another example of innovation expected to directly benefit the top line growth of many asset managers.

Figure 5: Level of satisfaction with outsourced operational services for ETFs



Source: PwC Global ETF Survey, September 2014
Note: ETF managers and sponsors only

Figure 6: Projected profitability of ETF business in 2014 relative to 2013



Source: PwC Global ETF Survey, September 2014

Improved distribution dynamics are also seen as a potential source of stimulus for sponsor revenues. This is particularly true in Asian markets, where deregulation and lower cross-border barriers could spur activity and growth.

The rise of ETF strategists will continue to benefit fund sponsors in the U.S. market. Already accounting for more than $100 billion of assets, the 145 strategist firms in the U.S. market continue to introduce complementary offerings in order to leverage their distribution networks and infrastructure.[10] How quickly the model is applied to other markets remains to be seen, but rapid adoption would benefit managers and ETF sponsors.

10 Morningstar, 'ETF Managed Portfolio Landscape', Q2 2014

Growth comes with costs. Marketing expenses in particular are expected to rise. With competition heating up in virtually every corner of the market, ETF sponsors cannot afford to be overlooked by investors.

The impact of traditional marketing and sales' activities should not be discounted. Investor education and brand awareness campaigns could have a meaningful effect on revenues, particularly in less mature markets where ETFs are only now starting to find traction among retail investors.

Meanwhile, deeper penetration of institutional segments and the broader secular trend towards indexing will also continue to benefit the top line for many ETF sponsors.

Growth comes with costs. Marketing expenses in particular are expected to rise. With competition heating up in virtually every corner of the market, ETF sponsors cannot afford to be overlooked by investors. Gaining and keeping mindshare among investors and intermediaries means increased spending on traditional marketing campaigns as well as thought leadership aimed at educating investors on how best to use ETFs to meet their objectives.

Operating costs are also set to rise. Upgrading technology, resources and processes will be critical as the ETF landscape becomes more complicated, with a wider variety of investors and a plethora of new investment strategies offered in ETF form.

The power of policy

The regulatory environment is widely believed by survey participants worldwide to have made a meaningful impact on the growth and innovation of ETFs to date. Less than one in ten say the impact has been negligible (Figure 7).

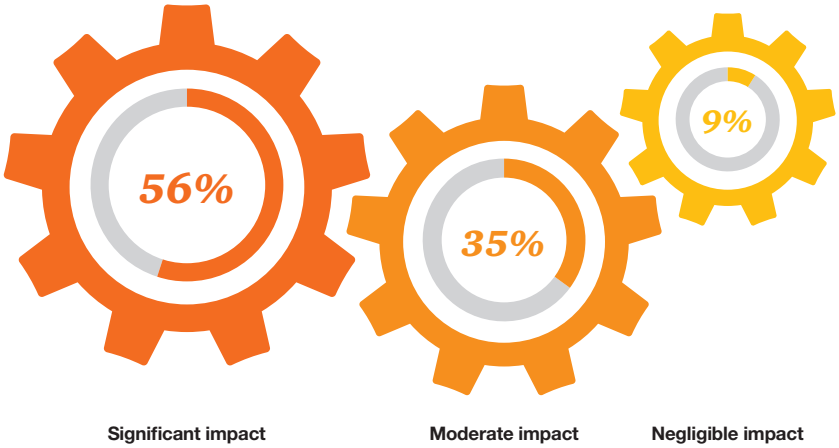
Pending regulations are also expected to have a significant impact on ETFs going forward. New regulations could spark further growth if they permit further product innovation or lower distribution barriers, but they could also dampen demand, particularly if new tax rules make ETFs less attractive or convenient.

What are some of the key regulatory developments expected to have an impact on the shape and direction of the industry's growth?

- In early November 2014, the SEC approved a version of non-transparent active investment product called exchange-traded managed funds. There are also a number of other pending filings reflecting a variety of proposed approaches. Will the impact be immediate? Not likely. But it does have the potential to set in motion a profound rearranging of professionally managed assets.
- More than three out of four U.S. participants surveyed said they would expect the regulatory approval of non-transparent ETFs to change the ETF landscape in the future of their firm (Figure 8).

In Asia, the three types of passporting of funds (see page 18) will necessarily cause regulators to work together to finalise bilateral agreements, be more transparent and clarify rules. The net effect could be a dismantling of certain regulatory requirements that were slowing the growth or innovation of ETFs in Asia. The impending 'mutual recognition' between Hong

Figure 7: Impact of regulations and tax rules on ETF growth and innovation



Source: PwC Global ETF Survey, September 2014

Kong and mainland China offers an appealing prospect to fund sponsors eager to penetrate the rapidly growing market on the mainland, should ETFs be included within its scope in the future. The success of the Undertakings for Collective Investment in Transferable Securities (UCITS) framework in Europe illustrates the importance of this phenomenon.

In Europe, financial transaction taxes (FTTs) remain an area of uncertainty. Broad public support will likely not be able to overcome fear of adverse economic impact, and failure to agree on common terms is likely to continue to prevent legislators and policymakers from developing the agreements necessary for broader enactment. The impact of the proposed European FTT on ETFs will depend on the form in which the FTT is finally implemented.

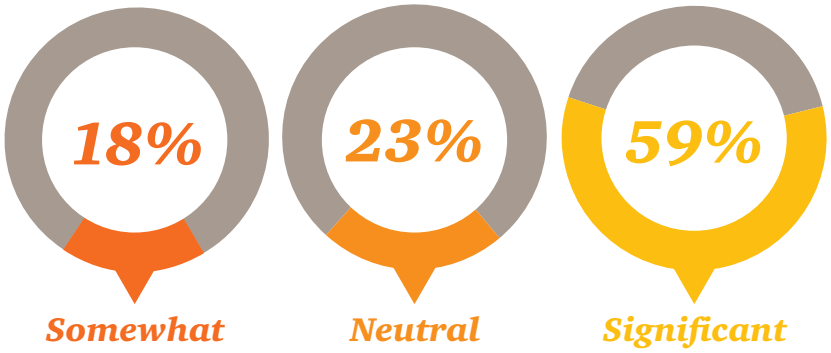
The distribution landscape is also being reshaped by regulation in Europe and elsewhere. By eliminating commissions, MiFID II and the RDR (more in Europe: Regulatory Transformation) are encouraging the use of ETFs. More importantly, they are promoting the ongoing digitisation of financial advice. With their specific, liquid, cost-effective exposure to virtually any asset class, ETFs are perfectly suited to new online advice platforms and apps that are emerging from the shadows of traditional intermediaries facing greater regulation.

Marketing compliance for ETFs is largely on par with what is required for other investment vehicles, at least in the U.S. where 58% of ETF firms in the survey say they are comparable in cost and complexity. ETF sponsors in other regions do not necessarily share this perspective (Figure 9).

Non-U.S. firms are more likely to say they expect to see the balance shift over the next five years, with regulatory barriers to growth coming down over time, lifting the compliance burden.

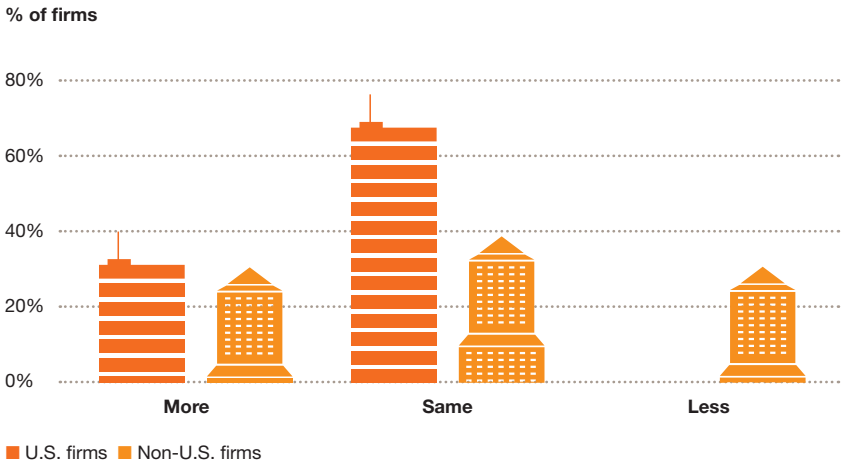
An additional wrinkle for at least some non-U.S. ETF firms is the question of where to list. More than one out of three survey participants from Asia think U.S. listings are viewed more favourably than local listings by investors in their home market. Perspectives vary from market to market, with tax implications, currency risk, cost and liquidity all playing a role. Some firms may simply decide to list in both U.S. and local markets, further complicating their compliance requirements.

Figure 8: Effect of the approval of non-transparent active ETFs on your firm



Source: PwC Global ETF Survey, September 2014

Figure 9: Cost and complexity of marketing compliance requirements for ETFs vs. other investment vehicles



Source: PwC Global ETF Survey, September 2014

Europe: Regulatory transformation

New regulatory initiatives are some of the biggest drivers of change in the European ETF business, affecting distribution dynamics and the product landscape in particular.

More retail investors

The provision of financial advice is radically changing across Europe and is likely to have a profound and beneficial effect on ETFs. EU regulations (MiFID II[11]) as well as national regulations like the RDR[12] in the UK are set to ban the use of commissions by independent financial advisors. This remuneration system has worked against ETFs in the retail market where financial advisors had little incentive to sell ETFs that did not pay commissions. As a result, institutions remain the primary users of ETFs in Europe.

MiFID II could be a game changer in Europe, where the adoption of ETFs by retail investors significantly lags their use by U.S. retail investors. MiFID II will become effective by 2017, but a number of countries (Germany, Switzerland, the Netherlands, the UK and Sweden) have already enacted legislation to ban commissions for fund sales.

New regulations change the game

UCITS V[13] could affect ETFs in at least two ways. If remuneration provisions are applied on a look-through basis (similar to the Alternative Investment Fund Managers Directive [AIFMD]), they will potentially impact the staff at investment managers responsible for creating ETFs. There will also be increased costs as a result of the depositary provisions.

UCITS VI is still at the consultation stage, but based on the current proposals, the introduction of a depositary passport could potentially save costs for ETFs.

Product landscape evolves

There are only a handful of European managers that now offer active ETFs. That is set to change as large U.S. houses look set to bring active ETFs to Europe.

There have also been moves by some ETF sponsors away from synthetic ETFs[14] and towards physical replication, due to regulatory scrutiny and at times, unflattering media attention.

MiFID II may result in a complexity label for certain structured UCITS funds, which can be sold to retail investors without financial advice. In Europe, UCITS funds are currently considered to be non-complex instruments. Any regulation that makes it harder to sell to retail investors is likely to hinder growth.

Streamlining operations

Inefficiencies in the way ETFs trade and the fragmented nature of the market in Europe are widely seen as holding back growth. Most European ETFs are listed on multiple exchanges, resulting in greater expense and inefficiency. In the future, it is anticipated that managers will look to launch cross-border European ETFs with centralised settlement. This move would enable ETFs to be traded on any exchange in Europe, but be settled centrally, which would be similar to the U.S. systems where trades are settled centrally. This development would make European ETFs more efficient and cost-effective.

MiFID II could be a game changer in Europe, where the adoption of ETFs by retail investors significantly lags their use by U.S. retail investors. MiFID II will become effective by 2017, but a number of countries (Germany, Switzerland, the Netherlands, the UK and Sweden) have already enacted legislation to ban commissions for fund sales.

11 Approved by the European Parliament in April 2014, the second Markets in Financial Instruments Directive is expected to have wide-ranging effects on the way stocks and bonds, derivatives and commodities are traded, cleared and reported.

12 The RDR (Retail Distribution Review) came into effect at the end of 2012 and is expected to have a significant impact on the operations of financial intermediaries authorised and regulated by the Financial Services Authority (FSA).

13 UCITS (Undertakings for Collective Investment in Transferable Securities) are a set of Directives allowing collective investment funds to operate freely throughout the EU.

14 Synthetic ETFs use derivatives such as swaps to track an index rather than holding actual securities like a physical ETF.

Asia: Fragmented opportunities

The competitive landscape can differ markedly from one country to another in Asia. Due to the difficulty of effectively penetrating these markets, ETF providers in China, Japan and Korea are dominated by domestic firms. Some large Chinese and Japanese ETF providers are now expanding into the European market, launching ETF products that are able to leverage their expertise in the local market.

In Hong Kong and Singapore, on the other hand, the market is mainly dominated by large global ETF sponsors. Still, many new ETF providers have emerged in Hong Kong over the past three years as Chinese asset managers establish funds under the Renminbi Qualified Foreign Institutional Investors (RQFII) programme. Under the RQFII programme, these Hong Kong ETFs are allowed to invest directly into the equity and bond markets in China using a quota system. These RQFII ETF products have become very popular in Hong Kong.

Product Innovation lags

Because the Asian ETF business is relatively young, traditionally, indexed products are still viewed as the major growth opportunity. As such, the development of new indices may spur further growth.

Product innovation is not generally viewed as an immediate priority due to the immaturity of the markets and regulatory hurdles, but a lack of experience may also be holding some firms back. Many see a deep talent pool as a critical factor in successfully developing innovative products.

Clearing distribution roadblocks

Distribution remains a challenge in Asia, where the use of commissions encourages the use of mutual funds rather than ETFs. The problem is exacerbated by the fact that many markets are closed, with only a limited number of Asian ETFs cross-listed in other markets in Asia. Fund passports could have a profound impact on the success of ETFs in Asia. The three Asian fund passports are:

1. ASEAN passport for Malaysia, Singapore and Thailand.
2. Mutual recognition between China and Hong Kong.
3. Asia Region Funds Passport for Australia, South Korea, New Zealand, Singapore, Thailand and the Philippines.

The ASEAN passport, operational since August 2014, means that retail funds (including physical ETFs) can be offered directly to investors in any of the three markets shown. Other ASEAN markets may follow. Although the scope and details of the latter two fund passports have yet to be determined, many firms currently focused on their home markets hope that a more open ETF market will permit them to expand regionally, or even internationally. By the same token, global players will also be able to leverage these passports to enter Asian ETF markets that are currently difficult to access.

Additionally, there is the Shanghai-Hong Kong Stock Connect market access programme, through which investors in Hong Kong and Mainland China can trade and settle shares listed on the other market, respectively, via the exchange and clearing house in their local market. Market players believe that this programme will have a positive impact on ETF developments in Hong Kong, although ETFs are not within its scope at the initial stage.

A fast-moving U.S. market

Recent growth of the U.S. market has been driven by RIAs, wealth management platforms, other asset managers, endowments, and foundations.

The U.S. ETF market continues to experience significant growth and innovation. ETF assets in the U.S. market grew to approximately $1.9 trillion across 1,600 funds by the end of June 2014.[15] The market continues to be dominated by the top three ETF sponsors with a combined market share of approximately 81%, as of 31 July 2014.[16]

Institutional investors drive growth

Recent growth of the U.S. market has been driven by registered investment advisors (RIAs), wealth management platforms, other asset managers, endowments and foundations. Each of these groups will continue to expand their use of ETFs over the next few years, but new opportunities will also emerge including insurance companies and retirement plans.

Insurance companies are a prospect because they offer two distinct opportunities. ETFs are already starting to penetrate the annuity market, in part because their suitability for use in increasingly sophisticated tactical strategies and allocation models makes them particularly appealing as sub-account options for variable annuity providers. In addition, ETFs are potentially well-suited as balance-sheet assets for insurance companies, a potentially huge market opportunity for fund sponsors.

Structural barriers make penetration of the retirement market elusive. Low-cost mutual fund share classes are designed for retirement plans, record-keeping systems are geared towards mutual funds and the tax efficiency of ETFs is not an advantage. Still, actively managed target date and target risk ETFs are being rolled out to defined contribution plans and the selective use of ETFs by defined benefit plans point to growing penetration of this market.

Active ETFs on the cusp

The vast majority (approximately 99%) of U.S. ETF assets are currently in passively managed index products. Active ETFs accumulated approximately $16 billion assets under management (AUM) between 2008 and mid-2014. Currently, the SEC requires active ETF sponsors to publish the full investment holdings for any active ETF, prior to the opening of the market on a daily basis.

The daily portfolio disclosure requirement is often cited as one of the primary reasons why active ETFs have not seen greater growth and innovation to date, as investment managers are hesitant to provide full transparency of their trading strategies on a daily basis. This contrasts with passive ETFs and mutual funds, which disclose their investment portfolios on a quarterly basis up to 60 days in arrears.

In late October 2014, the SEC denied requests for two firms seeking approval to launch non-transparent active ETFs and these firms subsequently withdrew their filings in mid-November 2014. In early November 2014, the SEC approved another version of non-transparent active investment product called exchange-traded managed funds (ETMFs). The SEC approval of ETMFs and potentially other requests for non-transparent active ETFs could lead to another phase of growth and innovation for ETFs in the U.S.

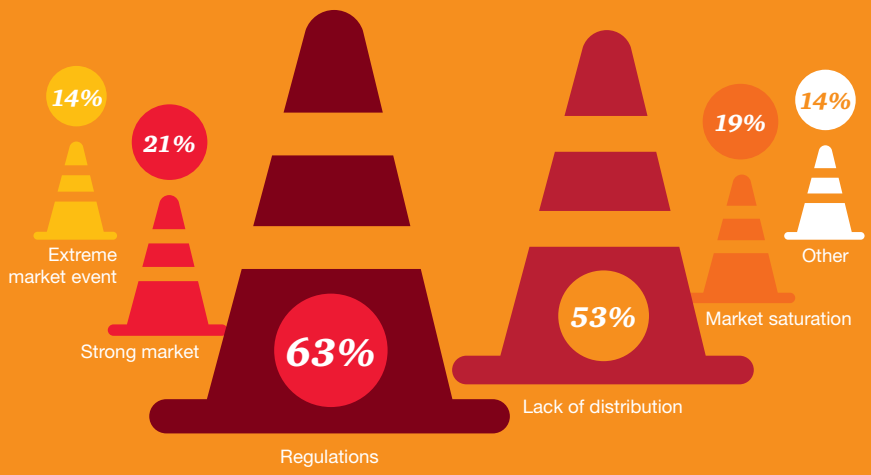
15 Strategic Insight, SimfundMF database, 30 June 2014

16 BlackRock, 'ETP Landscape: Industry Highlights', 30 June 2014

Challenges on the horizon

Existing and aspiring ETF sponsors will benefit from tailwinds in the coming years, but they will have to clear some hurdles along the way. Almost two out of three survey respondents see regulatory demands as potential obstacles to growth in their markets, for example, and non-U.S. firms in particular are likely to say that a lack of effective distribution channels is a concern (Figure 10).

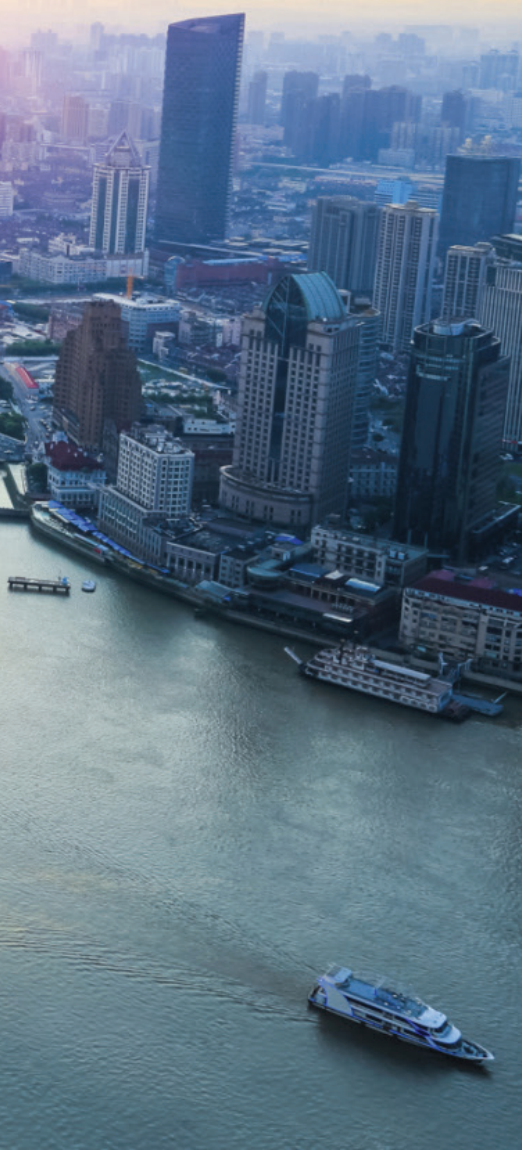
Figure 10: Obstacles to future ETF growth



Source: PwC Global ETF Survey, September 2014

Note: Survey participants were able to provide more than one answer

Regulations are a fact of life for asset management firms, but the regulatory regimes are likely to evolve more significantly for ETFs than other more mature investment vehicles.



- One out of five said strong market performance could take the focus off key advantages of ETFs such as their low cost and tax efficiency.
- A saturated market in which some believe that every asset class has been addressed by ETFs is seen by some as a potential obstacle.
- A few express concerns that an extreme market event could highlight the risks of ETFs and subsequently dampen demand.
- Exogenous factors like shifting demographics and disruptive technology also have the potential to stifle ETF growth.

Regulatory and tax issues

Tax efficiency has always been a key attraction of ETFs. As they expand into a growing number of markets, ETF sponsors will also need to evaluate various tax structures for proposed products in addition to country-specific tax issues, particularly in markets with significant growth potential such as Asia, South America and the Middle East.

Regulations are a fact of life for AM firms, but the regulatory regimes are likely to evolve more significantly for ETFs than other more mature investment vehicles. The challenge is amplified by the rapid globalisation of ETFs, which means that sponsors must be prepared to comply with changing regulations in a wide range of jurisdictions if they want to gain traction in those markets as they emerge. Fund sponsors also need to stay strategically flexible while also putting the appropriate processes, people and technology in place to ensure that compliance does not overwhelm.

The distribution problem

A lack of effective distribution channels also faces firms competing in some Asian markets where fee-based investment advice is not yet common. Japanese banks, for example, earn commissions by distributing mutual funds and have no incentive to sell ETFs. As long as securities companies have stronger incentives to sell mutual funds, ETFs will not capture substantial retail market share. Intermediary compensation is not the only hurdle in these markets. Banks are often key distributors in Asian markets, and their innate conservatism can make them very reluctant to embrace newer investment vehicles like ETFs. These are all key drivers for Asian players to look for more innovative and non-traditional distribution platforms such as the fund supermarket in South Korea and various online platforms in mainland China.

Increasingly crowded markets

Market saturation is another potential obstacle. With more firms piling in and opportunities for differentiated products becoming scarcer, newcomers face daunting prospects. Some firms will be able to trade on strong brands and distribution networks established on the back of non-ETF businesses, but the situation is likely to become increasingly acute for firms competing for assets in the U.S. in particular.

New entrants

There are additional challenges in store for firms entering the ETF market for the first time. There is a vast difference between entering the ETF market and doing it successfully. Despite their many similarities, ETFs are not as similar to mutual funds as many assume, especially when it comes to the sales and marketing process. In fact,

Firms offering ETFs will need to consider potentially rapid changes to the way asset management services are created and consumed, with the most dramatic changes enabled by technology.

more than two-thirds of those taking part in the survey said distributing ETFs requires a 'totally different approach' compared to other investment products.

With mutual funds, the emphasis has long been on appealing to intermediaries. With ETFs, the emphasis shifts back to the end-investor. New entrants into the ETF market will want to carefully consider the objectives and uses of ETFs by segment (e.g. retail, hedge fund, insurance, etc.) in addition to the role of intermediaries and how they are compensated for distributing various products.

Need for investor education

Greenfield markets such as Asia, the Middle East and South America may be wide open by comparison, but these markets come with their own challenges, namely the need for extensive (and potentially expensive) investor education. Without an awareness of the benefits of ETFs and how they could be used, global acceptance is unlikely. Investor education is important, but in many cases will need to extend so far as to convince investors of the need to invest for the long term rather than focusing on speculative trading strategies. ETF sponsors have an opportunity to build their brand, but they have their work cut out for them.

Innovation cuts both ways

Product innovation will continue, but significant breakthroughs will take time as regulators grapple with how to best protect investors from themselves. Unsuitable ETFs sold to unsophisticated investors could have regrettable consequences and result in a major black eye for the industry, due to bad press and potentially greater regulatory scrutiny.

Meanwhile, compliance costs will continue to rise and firms may in some cases have to accommodate longer product development cycles to balance risks and controls.

Representing the cutting edge of product innovation, active ETFs may ultimately spur additional growth, but they will also pose a significant challenge to regulators, index ETF sponsors and other active managers. Concerns that investors may not fully understand what they are buying become even more acute as more complex strategies, including the use of derivatives, are introduced to the marketplace.

Technological disruption

Technology will also challenge the industry. Firms offering ETFs will need to consider potentially rapid changes to the way AM services are created and consumed, with the most dramatic changes enabled by technology. Cloud computing, automation and crowd sourcing could all play a significant role in the delivery of investment advice, and ETF sponsors will want to ensure that they are not left on the sidelines as new market entrants inevitably emerge to capture the imagination of investors. Even without a major reshuffling of the landscape, ETF firms will need to invest in technology and establish strong links with vendors and operating partners in order to create cost-effective and efficient solutions going forward.

The strategic imperative

ETFs are being used in a growing number of ways by a wider variety of investors in more markets around the world. They comprise a disruptive presence and an increasingly prominent feature in the competitive landscape facing all asset managers. As a result, all firms need to carefully consider the impact of ETFs on their corporate strategies, whether they currently offer ETFs or not.

There is no question that ETF sponsors need to think strategically over the next several years as their competitive environment changes rapidly. Other asset managers will also need to plan their next moves carefully. Two out of three survey participants said firms without ETFs nevertheless need to have an ETF strategy (Figure 11).

A shifting competitive environment

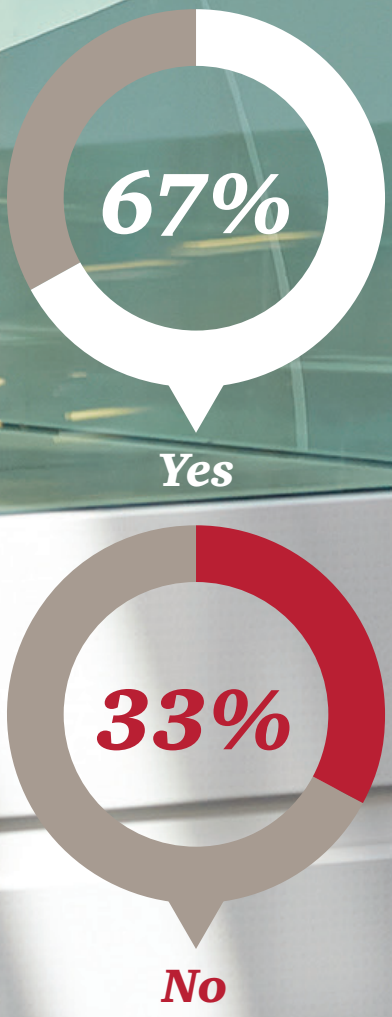
ETFs have, to some degree, existed in a parallel universe to the one inhabited by traditional mutual funds. Offered by a small number of firms and addressing a narrow slice of the overall market, ETFs did not necessarily figure prominently in the strategic planning of those not directly involved with them.

This is changing. Existing ETF firms will need to calculate the impact of new entrants on their business as they defend their positions and look for growth opportunities. New entrants will need to realistically assess their prospects in light of tightening economics and the potential for ETFs to undermine their existing businesses.

One asset manager in the survey concisely summarised the competitive situation by saying: "ETFs continue to take market share away from other products, and firms will either have to launch ETFs or create other investment vehicles which are competitive with the performance, tax efficiency, and costs of ETFs."

Some managers may feel forced to introduce new products that will almost certainly cannibalise some of their existing funds. But lest asset managers assume that the best way to respond is by introducing ETFs of their own, another survey participant warned: "It is necessary to consider the profit model and how to deal with losses before product launch. Operating costs are high and ETFs do not necessarily generate returns in the short term."

Figure 11: Do asset managers without ETFs need an ETF strategy?



Source: PwC Global ETF Survey, September 2014

"ETFs continue to take market share away from other products, and firms will either have to launch ETFs or create other investment vehicles which are competitive…"

Some barriers to entry are more significant than others. Operational requirements are met more easily than ever before, given widely available solutions from global services firms. Effective distribution, on the other hand, is likely to prove a bigger hurdle and may ultimately form a high enough barrier that regional markets for ETFs take on oligopolistic characteristics.

Existing firms are widely seen as having the upper hand. Three out of four survey participants say that current market participants are likely to expand. The fact that only one in three expect there to be any consolidation underscores the fact that, despite signs of maturation, this is still a growth business.

Successfully planning for 2020

In 'The next generation of ETFs', we offered six suggestions for firms formulating ETF strategies that bear repeating:

1. Differentiate your offering.
2. Monetise expertise.
3. Use content marketing.
4. Capitalise on regulatory developments.
5. Solutions, not products.
6. Cultivate pockets of demand.

Relevance may vary from one market to another, but responses to this most recent survey confirm all of these as important considerations in shaping ETF strategies.

Product differentiation

Largely limited in the past to tracking ever narrower or more exotic indices, product differentiation is likely to take on a completely different character as ETFs embrace non-traditional indices, active strategies and alternative investments. It is worth noting that product differentiation may have a shelf life. The ability to rapidly develop products can reap significant rewards for pioneering firms. Launching new strategies alongside similar offerings from multiple competitors is not likely to prove as successful.

Monetizing expertise

Still, as more types of strategies are permitted by regulators and operational barriers to entry are minimised, the doors will be opened to firms of all stripes interested in monetising their expertise by offering ETFs. It is almost a given that traditional active money managers will enter the ETF market, but we would not be surprised to see the competitive landscape also populated by technology companies, consumer product firms, or affinity organisations by 2020.

Content marketing

Effectively building a brand is challenging at the best of times, but many firms in less developed markets see this as the perfect time to establish awareness with investors by introducing them to ETFs and educating them on their uses and benefits. Content marketing becomes critical. Advertising may ultimately prove important, but gaining the trust and respect of novice ETF investors by educating them on the features and benefits of the product is priceless.

One Asian survey participant stated that: "Creating more awareness among retail investors is our first priority, as it will ultimately lead to wider adoption." Existing brands in the U.S. and Europe don't necessarily carry equal weight in

"Creating more awareness among retail investors is our first priority, as it will ultimately lead to wider adoption."

Asset management executive outlining part of their firm's ETF strategy

Asian markets, so the battle for market awareness in newer markets is taking place on a relatively level playing field, pitting global giants with hard-won expertise against regional players with specialised local expertise.

Leveraging regulation

Another area in which smaller local players may have an edge is regulation. Rules can cut both ways, but understanding the implications of changes in regulation may come more easily to firms practised in the art of navigating the red tape of their home market. Capitalising on the regulatory developments by expanding distribution, rolling out new products, or marketing more effectively could prove to be a key advantage for any firm willing to look at compliance proactively as an opportunity.

Solutions over products

The impact of ETFs is remarkable considering that they are relatively simple investment vehicles. Investors have so far managed to find many ways to use these relatively simple products. ETFs can of course be used as core holdings or tactical trading tools, but they are also used for transition management, cash equitisation, rebalancing and risk management. The myriad uses of this unusually flexible product hint at a key opportunity: How can ETFs be packaged as solutions rather than simple products? This opportunity is not limited to ETF sponsors and could potentially be addressed by virtually any firm interested in designing effective solutions to real problems.

"Creating more awareness among retail investors is our first priority, as it will ultimately lead to wider adoption."

Asset management executive outlining part of their firm's ETF strategy

Cultivating demand

However, it is distribution capabilities above all else, which are likely to determine the level of success of a firm competing in fragmented global markets that in many cases continue to favour entrenched competitors with established investment vehicles. More than 60% of all survey participants said that an effective distribution team and infrastructure were the most important considerations for new market entrants or current ETF sponsors looking to expand their presence in the market (Figure 12).

Effective distribution hinges on many factors, not all of which can be controlled. Hiring talented professionals to cultivate specific pockets of demand is a good start. Any firm wishing to compete for the ETF assets needs to be aware of the fact that clever products or a well-known brand are not likely to be sufficient. Success will hinge on being able to battle it out in the distribution trenches.

Figure 12: Most important considerations for new or existing ETF sponsors

Source: PwC Global ETF Survey, September 2014

Note: Participants could provide more than one response

Seizing the moment

Despite numerous challenges, the market for ETFs will almost certainly grow substantially over the coming years. Existing market participants will grow. New firms will enter or emerge. More investor segments will embrace ETFs in a growing number of markets around the world, potentially pushing assets above the $5 trillion mark by 2020.

The opportunities are there. It is up to individual firms to sift through them, identifying which trends are likely to present the best fit for their own capabilities and objectives. They will want to have an informed ETF strategy firmly in place.

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