A beneficial relationship

Ashley Fagan explains how pension funds are benefiting by using exchange traded funds (ETFs) for their indexing investments

How can ETFs help with the challenges that pension funds face?
These are challenging times – a low interest rate environment, recent market volatility and now 'pension freedom' in the UK. Pension fund managers and trustees have a lot to think about. The financial crisis drove the need for greater diversification, with investors seeking returns and looking to manage risk more than ever. Investors have been diversifying across a wider range of asset classes, making more use of tactical strategies and this has driven a need for more flexibility. With pressures on costs, many pension funds have reviewed their indexing products, to ensure that they are getting value for money. Active products have also been reviewed, to see if traditional active managers could be replaced with smarter indexing.

Over the last 10 years or so, exchange traded funds (ETFs) have become massively popular with pension fund investors as a tool to help navigate the investment landscape. ETFs are recognised for the benefits they offer: Low cost, transparent, liquid access to a broad range of asset classes via a fund traded on a stock exchange. In 15 years, from a standing start, European-domiciled ETFs have now grown to \$486 billion in assets under management (AUM). We are now seeing institutional investors use them for an ever-wider range of portfolio applications.

Not all investors are familiar with the benefits that can be gained nor the wide range of uses, so over the next few months, we will be demonstrating some of the ways pension funds can utilise ETFs for their benefit.

How are pension funds using ETFs?
In our experience, pension fund managers are using ETFs for either strategic or tactical purposes – with some investors using them for both. From investing in markets where access is limited or too expensive, to gaining exposure to core asset classes, right through to liquidity or transition management, ETFs are playing an important role. The breadth of strategies covered by ETFs now includes those which were previously only accessible via an active manager, such as smart beta equity or emerging market equity.

What have pension fund managers told us about how and why they use ETFs?
To find out, we teamed up with Greenwich Associates and their 2014 survey of European Institutions, where 25 per cent of institutional investors reported using ETFs. Although most of the pension fund users in the ETF study held up to 10 per cent in ETFs, about one in five had ETF allocations of 11–25 per cent of their total assets. About 28 per cent of the public and industry pension funds surveyed in the UK and continental Europe use ETFs, while 19 per cent of corporate pensions do. Why do they use ETFs? The managers mentioned ETFs' liquidity; the ability to achieve diversification at reasonable cost; and transparency. Some noted the efficiency, cost and also the way they can follow the ETFs' prices every day. One area that the Greenwich survey focused on was the wide range of reasons quoted for using Equity ETFs, which included ease of use as well as the speed of execution for gaining diversified exposure to equity markets.

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[1] Exchange Traded Funds are the largest category of Exchange Traded Products – the category also includes Exchange Traded Notes and Exchange Traded Certificates [2] BlackRock ETP research, BlackRock ETP Landscape [3] Source: Greenwich Associates 2014 continental European institutional investors' studies, based on responses form 673 in 2014.