Summary
- The ETF market is currently worth more than $2.6 trillion globally. Ten years ago it was worth less than $500 billion.
- ETFs are popular with both US institutional and retail investors. Take-up by US pension funds is growing, but in the UK interest from pension funds has been slower than expected.
- This slow growth may be attributed to concerns about counterparty risks and costs.
- ETFs may be increasingly used by fiduciary managers or within diversified growth funds, both of which tend to invest more dynamically.

A slow burner

Sandra Haurant explores why the take-up of ETFs by UK pension funds has been slower than anticipated

The noise around exchange traded funds (ETFs) has been building for some time now. Headlines frequently shout of phenomenal growth in the asset class, which is worth more than $2.6 trillion globally. And some predict the ETF market will continue to grow in leaps and bounds. Mark Wiedman, global head of iShares, the world's biggest ETF provider, has predicted it will swell by a further $1 trillion by 2017.

"It's a significant and growing asset class," says financial information services company Markit research analyst Simon Colvin. "If you go back to 10 years ago, there were less than $500 billion, so it's been one of the big fund management success stories over the past few years."

ETFs can hold an enormous variety of assets, covering stocks, commodities, fixed income investments and more. And there are plenty of ETFs to choose from; an estimated 5,200 or more, covering a dizzyingly broad range of underlying assets.

Slow take-up

Investors in the States, both institutional and retail, have long embraced ETFs, using them in a variety of ways to gain exposure to this wide spread of stocks, commodities, markets and assets. But in pensions, take up has not been quite as enthusiastic. And although ETFs have made ground in the States, in the UK they continue to be a fairly niche area.

The slow take-up has surprised some. Back in 2012, the *Financial Times* reported that "large UK pension funds" were making more use of ETFs as "confidence in their reliability" increased. With a greater variety of ETFs becoming available, a level of granularity that is hard to beat, and relatively high liquidity to boot, the improved perception seemed likely to encourage pension funds to dip more than a toe in the water.

After all, they provided a passive approach, which was a good fit with the changing attitude to the active versus passive argument. And their role as stop-gap investments between managers and in the equitisation of cash has made progress, but in spite of movements within the industry that might have led more pensions to ETFs, they remain a slow-burner.

UBS Global Asset Management UK head of ETF sales Andrew Walsh says: "There was a realisation that active was not necessarily the best path. ETFs offered part of the solution along with other passive funds." The stage appeared to be set for the arrival of ETFs for UK pensions – but instead of bursting on to the scene, they have in many ways remained in the wings; so far at least. "I think there was an expectation that pension funds in the UK would pick up on ETF usage more than they have," says Walsh.

And it is in the interests of the ETF sector to encourage pensions to take them on board. In a separate 2012 report in the *Financial Times*, analysts AllianceBernstein said that continued rapid growth in the ETF market depended on "new distribution channels" and particularly the US defined contribution pension

market. If the 401k market comes aboard, assets in ETFs were forecast to reach $9.2 trillion by 2025. Without that chunk of the market, the forecast is a less gigantic $5.8 trillion.

Reluctance

While they have been dipping a toe in the water, there are several reasons pensions have yet to plunge into the ETF market with both feet. One element may be perceptions around counterparty risk. The ETF market can be divided into two broad groups in the European marketplace; synthetic and physical. The physical kind replicates an index's performance by holding stocks directly, while synthetic ETFs deal in derivatives. Due to the financial contracts involved, there have been concerns about higher levels of counterparty risk, or the risk that a party in the contract may fail to meet its obligations.

But as Morningstar Europe senior ETF analyst Jose Garcia-Zarate explains in a Morningstar report on the subject, synthetic ETFs are not the only investments that incur counterparty risk, and there are measures in place to provide some level of protection and compensation: "It is generally accepted that investors in synthetic ETFs are compensated for taking on swap counterparty risk with the reward of comparatively lower management fees and more accurate tracking vis-á-vis ETFs employing physical replication techniques," he writes. "But there is also a series of regulatory measures that providers of synthetic ETFs must comply with as a means of protecting investors against this counterparty risk."

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And, argues Walsh, while there can be complicated elements and risk must be understood, as an asset class ETFs are "extremely transparent". Walsh explains: "Three or four years ago, the ETF industry was under something of an attack

from the regulators. There was a lot of misunderstanding and scare stories. The ETF industry really stepped up and has become better than almost any part of the market in terms of transparency. On almost every ETF website, you can see the underlying holdings and collateral that's used against the securities lending programmes, and all of that is updated daily. I think the ETF industry has been very commendable in being at the forefront on this."

Another deciding element may be cost-related. After all, with a trend towards a more passive approach in many pensions, what is it that makes schemes continue to favour more traditional passive funds instead of opting for ETFs? As PiRho Investment Consulting director Phil Irvine says: "ETFs may provide cheaper trading costs than other passive vehicles, as they enjoy two layers of liquidity: the primary market (i.e. the same market accessed by index funds) and the secondary market (i.e. trading on the stock exchange)."

However, he explains: "The possible advantages delivered by ETFs in terms of lower trading costs are outweighed by the fact that ETFs typically have higher total expense ratios than other passive funds. The key to the decision of whether to hold a traditional passive fund or the equivalent ETF is dependent on the holding period and the frequency of trading."

If what is required is a fund to hold on to for a longer duration, an ETF is unlikely to be able to rival an equivalent classic passive fund, which will work out cheaper under those circumstances. If, on the other hand, frequent trading is required over a shorter timeframe, the ETF may be the favourable choice.

"Given the costs of holding ETFs then a key benefit is the 'stop gap' measure as the portfolio is being re-organised," says Irvine. Walsh agrees: "A classic use for an ETF is as a stop gap. They may be between managers but know they need exposure to Japan, for example. An ETF can give that access short term." On the other hand, for longer periods they may not be the most suitable choice. "If a pension fund is going to hold something for five years, you could argue that a standard passive segregated mandate would be a better way to go, because it would be cheaper than using an ETF. ETFs have flexibility but you may not need that in these circumstances, so cost-wise it may not be best to use an ETF."

Growth potential

The flexibility, liquidity and potential for fast trading means the ETF lends itself well to a more dynamic approach, which is where pensions may benefit most. "The products may be used more frequently by fiduciary managers, implemented consultants or diversified growth funds working for pension schemes on a more dynamic basis," says Irvine. "There, the advantages of trading and the shorter holding periods mean ETFs might be favoured."

But if pensions have been slower than others to adopt ETFs, perhaps the landscape is set to change some time soon. A 2013 survey from FinEx showed that 38 per cent of 144 pension funds it surveyed were planning to increase allocation to ETFs in the next 12 months, while 42 per cent said they would do so over the next three years. It's a long way from the exponential growth the headlines have trumpeted elsewhere, but it is certainly a start.

Written by Sandra Haurant, a freelance journalist