Expanding ETFs

Ashley Fagan explains how pension fund investors use ETFs (Exchange-Traded Funds)[1] for a growing range of applications across asset classes

These are challenging times in which to be a pension fund manager or a trustee – in an environment of low interest rates, with high recent market volatility, with the transition from defined benefit (DB) to defined contribution (DC) schemes, as well as the relatively recent advent of 'pension freedom' in the UK to contend with. Another challenge for pension funds is, as the Pension and Lifetime Savings Association (PLSA) phrased it on the day the results of the UK's referendum on the EU were released: "The ramifications for UK pensions of the UK's decision to leave the European Union"[2] which, at the time of writing, are not clear.

The financial crisis drove the need for greater diversification across asset classes, with investors seeking to identify sources of return while looking to manage and monitor risk more carefully than ever before. Since then, investors have diversified across a wider range of asset classes, often using more tactical strategies, all of which has driven a need for more flexibility. With pressures on costs, many pension funds have reviewed the financial products that they use to ensure that they are getting the best value for money. Active products have been reviewed too, to see if traditional active managers could be replaced in some instances with other ways to access the underlying assets, such as via a passive investment vehicle. The investment landscape for passive investments has been changing and today there can be value to be added – and costs to be saved – for client portfolios through careful selection of passive investment vehicles to access markets.

There have been several headwinds, including new banking regulations put in place since the financial crisis, which has led to an increasing cost of funding for banks. The main catalyst of this increased cost has been the implementation of regulatory frameworks such as Basel III or the Volcker Rule[3]. For those investors looking to financial derivatives for index tracking, the costs of holding these instruments, such as equity futures, has increased. In fact, we have seen a transition of clients holding equity futures switching into ETFs due to lower holding costs and greater operational efficiency. Between June 2014 and 2015, we have seen $22 billion of client switches out of index futures and other financial instrument into our ETFs[4].

Meanwhile, Exchange-Traded Products, of which ETFs are the largest category, have seen steady growth and the ETP industry has grown to over $3 trillion[1] in assets under management (AUM) globally, with total expense ratios (TERs) and the transaction costs of the funds generally trending downwards while liquidity has been increasing. ETFs are increasingly being recognised for the structural benefits they offer which include low costs, transparency and liquid access to a broad range of asset classes via a fund traded on a stock exchange. The ability to achieve diversification at a reasonable cost and the transparency of the underlying holdings are benefits that are frequently mentioned.

Their adoption by institutional investors is most advanced in the US. In 15 years, from a standing start, however, European-domiciled ETFs have now grown to $529 billion in assets under management (AUM)[1].

In our experience, pension fund managers are using ETFs for a wider range of applications in a growing number of asset classes. 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 range of strategies covered by ETFs now includes those that were previously only accessible via an active manager, such as smart beta equity and emerging market equity.

We gained further insight into the increased usage of ETFs by institutional investors and the ways in which they are using these products from the results of the fifth ETF survey that we at BlackRock recently carried out in conjunction with Greenwich Associates[5]. The respondents included institutional funds (corporate and public pension funds, foundations and endowments), asset managers, insurance companies, investment consultants and advisers.

In the Greenwich survey, the most common ETF applications mentioned were:

• Making tactical adjustments to portfolios: 84%

[1]Exchange Traded Funds are the largest category of Exchange Traded Products – the category also includes Exchange Traded Notes and Exchange Traded Certificates. Source: BlackRock, ETP Landscape as at 31 May 2016.
[2]The PLSA (formerly the National Association of Pension Funds), sent a memo to all members on 24/06/2016, "The ramifications for UK pensions of the UK's decision to leave the European Union will start to become clear over the coming weeks and months. Much will depend on the precise nature of our future relationship with the EU, which may mean that some aspects of UK pension provision continue to be influenced by the EU. In other areas, UK pension law may need to be disentangled from EU legislation...It is essential that the UK government and policymakers in Brussels now act swiftly and decisively to manage current volatility and announce a clear plan to renegotiate our future relationship with the EU."
[3]Part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
[4]Source: BlackRock, as at June 2016.
[5]Greenwich Associates 2015 Global Exchange Traded Funds Survey

• Using ETFs for core allocations: 64%
• Gaining international diversification: 64%
• Rebalancing an existing portfolio: 55%
• Putting cash to work within equity markets: 37%

Source: Greenwich Associates 2015, U.S., European, Canadian and Asian Exchange-Traded Funds Studies.

Case study: Fixed income ETFs attract new users

One of the drivers of growth for ETF flows that was identified by the survey was an increase in demand for fixed income ETFs, which we believe will continue, based on the Greenwich survey. While 95% of ETF investors globally use ETFs for equity allocations, fixed income ETF use varies. In Europe, it has reached 82% of users in the asset management segment. However, although we have already seen significant growth in usage and total AUM, particularly in 2016 to date, fixed income ETFs still represent only a small piece of the overall fixed income market, particularly in Europe. In Europe, the recent Greenwich data noted that 30% of fixed income ETF users in the study have been investing in these funds for less than two years, so there is certainly room for growth.

Liquidity in fixed income markets has become challenging, transaction costs are now a significant portion of the total cost of ownership, and there are challenges involved in sourcing the underlying bonds. To this end, ETFs can offer fixed income investors an additional layer of liquidity. Fixed income ETFs can often be materially cheaper to buy and sell and can offer an inventory of bonds which has been built up over time. Some pension funds are using bond ETFs for cash and liquidity management as well as for cost-efficient transition management. Product innovation means that virtually all fixed income subsectors are now accessible, including high yield and emerging markets. Credit investors have been using fixed income ETFs to take or reduce exposure to a broad-based universe of credit. Tactically, they have used fixed income ETFs to take a directional view on the asset class. ETFs are also frequently used for putting large inflows to work quickly or meeting a large redemption.

One way that pension funds have been taking advantage of the potential liquidity fixed income ETFs can provide is by incorporating them into their funding level trigger based de-risking strategies. The fixed income ETF can provide a cost efficient tool that may allow pension schemes to get quick access to a diversified pool of underlying bonds at often lower transaction costs, when a funding level trigger is hit. When compared to investing in the underlying bonds directly, this can lead to significant time and cost efficiencies.

Investors sometimes raise concerns around how ETFs will react in times of market stress when compared with the underlying investments, yet in periods of market volatility we have actually seen ETFs hold up as robust financial instruments. For example, following the March ECB meeting this year we saw trading volumes spike in corporate bond ETFs because the ETFs offered price transparency at a point when the underlying market saw limited trading activity.

Going forward, we believe that pension schemes and their stakeholders could benefit from exploring how the passive investing landscape has evolved and the potential opportunities that arise to add value to an investment strategy. After all, in an environment where every basis point matters, can pension schemes afford not to have every possible tool in their toolkit to help them navigate these challenging times? We expect that the tailwinds that have drawn institutional investors to ETFs will persist, and continued growth will be driven by more innovative products coming to the market, and investors becoming more familiar with ETFs and how they can be used.

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Summary
- ETFs are gradually becoming a larger, longer-term part of pension portfolios. One of the first uses for ETFs among pension funds was as an instrument to aid in transitions from one investment vehicle to another.
- According to the ETFs in the *European Institutional Channel* study, around a quarter of continental European institutions and 20 per cent of UK pension schemes invest in them. Seventeen per cent of institutions on the continent who were not currently investing in ETFs said they intended to do so in the next year.
- Ease of use and the costs reduction in ETFs are two of the main reasons why people are now investing more in ETFs and turning away from derivative products.
- The access ETFs give to an extremely wide range of non-core markets is also an appeal, with increased interest in smart beta, non-market-cap weighted indices and factor indices, such as quality and minimum volatility.
- The use of pension funds is expected to increase given the need for transparency, cost efficiency and liquidity in pension schemes portfolios.

The golden nugget

Sandra Haurant comments on the changing shape of the ETF industry and how these investment vehicles are becoming more commonplace in pension funds' strategies

While we wait to know precisely what the referendum result will mean for the UK, one thing that is certain is that the markets' waters are choppy and navigation for pensions investors will require a firm hand on the tiller.

The industry reported recently that the UK's pensions were facing a funding hold of £900 billion after the vote to leave the European Union and in the immediate aftermath, a lot of decisions were made quickly. SPDR ETF sales strategy EMEA Antoine Lesne, writing in the midst of fast-moving markets on 25 June 2016, the day after the referendum results, said: "Many investors are trading, with numerous ETFs topping their 30-day average volume within just a few hours of trading." Indeed, the industry has reported a scramble to invest, highlighting a move into exchange traded funds (ETFs) linked to the FTSE 100 index, UK financial stocks, sterling and gold, with many in the City reporting exceptional trading volumes.

Composition and qualities

ETFs are investment funds that are traded on stock exchanges. Inside they hold various assets – equities or bonds for example, but also alternative assets – and usually follow an index, in a similar way to a traditional index-tracking fund. They are essentially a wrapper, but inside they behave just like passive index funds.

Pension funds' interest in them is not new. "Even prior to Brexit, it had become more and more important to assess the vehicles a pension fund uses and to make sure it has everything available in its toolkit to manage a portfolio as cost-efficiently as possible," iShares UK institutional sales head Ashley Fagan says. "It's essential *[for pension funds]* to look at the ways they are implementing investment strategies and make sure they are actually using the lowest cost vehicle that is available." And that, says Fagan, is frequently an ETF.

They certainly offer a variety of possibilities. "ETFs are available tracking a very wide range of market indices, providing the opportunity to invest in almost any liquid asset class without the risks and costs of selecting an active manager," PiRho Investment Consulting director Nicola Ralston explains.

ETFs are gradually becoming a larger, longer-term part of pension portfolios, but one of the first uses for ETFs among pension funds was as an instrument to aid in transitions from one investment vehicle to another. A fund wanting to move away from an underperforming active manager, for example, could use ETFs as a kind of interim instrument. "ETFs are a common solution for this interim beta exposure," explains Fagan.

But, JLT Employee Benefits senior consultant and head of manager research Murray Taylor warns this approach should be used with caution

and decisions need, of course, to be considered within the wider context of today's environment. "If you are completely disenchanted with your investment strategy and have not yet decided where you want to go, that is where an ETF can be useful," he says. "But we are now in a new world and currently need different thinking. Moving into an ETF is a change of strategy, albeit a short-term one, and inevitably what you do now will be wrong because we do not know what will happen next."

ETFs themselves are not a new product, and according to the ETFs in the *European Institutional Channel* study, carried out by Greenwich Associates, commissioned by BlackRock and published in December 2015, around a quarter of continental European institutions and 20 per cent of UK pension schemes invest in them. Those not yet using them may soon start – 17 per cent of institutions on the continent who were not currently investing in ETFs said they intended to in the next year. And in the same period, more than a third (35 per cent) of investors in continental Europe said they planned to increase their investments in ETFs.

Ease of use was a key factor for those switching to ETFs and away from derivative products, for example, and cost was of equal importance. The Greenwich study shows that almost half of respondents shifted from derivative products to ETFs in the past year, with 17 per cent doing so because of operational simplicity and another 17 per cent switching because ETFs were cheaper.

Costs

The costs involved with investing in ETFs have come down in recent years, says Fagan, making them more attractive to pensions. "I think what has changed is that the passive landscape has evolved significantly over the past 10 years, but even more so recently. We have seen that the ETF has become more cost efficient compared to traditional beta instruments," she says. "The ETF industry has grown, funds have become larger in size, and liquidity has increased. The amount of trading has increased, and that has brought down the transaction costs for ETFs."

She added that the cost of holding ETFs has also come down, because management fees, or TERs, have declined thanks to increased institutional usage. "We have seen an increase in numbers of clients using ETFs for long-term holdings, and we are aware that the longer an investor is holding a fund, the bigger the impact of the management fee on the total cost of ownership," says Fagan.

Ralston agrees: "ETFs are typically cheaper than active management – often much cheaper. However, fees vary widely and investors should not assume that all ETFs are cheap in absolute terms." Weighing up cost differences is, then, crucial to ensuring the product is the right choice – and the fall in fees is not enough to convince everyone that ETFs are the right choice. Taylor agrees: "The costs of some ETFs are coming down, but looking over a longer time frame, *[traditional]* passive vehicles are still more cost effective."

The access ETFs give to an extremely wide range of non-core markets is also an appeal. "We are seeing increased interest in smart beta, non-market-cap weighted indices and factor indices such as quality or minimum volatility," Taylor says. Where pension funds may not have internal expertise or find it difficult to get exposure to certain countries such as Canada, for example, or certain emerging markets, ETFs can be useful. "You can use ETFs almost as a completion mandate to complete that exposure to your strategic asset allocation," says Fagan. It is also relevant to fixed income, she adds. "We see an increased interest in emerging-market debt and high-yield ETFs, especially in a low-yield environment where it is difficult to find areas that give adequate yield."

Transparency

One of the other advantages of ETFs is that, in the main, they are transparent. "All of our iShares ETF holdings are published daily on our website, so trustees can have a very good understanding of what the underlying investments are on a daily basis," says Fagan. "Additionally iShares has a strong track record in managing our funds in line with the index, so that is an added layer of transparency because the index rules are very transparent. You can have a clear idea of how the fund will invest going forwards."

According to Ralston: "For many ETFs, transparency of holdings and costs is part of the appeal." However, she cautions, there are exceptions: "The sector is now extraordinarily diverse, and it is important not to over generalise. Not all ETFs are highly transparent." So-called synthetic ETFs, for example, do not offer the same levels of clarity. "Some ETFs, such as leveraged and inverse ETFs, are extremely complex and are unlikely to be suitable for most pension funds," she cautions.

Given the need for transparency, cost efficiency and liquidity, ETFs seem to have secured their place in pension funds' strategies. Ralston says: "It is likely that the use of ETFs by pension funds will continue to increase, as ETFs can be a good route to gain cheap passive exposure to certain asset classes. But she adds a note of caution: "The sector is now so diverse and complex that even the choice of a suitable ETF may be far from simple. And, as with any investment vehicle, the ETF label should not be seen as bypassing the need for proper analysis as to the terms and risks."

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