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Redemption: why ETFs will save the wealth management industry

The Australian wealth management industry has had a tough GFC, and the outlook isn't much better. Fresh from a collapse in revenues, the industry is now dealing with Ripoll, Cooper, and Henry – three veritable horsemen of the apocalypse.

While the outcomes of these reviews are unknown, we can make some reasonable guesses about how the landscape may change:

- Ripoll will attack embedded advice costs and restrict the payment of commissions to distributors, including dealer groups, financial planners, accountants, and others.
- Cooper will attack overall costs of the industry….but may go a lot further and change its fundamental structure.
- Henry will reduce the relative attractiveness of super relative to other forms of investing.

Combined with recent halving of deductible contributions, we are potentially looking at a substantial dismantling of the Costello system. For all its shortcomings, personal financial strategy was very simple – drop all of your savings into super.

Now we're contemplating a more complicated industry, but also a less profitable one. Analysts are already looking at the impact on valuation of listed companies in the sector. In such a landscape, it's hard to pick a winning new product – but we're happy to nominate one – ETFs.

What's an ETF?

Many people think they know what an ETF is, but few can explain it. Most confuse them with LIC's, listed investment companies.

ETFs - Exchange Traded Funds - are essentially open ended managed funds listed on a stock exchange such as the ASX. They are designed to track and provide the return of an index or investment strategy, which can be a common index such as the S&P200, or a customised index which provides a specialised exposure. Unlike LICs, ETFs always trade very close to their NAV because there is direct access to the assets of the fund.

After a couple of false starts and a long gestation period, the Australian ETF market is on the move.

Incumbent SsGA has been joined by iShares and

Vanguard, and they won't be the last. The largest ETF in Australia, the SPDR ASX200 fund, has doubled in size in the last six months, cracking the $2 billion mark, making it one of the fastest growing equity funds, listed or unlisted.

Retail and institutional investor numbers are increasing rapidly, gatekeepers are starting to rate the segment, and adviser interest is growing.

Why? ETFs possess many positive characteristics - simple to use, easily accessible, low cost, diversification in one trade, liquid, and often better tax outcomes compared to managed funds.

Why will ETFs move into the Australian mainstream ?

ETFs in Australia will follow the path they have taken overseas, moving from the alternative to the mainstream; and quickly. ETFs have been step change product category of the global asset management industry, growing at 25%pa over the past 5 years - and that includes the impact of the GFC. Global ETF assets today stand at ~$US800 billion.

The most stunning statistic is that in 2008, the US mutual fund industry saw net outflows of $179 bn – almost exactly matched by net inflows of $176 bn into US ETFs[1].

Three big reasons why you need to know where Australian ETFs are going.

1. **ETFs can be the industry's answer to SMSFs and HNW direct investors**

   Let's face it – the managed funds industry has been spectacularly unsuccessful in attracting the SMSF and HNW direct investor segments. The fastest growing investor segment has shown a strong preference for direct equities and cash over anything the asset management industry has been able to offer.

   These investors (and often their advisers) are wary of fund managers, sceptical of their ability to add value, price sensitive, tax aware, and want greater control over their investments. This means many have relatively undiversified portfolios with heavy cash weightings. They need the key benefits that managed funds provide – but it has to come in the right package,. An unlisted balanced fund, for example, is never going to cut it for these investors, despite its validity as an investment solution.

   ETFs look like a much better answer. In addition to providing diversification, they are cheap, tax effective, liquid, and easy to access off platform. Sixty seconds on ComSec vs filling in PDS application forms for an unlisted fund and waiting days for it to be processed.

2. **ETFs provide a business hedge against disgruntled investors and advisers**

   One of the effects of the GFC that we have noted is disenchantment amongst investors and planners with active management. The figures above demonstrate the extent to which ETFs are starting to substitute for conventional products.

   Dissatisfaction with funds and the platforms that carry them has arisen due to:

   - High fees and a renewed focus on value for money in a negative return environment

[1] Strategic Insight SimFund Data December 2008

- Poor after-tax outcomes due to portfolio turnover, the effects of derivatives and FX
- Inability of many funds to meet their performance objectives
- Fund closures, redemption freezes and failures, especially of popular income funds.

ETFs get around many of these issues. Being benchmark based, they tend to be predictable, true to label, and liquid.

The structure of ETFs also makes them particularly tax effective. As an index style product, portfolio turnover tends to be low for a start. Even where realisations occur (because of a large redemption for example) ETFs have the ability to flush taxable gains out to their market makers – resulting in better outcomes for investors.

3. **No you don't have to be a global index giant to play**

While the global giants of index management – SsGA, Vanguard, and BGI – are certainly prominent in the ETF market, that's far from the end of the story. ETFs are a diverse and vibrant market in which a range of different entrants have found space:

- Investment banks, particularly those delivering ETFsvia swaps rather than physical holdings.
- Niche ETF players such as US based PowerShares (now owned by Invesco) and Germany's ETFlab have demonstrated that there is room for a range of niche products, especially those targeted at the needs of local investors. A number of niche providers have seen extremely rapid growth by targeting their offer more accurately than the global majors.
- The first active ETFs have been launched.

This makes ETFs a far more diverse product category than the market for unlisted index funds and mandates. Active managers can play, and ETF businesses can co-exist within predominantly active firms. The biggest challenge for active managers is actually the leap in imagination that thinking about ETFs requires.

Enter The Fray

ETF businesses are not for everyone. They're quite different to unlisted funds, not cheap to set up, and need scale to break even.

But they are going to play an increasing role in Australian wealth management. Having had an excellent GFC, and seeing massive inflows in a period of deep distress for the wealth management industry, ETFs are on the move. Right now, it's the early adopters in both retail and institutional channels; but with just a little push from our three horsemen it can become the accepted wisdom.

Although change brings winners and losers, Tria believes this is clearly something to be welcomed. Not only is this one of the easier ways in which the forthcoming reform agenda can be addressed, ETFs have the potential to reconnect the wealth management industry with enormous numbers of investors who are currently not engaged with it. One way or another, ETFs really might save the industry.

For participants in the Australian industry, the most important thing is to put ETFs on your radar. Don't ignore the opportunity – if you're going to play – or the threat if you're not. Ignoring this trend is not a good idea, as many US and European fund managers have found out.

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