

dimensions

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Wealth management strategy and product specialists
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Road to redemption: why ETFs are taking off in Australia

In last September's edition *Redemption: why ETFs will save the wealth management industry*, we wrote of our optimism that ETFs would become a winning new product category in the Australian market, and brighten the prospects for the entire industry.

Nine months later, we've clearly made progress. ETFs are getting traction, especially in prized segments such as self managed super funds (SMSFs), fund sizes are expanding, and trading volumes are rising.

Rolling down the runway

Notwithstanding that much of the market can't define exactly what an ETF is, lead users amongst direct investors and financial planners have found ETFs and they like what they see:

- Direct investors get a managed exposure that they can buy, hold or trade themselves without the fees associated with intermediaries and active management.
- Planners get a means of reducing client portfolio costs, which is easily administered, and comes without the performance and tax issues of active management.

What will take ETFs into the mainstream however, is that they are playing into a particularly positive environment which just seems to get better with every regulatory change.

Consider our prospective world post-Ripoll, Cooper, and Henry – a world of unbundled product commissions, under pressure to lower costs, and with less concessionally taxed super. This is a world which calls for stripped down, lower cost products which are also tax efficient. Could the script have been written any better for ETFs?

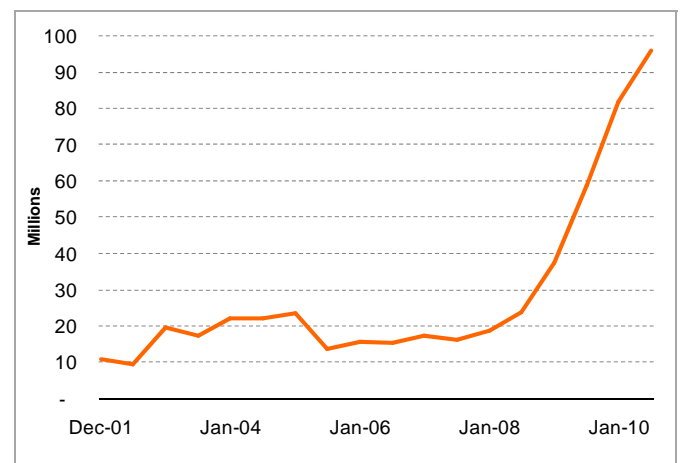
Even the recent clarifications regarding the way in which gearing in super will work further add to the ETF story.

By insisting (somewhat bizarrely in our view) that only a single asset within a super fund can be subject to a borrowing arrangement, it creates difficulties for a borrowing which relates to a portfolio of shares. In other words it's ok to gear into a single real estate asset but not a portfolio of BHP, Commonwealth Bank, and Wesfarmers shares. Go figure.

But step up ETFs again - implementing a super gearing arrangement using ETF units provides a diversified exposure and works just fine under the proposed rules; as indeed will any managed investment scheme. An ETF won't provide any alpha of course; but it's equally unlikely to underperform, and the tax outcomes (due to lower gains distributions) are almost certain to be superior.

Looks like an S curve to us

Unsurprisingly, the market is responding.



Units on issue, SPDR S&P/ASX200

It has to be observed that the overall size of the category is still only around \$3 bn – small beer in a \$1 tn market. But in 2009-10 ETF assets grew by more than 60%, indicating that this category is on a new trajectory, one that is considerably higher than the industry as a whole.

In fact, as the chart above indicates (we have used State Street's S&P200 ETF as a market proxy), the ETF market has formed the bottom of a classic S curve where the market jumps from early adopters to mainstream usage.

And if you look at what's going on within the registers of Australian ETFs, it's not hard to understand why.

Tria has been obtaining ETF registers regularly and we now have a unique dataset of ETF unitholder characteristics stretching over several years.

A large percentage of ETF unitholders (up to 40% in some products) is represented by SMSFs, despite the fact that until quite recently ETFs did not target them. So while the wealth industry has been searching for the Holy Grail product that will lead them to the SMSF market, the SMSFs have started on their own migration towards ETFs.

How far could it go?

Most product markets go through an S curve over their life:

- Enthusiasts and experimentation
- Early adopters
- Take off
- Exponential growth via mass market adoption
- Deceleration
- Maturity
- Fade

Trying to pick the mature size of the Australian ETF market is a challenge. But we have some comparisons – US ETF assets are ~5% of market cap after ~12 years, while Europe, which is less mature than the US, has reached ~3.5% after ~8 years.

Let's assume that Australian ETFs (which are at an earlier stage of market development) reach only half the US level of penetration – ie 2.5%. In that case, given a local equity market cap of >\$1 tn, we are talking about a potential ETF market size of over \$25bn, some 10x where we are today. The experience of the US, Europe, and Canada suggests that it takes 7-8 years of rapid growth from take-off until an ETF market starts to mature.

Everything you wanted to know about ETFs but were afraid to ask

With the positive outlook for the category, many of our clients are getting involved in, or thinking about ETFs. Here are some issues to consider:

- ETFs are chiefly passive.
- ETFs are not a means to revive a flagging active equities business. There is a lot of hype about active ETFs but on closer examination there are only around 10 active ETFs in the US, and they hold less than \$100m between them.
- The transparency provided by an ETF is predicated on being passive investments. While it is possible for an active ETF to provide this, not many active managers are willing to put their portfolio holdings on public display every day via an ASX announcement.
- The exception to the rule is hybrid active ETFs which are rules-based 'fundamental' products such as those with a style or income bias. We expect to see many variations of these products over the coming years.
- Introducing ETFs is not like rolling out a new product line. Although the ETF business is also about assets under management, it's not an extension strategy. The decision to go into ETFs is a decision to launch a new business which requires a new set of skills and activities.
- Nor is this a boutique business in our view (although a boutique has recently entered the Australian market). You just can't do it with a couple of guys and a Bloomberg terminal.

The costs involved in setting up, running and marketing an ETF business require some deep pockets and real commitment from across a business. Fixed costs need to be spread across a number of products in order for the venture to make financial sense.

Margins are not generous. The market expects ETFs to be priced inexpensively (except for exotic exposures like emerging markets), and there are plenty of service providers which will have their hands in your pockets.

For example, an Australian shares ETF will likely have to be priced at 30 bps or less, with index providers and the ASX taking at least 5 bps. Then there's the share registrar and specialist fund administrator both charging fixed fees that hurt in the early days. And that's before any marketing spend.

You can start to see the picture – obtaining scale (which is at least \$500m in the case of a small ETF range) is important. So notwithstanding that the prospects for ETFs are strong, there is an imperative to reach scale quickly to mitigate the financial pain of the early years.

Plan carefully: don't do a "fire, aim, ready"

The opportunity is as significant as the scope for losses, so ETFs are not something you want to stumble into. Entering this market needs to be carefully thought through.

Despite the obstacles, the best opportunities to enter are now as it will get harder over time. The big ETF issuers in the US today are mostly those that were there at, or soon after, the development of the market.

This is not to say that late entry is impossible. It is however more difficult and expensive to carve out a niche once the market is well established. You need a significantly different product strategy, such as Deutsche Bank's X Trackers, a significantly different target segment, such as the Stream platform aimed at hedge funds, or a local distribution advantage, such as ETFLab in Germany.

For the rest – like the diggers who came late to the gold rush – it's a fight for the leftovers in the tailings, and most will find the going tough.



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