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Liquidity and Transparency

Two Key Drivers of ETF Administration

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Assets in exchange-traded funds have nearly tripled in the past five years, from $302 billion at the end of 2005 to $819 billion at the beginning of this month. Year-to-date 2010 through August, investors have pulled $29 billion from traditional US equity mutual funds, while ETFs have seen $40.8 billion in inflows. Since risk aversion is rampant at present, what is driving this tremendous and curious interest in ETFs? Can this momentum continue to catapult ETFs to a second big wave of growth?

Appearing at *Money Management Executive*'s Live Web Seminar on ETF Administration at **SourceMedia**'s New York headquarters on Sept. 10 to discuss flows, liquidity, accounting and other key issues were:

- **Benjamin Fulton**, Managing Director, Head of Global ETF Business, **Invesco PowerShares**
- **Joseph Keenan**, Managing Director, Global Financial Institutions, **BNY Mellon Asset Servicing**
- **Jeffrey McCarthy**, Director, Global ETF Product Head, **Citi**
- **Kathleen Moriarty**, Partner, **Katten Muchin Rosenman**

BNY Mellon and **Citi** sponsored the Sept. 10 event, which was moderated by **Lee Barney**, Editor of *Money Management Executive*.

Lee Barney: The $821 billion ETF industry is one of the brightest areas of mutual fund industry these days, particularly in fixed income, commodities, emerging markets and leveraged ETFs. What are you finding to be the big sellers among your clients right now, and what do you expect will resonate in the future?

Ben Fulton: In the last year, we have seen most of our flows going to fixed income, which itself has gone through an interesting transformation. Five years ago, a fixed income investment would have been primarily tied around the **Lehman** egg, or maybe even a 10-year note. Now, index providers have started creating a lot of unique indices, anything from emerging markets, to sovereign debt, to municipals and **Build America Bonds**.

Joe Keenan: There are a number of commodity products in single asset classes, such as gold, silver and other precious metals, along with other very targeted investments—all of which have high volatility. And some of those products have different tax treatments as well.

Jeffrey McCarthy: Across **Citi**, clients continue to express interest in fixed income ETFs, with the expectation that interest rates will rise. The other big area is global products, with a lot of enthusiasm for emerging market frontiers, such as Columbia, which are rebounding and showing strong year-to-date returns.

As some of these frontier and emerging markets change, their regulations will allow more foreign investment into the markets, and we will see more access to products.

Kathleen Moriarty: The filings for future products we see are overwhelmingly for emerging markets and global commodities, and within that, fixed income.

Keenan: In tandem with that, there is now greater awareness of the volatility of the dollar as well. So we are starting to see products like emerging market fixed income products, that are both dollar-based, and local-currency based. However, investors need to be aware of the impact of the volatility of the foreign exchange market in addition to the rest of the markets.

McCarthy: Investors should also take into consideration the interest of money moving back into U.S. domestic. In the last 18 months, the banking and financial sector took a beating. It's precisely the investments that were hit with tremendous outflows that will deliver potentially bigger returns as we move forward, as fund managers and then investors look to take advantage of these beaten-down stock prices.

Keenan: Clearly, there is a desire for a clean product among buy-and-hold investors. But there is also keen interest in the type of exposure that would allow an investor to very quickly take advantage of volatility, which is why we are seeing the introduction of products tied to the VIX, the volatility index, itself.

Institutions and sophisticated investors are now using ETFs not just as long-term investments but as trading tools.

Ensuring that an ETF is liquid "is the SEC's first question. What's interesting is that even though the IPOV is being disseminated every 15 seconds, with the speed of the markets, exchanges have to fulfill information even more quickly."

—Benjamin Fulton
Managing Director, Head of Global ETF Business
Invesco PowerShares

Barney: But is the level of sophistication among investors—institutional investors, not just retail investors—keeping up with these increasingly complex designs?

McCarthy: Actually, no. I think ETFs have actually outpaced the sophistication of the investor. Some cannot appreciate the structural differences between a traditional ETF and a commodity, non-registered investment vehicle, in terms of the grantor trusts, the investment strategies or the heavy use of derivatives. Investors need to have a better understanding of how an ETF achieves its exposure, and how that affects its ultimate return when you go

to liquidate your position. These finer points are still not brought up to investors, who clearly could benefit from more clarity and education.

Keenan: I would have to agree that baseline retail investors may not understand the nuances and the importance of bid/ask spreads and liquidity. However, the level of sophistication among RIA fee-based planners has absolutely changed. We have seen it directly at BNY Mellon.

A few years ago, one of our subsidiaries, **Pershing**, hosted a conference on ETFs that attracted a mere 30 people, a few of whom had actually even purchased an ETF. Last year, we drew several hundred people attendees, who were asking some of the most sophisticated questions on how to use ETFs for portfolio construction, and how to educate their underlying clients as to why a particular product is better than another one even though they look the same.

I absolutely think that folks who are focused on investing money for a living are getting caught up the curve very quickly.

Fulton: At Invesco PowerShares, we have broken our ETF clients into three different categories. There is the retail investor—primarily high-net-worth and RIAs. There is the smaller institutional ETF investor—hedge funds and traders. And then there is the large institutional client—mutual funds, pension and endowments.

While there is a keen interest in ETFs among all three, their use of the products is very different. So, we identify and target products to certain groups.

For instance, we just offered a triple-up, triple-down, long-end-of-the-bond ETF. While it's an interesting product, we realize it might not be what high-net-worth are looking for, but that traders are keenly interested in.

Moriarty: When ETFs were first introduced, they were simple in that they represented indexes that were known to everybody. That's why SPDRS, based on the **S&P 500 Index**, were chosed to be the first.

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Director, Global ETF Product Head
Citi

As things have gotten more stratified and as products have become more sophisticated, ETFs are being structured around complex instruments being held.

Keenan: There is acute awareness among the regulators, the **Securities Exchange Commission** and others, to make sure investors are crystal clear on the nuances of these new products. That makes education essential.

That's why the SEC has put a halt on approvals for new fund and ETF filings seeking heavy use of derivatives.

Barney: Another key issue is price discovery. How hard is it to find accurate price discovery of the underlying assets, particularly those based on customized indexes, fixed income, active management or perhaps a physically backed commodity such as gold bullion?

Keenan: It is essential that the listing exchange has the ability to provide what we call in the industry, the Indicative Net Asset Value, also known as the Indicative Optimized Portfolio Value, or IOPV. That facilitates the intraday trading. So if you come up with a product whose underlying assets are highly illiquid, or you can't secure a price, that's going to be very difficult.

To date, I don't think there have been any products that have been approved that have this problem. But if you did offer an ETF based on an index where you couldn't secure an accurate intraday price, you would get very wide bid/ask spreads.

This is one of the persistent problems in the closed end fund industry, where you can get significant premiums or discounts to the actual value. And that's where the ETFs are meant to fix that problem.

For ETFs, the listing exchange or

another provider is able to calculate the intraday every 15 seconds. That becomes easier or more difficult to do depending upon asset class.

Moriarty: This prevents asset managers from offering illiquid ETFs, because they wouldn't trade. One of the first questions to ask before offering a new ETF is: How liquid is the underlying asset?

Fulton: For sure, it's our first question. It's also the SEC's first question. They want to have confidence that an orderly market can be made. What's interesting is that even though the IOPV is being disseminated every 15 sections, with the speed of the markets, exchanges have to fulfill information even more quickly.

So in some ways we actually argue in the industry: How relevant is the IOPV that we are disseminating if some traders are obtaining sub-second reporting?

When the munis and other fixed income ETFs started coming out, it was because **IDC** and other groups were able to disseminate that data that quickly.

Moriarty: Absolutely, that's exactly why the first fixed income products were all tied to government Treasuries, because they offered transparency. No one started out with esoteric corporate bonds.

McCarthy: Price discovery in and of itself adds liquidity to the marketplace. One of the things our traders will always look at are the underlying assets, i.e., the price, and the cost of obtaining them or replicating that exposure to hedge risk. You factor that into the costs.

You know, we at Citi are going to offer those shares on the primary market. And that price discovery goes into the IOPV, the bid/ask spreads that are offered in the market.

Fulton: When the first fixed income ETFs came about, I kind of wondered: How important are these going to be, because advisers like to buy individual bonds.

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—Joseph Keenan
Managing Director, Global Financial Institutions
BNY Mellon Asset Servicing

But what you realize is that the price discovery that was built under the product has forced most fixed income ETFs to trade at an tighter spread than the underlying security.

So, in some ways a retail client actually gets institutional pricing.

Barney: So what are the biggest challenges now in administering ETFs, given their increasing complexity and the number SEC rules?

Keenan: The vast majority of ETFs are 40 Act products. They have the same requirements, the same restrictions, that traditional mutual funds have. They have a board. They have meetings. They have to calculate the NAV, even though investors don't buy or sell your shares at net asset value on the secondary market.

They have the same need as traditional mutual funds for fair valuation.

What's very important is that spreads naturally widen later in the day because the spread is an indicator of risk for those institutions that trade the product.

We as administrators have to make sure that we respond to all the nuances and the sophistication that has emerged in the markets.

When there is an anomaly, like holding local shares where a market is closed, we have to be able to work in partnership with not only our clients, but also with the regulator and the exchanges, to be able to not only evaluate these portfolios, but also provide the reporting.

We are constantly retooling the factory to make sure that we can handle the next set of regulatory requirements.

McCarthy: In administering ETFs, there is an added level of complexity than a traditional mutual fund due to the fact that they are traded in both a primary and a secondary market. So, there's an added level of information and transparency you need to provide.

That means ETF managers need to be able to properly assess risk, hedge, and obtain accurate pricing. Some of that needs to be built into the processing engines, meaning treating corporate actions differently for ETFs because of their holdings transparency. For example, if you have an in-kind ETF, and there is a two-for-one stock splitting in the basket, that has to be adjusted. And that may have a ripple effect not only on how the stock is traded, but perhaps on its indicative value.

Keenan: Time frames are certainly compressed.

Moriarty: Corporate actions are another example. With fixed income ETFs, when accounting for the right income and accruals and so forth, you face a dual

process—one for the fund and one for the basket, which used for payment.

Fulton: I think the other tough thing is, as you are designing a product with the intention of being fully invested all of the time, you might find the liquidity situation changing within even three years.

At the launch, it might be easy to buy and sell, or even to do it all in kind. Then, all of a sudden, markets might become tighter or restricted. We oftentimes have built individual ETFs never intending them to become as large as they have. Who would have ever expected the original SPDR to become a $60 billion-dollar product?

We at Invesco PowerShares built a water product and found all of a sudden that we owned a large portion of every water company out there. How do you manage through that?

Moriarty: The way you manage is very different when you are little and when you are big.

Barney: With the flood of ETF products on the market, has that impaired liquidity? A year ago there were 731 ETFs on the market, and now there are 908.

Fulton: We actually see continued growth and an increase in liquidity. Half of our flows over the last five years have come from new products launched within the previous 12 months. So even though I have 150 products in the marketplace, in some ways the most important product to me is the newest. I think it's part of the ETF science.

Products tend to reach a correct equilibrium size. Our water product, for instance, has been at a billion dollars for probably three or four years now. It's not that people are not interested, but there is a natural level for buying and selling in the marketplace.

Moriarty: When we launched the **SPDR** in 1993, we never expected mutual funds to use ETFs to equitize their cash. So in a way, what people say is true: Liquidity begets liquidity. The more things that you have that are easy to trade and easy to price, the more they are used; the more they are used, the more other things happen. It all interlocks.

Keenan: The discussion on ETFs and liquidity is a very esoteric dialogue because there are so many interrelated parts. I don't think, though, Lee, that the continued proliferation of ETFs are the driver of any concerns about liquidity.

I do think that some of the fundamental market changes that have occurred—decimalization, NMS in 2005—have all placed burdens on market makers, including the fundamental shift of the **American Stock Exchange** from open outcry to the electronic or match order book. All of these have created an environment where those institutions that participate and provide liquidity to the primary market, are under pressure.

Additionally, it's not just the fund itself that drives liquidity. For instance, for some of the largest institutional products, the futures contract is important not only for tightening the spread, but there might be a futures product that exists against the underlying index or the ETF.

And then there is the securities lending marketplace, which also facilitates liquidity. So, ther are a lot of other forces that come into play to support liquidity.

Barney: How might the SEC's report on the May 6 Flash Crash impact the way ETFs are traded?

Fulton: We are all waiting for the SEC's release on May 6 Flash. Change definitely needs to happen in the marketplace, and when it does, we are going to have to react quickly and change the way we do our business. But at the end of the day, ETFs will go on.

Keenan: One of the most successful products Invesco PowerShares distributes is the **QQQ**, which has one of the highest interests, because it represents the top 100 tech stocks on the **NASDAQ** stock market.

Some might view shorting as a negative on the market, but the truth is, the moment the market corrects, that short interest causes extraordinary buying power and can actually act as a cushion to the market and reduce volatility.

The truth is that a large percentage of ETFs are very liquid and can actually help the market during a precipitous downturn.

Moriarty: In the old days, where there was a down-tick rule, ETFs were exempt from that precisely because of the liquidity they provided.

Barney: If the big players, like Fidelity, that have not yet offered an ETF were to bring one to market, what barriers to entry would these late-comers face?

Keenan: Actually, Fidelity did launch an ETF, the **1Q,** following the launch of the QQQ, but it didn't really garner significant assets.

McCarthy: Many of the large asset managers. Such as **Eaton Vance** and **John Hancock**, have filed an intention with the SEC.

But one of the biggest barriers is the traditional distribution models. Funds have traditionally been distributed under the model of 12(b)(1) fees on platforms through allocation tools.

If you look at Fidelity specifically, a lot of their products are distributed through their DB and DC business. ETFs have yet to make inroads on these platforms.

In addition, a lot of these asset managers have traditionally been active managers. There is a gray zone that exists for what will be required of active ETFs in terms of transparency and other regulatory hurdles.

I don't think these asset managers want to expend the time and energy on ETFs without knowing what the outcome will be.

Fulton: Brand is extremely important,

especially for ETFs. I like to say that ETFs grew up in the Internet age. Investors of our ETFs are in about 130 different countries.

The product development process for ETFs is different from mutual funds. It is typically based on the name of the product and is immediately comprehensible. Mutual fund product development teams, on the other hand, are infatuated with far greater complexity, such as "core" and "balanced growth." In our world we have to call it "Water," or "Clean Energy" or "Agriculture."

Keenan: That's right. If you can't explain the ETF in an elevator, it's not right.

Fulton: Yes—and in a short elevator ride, at that.

Barney: Do you think that ETFs will become as popular as traditional mutual funds and that firms and their back-office partners must prepare themselves for a second wave of ETF growth?

McCarthy: As a beta product, passively managed ETFs will continue to grab larger market share from those mutual funds, because transparency is not a concern.It'sjustabettermousetrap.Sure,you're offering the same strategy that tracks an index, but it has a lot more trading characteristics. You can but options on it. You can short it. You can get in and out throughout the day. But education is important, so once the remaining large asset managers get into this space, it will help the existing ETF providers.

Keenan: Are ETFs a category killer for the traditional mutual fund? I would say no. Admittedly, the traditional mutual fund industry in the United States is very mature. More than half of the households own them, and I think we are still at one in 10 for ETFs. So there is certainly great upside potential.

Where they are a category killer is traditional index products because it a better mousetrap.

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