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IT'S SHOWTIME

Trillions have flown into ETFs in just a few short years and even a global pandemic hasn't stopped the money. For the people behind the product, now is the time to prove their worth. **Elizabeth McArthur** writes.

01:
John Davies
head of exchange traded products
S&P Dow Jones global

02:
Alex Vynokur
chief executive
BetaShares

03:
Christian Obrist
head of iShares Australasia
BlackRock

May you live in interesting times.

Some say that phrase is an ancient curse, others say it's a blessing. Market analysts will tell you it's both.

For investors who have just cruised through the longest bull market in history, the interesting times have arrived.

S&P Dow Jones global head of exchange traded products John Davies[01] experienced a career first barely a quarter of the way into 2020 - actually, he had a couple.

As London went into a strict lockdown to manage the pandemic and Davies and much of his team were forced to work from home, volatility was so extreme that exchanges around the world were suspending trading on various days as circuit breakers kicked in.

If those exchange circuit breakers caused trading to be suspended on the day of an S&P rebalance, Davies explains, it could cause even more volatility and uncertainty.

So for the first time Davies can remember, and certainly for the first time in his career, S&P postponed rebalances on all its indices.

"It wasn't a decision taken lightly by any stretch of the imagination," he says.

"People had enough on their plates trying to manage the volatility in the world and, based on the feedback we got from clients and exchanges, I think we did the right thing."

The word "unprecedented" has become a cliché amid the COVID-19 pandemic, with politicians accused of an unprecedented preference for that particular adjective.

The market crashes that COVID-19 has ushered in are not typical or cyclical economic events though.

They are linked to a health crisis and to a public grappling with overnight industry-wide shutdowns and greater government control than it's ever known.

But curiously, the anxiety being felt around the world has not stopped investors looking to take advantage of the volatility.

Fear of missing out on buying while the market is down seems to be the driving force behind im-pressive flows in February and March 2020. And investors are turning to what has become the most accessible, affordable way to get in on the action - ETFs.

Rainmaker analysis shows the Australian exchange traded product market lost $6.7 billion in market value in March, ending the month at around $57 billion from $64 billion at the end of February.

Despite losing about 10% in market value, investors still wanted in. There were net inflows into the ETP market in March of $360 million.

February saw even stronger net inflows of $1.5 billion.

"What has been particularly noticeable has been a significant increase in trading volumes. In February we saw a record trading volume of around $7 billion, a figure that was promptly surpassed in March when there was $18 billion of trade in ETFs," BetaShares chief executive Alex Vynokur[02] says.

"Investor usage of ETFs has evolved in recent years to include both strategic, long-term asset allocation, and the adoption of satellite, or tactical, investment strategies."

As for the kinds of ETFs investors are piling into amid the pandemic, there are definitely some winners and losers.

Head of iShares Australasia Christian Obrist[03] has seen BlackRock's iShares AUD hedged equity ETFs enjoy a significant uptick in popularity during the volatility.

"As the AUD fell to a 19-year low against the USD, local investors piled in to IHVV (hedged S&P500) for US equities exposure and IHOO (hedged global 100) for broad global equities expo-sure," Obrist says.

And, following the initial sell-off in fixed income he says investors have again gravitated to bond ETFs for multiple reasons: equity diversification, income and capital preservation.

BetaShares Australian Equities Strong Bear ETF and BetaShares US Equities Strong Bear ETF both came out of March winners in the field.

While traded value is usually a function of the size of the product, the bear ETFs proved exceptions to this rule.

The BetaShares Australian Equities Strong Bear ETF makes money when the Australian shares index falls at a ratio of around 2:1.

It experienced strong inflows in March and had the highest traded value of any product during the period, at just under $2 billion.

This, for a fund that had just over $200 million at the beginning of the month.

"We've seen a growing level of interest in our Bear funds from financial advisers," Vynokur says.

"They are predominantly used as a tactical risk management tool in investor portfolios, especially for clients that are sensitive to the risk of significant portfolio drawdowns."

The BetaShares Geared Australian Equities Fund and BetaShares US Equities Strong Bear Fund also had high trading ratios of 8.8 and 4.7 respectively.

Rainmaker analysis indicates these products were not only being used in March to hedge portfolios, but to trade volatility for short term gain.

Vanguard Australian Shares Index, SPDR 200 and BetaShares Australia 200 ETF had the largest net flows for Australian equities ETPs during the period overall.

In international equities, BetaShares US Equities Strong Bear Fund was ranked first for flows, followed by iShares Core S&P 500 and Vanguard MSCI Index International.

Beyond Today FP certified financial planner Antoinette Mullins[04] has seen the undying enthusiasm for ETFs in the current environment first hand.

The market havoc COVID-19 has wreaked has not put Mullins off indexed strategies or ETFs, nor has it put off her clients.

She thinks it's during times like this that clients' financial literacy and understanding of risk goes up a notch.

Mullins says the main sentiment she's seeing from clients is that they wish they were in a position to buy more - they seem to broadly think it's a great time to get into the market.

"I think I fell in love with financial planning during the Global Financial Crisis," Mullins says.

"Clients need some hand holding in a crisis and it's when real decision making happens. And I think if you cut your teeth at a time like that it's the best learning environment."

Clients need some hand holding in a crisis and it's when real decision making happens. And I think if you cut your teeth at a time like that it's the best learning environment.
Antoinette Mullins

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Mullins' knowledge when it comes to what ETFs are available and how they can be used to benefit clients might be taken for granted in the financial advice industry now, but not so long ago cost-efficient indexing strategies were not so commonly spoken of.

Bell Direct head of distribution and marketing Tim Sparks[05] started his career with ETFs at BlackRock's iShares where he found that most financial advisers didn't really understand what ETFs were or how they could use them.

"Back in 2008 almost all ETF conversations we were having were educational in nature," Sparks says.

"Discussing ETF benefits – tax, cost, diversification, liquidity, transparency and instant diversification – and trying to explain (sometimes very poorly, as we were all a little green) how the ETF creation or redemption mechanism works."

As far as Davies is concerned the reality of what turned the tide on ETF popularity wasn't just education and smart distribution teams - it was also commissions.

Davies says after the Future of Financial Advice reforms saw trail commissions phased out, advisers were left with a dilemma. Some of the managed funds they had been recommending suddenly looked a lot less attractive.

Right now, financial advisers are wading through the next wave of industry reforms under the new FASEA education and Code of Ethics regime.

With the Royal Commission recently pushing vertical integration well and truly out of favour at the same time, in 2020 again there is a whole cohort of financial advisers reconsidering what they value when it comes to investment recommendations.

This year kicked off with a consultation into stamping fees paid by fund managers to advisers and brokers for exchange-listed funds, as public scrutiny into the practice mounted.

The outcome of that work is still up in the air but it seems likely these fees too will be turned off.

"In other markets where advisers moved from commissions to fees the economics changed and they had to look for the most cost-effective tools to implement investment strategies," Davies says.

"When you consider the fee levels attached to the average active mutual funds and then take away trial commissions there is almost no incentive to look at those, especially when you compare the performance of those funds to a passive product like an ETF."

S&P compares active and passive funds across the globe and, Davies points out, in general terms three out of five active managers fail to beat their benchmark.

"As investors become more aware of this the ETF will only become more attractive. Why invest through a high-fee, low performing active fund?" he says.

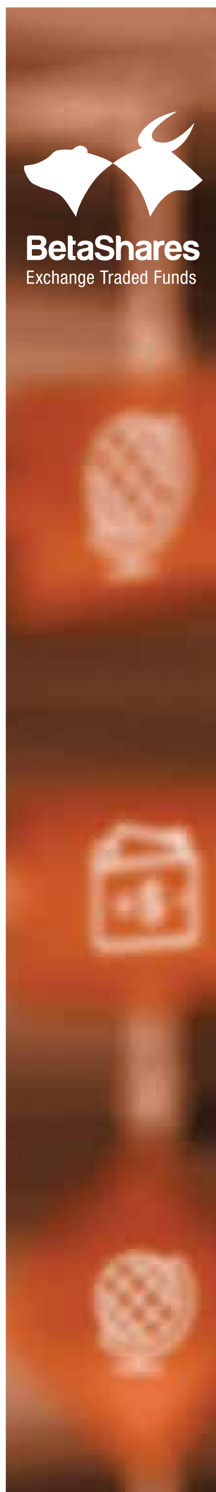
Who makes the market?

COVID-19 and the market havoc it brought with it has struck at would could be a delicate time for active ETFs in Australia.

Last year, the regulator "paused" listing of active ETFs as it mulled whether the holdings of these vehicles should be allowed to remain opaque and whether internal market makers, currently favoured by active ETF managers in Australia, should be permitted.

On 16 April 2020, ASIC provided guidance on these non-transparent ETFs.

ASIC asked ETF issuers only rely on publicly available information or a reference price as the input for market making quotes and to establish information barriers so people who know the current portfolio holdings don't submit the bid and offers.



The regulator was clear that it wanted "information asymmetry" in the world of active ETFs to be addressed but it did not go so far as to ban internal market making.

UNSW professor of economics Richard Holden[06] sees the intellectual property concern as the driving force behind the internal market maker versus external market maker debate.

"Precisely because it's internal there is less visibility around how those prices are determined and therefore less visibility into whether that's a completely accurate reflection of the market value of the underlying assets," he says.

"Funds have expressed a concern about protecting their intellectual property and from what I can see ASIC has been somewhat responsive to those concerns."

However, Holden points out that doesn't change the fact that visibility into true prices and market participants understanding the true net asset value is very important.

"The more one has a regulatory regime that protects the so-called intellectual property of exchange traded funds, the more concerned one could be about how accurate those signals about underlying asset value are," he says.

Overseas, in the UK and the US, regulators have demanded active ETF managers use third party market makers.

And, Holden doesn't really see why Australia would go another way.

"If I were making the decision, based on what I know, I would be inclined to operate the way overseas jurisdictions do," he says.

"I haven't seen a particularly strong argument made in a public forum by ASIC on why Australia's strategy should be different from the rest of the world. I don't see anything peculiar about Australia that would mean we would balance the two sides of that trade off very differently than other jurisdictions."

Davies also sees the internal market maker issue as peculiar to Australia.

He points out that it took quite a while for the Securities and Exchange Commission in the US to get comfortable with semi-transparent actively managed ETFs.

Recently American Century Investments became the first asset manager to launch two actively managed, semi-transparent exchange traded funds in US with the products going live on 2 April 2020.

The ETFs are American Century Focused Dynamic Growth (FDG) and American Century Focused Large Cap Value (FLV) and will publish their holdings quarterly rather than daily in an effort to protect the proprietary methodology of the manager.

Quarterly disclosures, Davies points out, is not so different to what was permissible for traditional mutual funds in the US.

While BetaShares' core business is in traditional indexing ETFs, it has partnered with some active managers to launch a number of active ETFs.

"We very much support ASIC's regulatory framework on active ETFs including the policy on market making," Vynokur says.

Chi-X chief executive Vic Jokovic says the most important thing in any ETF is that it trades at a fair price.

"Generally, portfolio holding transparency is the best way to ensure that happens," Jokovic says.

"Having said that, there are fund managers where full portfolio disclosure just isn't an option because of the intellectual property tied up in their basket information."

He says ASIC's recent regulatory guidance for non-transparent ETFs was an important step and set out some controls to manage that information asymmetry risk.

"ASICs engagement with industry was very extensive, detailed and I think commendable," Jokovic says.

"They met with overseas regulators and undertook significant work comparing non-transparent fund frameworks from other countries."

He believes the outcome of all of that work is that the regulator has prescribed standards for non-transparent ETFs and internal market makers which are "world class".

Fidante Partners ActiveX senior investment partner Sam Morris[07] explains the model that has been adopted in overseas markets where active ETFs have external market makers relies on selective disclosure of portfolio composition under strict non-disclosure arrangements from the product issuers to those market markers.

"ASIC has obviously considered this in its review, and through its updated guidance, has made it clear that it is not comfortable with some market participants having access to information that the broader market does not have," Morris says.

ASIC guidelines for non-transparent ETFs that employ an internal market maker say the manager must appoint a trading participant to act as execution agent to enter bids and offers in the ETP units throughout the day on behalf of the ETP (they should be independent from the asset manager themselves), he explains.

There were 27 active ETFs trading in Australia in March 2020 that do not disclose their portfolio holdings daily and 15 transparent active ETFs that do.

"Non-transparent equity ETFs have good reasons to want to protect the composition of their portfolios as a key source of intellectual property as well as to protect their investors from being front run," Morris says.

Bell Direct's Sparks, on the other hand, sees things a little differently

"It is a setback for the ETF industry when an active manager comes to the table and says they are pricing the entry and exit point for investors into and out of their products and will

04:
Antoinette Mullins
certified financial planner
Beyond Today FP

05:
Tim Sparks
head of distribution and marketing
Bell Direct

06:
Richard Holden
professor of economics
UNSW

not disclose how they are arriving at the price," he says.

"That creates risk for investors, as it gives active managers the opportunity to potentially generate outperformance through their own pricing gymnastics."

He thinks the solution is for active managers to ask their primary market makers to sign non-disclosure agreements.

"From inside these businesses what they may be doing is black and white, however to investors looking in it seems grey," he says.

Sparks points to another, possibly bigger, issue too.

Last year, Deutsche Bank shut down its ETF market making desk in Australia as part of a global axing of equities trading services at the banking giant.

"That team was about 80% of trading on some of the most widely used ETFs in the Australian market," Sparks says.

"ETF issuers were appearing at conferences discussing the 'two layers of ETF liquidity' and why investors should have confidence in ETFs, whilst not telling the market their primary market maker (whom investors need to buy the ETFs from) was shutting up shop."

If the void left by the Deutsche team is not filled, spreads on some ETFs in Australia could widen and Sparks thinks some less popular ETFs could even cease to be functional.

ETF issuers need to do a much better job at utilising their global market maker relationships to ensure adequate competition exists in the Australian market.
Tim Sparks

"ETF issuers need to do a much better job at utilising their global market maker relationships to ensure adequate competition exists in the Australian market," he says.

"Market makers have access to information that investors don't. Without other market makers present they can use this information to misprice the ETF for their own benefit."

The bubble question

With about $1.5 trillion tracking S&P indices in ETFs, it's the largest index provider in the ETF space.

Davies has seen the popularity of ETFs explode over his career.

He notes that it took 20 years for the first trillion to be invested globally through ETFs, the next trillion took about three and a half years and the third trillion took just a couple of years to add up.

Some people see risk in those numbers.

Michael Burry, the investor who famously predicted the global financial crisis and was immortalised in the book and movie The Big Short, is currently shorting ETFs believing there is a bubble in passive investing that's sure to burst.

Davies is very familiar with the argument.

"When the late [Vanguard founder] Jack Bogle, who created the first indexed funds, was at an investor day a few years ago he was interviewed in an auditorium surrounded by investors and journalist," Davies says.

"He was asked how big indexing could get and what the impact would be and, to paraphrase, he said indexing could get bigger and bigger and it would be a catastrophe.

"At that point, a load of journalists who were listening ran off to file copy or speak to their editors and say, 'the great Jack Bogle said indexing could be a catastrophe'.

"If they had waited another 30 seconds, he went on to say indexing could be as much as 70% or 75% of the market and it wouldn't be a problem."

And that "catastrophe" Bogle was talking about might not actually align with everyone's definition of the term.

"The impact would be on active managers, mediocre active managers would go out of business and you'd be left with true high conviction active managers that could actually deliver out-performance," Davies says.

Davies estimates that passive investing as a whole globally only represents about 15% of the total market.

In some regions where indexing has proved popular it may be as high as 25%. And, ETFs on their own, only represent 10% of the assets invested in global mutual funds so there's still plenty of room to grow.

Bogle's vision of a world where only the worthy active managers survive is still a while away.

Holden too doesn't buy Burry's theory.

While Burry's spectacular foresight into the sub-prime loans that sparked the GFC will go down in history, his new big short is up against some serious intellectual heft.

Holden points to two Nobel Prize winners - Eugene Fama and Richard Thaler - as staring down Burry from the pro-passive corner.

Fama is best known for his efficient-markets hypothesis and is sometimes referred to as the "father of modern finance".

Thaler won the Nobel Prize for his contribution to behavioural economics and is a proponent of the idea that humans do not behave rationally.

"So from the rational view and the behavioural economics view, both agree that if you're an investor and you're investing in stocks the best thing you can do is buy the index," Holden says.

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07:
Sam Morris
senior investment partner
Fidante

08:
Jonathan Shead
head of investments Australia
State Street Global Advisors

09:
Andrew Moore
chief executive
Spaceship

"Once you get into picking individual stocks, why are you any better than anybody else? Whatever end of the spectrum you come from, you're going to do worse."

And as for the theory that a bubble is being created as people are swayed to the passive way of doing things, Holden points out an increase in indexing only creates an opportunity for active managers to make money.

"The suggestion from Burry and others is that it creates lazy money, which doesn't hold companies to account," he says.

"You don't need the entire market to be active in order to get pricing discipline. You can have a big chunk of the market buying the index but there will always be some active investors out there."

Holden agrees with Bogle's theory, that when indexing becomes the overwhelmingly popular strategy it will be showtime for the active investors with real conviction.

That opportunity to make money as an active manager would in itself guarantee that active managers would continue to exist, no matter how big indexing through products like ETFs became.

Holden refers to this as a kind of self-correcting mechanism that he thinks would make it impossible for a bubble to form.

And, Pinnacle head of listed product Chris Meyer points out the $60 billion in ETFs in Australia represents around 7% of the retail managed fund industry's funds under management, compared to ETFs representing approximately 10% of managed funds FUM in Canada and 21% in the US.

"The question is more whether the size of the assets in ETFs is now causing a bubble in certain asset classes and stocks as these ETFs blindly follow share and bond prices higher and lower as markets rally and fall without any recognition of valuation or fundamentals," Meyer says.

"I disagree with this. Actively managed FUM in the US, which has the largest passive market, is still greater than 50% of total FUM. In other markets like Australia, this figure is much higher than 50%. I don't think the tail is wagging the dog."

That doesn't mean assets haven't reached something like bubble levels, he says.

"What's caused asset prices to reach 'bubble' levels is low interest rates, QE and general complacency about risk, not ETFs buying those assets," he says.

"All of this clearly changed in March with the reappraisal of risk off the back of COVID which saw asset prices fall, not as a result of ETFs selling."

Sparksagrees with Meyers that proponents of Burry's theory are accusing the tail of wagging the dog.

He points out the total market cap of the Australian stock market is about $1.7 trillion but ETF assets in Australia only make up about $60 billion.

"There is no bubble with ETFs. Historical bubbles invariably involve leverage. Leveraged ETFs make up a very small percentage of total ETF assets – about 1.5%," Sparks says.

"If you couple this with the fact that the early adopters of ETFs were SMSF investors who are long-term, buy-and-hold investors, then active management's argument for an ETF bubble is a very weak one."

Beyond 2020

SPDR launched some of the largest ETFs in the world in 1993; they've weathered the tech wreck, the GFC, the smaller sell off in 2018 and now the COVID-19 chaos.

State Street Global Advisors head of investments, Australia Jonathan Shead[08] knows ETFs will weather these interesting times just as they have others.

"It's not unusual to see ETFs increase in popularity in times of market volatility," Shead says.

"ETFs were around in 2008 and they weathered the financial crisis extremely well."

As for what is next for ETFs, Shead says State Street is seeing a clear theme from its institutionall clients such as super funds - ESG.

"I think we may see growth in ETFs with an ESG flavour or filter. We are a manager for large institutions and that's based on the trends we've been seeing in the institutional market," he says.

BetaShares is observing a similar effect.

"Our Global Sustainability Leaders ETF, and the Australian Sustainability ETF have both seen a significant level of interest from Australian investors," Vynokur says.

"In 2019, we saw around $150 million in inflows into ETHI, and around $180 million into FAIR. Combined, our ethical ETF suite now exceeds $1 billion in AUM."

These ESG ETF offerings are transparent and have a clear set of ESG screens in place.

And it's likely ETF providers will have to continue to cater to the needs of super funds, at least according to Spaceship chief executive Andrew Moore[09].

Spaceship offers two investment options that invest across a number of asset classes largely through ETFs, but also through managed funds.

Its investment strategy is part of the startup super funds' sell to young potential members.

"Much of Spaceship Super's funds under management has come from millennials, who have responded positively to Spaceship's simple and engaging way of investing," Moore says.

"We believe younger Australians have traditionally been disconnected from investing and there is untapped demand for simple and engaging investment products that are different to those designed for our parents and grandparents."

What's caused asset prices to reach 'bubble' levels is low interest rates, QE and general complacency about risk, not ETFs buying those assets.
Chris Meyer

Spaceship only launched in 2017 and has already captured $250 million in funds under management.

For Davies, a natural progression for ETFs exists already.

More active strategies, he says, are bound to be bundled up into an ETF wrapper.

"I think that if everything pans out as active managers want it to then more and more active funds will become ETFs but the true passive ETFs will still grow as well," he says.

As far as BetaShares is concerned, Vynokur says: "Looking forward to the next decade, we believe that asset allocation, liquidity, transparency and risk management will remain key areas of focus for Australian advisers and end investors. In that context, ETFs have a bright future."

Mullins sees how COVID-19 has impacted her clients, not necessarily financially but in terms of how they see the world.

"I think Australia will come out much better than any other countries because of the massive stimulus package," she says.

"But I think this will change how a lot of people think about risk. And ETFs might just be at the forefront of one way to diversify and to reduce that investment risk."

Meyers agrees risk will be the thing investors appreciate differently as the longest bull market in history ends its run.

But, we must also remember that ETFs have weathered many storms before.

"Bond ETFs trading below NAV and Oil ETFs trading negative have been widely publicised and have copped a bit of a black eye in the last few weeks but both have come through the 'crisis' well and the ETFs have actually shown price leadership ahead of the assets underlying those ETFs," Meyers says.

"Much like the GFC, while ETFs were 'blamed' for some of the fast price action during the selloff, ETFs actually provided liquidity and transparency to investors, more so than in the unlisted man-aged fund world, where some funds gated investors or widened their spreads to penalise redemptions.

Holden agrees that the future is bright for ETFs. Buying the index cheaply and re-investing dividends has been proven to be an investing technique that works, he says.

"Holding equities and waiting has always been a pretty good strategy and I think it will continue to be through this time," Holden says.

"People probably just don't want to look at how much they're down right now."

Through the pandemic, Mullins has connected with her clients in a different way and is glad to see her clients getting a whole new financial education.

One of the things she's found herself discussing at length is a healthcare ETF that her clients are particularly delighted to learn about.

A healthcare ETF doing well at the moment; a positive for everyone. **FS**

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