



ETF Outlook 2010

Our panelists discuss how the financial crisis has impacted ETFs and what they expect going forward. **BY MATT HOUGAN**

ETFs HAVE GONE MAINSTREAM.

That's the only conclusion you can reach as you survey the ETF landscape at the end of 2009. Just consider some of the large financial companies that have moved into the space over the past 12 months: Charles Schwab, BlackRock, Jefferies ... the list goes on.

Consider also the growth: Global assets in ETFs topped \$1 trillion for the first time ever in 2009, and U.S. ETFs are on pace to gather more than \$100 billion in net inflows for the year.

Of course, 2009 was not without its growing pains. Leveraged and inverse ETFs came under intense scrutiny from regulators and investors, many of whom did not fully understand how they are designed to operate. Commodity ETFs were blamed (in part) for increasing the volatility in some commodity markets. And, as of September, 2009 was on pace to set a record for the largest number of ETF closures in a single year.

These challenges, however, were overwhelmed by the larger trend: Investors and financial advisers, chastened by the fallout of the credit crisis, embraced ETFs for their liquidity, transparency and (for the most part) simplicity. Investors seemed particularly fond of commodity and fixed-income products, with the largest asset flows heading into ETFs offering protection from inflation, such as gold and TIPS. In many cases, ETFs offer the only practical way to access these markets.

As we move into 2010, the outlook for ETFs is strong. Many of

the "next-generation drivers" of ETFs that have been discussed for years have finally arrived, including actively managed ETFs, ETFs in 401(k)s and hedge fund replication products. And according to a survey by Cerulli Associates, ETFs are the No. 1 product advisers intend to use more in their portfolios in the years to come.

We think the reason for this is simple: ETFs are fundamentally changing the way investors and advisers approach the market.

In the past, the job of most advisers was to find active fund managers who could generate excess returns for their clients. Today, the best and most forward-thinking advisers are taking on that "alpha challenge" themselves: using ETFs to create strategic and tactical asset allocation strategies that can give investors the results they need. Given the low costs and broad coverage ETFs afford, it's a better model for everyone involved.

ETFs are one of the fastest-growing products in financial services for one reason: They are, for most investors, a better mousetrap than mutual funds. They offer lower costs, higher tax efficiency, better transparency and intraday liquidity. As long as those facts remain true, their growth will continue.

In anticipation of the Inside ETFs 2010 Conference, we've surveyed some of the leading thinkers in the ETF space to get their feedback on what trends investors should look for in 2010. Their thoughts should help all investors as they look to position clients for the days to come.

Gus Sauter, CIO, Vanguard

IndexUniverse (IU): What do you see as the most important development or event in the ETF industry in the last 12 months?

Gus Sauter (Sauter): The most important development—but not necessarily a positive one—is the proliferation of ETF products. There has simply been a tidal wave of new ETFs following a variety of strategies, from traditional active to leveraged and short. And there are more new entrants waiting on the sidelines. Today, nearly 800 ETFs are traded and more than 500 are in registration. The advantages of choice, innovation and competition are compelling, but flooding the marketplace with ETFs following niche markets or implementing risky strategies is not a good development for investors and, thus, not a good one for the industry as a whole.

IU: Now that the events of the market crisis of 2008 have largely shaken out, what kind of effect did it have on the ETF industry? Was it a positive or negative end result?

Sauter: The most recent bear market, like the one at the beginning of the decade, once again reinforced the advantages of indexing, as a majority of active managers under-performed. Investors have increasingly embraced indexing, and this has fueled the continued growth and acceptance of ETFs in the face of one of the worst periods in financial market history. In 2008, investors entrusted a record \$175 billion of net cash flow to ETFs, which is astounding given the economic and financial environment. We also find it encouraging that ETFs are increasingly being used by financial advisers as “building blocks” to assemble balanced, long-term investment programs. In other words, ETFs are not the trading vehicles that they are sometimes purported to be.

IU: What do you think investors should expect to see with regard to the ETF industry over the next year? Next five years?

Sauter: The outlook both near term and long term is rosy for ETFs. There will be continued growth in assets under management and number of products available to investors. There will likely be new ETF sponsors, but also some consolidation among existing sponsors. We do believe as the marketplace becomes more crowded and noisy, an ETF will need a distinguishing characteristic (or two) to be successful—whether it's low cost, broad diversification, a recognized brand name, healthy trading volume or a long history of tracking its underlying benchmark.

IU: What is driving the growth of the industry, from your perspective?

Sauter: Vanguard sees a tremendous amount of interest in ETFs from financial advisers who are employing broad-based ETFs to build sound, balanced portfolios for their clients. The underlying story, however, is the increasing popularity of the index approach, which is winning converts with financial intermediaries who tra-



Gus Sauter

ditionally favored individual stocks, separate accounts and actively managed mutual funds. And ETFs offer an accessible and flexible way for this constituency to index.

IU: Are retail investors becoming more or less important to the industry's growth?

Sauter: Institutions remain the power user of ETFs. However, the individual investor—primarily through a financial adviser—is definitely contributing to the industry's rapid growth. We see only modest, but growing, interest from retail investors buying ETFs directly from us.

IU: How have adviser attitudes toward ETFs shifted in the last couple of years? Do you expect them to evolve further?

Sauter: Advisers will continue to embrace ETFs because of the merits of the product—low cost, transparency, diversification, flexibility and administrative ease, among other things. That said, we believe advisers and other financial intermediaries will be more discerning in the products they buy and from whom. As with traditional mutual funds, expenses will become a more important evaluation factor for investors and will ultimately dictate whether a particular product will provide value and be viable over the long term. Low-cost products will win, in other words.



Michael Latham

Michael Latham, Co-CEO, iShares

IU: What do you see as the most important development or event in the ETF industry in the last 12 months?

Michael Latham (Latham): The use of ETFs has dramatically increased in the past year. They have provided a multitude of benefits to the investing world—diversification, access to hard-to-reach markets, trading flexibility and cost-effectiveness—but

perhaps two of their most underrated features became highly valued: ETFs provide liquidity and transparency when investors most need it during dislocated markets, particularly in fixed income. ETFs once again came through a period of stress and performed exceptionally, as expected.

IU: Now that the events of the market crisis of 2008 have largely shaken out, what kind of effect did it have on the ETF industry? Was it a positive or negative end result?

Latham: It was positive because people understand liquidity risk much better than they did before; they understand why transparency is important. These are ETF features that we have been educating people on for the past 10 years, and they came to the forefront last year. That's going to continue to help ETFs grow over the next few years.

IU: What do you think investors should expect to see with regard to the ETF industry over the next year? Next five years?

Latham: I think the ETF market is likely to double or triple in size over the next four to five years. The trend of ETFs in 401(k)s is going to take off now that the operational obstacles have been overcome. On the product side, there will be more fixed-income iShares to address the growing need for more fixed-income exposure of an aging population and the need for more price-transparent, liquid solutions in the fixed-income market.

ETFs are also going to continue to grow rapidly overseas. Europe had the best year ever last year. Latin America and Asia are also showing really good signs of significant growth.

IU: What is driving the growth of the industry, from your perspective?

Latham: More financial advisers will use ETFs due to the pressure on them to be fiduciaries for clients and the need for more transparency on fees. We are also seeing more opportunities for iShares to be used in multiple delivery platforms where aspects of the benefits of the product are appealing.

IU: Are retail investors becoming more or less important to the industry's growth?

Latham: I expect that the importance of retail investors essentially remains the same, except in the 401(k) area, where they could pressure and influence their employers to start offering ETFs in their plans.

IU: How have adviser attitudes toward ETFs shifted in the last couple of years? Do you expect them to evolve further?

Latham: Advisers have increasingly recognized the value of ETFs as core building blocks of client portfolios and as alternatives to single-stock investments. Most recently there's the growing understanding that "passive" ETFs can be used actively to generate positive returns. Partly due to events of the last year, advisers also have a higher expectation for the services that an ETF sponsor can provide, particularly during periods of market volatility.

Michael Sapir, chairman and CEO, Profunds Group

IU: What do you see as the most important development or event in the ETF industry in the last 12 months?

Michael Sapir (Sapir): After years of anticipation, a range of so-called actively managed ETFs found their way to the marketplace. While many thought this would be a transforming time for the ETF industry, so far it has been virtually a nonevent. These funds have had limited traction gathering assets. For actively managed ETFs to succeed, they are going to have to demonstrate their unique selling proposition. Why accessing active management through an ETF can be superior to accessing it through other methods like mutual funds is a question that their sponsors are going to need to clearly answer



Michael Sapir

for such funds to gain critical mass and come into their own.

IU: Now that the events of the market crisis of 2008 have largely shaken out, what kind of effect did it have on the ETF industry? Was it a positive or negative end result?

Sapir: At points before the crisis, some talked about ETFs as if they were virtually the perfect investment vehicle for all investors for all purposes. The crisis highlighted that ETFs are not immune from systemic market forces and are not flawless. In most cases, ETFs are a vehicle for investors to obtain exposure to a part of the market—and for many investors, they can be a superior delivery vehicle for that purpose. But with market exposure comes not only the potential for return but also the potential for losses and the risks associated with that part of the market. Since almost all parts of the market fell during the crisis—in many cases precipitously—so did the value of ETFs that focus on those parts of the markets.

Also, while the ETF structure largely held up well, ETFs showed that they are not necessarily the perfect product structure—not that anything is. For instance, during the extreme market turmoil of the crisis, trading spreads widened on some ETFs. So did tracking error on some ETFs.

At the same time, the past year underscored the value of the liquidity and transparency and the potential for diversification that ETFs can provide. As new developments during the crisis were rapidly changing the investment environment, having the ability to buy or sell intraday and knowing what they owned proved immeasurably valuable for many investors.

IU: What do you think investors should expect to see with regard to the ETF industry over the next year? Next five years?

Sapir: On the product side, I believe that the ETF industry will continue to be in the forefront of innovation. ETFs that simply track the well-known, broad-market indexes—the basic tools, like hammers and flathead screwdrivers—have been on the shelf for a while. That's not where new products are coming from and will come from. Recent ETFs that have been introduced fill out the toolbox; they are more innovative and narrower tools for specific tasks. For example, this year, we've seen an ETF designed to replicate certain options strategies. Also, this year, ProShares launched the first 130/30 equity index ETF. I expect more of these innovative ETFs, and that will continue to fuel product growth in the ETF industry.

Nevertheless, as the ETF industry matures, I believe the pace of product introduction will slow. While it may become easier to come out with new products from a regulatory standpoint if a generic rule is promulgated by the SEC, there will be fewer opportunities to introduce an ETF that affords its sponsor first-mover advantage, an important element to product success. Many ETFs have been introduced this decade so they could be the first of their type in the market, and a number of those products have not gotten—and may not get—to critical mass. As a result, you may start to see the pace of ETF product closures swell, a trend that we may have started to see some indications of with recent closings.

Finally, there are some metrics and trends that would suggest that that the ETF business may end up being dominated by a handful of sponsors—maybe five or six. This phenomenon would be consistent with the history of some other industries that required scale and that had products that weren't easy to differentiate. The large sponsors would likely be those who experienced success and gathered assets relatively early. The remainder of the business will likely be shared among a large number of small, specialty firms.

IU: What is driving the growth of the industry, from your perspective?

Sapir: I believe some of the key features of ETFs are what will continue to drive investor interest and demand. The recent market turmoil has served as a stark reminder to investors of the value of liquidity and transparency. More investors also are coming to the conclusion that being invested in the right segment of the market is more important than selecting specific securities. ETFs can be an ideal product to gain exposure in segments of the market.

And while many ETF sponsors aspire for their funds to be held for the long term by their investor bases, most data would suggest that ETFs are being used mostly as a tactical, shorter-term investment. ETFs are ideal tools for that type of approach. With market declines eliminating a decade of returns, many investors are rethinking the “set it and forget it” mindset that many were advocating in the past decade. It appears that investors may be shifting toward a more tactical approach to their portfolios and a more dynamic, short-horizon investment view. This would be a trend that would help fuel continued growth of the industry.

IU: Are retail investors becoming more or less important to the industry's growth?

Sapir: There are some who are of the view that ETFs have transformed into primarily a retail product. I disagree. In the early history of ETFs, the prominent users were clearly institutions, and current statistics indicate they continue to be a large percentage of ETF holders. Retail investors have started to use ETFs to a greater degree, and retail use will continue to grow.

But a shift in use from other vehicles such as mutual funds to ETFs—if it occurs—will be gradual, not dramatic. The large-scale adoption of new technology—and I think ETFs are new technology—even if it is superior technology, can take time.

IU: How have adviser attitudes toward ETFs shifted in the last couple of years? Do you expect them to evolve further?

Sapir: Acceptance of ETFs is getting stronger among financial advisers. In fact, advisers say ETFs are the top product that they intend to use more frequently in coming periods, according to a recent Cerulli study. I believe one key trend that will help fuel adviser adoption of ETFs is the increasing use of core-satellite portfolio structure: ETFs are ideally suited to fit into both the core and the satellite portions of a portfolio.

The tax efficiencies and low cost of vanilla ETFs make them ideal as core holdings for the basic asset allocation part of a port-

folio. More specialized ETFs—such as those that track narrow segments of the market, leveraged and inverse ETFs and ETFs with specialized investment strategies—are ideal to implement more tactical strategies, or the “satellite” parts of a portfolio. As mentioned earlier, as ETFs continue down the adoption curve, advisers are getting more comfortable using this newer technology as part of their everyday portfolios.



Mariana Bush

Mariana Bush, senior analyst, Wells Fargo Advisors

IU: What do you see as the most important development or event in the ETF industry in the last 12 months?

Mariana Bush (Bush): I think that, in hindsight, in the last 12 months, the market meltdown helped ETFs tremendously. It made investors realize the importance of certain characteristics, like transparency and

liquidity—they knew exactly what they were getting, as opposed to investments in a hedge fund—and the fact that active management did not necessarily outperform the indexes. This re-emphasized some of the strengths of ETFs.

On the negative side, I think it also highlighted some weaknesses of ETFs. We saw wider premiums and discounts that we were not really used to. Pre-meltdown, premiums and discounts used to be so tiny that few people would focus on them, but now it's something that, every once in a while, with certain funds, it's worthwhile just checking and asking, “Where are we?” The market meltdown highlighted some risks that had not really been evident before.

On the ETN side, credit risk also became more obvious.

IU: Now that the events of the market crisis of 2008 have largely shaken out, what kind of effect did it have on the ETF industry? Was it a positive or negative end result?

Bush: I would say it was fairly positive—even though some of these weaknesses surfaced, the balance still favored ETFs.

IU: What do you think investors should expect to see with regard to the ETF industry over the next year? Next five years?

Bush: Over the next year, I would say more growth. Probably more asset classes—and ETF sponsors are much more creative than I could ever be in coming up with new exposures. Since we already have seen a lot of the “exposure” ETFs—to a sector, to a country, to a theme, you name it—what I suspect we are going to see more of in the future is more strategies. And we've already started seeing some of those strategies. The leveraged ETFs—those could be considered a strategy. Others include the rotation strategies—industries, sectors, countries—and even the equal-weighted products, such as the equal sector weight ETF; I think you could consider that a strategy. I think we'll also get more long/short strategies. In general, we're going to see the industry launching more hedge-fund-type ETFs.

In the next five years, I would expect that we will see more

happening with 401(k)s. I understand that there is already some 401(k) work going on, but I think it could increase substantially. From what I understand, that is what really helped mutual funds to take off; so just imagine if you had an option to use ETFs instead of open-end funds.

IU: What is driving the growth of the industry, from your perspective?

Bush: My guess is very simple: 1) the natural characteristics of ETFs—the flexible trading, the tax efficiency, the transparency, the low cost, which always helps performance. I think just the nature or the pure characteristics of the instrument; and 2) there is this trend toward fee-based from a financial adviser's point of view as opposed to more commission-based. I think that's going to help ETFs as well.

“This industry is exploding due to three simple things: liquidity, transparency and diversification.” —Kim Arthur, Main Management

IU: Are retail investors becoming more or less important to the industry's growth?

Bush: I would say more. People I meet—typical retail investors—know about mutual funds but not necessarily about ETFs, and that is what makes me think that there's still so much room for ETFs to grow. I think as they become more familiar with ETFs, they will be asking for them more.

IU: How have adviser attitudes toward ETFs shifted in the last couple of years? Do you expect them to evolve further?

Bush: I think they're becoming familiar with them, more comfortable with them, and they're using them more. They're more open to ETFs and willing to use them.

**Kim Arthur, CEO,
Main Management**

IU: What do you see as the most important development or event in the ETF industry in the last 12 months?

Kim Arthur (Arthur): The crash of fourth quarter 2008/first quarter 2009 was a seminal event for the ETF industry. At the beginning of 2008, managers had moved so far out on the risk curve that they actually believed that alternatives were zero betas and you could borrow money to put on that exposure and not increase your risk profile. We all know what happened. These zero-beta investments became 100 percent correlated to the market and lost money. With ETFs, the transparency allows you to know what you own at all times. There were no gates [barriers to redemption] put up with ETF strategies, and no unintended capital gains distributed.

IU: Now that the events of the market crisis of 2008 have largely shaken out, what kind of effect did it have on the ETF industry?

Was it a positive or negative end result?

Arthur: It was a very positive impact. There were \$180 billion of outflows from mutual funds and \$180 billion of inflows into ETFs. BlackRock's purchase of BGI is a ringing endorsement of the future growth of ETFs: [Larry Fink, BlackRock's founder and CEO,] has an enviable record of being ahead of the pack and creating enormous value for his shareholders.

IU: What do you think investors should expect to see with regard to the ETF industry over the next year? Next five years?

Arthur: ETFs will continue to gain market share against mutual funds, alternatives, etc. The 401(k) space is teed up to be the next battle front against the mutual fund industry. iShares has partnered with SunGard to expand the number of [third-party agreements

that provide] ETF-based 401(k) solutions to 2,000. This is big. When you couple this with professional management of ETF solutions for plans and unbundling of pricing, ETFs are poised to grow dramatically in this space.

IU: What is driving the growth of the industry, from your perspective?

Arthur: This industry is exploding due to three simple things: liquidity, transparency and diversification. As a bonus, you get low-cost and tax-aware [strategies] thrown in.

IU: Are retail investors becoming more or less important to the industry's growth?

Arthur: Retail will continue to have a major impact as mutual fund flows go into ETF solutions and as 401(k) plans open up to ETF solutions, but the institutions have the ability to hockey-stick the growth of ETFs in the near term. Five years ago, institutions were reluctant to use ETF managers because of the embedded fees and the perception that they were only beta plays. There is a growing realization that, since sector, country and style rotation has more alpha generation than individual stock selection, ETFs are a great product to help with these strategies. Additionally, the efficiencies that ETFs bring to trading are enormous. The cost to trade all names in the Russell 2000 is 13 times more expensive than the ETF. The same can be said for credit ETFs.

IU: How have adviser attitudes toward ETFs shifted in the last couple of years? Do you expect them to evolve further?

Arthur: Many advisers viewed ETF strategies as a passive strategy, as institutions did. (And similar to institutions, advisers have realized how ETFs can be used to implement alpha-generation strategies and have come to see the benefits they carry.) With over 800 products and a pipeline growing every day, however, these strategies require deep plumbing analysis and a sharp eye to avoid the pitfalls that many of the ETFs face when they are stress-tested in the real-world markets.



Kim Arthur