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Exchange Traded Funds: Institutional Investors' Friend or Foe?

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EXECUTIVE SUMMARY

* Historically, institutional investors (e.g. pension funds, endowments, defined contribution plans etc.) have not allocated large portions of their portfolios to exchange traded funds
* The U.S. ETF market now offers more than 1,500 products, which have approximately $1.7 trillion in AUM
* There are key differences between ETFs and mutual funds, including tax treatment, liquidity and tradability
* There are a number of considerations that should be studied before making an investment in an ETF including, but not limited to, fees, product design, underlying exposures and fiscal health of the ETF sponsor
* There are situations in which ETFs should be at least considered by institutional investors

Introduction

Exchange traded funds (ETFs) have been around for more than two decades, but adoption by institutional investors (defined as pensions, endowments, insurance general accounts, defined contribution plans, etc.) has been modest. A recent study by Greenwich Associates notes that only 16% of corporate pensions had an exposure to ETFs in 2013. For long-term investors whose decision-making timeframe is more likely measured in months than minutes, the "all day tradability" of ETFs that has been widely advertised is not likely to be a significant draw. Although the speed of execution offered by ETFs may not benefit many institutions, there are other characteristics of ETFs which we believe warrant further examination. The balance of this paper provides an overview of the ETF market and seeks to identify ways in which institutional investors might make use of these products.

Overview of ETF Market

The first ETF launched, the SPDR S&P 500, was introduced in 1993 and today is one of the world's most liquid securities. While asset growth and product development were slow for much of the next decade, the most recent 10 years have seen explosive growth in both assets under management and products available. Currently, there are over 1,500 ETFs listed on U.S. exchanges with an estimated 1,000 more in registration. Total U.S. ETF assets as of September 30, 2014 were approximately $1.7 trillion, with much of the growth coming in the years following the global financial crisis[1]. Although today's assets pale in comparison to the more than $15 trillion invested in traditional U.S. mutual funds, some pundits expect ETF assets to eclipse mutual fund assets over the next decade. Unlike the mutual fund market, the ETF universe primarily consists of passively managed strategies[2]. Given the passive approach of many ETFs, expense ratios for ETFs are generally competitive relative to other passively

1 At the end of 2008, there were 728 ETFs with total AUM of just $496 billion.

2 Recent estimates show than 98% of ETF assets were in passively managed products.

managed institutional vehicles. Passive public market equity exposures across market capitalizations, regions and sectors in ETFs are generally available for less than 10 basis points. Costs for broad market fixed income ETF exposures, while more expensive than equity offerings, are still reasonable in absolute terms. As an example of the fee reasonableness, the Vanguard Total Bond Market ETF (ticker: BND) has an expense ratio of 8 basis points while the iShares High Yield Corporate bond ETF (ticker: HYG) has an expense ratio of 50 basis points.

A primary difference between mutual funds and ETFs is greater tax efficiency afforded by ETFs. ETFs are securities which are bought or sold on the secondary market which typically eliminates the need for any sale of securities within the ETF structure. In contrast redemptions from a mutual fund typically triggers the sale of securities within the mutual fund portfolio which in turn can result in capital gains distributions to all shareholders of a mutual fund. ETFs, on the other hand, rarely, if ever, distribute capital gains to shareholders. It should be noted that many intuitional investors (namely pensions and endowments) have a tax-exempt status, thereby reducing the importance of the aforementioned ETF tax benefit. The table below highlights some additional differences and similarities between ETFs and mutual funds.

Figure 1: Comparison of ETFs and Mutual Funds

	Exchange Traded Funds	Mutual Funds
Trading	Trade on major stock exchanges; Can be bought or sold anytime during the trading day	Can be bought or sold only once per day, after markets close
Pricing	Prices will fluctuate throughout the day just like stocks	Priced once a day after the markets close
Transaction Costs	Bid-Ask Spread	Purchase/Redemption Fees
Minimum Investment Amounts	None	Varies by mutual fund; can be high in some cases
Active or Passive Management?	Primarily passive	Both
Transparency	Generally disclose holdings daily	Generally disclose holdings quarterly

Source: Vanguard; BlackRock

Aside from fee comparisons and the lack of tax benefits, there are additional hurdles for plan sponsors using ETFs within defined contribution plans. For example, some industry experts believe that there is a mismatch in objectives when offering ETFs on a defined contribution platform (i.e. offering intraday trading while advocating long-term investing). Additionally, there are recordkeeping challenges when including ETFs in DC plans that few providers are able to handle.

How can institutions use ETFs?

As mentioned at the outset, institutional investors have generally not allocated large parts of their portfolios to ETFs. Admittedly, for larger institutional investors, the fees available on separate accounts or commingled vehicles are typically more favorable than the expense ratios charged by ETFs. However, ETFs can still make sense in a number of different scenarios.

One such scenario would be when investors are looking for a targeted exposure. For example, the energy renaissance taking place in the U.S. may tempt some investors to take a position in public energy stocks, or the current pro-growth government in Japan might be a reason to target Japanese equities. Less tactically, investors might want to plug existing holes in portfolios with industry specific exposures in REITs or utilities which are often overlooked industries by active equity managers.

Aside from targeted exposures, ETFs can also play a role in transitions among traditional active managers. Transitioning between investment managers for some institutions can often be a lengthy process. Many times, replacement candidates must be identified, due diligence on replacement managers needs to be pursued and committees need to meet and make a decision before a transition takes place. ETFs could be used to bridge the gap during these often time consuming manager transitions. ETFs may also be used as a long-term holding under certain circumstances. Insurance companies in particular might find ETFs attractive given that certain fixed income ETFs are National Association of Insurance Commissioners (NAIC) rated, providing more favorable capital treatment[3]. ETFs may make sense in a variety of situations as a long-term holding assuming the fees are competitive and the tracking to the underlying benchmark is acceptable. We would encourage investors looking at passively managed vehicles to consider ETFs alongside traditional mutual funds, separate accounts and commingled funds and make an informed decision based on a number of considerations including those highlighted below.

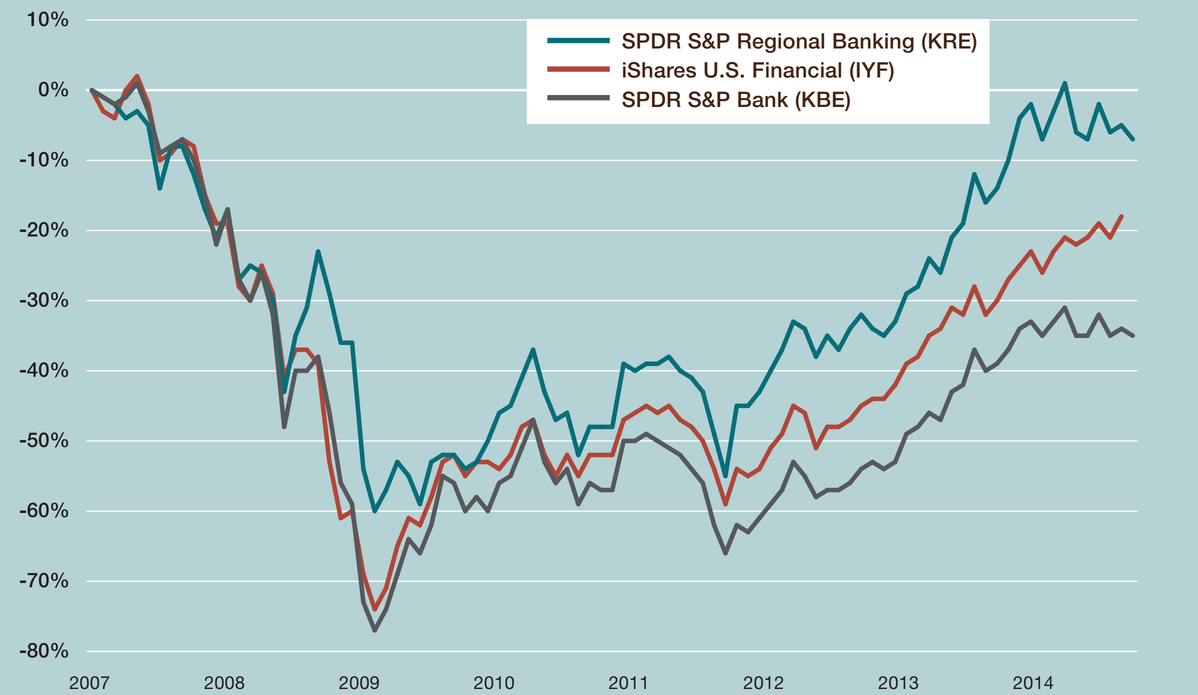
Considerations

A number of factors should be taken into account when determining if an ETF is an appropriate investment. Identifying an ETF with a suitable objective would be chief among these considerations. With 1,500+ products available to investors, there are more than a handful that are not appropriate for institutional investors with a long-term time horizon. Levered and inverse products, for example, should generally be avoided. These products use derivatives to gain exposure and the results for these ETFs may not line up with a long-term investor's time horizon[4]. While these products can serve a purpose for short-term, trading oriented investors, they are generally not appropriate for institutional investors. Knowing which benchmark the ETF is designed to track is also critical. As an example, the dispersion of returns among products designed to provide exposure to the "U.S. financials sector" has been significant (see figure below). Further, investors must be aware that the stated benchmark of an ETF may differ from broader, more commonly used indices. For example, high yield ETFs are often designed to track indexes focused on the most liquid part of the asset class (typically issues with greater than $400 million outstanding). While the ETF may achieve this objective, the performance of the liquid index may differ from the performance of the broader high yield index.

3 NAIC ratings allow insurance companies to treat some ETFs as fixed income securities. Many mutual funds receive less favorable tax treatment and are often counted as equity securities, regardless of their underlying holdings.

4 Leveraged and inverse ETFs require daily rebalancing of the underlying derivatives in order to match the rise or fall in an index on a given day. Ultimately, these products can only be counted on to perform (as promised) for a single day and not over a long time horizon.

Figure 2: Cumulative Performance of Financial Sector ETFs since 2007



Source: Bloomberg

Investors should also be mindful of an ETF's "premium/discount to net asset value (NAV)." ETFs have both an NAV (total value of the underlying securities) and a market price for the ETF itself. The market price is driven by the NAV of the ETF as well as supply and demand, just as a stock's price would fluctuate. At times, the market price may deviate from its underlying NAV, resulting in a premium or discount. Although they tend to be short lived, such deviations may be significant at times, creating significant tracking error to the target benchmark[5]. Investors should understand an ETF's relationship of price to NAV when trading the ETF. The total assets under management (AUM) and liquidity of the ETF should also be reviewed for any ETF before investing. Examining trends in AUM and average daily volumes over 30, 90 and 120 day periods are a good place to start. While secondary market volumes are helpful, there is typically additional liquidity in the primary market. Finally, the fiscal health, stability, and commitment to the ETF business of the underlying ETF sponsor are potential additional considerations.

Conclusion

There seems little doubt that exchange traded funds will be a fixture in the investment landscape for years to come. The ability to target specific market exposures and to do so in a timely manner makes ETFs worthy of consideration for certain market participants. For much of their existence, institutional investors have not made extensive use of ETFs. However, under the right scenario, investors may be able to lower costs, obtain more favorable tax treatment or, in the case of insurance companies, receive more favorable capital treatment. As with any financial product, investors should do their homework and determine if the product is the right fit for their portfolio.

5 Although premiums/discounts may exist from time to time in ETFs, they are generally short lived as there are mechanisms in place to eliminate these deviations.

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