

COMING OF AGE

Despite the perception they're simple, exchange-traded funds have quickly gained a reputation as the most important financial product in the last 25 years among advisers and institutional investors alike. Upon its 18th birthday in Australia, **Harrison Worley** writes about the coming of age of the humble ETF.





01:

Marshall Brentnall
director and financial
adviser
Evaesco Financial
Services



02:

Christian Obrist
head of iShares
Australia
BlackRock

In today's world, it seems there is nothing more difficult to achieve than consensus. With almost every topic a matter for partisan debate, asking a group of people to respond to a common piece of stimulus will typically result in a range of reactions, no matter how straightforward that stimulus might appear.

Put it to a group of Australians that the sky is blue and you're almost guaranteed to be faced with a diversity of views.

However, ask a group of experts - financial advisers, heads of investment, product providers, asset consultants and the like - about the importance of the exchange-traded fund, and you'll find a strange uniformity in their replies.

Do you agree ETFs are the most important financial product of the last 25 years?

"Absolutely yes."

"ETFs would be one of the most important financial products, and certainly the most important investment product in the last 25 years."

"Undoubtedly."

"I actually would agree with that."

"I would agree that in terms of products, and the impact they have had, ETFs are one of the most important financial products in the last 25 years."

In the 18 years since the first ETF was introduced to Australia in 2001 through Saloman Smith Barney's IndexShares 100 ETF, the local ETF market has grown to more than \$53 billion, including hitting a high of \$53.3 billion in funds under management in July 2019.

The broad narrative of ETFs in Australia is similar to other markets in the world: liquidity, transparency and lower fees have made a significant impact on the local investment landscape.

But is that the whole story?

There's always two sides

It would appear that Australia's ETF story is largely one of success.

Evaesco director and financial adviser Marshall Brentnall⁰¹ says the only thing that's made a bigger impact on the local investment market is the introduction of Australia's mandatory superannuation system in 1992.

"No other product type is used by investors, professional and personal alike, to access markets with such speed, diversity, transparency, flexibility and cost-efficiency as ETFs," Brentnall says.

But like all stories, ETFs in Australia are a tale of two sides.

On one hand, ETFs have democratised investing for smaller players.

The accessibility of investing has increased for retail investors thanks to the low cost, transparency and access to liquidity ETFs allow.

But perhaps more importantly, smaller investors no longer remain locked out of asset classes they previously couldn't access without substantially more means.

For instance, Australian retail investors looking for protection from the downside risks of their Australian equity-heavy portfolios were previously unlikely to meet the minimum denomination requirements of an international bond portfolio asking for a cool \$250,000.

As BlackRock's head of iShares for Australia Christian Obrist⁰² points out, ETFs enable exposure to markets smaller investors previously never dreamed of.

"So it's very difficult to get a diversified portfolio in bonds," Obrist points out.

"With an ETF - some of these ETF unit prices are as low as \$10 - you can have hundreds of bonds in there, you're getting that exposure. So that for me is access."

However, on the flip side, is Australia's institutional market.

Unlike in other countries, local institutional investors haven't wholly embraced the ETF or its benefits, according to Fidante general manager Nick Hamilton⁰³.

"Overseas, institutional investors have been quite active as holders of ETFs," Hamilton notes.

"But I'm not sure that is universal here."

The low-flow zone

Opinions on why Australia's institutional investors don't sit so strongly in the ETF camp are varied.

For Obrist, there's a historical perspective to consider.



We want to ensure our clients are invested in assets that they understand, aren't engineered or overly complex, and most importantly won't blow up.

Marshall Brentnall

He points out that the local ecosystem hasn't been set up to allow for the ease of trading typically ascribed to exchange-traded funds.

"What you have not had, is an ecosystem here, that was really able to buy these ETFs," Obrist says.

"So if you think of the super funds and these ever growing industry funds, five or six years ago nobody was trading any securities themselves."

Obrist says the current trend in Australia's super system to internalise funds management has seen funds set up trading desks - or "implementation desks" as he notes they're referred to as in Australia - in-house (with brokerage lines to banks and brokers) which previously weren't features of local fund operations.

"And without that, you can't even trade an ETF," he says.

"So I think there's been a structural reason why pension funds in Australia haven't had a widespread adoption of ETFs."

Be that as it may, Frontier Advisors head of sector research Paul Newfield⁰⁴ argues there are a variety of other reasons large wholesale or institutional investors shy away from ETFs, and puts forward the case that the issue of low ETF use among institutional investors isn't confined only to Australia.

He cites high level exposures, longer investing timeframes, no need for day-to-day liquidity, higher costs through ETFs and tilts as reasons why the uptake has been low at the top end of town.

While he says he doesn't believe "any of those in and of themselves prohibit ETFs from being used", Newfield notes that when taken in aggregate with one another, those reasons do create headwinds for ETFs being part of an institutional portfolio "in the main."

"ETFs are not the bread and butter of large wholesale investors, the world over," he says.

"They are utilised for some specific purposes, and I think that they will have a place in these specific areas. But I think the bread and butter of what wholesale investors do, how they operate and some of the characteristics that they have, I think mean that they'll always be on the periphery rather than in the main."

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03:
Nick Hamilton
general manager
Fidante Partners



04:
Paul Newfield
head of sector research
Frontier Advisors



05:
Duncan Burns
head of equity index
group Asia Pacific &
ETF Capital Markets
Vanguard

The benefits can be difficult to see, with Newfield pointing out some ETFs are created in an attempt to provide retail investors with “an easy replication strategy to access ideas that wholesale investors can access more directly”.

Despite Newfield’s assertion, Duncan Burns⁰⁵, head of Vanguard’s Equity Index Group Asia-Pacific and ETF Capital Markets, says institutions were early adopters of ETFs in other markets around the world, particularly the United States and Europe.

“And perhaps it started there and pushed into the smaller end of town. In Australia, it’s really been the opposite, where we started with your retail and advisory, and institutions are coming late to the game,” he says.

“It’s important to note that the nature of the institutional market here in Australia is a little different to that of the US and perhaps the UK, or Europe. Aussie institutions traditionally use SMAs to access low cost indexing.”

According to Burns, the Australian institutional market simply doesn’t have a deep pool of hedge funds - like in the US and Europe - who he believes were “probably some of those early adopters.”

Given antipodean institutional adoption of ETFs has lagged when compared with the other side of the world, Burns reckons ETFs were probably thought of as a “retail tool” for much of their 18 years down under.

VanEck managing director Asia-Pacific Arian Neiron⁰⁶ says the question has two answers: the number of institutional investors who call Australia home is far lower than elsewhere, and the smaller institutions have had “a significant bias and incumbency to active management”.

“So I think the big thing is, they’re very big, they can get passive, very, very cheap,” Neiron says.

He says that with the barriers to entry into Australia’s funds management industry - such as the cost of doing business - so high, the local market is quite expensive comparatively.

As a result, ETFs end up being more expensive for an institutional investor than simply choosing to go passive.

Of the four superannuation funds *Financial Standard* approached for this feature, only one offered commentary on the use of ETFs across their investment operations: \$57 billion industry fund Rest.

A spokesperson for the fund said only that Rest “firmly believes in the benefits of active management to protect member’s retirement savings”, and pointed out most of its equity exposure was actively managed.

In the game

Despite these issues, the experts agree Australia’s institutional investors are starting to get into the game.

“The reduction in management expense ratios, the growth in assets, the increase in the number of products, the greater understanding of the ETF ecosystem, and the underlying liquidity of ETFs has made them a more attractive proposition for insto investors,” Vanguard’s Burns says.

“And with each conversation our capital markets team here has with instos, we’re continuing to find new use cases for where ETFs can assist.”

According to Burns, Australia’s institutional players have now begun to leverage ETFs as a tool for portfolio management, which leads Vanguard to believe local institutional interest in ETFs will play a major role in the next phase of ETF growth in Australia.

Back at VanEck, Neiron says he is noticing the big end of town “buying where there is liquidity.”

Taking VanEck’s USD\$16 billion gold equity ETF GDX as an example, Neiron says local institutional players are using ETFs for liquidity management.

They want to navigate the market without moving it, he says.

“They can see the liquidity, the spread is super, super tight. There’s a host and a range of market participants doing that,” Neiron says.

“We’re seeing institutional investors in Australia buying into offshore more mature ETFs markets and a more mature range of opportunities.”

Further, he says institutional use of fixed income ETFs are on the rise, though notes take-up is still “slow”.

“We’re seeing fixed income ETFs are really offering institutional investors a platform of opportunities, as to buying directly,” Neiron points out.

With banks not able to “prop trade” or hold too much fixed income inventory after changes to capital adequacy in the wake of the GFC, Neiron says ETFs have filled the void by offering greater price discovery and exposure to fixed income assets.

“And that’s across a whole range of fixed income. It can be government bonds, senior government bonds, inflation linked bonds, emerging market bonds, corporate bonds, high yield bonds, fallen angel bonds. There’s a whole plethora of fixed income opportunities that’s really put up in the ETF’s wrapper,” he says.

Almost undisputed

Where the 18 years of ETF use in Australia appears to have excelled most is in adviser land, where clients with smaller balances have benefited from the liquidity inherent with exchange-traded funds, and the transparency of their underlying investments.

TWD head of investments Abby Macnish⁰⁷ says the impact of ETFs is clear in how clients have been enabled to invest over the last

18 years, particularly when it comes to those with balances previously considered too small to efficiently be invested in active funds and their ilk.

“If you think about products like Raiz, they wouldn’t have been able to do what they’re doing for clients with small amounts if not for the invention of ETFs,” Macnish notes.

“So it means that retail investors can start investing earlier with lower costs, so the investments aren’t being eaten up by costs.

“And they have that certainty of returns, the same as market. Obviously, they’re not going to get alpha on passive ETFs, but they will know with a high degree of certainty the outcomes.”

Macnish explains that TWD has been using ETFs for at least the last five years, and says they’ve fit well into the firm’s “advice for every Australian” ethos.

“We don’t want to turn clients away if they don’t meet a certain FUM expectation,” Macnish says.

“So what ETFs allow us to do - particularly in the domestic market - is be able to provide diversification for smaller accounts without having to buy a whole lot of small parcels of individual stocks.” You can still build a really good portfolio with great diversification using ETFs for smaller accounts, she says.

After dipping its toes into exchange-traded funds with international ETFs, Macnish says the firm has evolved its usage over time.

“For example, in international we would use an ETF to get the global 100 shares. It’s a very competitive space, it’s difficult to outperform broadly in that market because it’s very transparent,” she explains.

“And then we’ll blend them with say, an active concentrated manager, that’s only picking 25 to 45 stocks that are the best performers, and we’ll use our fee budget to pay for that alpha.

“And then we might pay an active small cap manager or active emerging markets manager where you really do want that specialist skillset that an ETF can’t provide.”

Evaesco’s Brentnall says the firm - a member of the Australian Advice Network - takes a different approach, using ETFs as part of a series of models employed by all five AAN firms.

According to Brentnall, the models allow the firms to use their “combined energies and scale” to put downward pressure on portfolio costs for clients, while “increasing transparency, oversight, efficiency and consistency of returns.”

“We want to ensure that our clients are invested in assets that they understand, aren’t engineered or overly complex, and most importantly won’t blow up,” he says.

It’s an important point to make, given the growth of levered inverse ETFs, which were actively derided by all who spoke of them to *Financial Standard*.



I think there’s been a structural reason why pension funds in Australia haven’t had a widespread adoption of ETFs.

Christian Obrist

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Arian Neiron
managing director
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07:
Abby Macnish
head of investments
TWD Australia



08:
Jenny Brown
chief executive
JBS Financial Services

“At both Evalesco and AAN our investment philosophy very much revolves around the premise of keeping things simple, and not making decisions that will risk our client’s capital,” Brentnall says.

“We understand that markets will rise and fall, however, also don’t see it as prudent to take unnecessary risks with using products that are too small or lacking in liquidity.”

Brentnall - who sits on the AAN investment committee - says the group takes an agnostic approach to the investment vehicles it uses, though notes the decision becomes clearer when the “key drivers” - cost, liquidity, transparency and efficiency” are taken into account.

“Across the models that we have built and administered by Praemium, we have ETFs in our models that provide our clients with access to cash, fixed income, property securities and equities, and use passive and smart beta driven approaches,” he says.

Brentnall notes the use of ETFs on older platforms however is “cumbersome, more expensive and not scalable”.

The only spokesperson who chose not to wholly commit to agreeing that ETFs were the most important financial product of the last 25 years, JBS Financial Services founder, chief executive and head of strategy Jenny Brown⁰⁸, says the disruptive impact of ETFs lies in their ability to match the index for fees much lower than active managers who often don’t beat the benchmark.

“With so many active fund managers at best matching the index, to get a low cost index ETF can add significant value to a portfolio,” Brown says.

Brown says she’s used ETFs for around 10 years “in one form or another”, first putting them to work to provide exposure to the broader indexes depending on where the firm and its clients wanted exposure.

Now, Brown uses ETFs to gain exposure to international markets where obstacles like a lack of research and lower cost-effectiveness than the Australian market, prohibit her from investing in direct shares.

In the local market Brown says ETFs complement direct share holdings and form an “integral part” of her clients’ portfolios.

Being active

Fidante’s Hamilton says it’s prudent to acknowledge that the ETF is still only a structure, and that what is inside the structure is crucial to the success or otherwise of any particular product offering.

“The ETF is a wrapper, it is a structure,” Hamilton points out.

“What is inside that structure is the most important thing, the underlying investments that you’re accessing. And that it is provided within a regulated environment, where there is higher degrees of transparency, I think that is a positive for investors.”

While what’s inside many ETFs can be similar, Hamilton’s most recent accomplishment

ASIC halts internal market making

As revealed by *Financial Standard* in July, ASIC has requested Australia’s two stock exchanges - ASX and Chi-X - no longer admit active ETFs that use internal market making as ASIC reviews these arrangements.

While most of Australia’s \$53 billion ETF market is made up of passive ETFs, actively managed ETFs have grown to more than \$3 billion.

ETF issuers are required to engage a market maker to buy and sell securities as investors move in and out of the fund. For a market maker to meet its function, the ETF issuer must disclose its portfolio holdings to the market to ensure all participants are treated fairly.

This poses a problem for managers of active ETFs, who would prefer not to disclose the intellectual property of their investment strategy to the market, which could include competitors.

In an effort to deal with this issue, active managers had begun using an internal market making model, which saw them act as the market maker through an access provider so as to not disclose portfolio holdings daily.

Fidante’s Nick Hamilton shared his insights on how external and internal market making work.

The business was happy to use external market making for its first active ETF, since it used fixed income products and disclosing the underlying holdings was not an issue.

“That obviously is consistent with the market making model for passive,” Hamilton noted.

Recently, the US Securities and Exchange Commission allowed ETF provider Precidian Investments to limit the market disclosure of its ETFs by disclosing its underlying portfolios to limited participants but not the broader market.

“Now what we’ve seen recently in developments in the US – and I think this will presumably play into ASIC’s thinking – is active managers being able to use ETF structures that have a limited market disclosure,” Hamilton said.

“That would give an additional level of transparency.”



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Jenny Brown

- Fidante’s ActiveX series of ETFs - are different, because Fidante’s boutiques fill that overarching structure with their active management expertise.

After developing a strong following among its investment boutiques, Hamilton says Fidante saw the lack of active products in the market after observing changes underway in both the advice and broker landscapes.

“There was the mFunds program, but that wasn’t ubiquitous for most investors - a lot of investors couldn’t access mFunds - and the active ETF is an instrument that all investors who have a share trading account can access,” Hamilton says.

After launching the series with its Ardea Real Outcome Bond Fund in December last year, Fidante is preparing for the take-off of another fixed income active ETF, the Kapstream Absolute Return Income Fund, which Hamilton says is not too far away.

Launching its active ETF series with fixed income was a decision made in part because of a limited product choice addressing Australian investors’ “strong demand” for defensive income, according to the Fidante general manager.

“In our business we have some very well regarded, highly rated and used managers, who have some exceptional product,” Hamilton notes.

“So that’s why we made the decision to launch first with fixed income. Obviously with Ardea as our first one, and we’ve got Kapstream coming very shortly.”

Hamilton is hoping investors see the series as a solution to the problem of low rates of return in products like term deposits.

“Accepting you’re taking more risk in an ETF than a bank deposit, but investors are looking for cash plus type returns,” he says.

As for whether ETFs are the most important financial product of the last 25 years, Hamilton is balanced but agrees, and reiterates his point that while the ETF is fundamentally little more than a structure, the combination of its benefits and the regulated environment it sits in ensure investors can access diverse opportunities with the protection afforded by regulated surroundings.

“I think in financial services whenever there’s problems and people end up in strategies or structures that don’t suit them, a lot of them are always preposterous, and they’re off-market, making grand claims,” he says.

“And I think that what the ETF structure allows - you can still get into trouble buying the wrong thing - but because it’s sitting inside quite a heavily regulated environment, I think that does lend quite a lot of protection for the consumer.

“I’m happy to say as a product wrapper, I think it has done some pretty amazing things for investors over this last 25 years. So I think for balance, I’m happy to sit in the yes camp.” **FS**



01:
Sam Morris
investment
specialist
Fidante Partners/
ActiveX

More money, more problems

The lyrics of an iconic rap song deftly describes the main challenges that financial advisers face when designing investment solutions for their clients.

When the Notorious B.I.G wrote his seminal hit, “Mo Money, Mo Problems,” I’ll bet he never thought he’d be referenced in an article about investment asset allocation.

But the chorus of his lyrics “*I don’t know what they want from me. It’s like the more money we come across, the more problems we see*” just about sums up the central problem facing advisers grappling with how to put clients’ money to work today. Let me explain.

The price of money, being interest rates, quite simply is at record lows because the supply of capital exceeds the demand for it.

The economist William J. Bernstein wrote in 2004, very presciently five years before the GFC and the onset of quantitative easing, that “*Make no mistake about it: over the past several thousand years, the cost of capital, and with it, investment returns, have been falling.*” He goes onto to explain that this has been caused by two key factors.

Firstly, investment frictions have been “*ruthlessly decreased*” - money can be moved around the world in a few mouse clicks - thus reducing investment returns that come about from asymmetry of information.

But the bigger driver is that there is simply too much excess savings in the world. Quoting from Bernstein, “*... as societies grow their per capita GDPs beyond the subsistence level, the supply/demand equation shifts in favour of capital’s consumers.*”

The Amsterdam Stock Exchange, founded in 1602 to facilitate trading shares of the Dutch East India Company, frequently delivered investors dividend yields of 40% or more. Sensible risk pricing when prevailing Dutch

government bonds yielded about 4% and life expectancy was about 40.

We are in uncharted waters, much like those early Dutch sailors - but at least then equity risk premium was adequate compensation!

Today governments, mortgagees and corporations in some parts of Europe and Asia are paid by the lenders to borrow money and depositors pay banks to lend them money (huh?) Companies like WeWork, which sub-leases expensive desk space to ‘co-workers’ with free beer, can arbitrage a tech company valuation over a leveraged commercial real estate business model at negative operating margins funded extensively by a repressive government who only recently deemed it acceptable for women to drive.

In short, excess capital knows no boundaries and ‘auto-pilot’ money crashes into crazy valuations at rates we haven’t seen since 1999 and 2007.

But back to the ‘mouse clicks’ problem and what to tell your clients. When Jack Bogle, founder of Vanguard, was offered the opportunity to list the first US ETF with his then revolutionary passive index fund approach, he turned this down, believing that ETFs would encourage excessive trading at the expense of sound long-term investing principals.

Yet ETFs have exploded in popularity with all investors – institutional or retail, traders or investors – by leveraging the liquidity provision, clearing and settlement infrastructure of stock exchanges to allow low-friction rebalancing, simultaneous trade price confirmation with cash-position management and embedded custody.



The quote

Never has active management been more important to purchase assets at sensible valuations with prudent risk management processes.

Stock exchanges not only facilitate trading, but they democratise data and reporting flows, which is facilitating development of a rich ecosystem of fintech to empower direct investors and advisers with more transparency and control than ever before at lower costs.

Never has active management been more important to purchase assets at sensible valuations with prudent risk management processes. Better yet, why not take advantage of the enormous distortions the ‘mouse-clicks’ create in global markets to undertake fixed income arbitrage strategies or invest in high-quality corporate bonds in a benchmark-unaware fashion, allocating to recession resistant sectors and countries that still yield positive and attractive returns above cash.

The judgment and risk control of active management and the flexibility of the exchange implementation of asset allocation decisions now co-exist in Australia with active ETFs. For the adviser looking to navigate a world of low yields, best interest duties and client demands for better user experiences with fewer cost layers, they are well worth a close look. One solution to their problems may be active ETFs. **FS**

ActiveX, issuer of the ActiveX Ardea Real Outcome Bond Fund (Managed Fund) (XARO) and the soon-to-be launched ActiveX Kapstream Absolute Return Income Fund (Managed Fund) (XKAP)

¹ Bernstein, W.J. (2004) Too Much Capital. <http://www.efficientfrontier.com/ef/adhoc/coc.htm>

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