# EXCHANGE TRADED FUNDS GET ACTIVE


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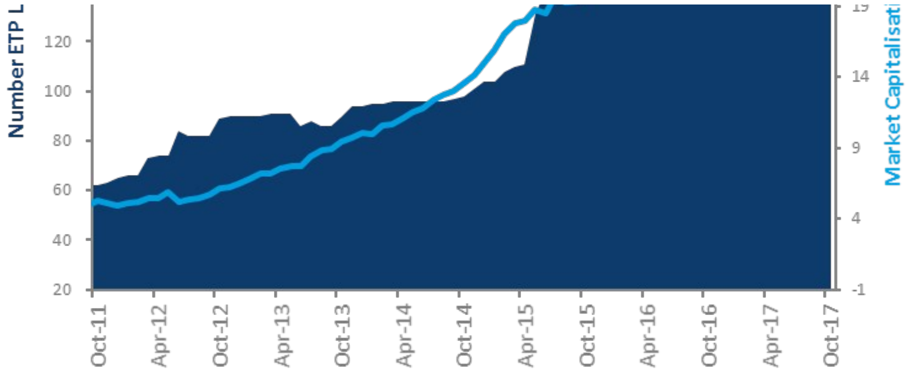
Around the world, Exchange Traded Funds (ETF) assets have enjoyed staggering growth. Their value totalled just US$417 billion in 2005 but reached US$4.4 **trillion** by 30 September 2017 – a cumulative average growth rate (CAGR) of around 21%. EY global research estimates that ETF assets have the potential to hit US$7.6 trillion within three years, which assumes a future growth rate of around 18%.

When it comes to ETF growth, Australia is certainly playing catch up. The value of Australian ETF holdings grew to an all-time high of $36.6 billion (as at January 2018).That's up from $25 billion in 2016 with market cap growth for the past 12 months of nearly 45%. Today, there are 275 Exchange Traded Products including LICs on the ASX (ETF Watch 2017). International equities are a leading category for inflows.




Source: Perpetual & ASX Fund Roundtable, November 2017

**Perpetual Corporate Trust facilitates a wide range of asset management structures for our clients – including ETMFs, LICs, LITs and mFunds. Depending on your business and distribution strategy, we can help you set up a vehicle that can help you achieve your business objectives**

**ETFs versus traditional managed funds.**

**What's changed?**

Because of our compulsory superannuation system, Australia's managed fund sector is one of the biggest in the world. Many funds are not available to direct investment by retail investors.

For many, a single brokerage account allowing buying and selling of funds with a click of a button is appealing. It's partly because of this convenience that investors, and their brokers and advisers, are looking to ETFs, and managed fund providers are meeting this demand by providing their own ETF products.

According to EY[1], overall ETFs also benefited because they provided index replication at a lower cost. Other trends that have worked in favour of ETFs are the shift to self-directed retirement saving, low yields, regulation, and digital distribution.

With such a rapid adoption of these ETF vehicles, there are some new dynamics worth noting.

**Millennials are a driver of growth**

The composition of ETF investors in Australia differs from the United States, Canada and Europe where institutional investors account for a larger share of investors. These compositional differences are partly a result of ETFs in North America and Europe being originally targeted to institutional investors, while ETFs have had more of a retail focus in the Australian market.

Although investors of all types have embraced the ETF market in recent years, millennials continue to gravitate to the sector. Millennials are attracted by the low cost, simplicity and ease of use of ETFs, as well as their ability to provide tailored exposure to investment themes that matter in their lives. Market figures appear to bear out these trends – in Australia this year, according to CommSec, millennials were responsible for 25% of all ETF trades.

**Fixed income ETF**

In the last year, in particular, there has been significant innovation in this space with rapid growth in fixed income ETFs. With interest rates at record lows, exchange traded products are giving investors vehicles to gain exposure to income securities that go beyond traditional fixed-rate exposure. The most recent innovation in Australia is the launch of floating-rate bond ETFs. Generally, in 2018, we expect to see further innovation in fixed income ETFs providing direct investors with much-needed access to lower risk, income-producing assets.

Asset allocation also differs by the type of investor: Self managed super funds (SMSFs) tend to hold more domestic equity ETFs, whereas direct investors tend to hold a greater share of international equities. Meanwhile, institutional investors are more exposed to fixed-income ETFs.

**Active ETFs are on the rise**

The next big trend in the ETF space is the rise of active management. The past year has seen many active ETF launches. These exchange-traded managed funds (ETMFs) give investors more opportunity to diversify their portfolios alongside the passive ETF investments. We expect to see active ETMFs growing in popularity in 2018. Indeed, active ETMFs have the potential to match the growth of passive ETFs.

This growing category of listed fund allows investors to allocate capital toward active managed strategies without the hassle of filling out additional paperwork and with the benefit of knowing the price at which you will be buying or selling units at the time of transaction.

Active ETMFs offer investors all the benefits of ETFs:

- low minimum investment barriers
- a cost-effective means of diversifying portfolios using a single product
- access to markets that have traditionally only been available to institutional investors
- the same ability to buy and sell as any other listed security
- pricing transparency and intra-day pricing versus at the end of day
- a single stock holding makes administration and tax reporting easy

Active ETMFs offer investors all these advantages and the specific characteristics of active management:

- expert asset allocation and stock selection in line with a defined and codified investment style
- a distinct risk-management approach. While ETFs offer wide diversification, they also force investors into assets that may be overvalued or of low quality. Active managers can help investors avoid those assets
- the ability to offer funds in areas where active management is perceived to be more effective - for example small caps and global equities.

The fund managers themselves benefit from an open-ended structure, reduced paperwork and the ability for investors to hold the fund alongside their advised products within a platform or in their broker account.

At present, there are 14 actively managed funds listed on the exchange with varying mandates, from those that focus on yield, to small caps, to international equity markets. In 2017, five new actively managed funds came to market and we see this becoming an increasingly common way for fund managers to structure their funds.

Last year, Perpetual Corporate Trust supported the launch of the Montgomery Global Equities Fund (MOGL). This fund was listed on the Australian Stock Exchange (ASX) after raising more than $54 million predominately from retail investors. Montgomery Global Investment Management Chief Operating Officer Paul Mason said: "*We believe in doing what's right for our clients. MOGL was launched as an open-ended, ASX-quoted exchange traded fund because we believe it is the cleanest, fairest and most convenient structure for our clients. Since being issued on the ASX in*

*December 2017, over the last three months the fund has grown funds under management by 30%, raising $71.6m*."

**More growing markets**

Another two sectors accessible via the ASX that have enjoyed stellar growth are Listed Investment Trusts (LITs) and Companies (LICs) and mFunds. As at October 2017, the value of LICs and LITs reached $37 billion with a growth rate of 19%. There are also 187 funds listed on the ASX through MFunds with $452m in FUM. Over the past 12 months average, transactions have doubled.

The table below outlines some characteristics of each vehicle.

| Product | LIC | LIT | mFund | ETMF | ETF |
|---|---|---|---|---|---|
| Investment Style | Active | | | | Passive |
| Structure | Listed Company<br>Closed end – fixed # of shares | Listed Trust<br>Closed end – fixed # units | Managed investment Scheme (MIS)<br>Open end – units created/cancelled to meet demand | | |
| Rules | ASX Listing rule framework | | ASX AQUA product rule framework | | |
| Admission | Listed, traded, cleared and settled | | Settled | Traded, cleared and settled | |
| Liquidity | Secondary market trading<br>Priced set by supply/demand | | Primary market<br>Price set by manager around NAV | Secondary market trading<br>Price set primarily by market makers around NAV | |
| Governance | Board, company secretariat, AGM | Responsible Entity (RE) | Responsible Entity (RE) | Responsible Entity (RE)<br>Market maker for pricing | |
| Disclosure | Continuous disclosure obligations<br>Annual portfolio holdings<br>NTA monthly (14 days after EOM)<br>Periodic disclosures –annual/half year rpts | | No portfolio holdings<br>Quarterly NAV | iNAV – intra-day Portfolio holdings – at least qtrly | iNAV – intra-day app/red, basket holdings NAV – daily |
| Income | Paid as dividends after tax at 30%<br>Can be franked if company makes profits in Australia<br>Amount of tax can be streamed over following years | Paid as distributions tax free in the hand of the investor<br>Distribution not franked, however, if franking flows from underlying investments, can be passed through<br>All income, capital gain etc is passed through to end investor | | | |
| Access to management & investment performance | AGM<br>Many provide 'investor briefings' and/or regular electronic communications | Do not hold AGMs<br>Many provide 'investor briefings' and/or regular electronic communications | | | |
| Access/custody | Via an ASX broker<br>Units held in CHESS with electronic connectivity to share/unit registries and tax & portfolio administration | | | | |
| $70.7Ms/460#s | 34,30 | 2,80 | 0,40 | 1,40 | 31,80 |
| Oct-17 | 90 | 15 | 187 | 12 | 156 |

Source: Perpetual & ASX Roundtable, November 2017

1'Reshaping around the investor' – Global ETF Research 2017, EY