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ETFS – THE BEST IS YET TO COME

Thibault Gobert
Head of Liquidity Pool, Spectrum Markets

At the end of 2023, global assets under management (AuM) in exchange-traded funds (ETFs) reached a record volume of USD 11.6 trillion[1]. This impressive figure is bolstered by the rapid growth rate of ETFs, with a compound annual growth rate (CAGR) of nearly 20% over the past five years and above 20% over the past 20 years. Despite such historic growth rates, expectations for future growth in the ETF sector remain optimistic.

A Look into ETF History

Today, ETFs are praised for their simplicity, transparency, liquidity, flexibility, security and versatility. However, this wasn't always the case. In Europe, ETFs became available 24 years ago, but their conceptual foundations date back much further. The first scientist who computed the chances of beating the market through individual equity investments was the French mathematician Louis Bachelier[2] in 1900. His Theory of Speculation[2] – quantifying this probability to be 50% – fundamentally influenced the work of Harry Markowitz[3] and William Sharpe[4], who are well-known for their work in portfolio risk and asset diversification.

The first index fund, which opened the opportunity for individual investors to build exposure towards a market-wide array of shares, was initiated by John Bogle[5] at the end of 1975. Although not an ETF at the time, it laid the groundwork for what would become the most successful asset class revolution in capital market history. Bogle later founded Vanguard, one of the world's leading ETF issuers and the world's second largest asset management company.

Broader market developments and increasing investor recognition of the shortcomings of actively managed funds further fuelled the growth of ETFs. In Europe, the introduction of ETFs coincided with the burst of the dot-com bubble and subsequent financial crises, which heightened investors' cost awareness and risk aversion. The demand for investing into diversified, risk-balanced portfolios was met by the desire to invest cost-efficiently. It's no coincidence that the sharpest and longest incline in demand that the ETF market had seen thus far, started after the market turmoil of then. It's no surprise that this approach, though determined by many other factors today, remains a fundamental principle when it comes to asset accumulation for creating a wealth of individuals based on, e.g. ETF savings plans. However, in order to understand why the ETF demand curve is still steep today and why demand will rise further, one has to consider a broad range of influencing factors.

Transparent Pricing

Mutual funds publish the net asset value (NAV) once a day. In Contrast an ETF's indicative net asset value (iNAV) can be computed continuously throughout the trading session and published by the listing exchange or a mandated calculation agent. In a mutual fund, investors trade shares of the fund against the issuing investment company, which, in turn, trades the cumulative buy or sell interest against the relevant market. This can be on-venue or OTC but usually takes place once daily. A mutual fund's NAV is calculated by adding the total value of its securities and cash held, deducting any liabilities, and dividing them by the number of outstanding shares.

In contrast, ETF shares are generally not bought from or sold to the issuing investment company but traded on an exchange. Accordingly, the value of an ETF is not determined by the issuing investment company but – as with the securities represented in the fund – based on the buying and selling interest on that exchange. In order to calculate an ETF's iNAV, the market value of the ETF's underlying assets, less any liabilities, is divided by the total number of shares outstanding. The market value of the underlying assets is determined by taking the last traded price of each asset or an average of the bid and ask prices. The frequency of an ETF's iNAV calculation can be as often as every 15 seconds but, depending on its trading volume and liquidity, less frequent, too. The more frequent its calculation is, the fairer the iNAV. Being in indication by definition, however, the iNAV is unlikely to differ much from the listed fund's real value in functioning markets where differences, like bid/ ask spreads in liquid on-venue trading, are balanced by market makers.

ETF Trading Lifecycle

The primary market for ETFs is also referred to as the Creation/ redemption mechanism, whereby market makers (Authorised participants, APs) receive ETF shares (Creation units, CUs) from the issuer in exchange for a basket of securities (Creation). Conversely, APs return creation units to the issuer in exchange for securities, this is the Redemption process.

These shares are then traded on exchanges, and the cycle of creating or redeeming shares then depends on market demand: whether those mechanisms will be necessary at all because in a first step, APs will try to trade them against own their inventory on the relevant buying or selling interest in the market.

Physical and Synthetic ETFs

ETFs can be physical or synthetic.

Physical ETFs hold the actual underlying constituents of the index they track, while synthetic ETFs enter into swaps with counterparties to replicate the cash flows. Synthetic ETFs, while reducing certain transaction costs and tax burdens for dividends, introduce counterparty risk from swap providers. Enhanced risk management has mitigated some concerns, but transparency issues, especially regarding ESG disclosures, remain. ESG disclosure rules[6]. I.e., current disclosure requirements are met at index level and do not encompass the securities used as collateral in the swap agreement. ESG-oriented investors will thus want ETFs to extend transparency to include sustainability information on the collateral. In terms of asset utilisation, synthetic ETFs also have a disadvantage in that no securities held physically means no securities can be used for securities lending operations.

A Growing Investment Universe

The original and still most common form of ETFs are passive ETFs that track a national, supranational, or global index. Over time, they have expanded to cover specific sectors such as emerging markets or industries or combinations thereof, geographic regions, and various asset classes, making them versatile investment tools.

Unsurprisingly, with so many variations, confusion over terminology is predicted. As an example, the term ETP (Exchange-traded product) is often used to delineate them from ETFs, which is not accurate. ETP is a generic term that includes ETFs, ETCs (Exchange-traded commodities) and ETNs (Exchange-traded notes).

ETCs are exchange-traded debt instruments which are linked to the performance of commodities. ETCs allow investors to participate in the performance of commodities without purchasing them directly. ETNs are debt instruments issued by a financial institution. The issuer pays the ETN holder the return on an index over a defined tenor, whereas the referred debt instrument can be a commodity, a stock index, currencies, etc. At maturity, the issuer also returns the principal of the investment.

In contrast to ETCs which are backed either by the underlying asset itself or by collateral such as cash or stocks, ETNs are unsecured and involve the issuer's credit risk. It's important to note that, unlike ETFs, neither ETCs nor ETNs fall under the governance framework of the UCITS[7]. Hence, investors don't benefit from the inherent protection.

Strategies

ETFs have evolved beyond passive strategies to include smart beta ETFs (Factor ETFs, Style ETFs or Strategic-beta ETPs) which aim to outperform market-cap-weighted indices by targeting specific factors like Value, Small Cap, Quality, Momentum, and Low Volatility or combinations (Multi-Factor). These ETFs combine passive index tracking with active management elements while trying to identify factors which for whatever reasons are generally or non-fundamentally biased by investors. I.e., common investor behaviour may unjustifiably prefer or neglect specific stocks where they shouldn't when considering a relevant factor on a neutral, purely data-driven basis. Because investors' broad buying and selling interest determines a stock's market capitalisation, the relevant indices covering these stocks must mimic this "pollution". Historically, however, there is little evidence that smart beta ETFs outperform their classic siblings on a broad basis. According to report by Global Guide to Strategic-Beta Exchange-Traded Products, the market share of Strategic-Beta ETPs in Europe is below 7%.

Additionally, thematic ETFs and actively managed ETFs have emerged, offering diverse investment strategies while maintaining the benefits of traditional ETFs. Thematic ETFs or Strategic-Beta ETPs, which are a hybrid of active and passive investing, are also strictly active ones. While they refer to an index, too, they don't replicate it but actively change allocations and insert individual transactions with the aim of outperforming the referenced index.

Liquidity and the Role of Exchanges

In contrast to a mutual fund, an ETF is traded on both the primary and the secondary market. Through the players' versatility, the liquidity support for ETFs is significantly higher than for mutual funds. In addition to the entities involved in the creation/ redemption cycle mentioned above – i.e., Issuers and APs – there are additional market makers, broker/ dealers, derivative trading desks and short sellers all contributing to the ecosystem, thus facilitating efficient trading. At the core of the ETF liquidity ecosystem, however, is what seems too obvious to being mentioned as it is the 'ET' in ETF. The talk is of the exchanges. On-venue liquidity ultimately facilitates the multidimensional concept of tightness (transaction costs), immediacy (or likelihood) of execution, depth (number of orders above and below the current trading price), breadth (orders in large volumes) and resiliency (speed of price and order adjustment). While there are multiple players involved, as discussed, the exchanges have to provide the infrastructure that enables fair and transparent trading. Where a market and a trading product are otherwise highly comparable and thus very competitive, execution quality has become an ever-more decisive factor. Where exchanges can perform swift and stable execution even under dynamically changing load, uncompromising liquidity and trading at extremely low costs, ETFs can pass these advantages to their clients. In other words, if an exchange can provide a very efficient execution infrastructure, this will help the ETF issuer to optimise its fee structure where margins are under pressure. Looking at the distribution among ETFs, it is no surprise that most assets sit with ETFs with the lowest TER[8].

Global Asset Distribution and Future Demand

The United States dominates the ETF market with a 70% share exceeding USD 8.0 trillion last year[1], followed by Europe (15%) or USD 1.8 trillion in 2023 and the Asia Pacific region (11%), USD 1.26 trillion. As both institutional and retail demand for ETFs continues to grow, driven by cost efficiency and expanding investment strategies, the market is expected to see further significant growth. Regulatory changes and competition among index providers will likely drive down costs, enhancing the appeal of ETFs.

Tighter regulations like MiFID II[9] have scrutinized investment advice and fee models, pushing investment advisors to incorporate more ETFs into their offerings. This trend is expected to lead to a substantial increase in ETF savings plans, particularly in underrepresented European markets.

Lastly, the abovementioned sophistication in index creation is likely to have a positive impact on less liquid asset classes too, where the reason for the dried-up liquidity is not the result of a general investor disinterest but of access restrictions.

Conclusion

The ETF market's growth trajectory shows no signs of slowing down. With continuous innovations, expanding investment options, and regulatory advancements, the future of ETFs looks brighter than ever.

New Opportunities with Spectrum Markets

Spectrum Markets has expanded its offer including with more than 1800 Exchange Traded Funds from more than 30 leading global fund providers, including BNP Paribas, Goldman Sachs, Fidelity, Franklin Templeton, HSBC, iShares, JP Morgan, Legal & General, Pimco, State Street, UBS, Vanguard, and WisdomTree.

ETFs are the most exciting and in-demand asset class right now, due to their diversity, transparency, liquidity and competitive fees. Through its advanced infrastructure and technology, Spectrum Markets enables brokers to facilitate intraday trading for their retail investors, within a regulated trading environment, throughout extended trading hours.

About the Author

Thibault Gobert is Head of Liquidity Pool at Spectrum Markets, covering sell-side firms, namely issuers and market-makers. He spent 23 years in the capital markets and investment banking industry in different roles at institutions such as Citigroup, Société Générale or BNP Paribas where, as Managing Director, he was head of European desks for securitized derivatives. Thibault was the founder and chairman of the French trade-lobby association for retail structured products, and board member of the European EUSIPA in Brussels.

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1 According to research by ETFGI
2 Louis Jean-Baptiste Alphonse Bachelier (11 March 1870 – 28 April 1946) was a French mathematician and is credited with being the first person to model the stochastic process now called Brownian motion, as part of his doctoral thesis "The Theory of Speculation"
3 Harry Max Markowitz (August 24, 1927 – June 22, 2023) was an American economist and Nobel laureate, best known for his pioneering work in modern portfolio theory, studying the effects of asset risk, return, correlation and diversification on probable investment portfolio returns.
4 William Forsyth Sharpe (June 16, 1934) is an American economist, Nobel laureate and one of the originators of the capital asset pricing model (cp. "Sharpe Ratio")
5 John Clifton "Jack" Bogle (May 8, 1929 – January 16, 2019) was an American investor and founder and CEO of the Vanguard Group and about whom Warren Buffet said: *"If a statue is ever erected to honor the person who has done the most for American investors, the hands down choice should be Jack Bogle."*
6 Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector, the "Sustainability Finance Disclosure Regulation (SFDR)"
7 Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, the "UCITS Directive"
8 Total expense ratio
9 Directive 2014/65/EU, the "Markets in Financial Instruments Directive"

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