INSIGHTS
INVESTMENT

Coming of Age: Institutions Find Novel and Innovative Uses for ETFs

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Deutsche Asset Management experts run down the many new applications for ETFs in institutional portfolios — taking a traditionally retail-oriented product in sophisticated new directions.

|Q.| ***ETFs traditionally have been used by retail investors and advisers. What's driving higher adoption among institutions?***

|**Orit Hodarkovsky**| There are many different drivers, but one of the biggest is linked to the demand for multi-asset strategies. Multi-asset portfolios have historically used active strategies as building blocks, but increasingly ETFs are being employed for core asset allocation, particularly in equities. In these portfolios, the alpha source is generated by how the asset allocation model is constructed, which is different from the view that alpha is generated by choosing active managers with the highest perceived skills to fill these portfolios. Of course, such applications have in large part been driven by fee pressures, which we don't see abating any time soon.

But there are other drivers as well, such as regulatory reform. The National Association of Insurance Commissioners evened out the playing field between ETFs and other holdings. Because of new accounting treatment, fixed-income ETFs now look very similar to baskets of bonds held in insurance portfolios, for example. From a capital charge and accounting perspective, those kinds of regulatory changes are very meaningful as they can unlock greater efficiencies in portfolio implementation using ETFs.

|Q.| ***Apart from long-only, strategic allocations, where are ETFs finding new and interesting uses?***

|**Luke Oliver**| ETFs are finding homes in lots of different places in institutional portfolios. For example, many investors assume that derivatives are the cheapest, most efficient way of implementing views on specific markets or asset classes. That's not always the case. Often there are hidden costs inside futures and swaps products, making them quite expensive to hold. Instead, it may be more efficient to own an ETF and pay a very small management fee.

ETFs can also be used for securities lending programs, where some assets, like individual bonds, cannot. A fixed-income ETF, by contrast, is a trading tool that can be lent back out into the market and earn a lending fee for the asset holder.

|**Arne Noack**| Another great example is the use of an ETF's creation-redemption facility to move securities in and out of portfolios.

Fixed-income managers, for example, can put together a package of individual bonds and make an in-kind exchange with an ETF manager — exchanging the bonds for shares in an ETF. The investor thus moves bonds out of the portfolio without having to sell individual bonds on the open market. The process can also be done in reverse: buying shares of an ETF that holds an attractive basket of bonds — that is, individual bonds that the institution wants to own. The ETF shares can be exchanged for physical bonds that become part of the institutional portfolio, without having to buy potentially dozens of bonds on the open market and incurring transaction fees for each trade.

$1.4T
Institutional assets in U.S. ETFs*

ETFs are also being used for cash equitization, where cash flows into a portfolio, like equity dividends and bond-coupon payments, can be invested temporarily in the market while the manager is looking for ways of putting that cash to good use.

|Q.| ***Even as the uses of ETFs are evolving, ETFs themselves are evolving. What are some of the newest developments in ETF design?***

|**Hodarkovsky**| Smart beta strategies have become integral to institutional portfolios, and ETF managers definitely have embraced that trend. Factor-based investing lifts the hood on alpha generation, revealing whether outperformance vs. a market benchmark may be driven by a manager's overall style — like value, momentum or quality — rather than manager skill.

Increasingly, the conversation about individual manager alpha has evolved toward a discussion about factor investing and its impact on policy benchmarks, portfolio alpha and the investor's performance objectives.

With better insight into portfolio performance, many institutions are actually now running internal quant-type platforms and building customized, passive, factor-based portfolios from the bottom up — looking to generate outperformance over their strategic benchmark. We also see smart beta ETFs used alongside current passive strategies, such as allocating 50% to pure passive index funds and 50% to smart beta or multi-factor strategies, with a goal of enhancing returns.

|Q.| ***How good are ETFs at capturing factor performance vs. other investment vehicles?***

|**Noack**| It's not specifically the vehicle that captures factor exposures, but rather the portfolio construction process. The devil's in the details, and much depends on the objective of the client: How does the investor look at factors? Do I want to employ factors to express specific market views, or do I want to construct a portfolio that has high factor exposures in order to generate excess returns over longer periods of time? After that, it becomes a question of risk budgeting and how much deviation from the benchmark the investor is able to allow.

|**Oliver**| Where the ETF wrapper shows unique value is in its liquidity. ETFs require the presence of a market maker to manage the creation and redemption process — i.e., an asset risk manager who puts the portfolio together in the most efficient way. So as far as exploiting risk premia is concerned, sophisticated market makers are pricing these ETFs in a way that investors potentially get the cleanest, purest exposure to those strategies when they choose to implement them.

|Q.| ***And what about risks — what risks are investors most concerned about?***

|**Oliver**| A question we get a lot is whether ETFs can get too big and in some way cause structural risk or price disruption in the market, especially the bond market. The short answer is that they haven't. Mutual funds are forced to sell underlying assets to supply liquidity when investors sell shares, potentially impacting the market. With ETFs, the manager can just pass bonds out through the redemption process — those bonds end up with a risk manager who isn't forced to sell them immediately in the market.

So ETFs have a liquidity and risk cushion that mutual funds lack. ■

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* Source: Deutsche Bank

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