A new dawn for Europe’s retail ETFs

Retail use of ETFs in Europe is set to grow sharply in the coming years as regulatory, structural and market forces combine to drive demand.

Europe has lagged the US in attracting retail investors as investors in Exchange Traded Funds (ETFs). While retail accounts for around 45% of the US market, the equivalent figure in Europe is estimated at between 10% and 15%. Why the divide? And what chance is there of the gap closing?

There are a number of reasons for the disparity between the two markets. For a start, the US market is a lot more mature, with around USD 3 trillion of assets gathered since the first ETF was issued in 1993. ETFs only arrived in Europe seven years later. Total assets in Europe now amount to USD 734 billion, according to research and consulting firm ETFGI.

US investors, accustomed to managing their own retirement funds and are more likely to own shares and mutual funds and more familiar with what ETFs can offer. ETFs now account for around 30% of US trading by value. They regularly make up half or more of the ten most active securities on any given day.

In Europe, investors have historically relied on advisers who generally favoured actively managed mutual funds on which they received up-front commissions and retrocession. The majority of investment platforms, an area of huge growth in recent years, also focused until recently on mutual funds.

Several factors driving change

A wave of regulation across Europe is transforming the advisory landscape. Measures such as the Retail Distribution Review (RDR) in the UK, and its equivalent in the Netherlands, have eliminated commission-based remuneration on new fund sales for independent advisors. The measures came into force over the course of 2013 and 2014 and theoretically put ETFs on a level playing field with mutual funds.

Joe Parkin, Head of UK Wealth and Retail at BlackRock, says: “The regulatory model in the UK has made everything more transparent.” Combined with increasing margin pressure, regulation has led many independent financial advisers to outsource the investment process, he points out. “That has generated big flows into multi-asset funds, where ETFs are the most cost-effective tool for moving risk around.”

“Many industry platforms need a technology upgrade if they are to facilitate the buying and selling of ETFs.”

Deborah Fuhr
Managing Partner, ETFGI
Those flows are just part of a worldwide shift from active to passive investment that has characterised the market since the financial crisis. In the US, for example, flows out of actively managed mutual funds have topped USD 1 trillion over that time. The money has gone into passive funds and ETFs instead.

Process remains slow
At ETFGI, Managing Partner Deborah Fuhr warns against expecting dramatic change once MiFID II comes in next year. “It is in effect an extension of RDR, and the reality is that changes due to RDR in the UK have been muted – despite the fact RDR has been in effect for a number of years.”

There are a number of reasons for that, she says: “Many of the platforms need a technology upgrade if they are to facilitate the buying and selling of ETFs securities. In addition, the platform industry seems to think the term ‘tracker’ refers only to index mutual funds. ETFs are often not included when a search for trackers is made.”

Britain’s Financial Conduct Authority (FCA) has launched an investigation into investment platforms. Among the areas of focus are whether investors are readily presented with a range of passive funds and how model portfolios are constructed. “Key questions are which ETFs are on the platforms? Where are they put? Are they included in the comparison algorithms?” says Fuhr.

Mohamed M’Rabti, Deputy Head of FundsPlace and Head of ETFs at Euroclear, acknowledges the issue with platforms. “We have been talking to platforms about adding ETFs and working with issuers to get their products on there,” he says. ETFs are becoming more available on platforms – something that has been given added impetus by the likes of Euroclear’s FundSettle, which provides a one-stop shop for both mutual funds and ETFs. “We have grouped all ETFs on the system into a single class to make things simpler”.

At ETF issuer SPDR, Mark Harris, Vice President of Capital Markets, says things are changing on the platform front: “In the last six months some of them have been coming to us and asking how they can get our ETFs on their platform. Execution was an issue for them but we are now seeing momentum build. It seems increasingly likely that there will be a steady rise in retail demand over the next few years as the platforms get up to speed.”

The role of robo-advisers
“A lot of the retail interest in Europe comes to us via FundSettle, particularly in the Netherlands.”

Mark Harris
Vice President of Capital Markets, SPDR

RDR created an advice gap in the UK retail financial services marketplace leading the banks to pull back from mass advisory work. That gap, however, is progressively being filled by robo-advisers, and their success is encouraging some of the banks to return to the market with a similar approach.
Employing a centralised model that has asset allocation at its core, many robo-advisers turn naturally to low-cost ETFs. They are already the investment vehicle of choice for robo-advisers in the US. “We see an enormous increase in the number of people coming into this market and targeting people with GBP 250,000 or less,” says Joe Parkin, Head of UK Wealth and Retail at BlackRock: “If your business is scalable, the size of the client shouldn’t matter too much.”

“There has been a particular pick-up in retail volumes in Germany.”

[Quote from Frank Mohr, Head of ETF Sales-Trading at Commerzbank]

In Europe, increasing retail interest in ETFs is being driven by online banks and platforms that offer regular savings plans for as little as EUR 100 a month. Frank Mohr, Head of ETF Sales-Trading at Commerzbank, a leading market-maker in ETFs, says his firm started to offer on-screen market-making to platforms in 2009. He estimates that retail business has doubled over the last two or three years and now constitutes between 10,000 and 15,000 trades a week out at his firm of a total of 30,000 to 35,000. That is consistent with a decline in the average trade size. “There has been a particular pick-up in retail volumes in Germany,” he says.

Commerzbank operates a multi-channel model – dealing on-exchange but also with institutions (via Bloomberg), platforms and FundSettle. As an international service, FundSettle is important because “it opens the door for people to sell ETFs through the same channel they use for mutual funds”, says Mohr.

Rise of fractional trading

The answer is fractional trading, which is already well established in the US. Mohr says a number of continental banks have solutions where they warehouse fractions in-house. In the UK, there has been a fully-fledged solution to trade fractions of ETFs since May 2017 when Winterflood Business Services (WBS), the agency services and custody arm of market-maker Winterflood Securities, started to offer trading in fractional ETFs to their client base, which includes robo-investors, advisor platforms, and other financial institutions.

As a market-maker, Winterflood Securities executes around 65% of all retail ETF trading in the UK. Through its bilateral relationships with retail brokers it provides speed, highly competitive pricing and often greater liquidity than is available in the London Stock Exchange (LSE) order book – though all transactions are on-exchange and so governed by LSE rules.

“There’s a real demand for fractional trading of ETFs in the UK,” says Alex Skrine, Director, Electronic Trading at Winterflood Securities. “Not only from traditional advisor platforms, who want ETFs to be as tradable as mutual funds so that portfolio switching becomes more straightforward, but also from new fintech robo-advisers looking to plug the advice gap by facilitating regular investing / micro-investing to a new generation of investors.”

“We do provide the same quality of execution for clients regardless of where the assets are held”

[Quote from Alex Skrine, Director, Electronic Trading at Winterflood Securities]

The WBS solution is designed to overcome the main challenge to fractional trading in the UK — that you cannot trade a fraction in the market, settle a fraction in the settlement system, CREST, or have a fractional nominee holding. When WBS gets demand for, say, 3.2 shares in a given ETF it buys (and settles in CREST) four shares into the WBS Nominee, but internally allocates the 0.8 of a share in a residual account. It maintains a ‘value cap’ on the maximum holdings in that account. The entire process is fully automated, including any aggregation and reallocation requirements, leveraging technology to create a seamless experience for the end customer.

Skrine continues: “We do provide the same quality of execution for clients regardless of
where the assets are held. Domestic retail assets are typically all held in Euroclear; whereas institutional assets are a mix of both domestic and, where applicable, the new International Central Securities Depository (ICSD) model with Euroclear. Either way we can provide our customers with the same high levels of service, and have worked closely with Euroclear to ensure seamless and cost-effective realignment where necessary.

**Technology opening new doors**

BlackRock’s Parkin is enthusiastic about the role technology will play in the development of the retail market. “Between the financial crisis of 2008 and very recently, everyone was focused on getting to grips with new regulation and on getting the right people and processes in place. In the last six to nine months, we’ve seen the focus shift to what client engagement means in the era of digitalisation – how to reach those who interact by iPhone and Android.”

“Technology is going to allow us to get to more people but you will need to put it across in no more than three minutes. It has to be simple. ETFs are a natural tool for the retail digital marketplace. “The rise of the robo-adviser, he maintains, is just the start of the process. “We have barely begun to leverage the technology.”

Technology is also playing a role in the development of the product. As the management of data improves, so does the ability of index funds to capture different outcomes. Hence the expansion of ETFs into areas such as smart beta and thematic investing. Figures from Blackrock show that in 2016 one euro in every three invested in a UCITS equity ETF went into smart beta. ETFs investing in robotics and automation have already attracted around USD 1.6 billion. Parkin predicts that impact and Environmental, Social and Governance (ESG) investing will become increasingly popular in the coming year.

**The MiFID II watershed**

For now, the prime focus is on MiFID II and the impact it will have on Europe’s retail ETF market. “RDR raised awareness of the effect of charges on performance and MiFID II will expand that awareness across the rest of Europe,” says ETFGI’s Deborah Fuhr. “There are a lot of good outcomes from these changes.”

“ETFs are the most cost-effective tool for moving risk around.”

Joe Parkin, Head of UK Wealth and Retail, BlackRock

Mohr says next year will be key: “Employer and state pension funds in Germany are largely invested in mutual funds. With the transparency imposed by MiFID II they will start to recognise the difference in costs between mutual funds and ETFs”. As for the retail market, he says “some of the online banks are thinking of changing their models once they have to show all of the costs to their investors”.

BlackRock’s Parkin says the extent of the disclosure under MiFID II will come as a shock to some. “Clients will see the cost of the product, the cost of the advice, the cost per year and the cost over five years.” At Winterflood, Skrine agrees: “We see huge potential for further growth in ETFs as greater transparency on costs and charges under MiFID II will no doubt level the playing field for investors who are comparing Unit Trusts with ETFs.”

**Transparency: Shining a bright spotlight on pricing**

<table>
<thead>
<tr>
<th>Example of cost disclosed to investor by wealth manager</th>
<th>Source: BlackRock 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of product (pa)</td>
<td>327 EUR</td>
</tr>
<tr>
<td>Cost for investment advice (pa)</td>
<td>497 EUR</td>
</tr>
<tr>
<td>Projected costs over 5 years</td>
<td>4,126 EUR</td>
</tr>
<tr>
<td>Average cost per year</td>
<td>3%</td>
</tr>
</tbody>
</table>

Investing looks costly...

wealth managers need to increase the actual and perceived value they provide
All parties agree that education remains a weak link in Europe. “I’m very positive on the future of ETFs,” says Mohr, “but what’s needed is more financial education. It must start in the schools. Everybody has a responsibility to get involved – banks, networks, exchanges, Euroclear’s FundSettle etc.”

Parkin agrees. “Retail is the fastest-growing segment of the ETF market, but the people who are coming direct through the platforms are relatively sophisticated. The challenge is to get to all those who are sitting in cash, who do not have an investment account. With the shift from Defined Benefit (DB) to Defined Contribution (DC) pensions and increasing longevity, many of these people will not have enough money in retirement.”

Euroclear’s M’Rabti says: “The next year will likely be a watershed for the retail ETF market. Given the changed regulatory backdrop, the combination of transparency, low fees and good liquidity that ETFs offer is set to attract big retail flows. Within five years, retail could well account for between 25% and 30% of Europe’s ETF market, which is itself on a strong growth trajectory.”