ESG has entered the ETF industry to stay

BY JOLANDA DE GROOT

As one of the largest independent research firms in the field of investment funds and ETFs, Morningstar closely monitors the in- and outflows of ETFs. What trends does Jose Garcia Zarate, Associate Director of Morningstar's UK and cross-border European passive fund research team, see? What are the most important developments in the ETF market? And what are the expectations for future developments in the ETF market?

What are the most important developments in the ETF market over the past year?

'2019 was a bumper year for the European ETF industry, with record high net flows of EUR 107 billion, strongly up from EUR 46 billion in 2018 and the previous high of EUR 98.5 billion in 2017.

The shift towards low-cost passive investment propositions is solid and investors around the world continue to wake up to the realisation that keeping a tight rein on fees is one of the surest ways of maximising the potential for returns. We have no control over how the markets will behave, but it is in our hands to decide whether we want to pay high or low fees.

On a more detailed note, the two key points to highlight for 2019 were the considerable flows achieved by fixed income ETFs and the explosion in flows for ESG products.'

In which asset classes and regions do you see major growth?

'Equities dominate the European ETF market and account for 65% of all the money invested in ETFs. However, bond ETFs had a stellar performance in 2019. In fact, flows into bond ETFs in 2019 totalled EUR 54 billion and were higher than for equities (EUR 46 billion), while assets in bond ETFs already account for 25% of the ETF market and have grown vigorously over the past few years from a low base.

Fixed income has been earmarked as a key area of growth by all ETF providers. At a time of ultralow yields, which are expected to continue for the foreseeable future, controlling for costs becomes even more crucial. Also, there has been a lot of work behind the scenes to make fixed income workable in what essentially is a stock-like wrapper such as an ETF. Bond indices are now by and large investable propositions and the Authorised Participants that keep the ETF market going do a good job at providing the necessary liquidity.

Equities dominate the European ETF market. But in 2019 flows into bond ETFs were higher than for equities.

Another key area of growth is ESG. In fact, ESG is the hottest topic in investing now, and this affects both equities and fixed income. The ESG ETF offering is still developing, but 2019 saw many new products coming to market. In fact, although assets in ESG only represent 3.3% of the European ETF market, flows into ESG ETFs in 2019 amounted to EUR 17.6 billion, which is 16.5% of total flows into ETFs in the year. This is clear evidence of a mounting trend that I expect to accelerate in coming years.

ETF providers are already responding to this growing demand. Just look at iShares. In its 2020 letter to CEOs, Larry Fink announced that the company will launch many ESG ETFs. I'm sure other ETF providers will do the same.'

What is the size of the current ETF market?

'Total assets in ETFs grew to EUR 923 billion, a 37.2% increase from EUR 656 billion in 2018. The outlook remains firmly footed. Hitting EUR 1 trillion will happen anytime now.'

Have you seen many new providers joining the ETF market?

'Yes. The last three years have seen several new providers joining the European ETF market. Examples include JP Morgan, Legal & General, Franklin Templeton, and more recently Goldman Sachs. So far, some have been more successful than others, but they all acknowledge that they have to offer a good selection of passive investments to their clients. Many are aiming to do this without abandoning their active side of the business. And I'd say that's the right way to go. There is no point in fighting battles between passive and active, when the obvious solution is to mix both and use each style whenever it suits.

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In any case, I'd like to point out that the European ETF marketplace remains a tough business area where not all are able to survive. For example, in November 2019, BMO, highly successful as an ETF provider in its native Canada, threw in the towel and announced the closure of its European ETF venture.'

How is the ETF market currently divided when it comes to physical, leveraged and synthetic ETFs?

'The 2009-2019 decade has seen a significant shift in the distribution of ETF assets by synthetic replication in favour of physically replicated funds. From a broad 60/40 physical/synthetic split at the beginning of the period, physical funds now account for over 80% of equity ETF assets and over 90% of fixed income.

The decline in assets in synthetic ETFs has been driven by investors' preference for the simplicity and lower perceived risk of the physical approach. Providers who started as synthetic ETF businesses, (for example, Xtrackers, Lyxor and Amundi) have switched most of their ETFs to physical replication.

This is not to say that synthetic is dead. In fact, there are investors who are comfortable with the synthetic structure. They value its more consistent tracking, as measured by tracking error. Also in the case of certain market exposures (for instance, US equities) synthetics offer superior returns compared to physical ETFs. However, it is very unlikely to see a sea-change in the current landscape that puts synthetics back again on an even keel to physical.

As per leveraged and inverse, they represent a tiny proportion (namely less than 1%) of the total assets invested in the European ETF market. At Morningstar we see these as trading instruments rather than investment propositions.'

What are your expectations in terms of how the ETF market will develop?

'As I've mentioned, the outlook for passives remains positive, so it's difficult to foresee anything other than further asset growth and ongoing shift from active.

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I think it has become accepted that for plain vanilla equity and bond market exposures (the basic building blocks of any investment portfolio), low-cost passive funds are now the default option. Then for the remaining part of the portfolio there will be an interesting choice between active and passive (for example, smart beta).

In the wider scheme of things, we'll keep a close eye on developments pertaining to ESG indexing, as this is panning out to be a massive growth area.' «

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JOSE GARCIA ZARATE

Fixed income has been earmarked as a key area of growth by all ETF providers;

ESG ETF offering is still developing, but is expected to accelerate;

The European ETF marketplace is a tough business area.