Ramping up the ETF race

Shopping among the plethora of exchange-traded funds, as alternative investment vehicles, is increasingly complex

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DECISIONS, DECISIONS: A businessman shopping.
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David Berman, Financial Post
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Hedge funds may dominate the imagination because of their often complex and mysterious investment strategies. But in terms of popularity, it's hard to beat the lowly exchange-traded fund (ETF) -- a dirt-simple product that has taken the investing world by storm.

In 2005, global ETF assets grew 35% to almost US$417-billion. Assets are expected to grow to US$1-trillion by 2010, according to Financial Research Corp.

Twice as many new ETFs kicked off last year as did durinag the previous year -- 119 funds, up from 53 in 2004 -- bringing the total number of funds to 453 worldwide.

"Certainly, when the original products were being developed, I don't think anyone in their heart of hearts thought there would be a global product category like this," said Cliff Weber, senior vice-president of the American Stock Exchange ETF Marketplace.

But as new products hit the shelves and assets pour in from institutional and retail investors, the competition among ETF firms is also heating up as they strive for dominance in this increasingly important market.

Exchange-traded funds look a lot like mutual funds in that they generally hold a basket of stocks. However, ETFs trade on exchanges, giving investors great flexibility buying and selling throughout the day.

They are also cheap: While mutual funds often come with early-redemption charges and steep annual fees, most fees linked with ETFs are wafer-thin (although investors are still charged brokerage commissions).

In their early years, most ETFs tracked major stock market indexes such as the Standard & Poor's 500 or the MSCI EAFE index. But with the exponential rise in assets, the variety of funds has exploded in recent years.

"In addition to the bigger, broader index-based products, companies are starting to move into more thematic-type indexes," Mr. Weber said.

Already, investors can buy funds that track specific indexes, such as South Korea and Mexico. They can also buy funds that track particular sectors, like energy producers. They can even buy ETFs that have nothing to do with equities: Some hold bonds while some of the hottest ones lately track commodities.

Investors have welcomed many of the new issues with open arms. But as companies ramp up their offerings, the field is growing increasingly crowded -- and that has led to some serious jostling.

In the United States -- and elsewhere -- Barclays Global Investors, a division of Barclays PLC, leads the pack with its collection of iShares. At the end of 2005, it had a 57% market share with US$170.2-billion of assets spread among 102 funds. The ETF business is contributing significantly to the global bank's growth: Profits before taxes grew 60% at Barclays Global Investors for the first half of 2005, and ETF growth was one of the main drivers.

State Street Global Advisors, a division of State Street Corp., is the No. 2 provider in the United States, with US$83-billion in assets and 32 funds.

Other major players include Bank of New York Co. and Vanguard Group. In January, mutual fund manager Amvescap PLC jumped on to the scene with its acquisition of PowerShares Capital Management LLC, which manages 36 ETFs.

That deal, worth up to US$700-million, gives Amvescap instant exposure to the ETF industry -- if you can't beat them, buy them -- but the price tag also illustrates how challenging it can be to build exposure in the current competitive environment.

In Canada, Barclays has a virtual monopoly over the industry, with 16 funds and $11-billion in assets. State Street has come and gone. And TD Asset Management, a division of Toronto-Dominion Bank, is the latest casualty. In mid-December, TD said it would pull the plug on its four funds by mid-March.

"Size is critically important in the ETF game," said Dan Hallett, president of Dan Hallett & Associates. "You need scale to compete in money management, and that's magnified with ETFs" because fees are so low. Barclays has also made inroads into the financial advisor community, which has given it a distribution advantage, he said.

But Barclays won't be enjoying an empty field. This week, Claymore Investments Inc., a subsidiary of Chicago-based Claymore Group LLC, is launching FTSE RAFI Canadian Index Fund -- an ETF that weights stocks partly on valuations, giving lower weight to sectors that are deemed overvalued by some measures.

"Our strategy in the ETF space is to move into more of an 'enhanced' index proposition," said Som Seif, president and CEO of Claymore Investments. The money management firm, which manages about US$12.6-billion, already runs four closed-end funds in Canada and 14 in the United States.

Price -- or management fees -- usually plays a small role in the success or failure of an ETF. Management expense ratios are already tiny and don't vary much from fund to fund.

The key to success is being the first to tap a popular niche. For example, State Street launched streetTRACKS Gold Trust gold bullion fund two months before Barclays launched iShares Comex Gold Trust. While the two are virtually identical, their success is not. The State Street fund has nearly US$6-billion in assets, while Barclays is 1/10 the size, with US$550-million in assets.

Trading volumes, which are critical to large investors who need liquidity, tell a similar story: First-to-the-market State Street trades an average five million shares a day, while Barclays trades 200,000.

This first-is-better strategy certainly has worked in the case of the S&P Depositary Receipts, or "SPDR" -- the granddaddy of all ETFs, launched in 1993 by State Street Global Advisors. The fund has more than US$52-billion in assets.

"Unlike active management, where you can have 150 Canadian equity funds, how many index-linked ETFs do you need of the same index?" said Howard Atkinson, principal at Barclays Global Investors Canada. "The marketplace has clearly said 'one' in almost every case."

For the most part, ETF sponsors are avoiding launching new funds that go head-to-head with existing funds. Instead, they are treating the ETF market like a land claim, devising unique funds that aim to capture the imagination of investors -- not to mention their assets.

"A lot of the competition is on what kind of index you're getting exposure to," Mr. Hallett said. "They are drilling down to more focused exposure to specific industries and sub-sectors."

For example, PowerShares Capital Management made a name for itself with its line of innovative ETFs. In 2004, it launched the WilderHill Clean Energy Index fund, which tracks companies that will benefit from a transition to alternative energy sources such as solar power. More recently, it launched the PowerShares Water Resources Portfolio, which tracks U.S.-traded companies involved in the global water industry.

Meanwhile, the Deutsche Bank Commodity Index Tracking fund launched earlier this month, is based on futures contracts for a basket of commodities, including crude oil, aluminum, gold and wheat. There is also talk a silver ETF might be launched later this month.

Observers say active management will form the next frontier for ETFs. That is, instead of passively tracking an index, these new funds will be steered by managers who will attempt to beat an underlying index using strategies associated with mutual funds.

"It's something we've been working on for a number of years, getting all the technology in place," Mr. Weber said. "We're talking with some mutual fund issuers about using our methodology, which will allow actively managed funds to trade without disclosing any of their holdings."

If these new products get up and running, they will open a vast new market for ETFs. More important, they will open a new front in their competition with traditional mutual funds -- and each other. In other words, the competition is just starting.

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