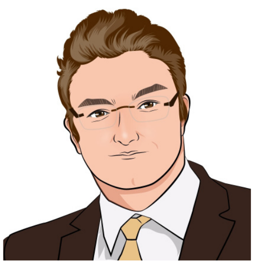
ETFs – Their Rising Importance for Well-Formulated Private Client Portfolios in Asia

On June 23, Hubbis hosted a virtual Digital Dialogue discussion about the evolution of the global USD10 trillion-plus Exchange Traded Fund (ETF) market and the rising prominence of ETFs for the wealth management community in Asia. The panel focused on the advantages of ETFs in terms of transparency, tradability, liquidity and cost, as well as analysing how ETFs can be used as part of smart, robust core portfolio formation by Asia's private investors. They explained how, due to the immense variety of ETFs available these days across numerous asset classes, markets, geographies, sectors and different thematics, ETFs are increasingly well-suited to the articulation of smart beta, and for low-cost investment and trading diversification within satellite portfolios. And the panel explained why these funds are not only highly relevant for HNW and UHNW investors, but also for the mass affluent and retail segments, noting that these latter two categories are increasingly served by robo advisory platforms that assemble personalised, risk-appropriate model ETF portfolios. They concluded that the ETF market has come far and fast, but that there is still considerable room for growth and further innovation ahead.

SPEAKERS



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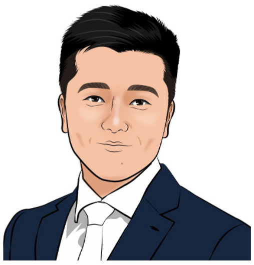

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THESE ARE SOME OF THE QUESTIONS ADDRESSED IN THE DISCUSSION:

- Why has the ETF market grown so far and so fast?
- Are Asia's private clients increasing their exposures via ETFs, and why or why not?
- What is the wealth management community doing to promote the use of ETFs in private portfolios?
- Are ETFs useful for thematic exposures? Why and how?
- What are smart beta ETFs, and why should Asia's private clients add these types of exposures?
- Are private investors buying into alternative asset ETFs to easily gain exposure to precious metals or currencies and other assets?
- Can Asia's investors boost the ESG credentials of their portfolios using ETFs? If so, how?
- How can ETFs fit within advisory and discretionary mandates?

Setting the Scene

The creators and proponents of ETFs have increasingly been emphasising the key attributes of ETFs, including the low entry and exit costs, their liquidity and ease of trading (they are quoted on the market like stocks and not 'priced' only once a day like mutual funds). They have been highlighting their role in core/satellite portfolio formation, as well as their value in offering investors smart beta and targeted thematic exposures through specifically tailored composition around selected indices and sub-sectors.

In short, the right blend of ETFs can allow private investors to assemble a diverse, liquid and interesting set of exposures across the universe of listed equities and also public-market fixed income. And the ETF market also encompasses the growing inclination to invest in alternative assets, including precious metals, commodities, and currencies.

The panel zoomed in on how the wealth community can help investors invest in specific trends that can be captured through tailored ETFs, such as global medical and healthcare, or perhaps country-specific ETFs such as China as the economy reopens. Or perhaps they have been using ETFs to access the dynamism of Vietnam, or to buy into commodities as supply chain issues persist and as crude oil has been rocketing skywards. And they analysed how ETFs can also help investors capture the global trends towards ESG and sustainability.

The discussion was naturally directed towards the Asian wealth management community in order to debate where such ETFs fit into private client portfolios in the region and how and why those clients should build their allocations. And the panel discussed where these investors most need considerable guidance and support, faced as they are with an enormous array of choices – there were an estimated roughly 8600 ETFs in 2021, representing some USD10 trillion of assets, according to Statista.

The range and versatility offered by the ETF universe are constantly expanding and with considerable innovation

In recent years, ETFs have become both incredibly numerous, remarkably diverse and extremely versatile overall, an expert reported, meaning that investors can buy into or trade numerous asset classes, particular countries or regions, sectors or themes. And all at incredibly low fees, especially in the vast US market. He said in the US, for example, ETF access can cost as little as 0.05% per trade, which is negligible, especially compared with an actively managed fund, the costs of which can run to 1%, 2% or more.

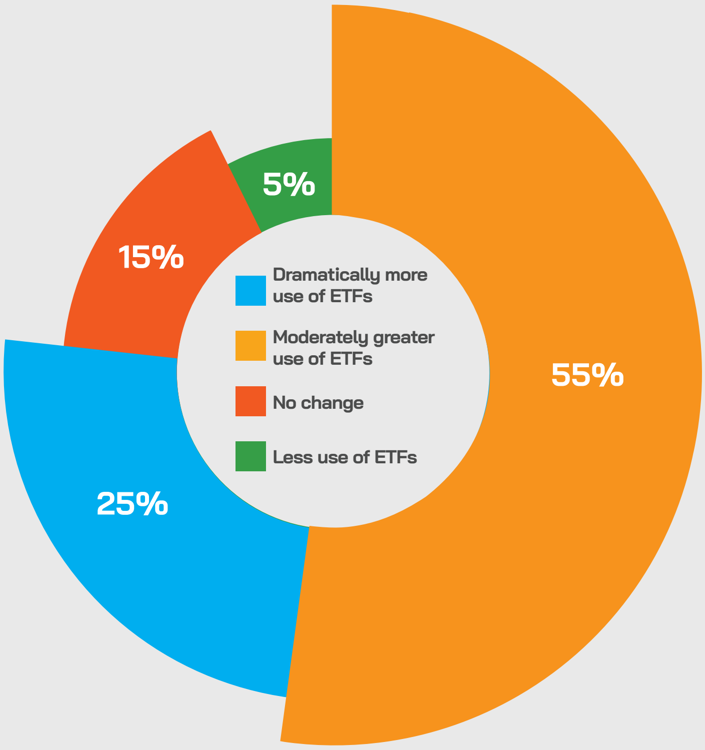
"And the fact is, if you look back at history over the last 15 years, almost 85% of these active managers end up underperforming the index," he cautioned. "And of course, it is the indices that ultimately ETFs represent. In my view, it is incredibly difficult to beat the index, so if you take the S&P500, for example, the weak performers drop off and the better-performing stocks come on, making it incredibly tough to beat."

A guest agreed, adding that there had been noteworthy evolution in the design and the distribution of ETFs that have significant implications for how they are used.

"Historically, these were purely index funds, but nowadays people are increasingly using ETFs in portfolios to replicate any beta, and in some cases, some alpha as well," he explained. "In other words, the application of ETFs is far broader now than ever before, and that has been a big factor in the increasing use of ETFs over the last 10-15 years or so."

The Hubbis Post-Event Survey

SINCE INFLATION, HIGHER RATES AND OTHER GLOBAL WORRIES HIT HARD, WHAT HAS BEEN HAPPENING TO DEMAND FOR ETFS AMONGST ASIAN HNW AND UHNW CLIENTS?



He agreed that one of the compelling appeals had always been the cost. "When you are looking at the lower alpha elements of the portfolio, fees are a really big factor in beta capture, meaning that the lower the fees, the easier it is to justify using ETFs. Our portfolios tend to be typically around 30% to 50% in hedge funds, and most of the balance tends to be in ETFs, because they are generally the most cost-effective way to go and capture those areas that are not mainly driven by alpha."

He expanded further on this, noting that being able to conduct index-based trading and to put in limit sells and limit buys, had been a major advantage for his firm over the last few years. "Any time there is volatility, you want to be able to get in, get out at certain points, and with ETFs, obviously, you can set limits, whereas with daily traded funds, you can't," he explained. "We cannot monitor the markets around the world 24 hours a day, so it is ideal to have open limit sells, and limit buys in the ETFs universe."

There is such a wide choice in the ETF universe today, with more and more thematics, that they can be used more 'actively' in satellite portfolios

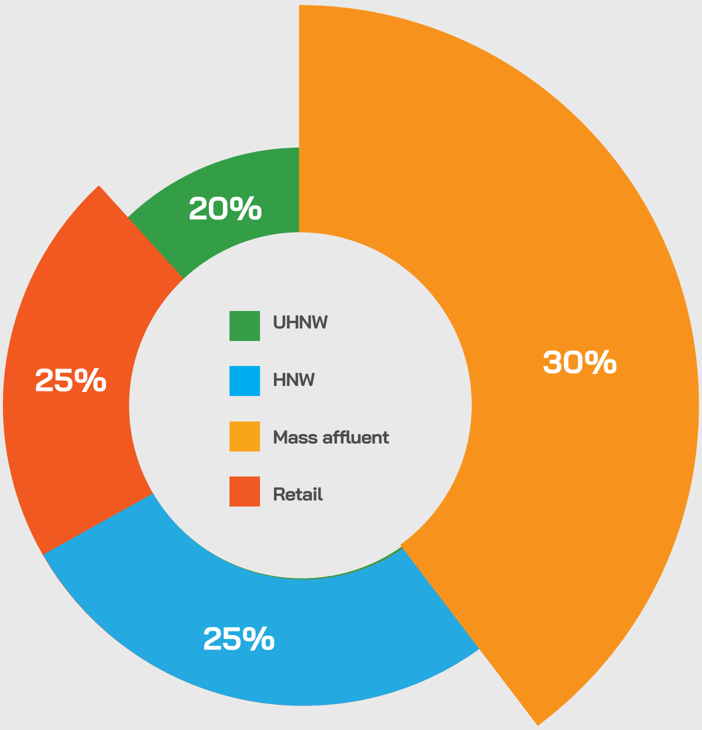
A guest noted that the purpose of the ETF is really to generate returns and performance of the underlying index with as low a tracking error as possible. "And what that means is you will not have surprises, you will not have deviations with respect to where the markets are, and this transparency has appealed to the new generation of investors. And with the ETF universe having expanded to offer such choice, so many different specific exposures, you can also employ ETFs to implement a more 'active' kind of strategy that can be layered on top of your clients' core portfolios."

Another expert also noted the importance of ETFs for delivering thematic investment ideas. "We should really take our hats off to the indices compilers," he said. "Why? Because the rise of ETFs is also linked to the rise of numerous different indices, including very specialist indices within different sectors, factors, and sub-sectors. As an asset selector, this really helps us with more and more benchmarks against which to measure performance."

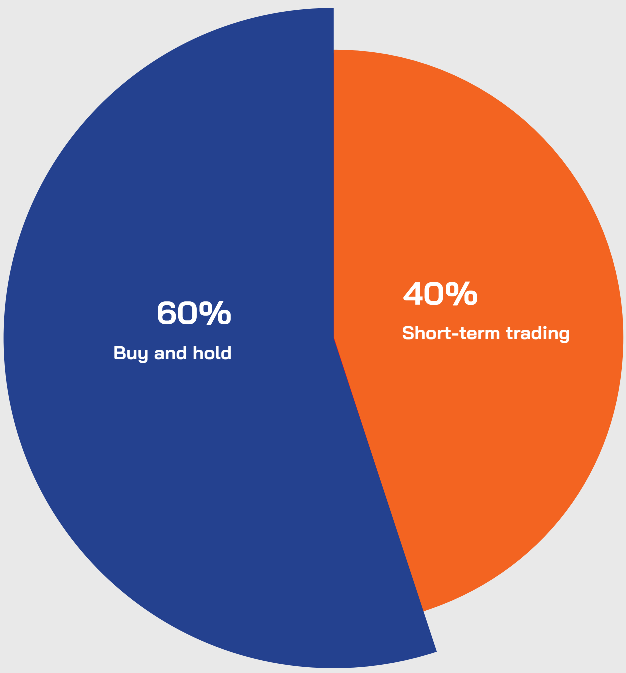
He said that thematics are all about finding something interesting you want to invest in it, and then investing. "The easiest way to find out what it should be returning is to find some historic measurement," he elucidated, "and the best independent way of doing that is often a benchmark. Having a thematic ETF, and being able to monitor that against the benchmark, makes the job so much easier."

And that is why, he reported, for the first time in his career, he had been able to invest via ETFs in areas such as wheat, crude oil and other areas that had become more interesting as a result of the Russian invasion of Ukraine.

WHICH SEGMENTS OF THE ASIAN WEALTH MANAGEMENT MARKET ARE ETFS MOST RELEVANT AND USEFUL FOR?



CHARACTERISE HOW YOU AND/OR YOUR ASIAN HNW AND UHNW CLIENTS ARE USING ETFS

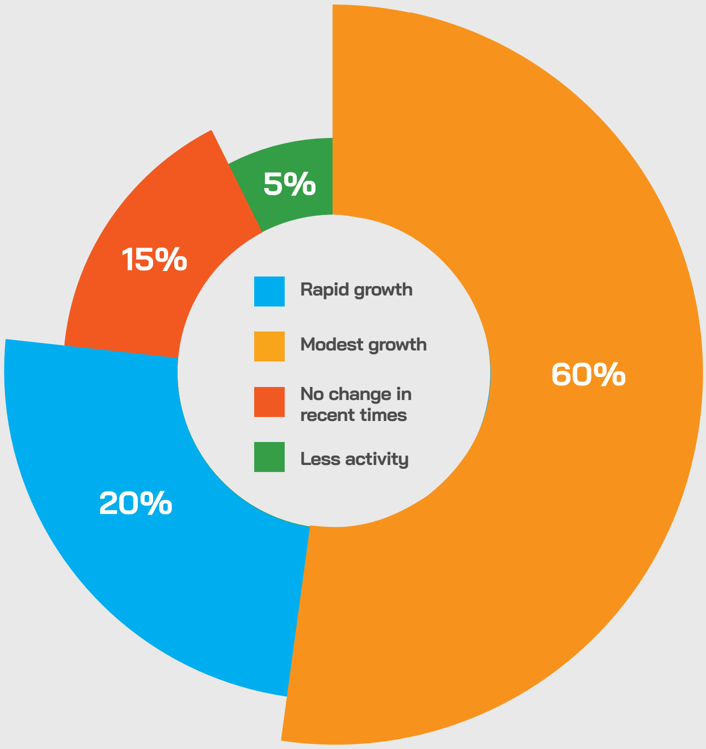


"ETFs like these to tap into these particular segments and trends would not have been available a few years ago, so we owe a lot to the ETF industry, which in turn owes a lot to the indices industry," he said. "Add to that the trading charges for buying and selling ETFs have come down so much – in fact some private banks we deal with offer zero fee trading on ETFs – that accessing and trading these specialist exposures is increasingly attractive."

He said that amongst other thematics, ETFs also help curate increasingly interesting access to the world of fixed income. "For example," he told delegates, "you can obtain fantastic US Treasuries exposure through ETFs, such as through PIMCO to a 25-year plus zero-coupon treasury strip, resulting in about 1.6 times the beta of a 25-year treasury. And actually, as an aside, I would rather like to put a lot of my personal investments into those right now, because I don't believe that interest rates are going to be higher than this in a few years' time. They may be higher in a few months' time, but I don't think they're going to be higher in a few years' time. In short, they are a fantastic play."

He added that ETFs had also emerged in recent years that offered access to key trends. For example, his firm had done well in an ETF that is long on E-commerce and short on the traditional retail sector. "We bought in a few years ago and it did incredibly well, and we sold out, and we keep our eyes on it as a major long-term theme. The Amazons of this world are more likely over time to outperform the supermarkets and hypermarkets."

CHARACTERISE YOUR AND/OR YOUR ASIAN INVESTOR CLIENTS' ACTIVITY IN IMPACT-DRIVEN ETF STRATEGIES, ESPECIALLY ESG ETFS, SINCE 2020.



ETFs are also ideal for robo platforms to help drive the curation of personalised, client-specific model portfolios

A digital platform/robo advisory expert told delegates how they are driving scalable, long-term, diversified, low-cost investment solutions to private clients – retail and mass affluent primarily – to help simplify and demystify the whole investment process. "Passive vehicles are at the heart of our construction process, with the cost and efficiency benefits passed on to the investors," he reported. "Investors can invest across asset classes, which combine public, private markets and alternative asset classes, but for the public market space, the capture of the cost-effective beta is key."

He said that all too often these investors had been 'pushed' products over the last few decades by advisors at the banks who are compensated by retrocessions embedded in those products. "Today," he reported, "the key attributes that are most discussed in both the asset and wealth management industries include transparency, low fees, and the ability to trade intraday, all of which are driving towards more ETFs, and this is part of the growing democratisation of the fund landscape."

ETFs are increasingly employed in advisory and DPM mandates and also generally in helping the wealth industry become more transparent and more aligned to their clients

DPM ideally suits ETFs for both core and tactical asset allocation. "For DPM, when we want to deploy rapidly, we can use ETFs as an element in addition to mutual funds or direct holdings," another expert reported. "Especially in today's highly volatile markets, it is very important to deploy tactically, rapidly and at low cost, and ETFs work well, particularly, as had been discussed, with the range and innovation so much greater today."

He said ETFs now span very interesting areas, be it smart beta, where people more and more research on factor base, whether it's value, whether it's growth, momentum, size, or minimum volatility, all these can be easily deployed.

"We have seen a turn of faith this year, so for investors who quickly wanted to shift from growth to value, ETFs have made it all easy," he observed. "And there are so many interesting thematic ETFs, helping people buy into areas where they believe the long-term secular trends, whether it is cloud computing, or FinTech, 3D printing, digital payments, and so forth. Moreover, there are more and more alternative asset ETFs covering areas such as precious metals, currencies, commodities, all of which are tricky and cumbersome for people to buy into outside ETFs, especially when prices are moving fast."

IN A WELL-FORMULATED HNW OR UHNW MODEL PORTFOLIO, WHAT PERCENTAGE OF ALLOCATION SHOULD BE GIVEN TO ETFS OF ALL CATEGORIES/TYPES?

He added that active funds are far from out of the picture, and that they still have a valid place in portfolios for strategic asset allocation, especially in the European and Asian markets. "But, having said that, ETFs are certainly a very cheap, low-cost investment vehicle for people to employ a core satellite approach in their investments," he noted. "And you can easily deploy using ETF and as mentioned, be it on the bond side or be it in the equity side, global thematic side, on the smart beta side, as there are so many ETF segments that now people can implement so easily at low cost."

Another expert added that the fact that ETFs have grown the way that they have over the last 10 to 15 years is a sign that that the wealth industry as it has been, is being challenged.

People used to say ETFs would never work because advisors couldn't make enough from them, he observed. But he observed that if one now looks at the volumes and at the transparency of fees, it is possible to extrapolate that the wealth industry is shifting towards a different model where fees are more transparent, there are fewer and fewer retrocessions, and where clients will gradually pay for advice, so their advisors are fully aligned with their own goals. That, he explained, has been his EAM model and vision since inception.

Regulation is also helping propel the ETF market

A panellist explained how regulation is a major contributor towards the growth of ETFs. He said MiFID in Europe and RDR in the UK have changed the way the revenue model works for financial advisors. This had helped propel demand for ETFs, and ETFs have helped in the democratisation of investing, especially with the great range of ETFs available now beyond just the traditional assets and the developed markets, the choice is huge.

"Another reason for the shift to ETFs is their immediacy," he observed. "With a traditional fund, you still have that lag, from getting into a fund and selling the fund. But with ETFs, it is more instant and transparent," he observed. "And ETFs can be created rapidly, and brought to the market speedily, to capture the trends and opportunities." Whereas for active funds of course this is altogether a much slower process.

The range, diversity, accessibility and cost of entry for ETFs in Asia is better than ever before

An ETF specialist highlighted the developments taking place rapidly in the past decade or more in the world of ETFs launched out of Asia. Expanding from their country base, this expert reported how they had been working through their Hong Kong

IN A WELL-FORMULATED RETAIL OR MASS AFFLUENT PORTFOLIO, WHAT PERCENTAGE OF ALLOCATION SHOULD BE GIVEN TO ETFS OF ALL CATEGORIES/TYPES?

operation to curate ever more viable and relevant opportunities for clients, whether focused on Korea, China, ASEAN, or favoured sectors such as technology of finance. Whatever the focus of each ETF, the overriding mission is to provide simple tool, low-cost investment solutions to Asia investors, he told delegates.

"We are seeing an increasing wave of thematic ETFs, smart beta ETFs to offer the market more targeted exposures," he reported. "So, you can potentially implement some active strategies, or more easily align your investments to your ideas and values. This has really helped in the distribution and adoption of these instruments in the region."

He pointed, for example, to trades to offset volatility and price erosion in the main markets, such as their biggest ETF in Asia, offering a way to play rising crude oil prices. He said this particular ETF was up more than 50% this year as crude prices shot up. Another vehicle focuses on APAC risk, which historically tends to outperform the broader market during an inflationary cycle, and that had been further propelled by the emergence of the region's economies form the worst of the pandemic lockdowns and restrictions. As a significant play on rising property and rental prices, this strategy currently offers a roughly 5% yield with quarterly payouts.

He added that the next stage is moving into areas like direct indexing, where they are replacing these ETFs and constructing ETF-equivalent exposures themselves. "Because the brokerage costs have been marked down almost to zero, we can ourselves construct these same index components, without having to even pay those small ETF fees, so that is the latest innovation now happening," he explained, "helping customers customise their portfolios. That has been made possible with the advent of direct indexing."

The market still has plenty of room for evolution and improvement, and meanwhile ESG-centricity beckons

A guest remarked that despite all the progress across the board, the ETF market has still room for improvement. He cited fixed income, where not all is backed by actual holdings, with a lot of the structuring based on synthetic fixed income underlying. "The tracking error can therefore be wider than people expect during distressed times," he observed. "Another area is ESG, where the delivery of ESG via ETFs needs to improve significantly."

Another expert noted that their research and activity is predicated not on ESG as a driver for alpha but as a driver more for values-based investing. Expanding on this, he observed that more and more private banks in Asia are starting to look at ESG ratings on each and every fund selection and each individual stock or bond. "In short, we are moving to a place where ESG is going to be more mainstream, and not a separate segment of the portfolio. And we see that more and more ETF providers are nowadays also trying to see if they can add some form of ESG into the index. This does not necessarily mean an ESG index, but them wanting to ensure that certain elements of the index of ETF take care of these ESG issues or the ESG risks." ■