MULTI-LISTED ETFS MULTIPLY IN EUROPE

On Clearstream's Vestima platform, exchange-traded fund assets have grown five times over in the past three years, says Philippe Seyll, co-chief executive officer of Clearstream Banking.

PASSIVE INVESTMENTS ARE TAKING a bigger share of overall fund assets than ever before and exchange-traded funds (ETFs), which account for a large chunk of passive investment, have been the standard-bearer for this shift.

According to ETFGI, a consultancy, there is now more than $3.6 trillion in ETFs globally. Although the US is the largest market, Europe accounts for a significant share. About one-sixth of the global total of ETF assets are held in European ETFs.

The shift from active funds to passive funds presents many challenges for traditional asset managers. Not only must these firms pivot their business models to account for the popularity of passive instruments, they must also accommodate to a much tougher operating environment in which there is a greater focus on cost than ever before.

For market infrastructure firms, the shift towards passive investment presents some operational challenges too, but there are also opportunities to realise greater efficiencies, says Philippe Seyll, co-chief executive officer of Clearstream Banking.

GROWING UP

In line with the European trends, Clearstream has witnessed a rapid increase in ETF assets in recent years. Starting from "a low but not insignificant base", ETF assets under custody have increased five times over in the past three years, says Seyll. He predicts more growth to come, suggesting that in the next three years, the sum will more than double.

That growth reflects the changing tastes of Europe's fund investors. There are many reasons to choose this type of fund: ETFs are transparent, with their holdings visible at all times – unlike traditional mutual funds which tend only to reveal their holdings at periodic intervals, for instance quarterly. ETFs are low on costs too, with fund fees typically measured in basis points. As their name implies, ETFs have the advantage of being traded on exchanges, meaning investors can deal in them as if they were equities.

» **IN EFFECT, WE HAVE EXPANDED WHAT WE'VE DONE FOR CROSS-BORDER FUNDS INTO MULTI-LISTED ETFS. IT MEANS A FRENCH INVESTOR CAN BUY INTO A GERMAN-LISTED ETF AND SELL IT ON THE UK STOCK EXCHANGE SEAMLESSLY.** «

Philippe Seyll, Clearstream Banking

TRADING TROUBLE

Many investors like the idea of being able to trade a fund as they might trade a stock. But there are problems with this approach, as Seyll explains.

"Stock exchanges consider ETFs as equities. ETFs follow the same back-end process on the stock exchange, which means going through the central counterparty of the exchange and being custodised, in most cases, by the central securities depository (CSD). The issue is that ETFs are funds and funds are not suited for secondary markets. They are, by definition, a primary market product. When you buy a fund, you subscribe into a fund and when you sell, you don't actually sell; the fund redeems it from you. Every time someone buys into a fund, the transfer agent has to issue a new unit and every time it's sold, this unit has to be redeemed."

In order to sell to as many European investors as possible while keeping costs low, ETF providers often list the same ETF in different countries. An ETF that is domiciled in Ireland, for example, may be listed on a number of exchanges, such as in London, Frankfurt or Paris. The technical challenge is that, when a share of the ETF is bought in Germany, that unit is custodised with the German CSD. In order for that same unit to be sold in London, the back-end side has to find a way to move that unit from the German CSD and on to the British CSD.

"This is a big task," says Seyll. "It has a cost and an impact on the liquidity of these products as these realignments regularly cause settlement delays or fails."

As an international central securities depository (ICSD), Clearstream can offer solutions such as new issuance models for

EFFECTIVE: The shift towards passive investment offers opportunities to realise greater efficiencies, says Philippe Seyll.

ETFs. Last year, the ICSD model was set up and adopted by some major issuers, improving liquidity, reducing cost and speeding up realignments within Europe. Clearstream can also offer ETF issuance through LuxCSD, the latest product launched under a suite of ETF issuance services in its Vestima suite of services. Issuers of Europe-domiciled ETFs benefit from LuxCSD's direct access to the Eurosystem's settlement platform TARGET2-Securities (T2S) and to the international distribution network via LuxCSD's link to the ICSDs.

Clearstream has further expanded its Vestima platform to be able to handle ETFs in the same way it handles conventional mutual funds. Investors are increasingly seeking to combine ETFs and mutual funds in a single portfolio. Vestima meets these needs by enabling ETF trading on an over-the-counter/infrastructure basis. Although fund units are custodised in the countries where they are listed and sold, Clearstream creates a mirror of transactions in its ICSD in Luxembourg. The service allows for transactions in ETFs listed in multiple exchanges, without the hassle and pain.

"Our system takes care of the complexity," says Seyll. "It's low on cost and it's automated. In effect, we have expanded what we've done for cross-border funds into multi-listed ETFs. It means a French investor can buy into a German-listed ETF and sell it on the UK stock exchange seamlessly."

THE TRENDS

Clearstream has invested in expanding its ETF services for a simple reason: its management team believes ETF demand will continue to rise. For Seyll, the reasoning is simple: as investors improve their understanding of the financial world, they like to take more control over their own investments, and ETFs are the perfect tool for doing so. If a sophisticated investor wants to increase their exposure to the US equity market, a straightforward and cost-effective way to do so is to buy an ETF tracking a major US equity index, such as the S&P 500 index.

Unlike in the past, when retail investors typically allowed their financial adviser to make financial investment decisions on their behalf, there are more and more investors in Europe who want to have a hand in shaping their portfolios, says Seyll, and this points to a growing demand for ETFs in the retail market. Institutional investors, too, are increasingly large buyers of these products.

That's not to say that retail investors will become wholly self-reliant. A notable trend is for investors to choose a set-up in which they invest in a range of ETFs, but defer the allocation between those funds to their adviser. This kind of hybrid approach seems to be on the rise among European wealth managers.

» THE MOVE FROM ACTIVE TO PASSIVE PLAYS IN FAVOUR OF HEDGE FUNDS. HIGH-NET-WORTH INVESTORS OR PENSION FUNDS WILL PROBABLY SHIFT PART OF THEIR PORTFOLIOS TO PASSIVELY MANAGED FUNDS BUT WITH WHAT REMAINS, THEY WILL BE MORE INCLINED TO TAKE MORE RISK. «

Philippe Seyll, Clearstream Banking

ROOM FOR ALPHA

But will ETFs entirely displace actively managed funds? This seems unlikely, despite some predictions.

According to critics of asset management, the shift to passive investment is characterised as a battle in which ETFs have everything to gain and actively managed funds everything to lose. Certainly, managers of developed market, long-only equities are under pressure to justify their fund fees in an environment when the majority of managers fail to beat their benchmarks once fees, custody and transaction costs are included. For these managers, ETFs are a constant challenge and there is evidence that influential investors, such as pension funds, are using the growth of ETFs as a bargaining tool to force down asset managers' fees to historically low levels.

However, there are a range of actively managed strategies which are likely to remain popular, or perhaps even gain in popularity, despite the growth in ETF assets. To succeed, such funds must demonstrate the ability to generate alpha returns which are uncorrelated to the major markets.

Hedge funds are a good example of a fund type that has the potential to thrive in an environment where ETFs are more common, says Seyll.

"The move from active to passive plays in favour of hedge funds," he says. "High-net-worth investors or pension funds will probably shift part of their portfolios to passively managed funds but with what remains, they will be more inclined to take more risk. That will favour funds that can exploit market inefficiencies."

However, from Clearstream's perspective, as a market infrastructure, it doesn't matter which types of funds are in favour. This is because the firm has built its strategy on the basis of serving every type of demand, a so-called one-stop shop for all fund classes.

"We don't mind what investors buy because we have equipped ourselves to take passive, active and hedge funds," says Seyll. "We at Clearstream are neutral."