

ETF INSIDER

SEPTEMBER 2024 • EUROPE'S LEADING ETF MAGAZINE FOR PROFESSIONAL INVESTORS

High-fee legacy ETFs exposed

Why investors still house billions
in expensive products



p.11 Expert Investors:
JP Morgan's Katy
Thornycroft

p.18 Active US equity
ETFs in focus

p.24 Volatility reigns:
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equity ETFs?





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A spotlight on legacy ETF fees

Welcome to the September edition of *ETF Insider*, the first ETF magazine dedicated to professional investors across Europe. Each month, we produce analysis on a specific area of the market, be that fixed income, emerging markets or factors while also providing expert insights into the latest on asset allocation and portfolio construction, always through an ETF lens.

This issue focuses on equity ETFs. While much of the focus has been on fixed income in an era of higher for longer interest rates, overexuberance in equities has been a major concern for investors with many split on how far the AI-driven rally can go.

This was tested in the flash crash of early August which saw the Nasdaq 100 post its worst day since 2022. Investors spotted the opportunity however, ploughing over \$2.4bn into US equity ETFs in the first three weeks of the month. *ETF Stream* reporter Lauren Gibbons takes a look at whether the fun is over for tech-focused equity ETFs.

Fees have also been a huge story within equity ETFs over the past few months, most notably when State Street Global Advisors created Europe's cheapest US equity ETF when it cut the fees on the SPDR S&P 500 UCIS ETF (SPY5) from 0.07% to 0.03% forcing others to follow suit.

This all happened when many in the industry were saying the cost of broad beta equity ETFs could not get much lower. Why then, are so many assets still lingering in more expensive legacy ETFs often tracking the same index? For example, the iShares MSCI World UCITS ETF (IWRD) launched in 2005 with a TER of 0.50%. This was undercut by the launch of the \$81.3bn iShares Core MSCI World UCITS ETF (SWDA) in 2009 with a TER of 0.20%. However, the former still holds \$7.3bn assets under management.

Is it investor inertia? Fee grabbing from asset managers? Or perhaps there are more structural reasons behind the phenomenon. Jamie Gordon, features editor at *ETF Stream* explores why this might be the case (p.30).

Elsewhere, Parala Capital's Steven Goldin compares the characteristics and performance of active US equity ETFs in a fascinating deep dive into the ever-growing segment of the active ETF market (p.18).

Finally, keep an eye out for the usual segments 'ETF of the month' (p.13) and 'Fund Fights', where *ETF Stream* compares the strengths and weaknesses of similar ETFs (p.15). Finally, I want to highlight our Expert Investors series where ETF fund selectors about their asset allocation and ETF usage (p.11).

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ETF INSIDER

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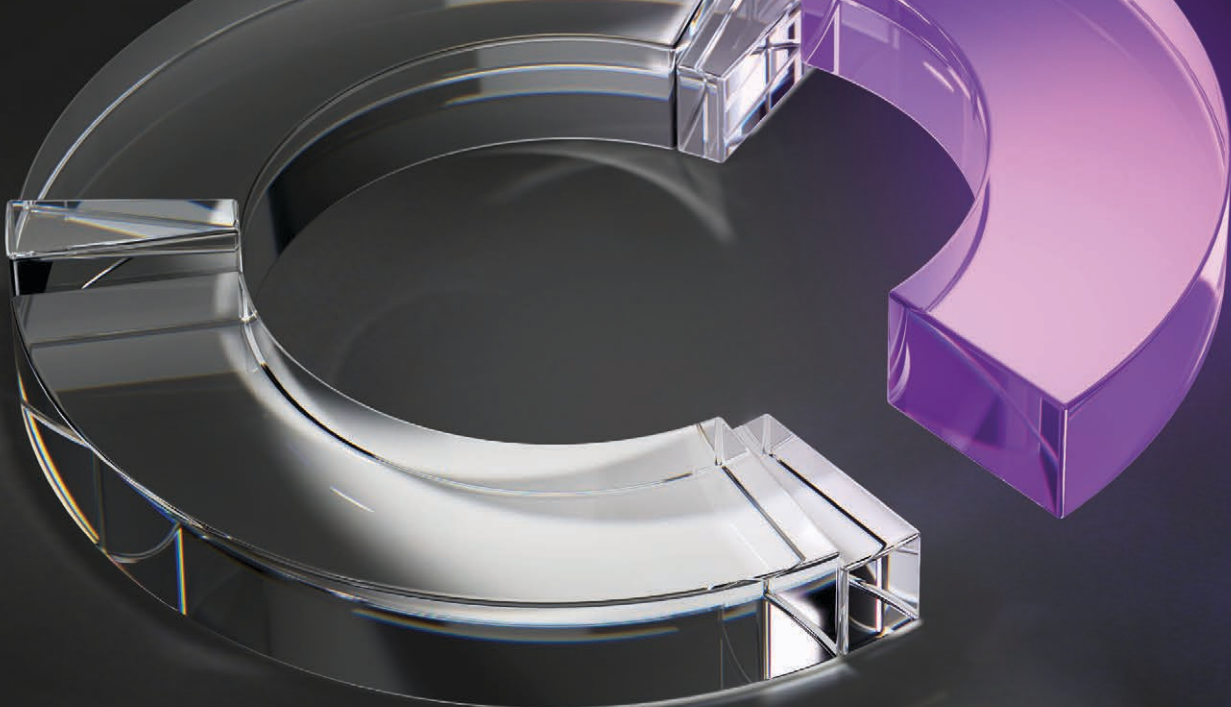
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The ETF Stream Awards is back for its fourth year, with the continued aim of bringing together and celebrating the European ETF ecosystem. The awards ceremony will act as a barometer of the industry's growth and achievements over the past 12 months.

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News & views

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Vanguard ownership limit warning: ETF hysteria or reality check?

Regulators eye ownership caps for large-scale asset managers

By **Theo Andrew**

Vanguard's warning last month that US regulators were eyeing the possibility of restricting stakes in certain sectors caught the attention wider ETF industry, but is this another case of 'passive power' bashing or the reality check investors needed?

The asset manager filed disclosures across several funds with the Securities and Exchange Commission (SEC) highlighting the possibility regulators could enforce caps on its physical equity ownership of individual banks and utilities. Currently, regulators allow asset

managers to exceed 10% ownership stakes provided they do not seek management roles.

If implemented, passive giants would be required to sell their physical exposures in these sectors, instead relying on derivative-based exposure which could come at an additional cost for investors.

The caution again raises the issue of the dominance of the 'Big Three' – Vanguard, BlackRock and State Street Global Advisors (SSGA) – which has threatened to boil over throughout the meteoric rise of passive investing. ETFs and index funds have found themselves

“The caution again raises the issue of the dominance of the ‘Big Three’ – Vanguard, BlackRock and State Street Global Advisors (SSGA) – which has threatened to boil over throughout the meteoric rise of passive investing.”

in the firing line from some big US hitters over the past few years, including Elon Musk and Bernie Sanders, with the latter stating “democracy would not survive” at current ownership levels of the ‘Big Three’.

The trio own over \$21trn in assets and controls roughly a quarter of the votes of the entire S&P 500, according to Martin Schmalz, professor of finance and economics at Oxford Saïd.

The potential of further capping limits by the SEC on the physical ownership of equities is the first that could dramatically hit investor portfolios, with fund costs and performance directly impacted by the requirement to hold derivatives.

Industry bodies have been quick to debunk the myths associated with the warning, noting it risked harming “tens of millions of American investors”, although in reality the damage is likely to spread much wider.

In a statement, Vanguard said: “It is not always possible to secure relief and there is an increasing amount of uncertainty around how much ownership limitations relief regulators will grant to asset managers like Vanguard.”

One way issuers have tried to alleviate regulatory pressure is by implementing proxy voting programmes. BlackRock and SSGA both expanded their voting powers last year, with the former announcing plans to include retail investors in its proxy voting choice programme on its largest ETF, the \$516bn iShares Core S&P 500 ETF (IVV), while Vanguard also said it would trial proxy voting.

The success of these programmes has yet to bear fruit however, despite being their main defence against passive power criticism.

It is the latest in a series of attacks on the ‘Big Three’ and its impact on markets, in addition to the idea the rise of indexing is distorting markets. Investors must keep an eye on developments as one that has the potential to pose a real threat to portfolios.

Theo Andrew is Editor at ETF Stream

Dateline: The month in review

01 August

State Street slashes global equity ETF fee

State Street Global Advisors (SSGA) cut the fee of its global equity ETF from 0.40% to 0.12%, with the move making it the second cheapest all-world ETF in Europe. Despite the cut, the SPDR MSCI ACWI UCITS ETF (ACWD) still sits behind the Amundi Prime All Country World UCITS ETF (WEBG) with a total expense ratio (TER) of 0.07%. SSGA also reduced the fee of its euro government bond ETF from 0.10% to 0.07%. The fee cut matches the TER of the iShares Core Euro Government Bond UCITS ETF (SEGA) and the Vanguard EUR Eurozone Government Bond UCITS ETF (VETA). The Amundi Prime Euro Govies UCITS ETF (PRIR) remains the cheapest in Europe, with a TER of 0.05%.

05 August

Nikkei 225 ETFs suffer worst day on Bank of Japan hawkishness fears



Nikkei 225 ETFs experienced their worst daily loss on record after Japan's flagship index slumped following additional rate hikes from the Bank of Japan (BoJ). The Nikkei fell 12.4% on 5 August, triggered by the BoJ's decision to hike rates for a second time to 0.25%, after ending its negative interest rate policy (NIRP) with its first hike since 2007 in April. The effects were seen in the \$353m WisdomTree Japan Equity UCITS ETF - GBP Hedged (DXJP) which fell 11.7% in the week to 2 August.

02 August

BNP Paribas in talks to acquire AXA IM in €5.1bn deal

AXA and BNP Paribas proposed tie-up could have a profound impact on the European ETF market with the former selling its investment arm in a €5.1bn deal. The partnership would create a €1.5trn asset manager and would mean that BNP Paribas would acquire AXA IM and its Select business as part of a long-term strategic partnership. This is the second joint venture between AXA IM and BNP Paribas, with the two asset managers co-founding EasyETF in 2005. Thomas Burberl, CEO of AXA said: "In the context of a rapidly consolidating and highly competitive asset management industry, the group has considered different options to support the future



development of AXA IM and to best align with the strategic goals of AXA to further simplify its business profile and grow its insurance businesses. By joining forces with BNP Paribas, AXA IM would become a global asset manager with a wider product offering and a mutual objective to further their leading position in responsible investing."

13 August

EFAMA does not expect a 'wave' of new asset classes for ETFs

The European Fund and Asset Management Association (EFAMA) said it does not expect a significant expansion of asset classes that will be eligible under UCITS following the European Securities and Markets Authority's (ESMA) review. EFAMA deputy director Federico Cupelli suggested only a "gradual opening-up" of new asset classes might occur, despite initial expectations the review could include assets such as cryptocurrencies and commodities. The two asset classes are already available via exchange traded products (ETPs), meaning their inclusion under UCITS is not immediately pressing.

16 August

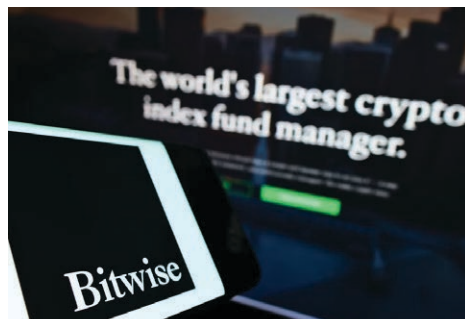
JP Morgan AM appoints Spence global ETF head

JP Morgan Asset Management (JPMAM) named Travis Spence global head of



ETFs, as the firm continues to build out its already expansive active ETF share in Europe. In his new role, Spence will lead ETF product development, capital markets, the firm's newly formed ETF insights division and continue to head ETF distribution across EMEA. Spence's promotion comes after the departure of former global ETF head Bryon Lake, who left the firm for Goldman Sachs Asset Management. Spence said: "Our ETF franchise will continue to be anchored by our deep fundamental and quantitative research, active management, and risk management capabilities — supported by the deep expertise of our ETF specialists, product development, capital markets and strong client relationships across every region."

19 August Bitwise enters Europe with ETC Group acquisition



Bitwise Asset Management has entered Europe with the acquisition of ETC Group, a move that boosts Bitwise's total assets under management to \$4.5bn. Following the acquisition, ETC Group's existing crypto ETPs will be rebranded under the Bitwise name while keeping the same investment objectives. The move follows Bitwise successfully launching its first bitcoin ETP in January in the US – the Bitwise Bitcoin ETF (BITB) – which has gathered \$2.2bn since its launch. ETC Group has also made senior appointments in recent months with the hire of Ronald Richter as director of investment strategy and Wendy Langridge as chief regulatory officer in March.

20 August Morgan Stanley to close six remaining ETFs on FundLogic platform



Morgan Stanley is closing its remaining six smart beta ETFs available on its FundLogic platform after assets of the ETFs had fallen below a specific threshold. The multi-factor range lost 91.7% of its assets in 2023 after amassing €300m in its first five years. The decision highlights

that smart beta ETFs have fallen out of popularity, with the asset class suffering outflows of €1.5bn in Q1 2024.

21 August Active ETF investment process needs more transparency

An *ETF Stream* survey of its ETF Buyers Club revealed that investors believe the active ETF investment process requires greater transparency. Many respondents said they desired more clarity around how active ETFs are managed, which can impact their decision making. The survey also highlighted the growing demand for more detailed insights into the strategies and processes behind active ETFs.

23 August Robeco makes ETF sales push ahead of European entry

Robeco is intensifying its ETF sales efforts as it prepares to enter the European market, with the company making hires to support its upcoming ETF product launches in Europe. It comes as the firm appointed Nick King in October last year, while *ETF Stream* revealed last month that Robeco appointed Dorcas Phillips as head of capital markets from Fidelity. Phillips reports to King and the pair had previously worked together during the latter's time at Fidelity.

27 August ESG fund naming rules set for November

New ESG fund naming rules are set to be implemented in November by the European Securities and Markets Authority (ESMA), aiming to protect investors from greenwashing and unsupported sustainability claims. The new rules will mean funds with the term ESG or sustainable in their name must have at least 80% of investments tied to environmental or social characteristics. According to Morningstar Sustainalytics, only 21% of ESG funds set to be impacted are ETFs and index funds.

Most read August

1 Fidelity poaches active ETF product specialist from BlackRock



2 Vanguard to fully replicate emerging markets ETF on market volatility

3 BNP Paribas AM and AXA IM tie-up underscores dangers for mid-sized issuers

4 How rising retail ETF trading can benefit institutional investors

5 State Street slashes global equity ETF fee

6 Why combine gold and yield in an ETP?

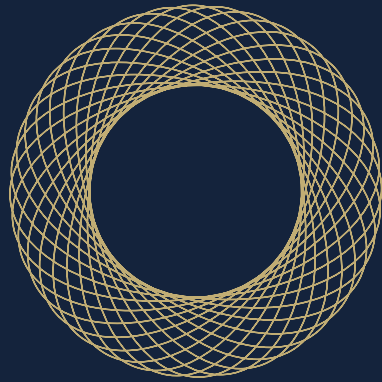
7 Five ETFs for Federal Reserve rate cuts

8 Regulatory dispersion hinders European ETF growth

9 Robeco makes ETF sales push ahead of European entry

10 Are European regulators rushing to 'charm' active ETF issuers?

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Expert Investors



ETFs finding pockets within institutional portfolios

Expert Investors is a series where ETF Stream interviews fund selectors on the role of ETFs within their asset allocation. In the hot seat this month is Katy Thorneycroft of JP Morgan AM

By **Jamie Gordon**

While institutional investors have yet to undergo the cultural shift towards widespread ETF adoption, Katy Thorneycroft, CIO for international multi-asset solutions at JP Morgan Asset Management, said the wrapper comprises a growing role within certain institutional portfolios.

Thorneycroft, whose team covers approximately \$50bn of non-US mandates, noted her firm's clients view ETFs as "a very helpful vehicle" owing to intraday pricing and trading. "While it is still a relatively small part of what we do, we are increasingly finding clients have a preference for ETFs, depending on the

types of clients they are and what they are looking for," Thorneycroft said.

She added where ETFs play a role, this has tended to be as a vehicle for providing exposure to existing strategies such as JPMAM's 'research enhanced index' systematic active approach for smaller mandates looking to minimise tracking error. "We would typically use ETFs more strategically for those kinds of clients," she said. "We have got an increasing number of clients that would like advised model portfolios and ETFs are a useful tool as the end client can easily trade the advice when we are using ETFs as part of it."

Small caps primed for comeback

Turning to asset allocation, Thorneycroft noted her team retains an overweight to

the S&P 500 and sectors including energy, but expects an acceleration and broadening out of earnings beyond 'Magnificent Seven' names.

"The next step for us is to look at ways to access the rest of the US equity market, for instance looking at equal-weight indices or small caps," she said.

"We are neutral small caps for now, but we have seen smaller companies run hard as we have started to get expectations that we are eventually getting closer to Federal Reserve rate cuts."

She cautioned investors to evaluate whether a potential small cap revaluation is just the effect of rate cuts being priced in, or whether this part of the market can deliver consistent earnings.

"We need to be mindful that as we see rate cuts, whether this takes off enough of that financial pressures for some of those loss-makers who are perhaps more highly leveraged and whether there might be a follow-through in earnings growth to take that revaluation story a little further," she said.

Beyond the US Treasury yield curve

Within fixed income, Thorneycroft's team has not confined itself to this year's playbook path of restoring US Treasury duration exposure to near benchmark levels, instead also spying opportunities within the credit space.

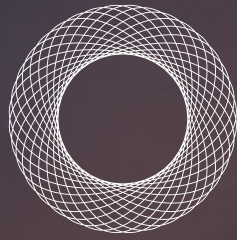
"As an asset class, high yield, for instance, works very well in terms of the carry," she said. "We have to be upfront about the fact we will not get much spread tightening, but absent a difficult growth environment, you can pick up that carry nicely and get attractive all-in yields for credit assets at the moment."

Within sovereign bonds, she added her firm is underweight duration and "leaning away" from the US.

"We like markets such as UK gilts and we are underweight markets such as Japanese government bonds, as we know the Bank of Japan is going to continue wanting to normalise interest rates."

"We have got an increasing number of clients that would like advised model portfolios and ETFs are a useful tool as the end client can easily trade the advice when we are using ETFs as part of it."

Jamie Gordon is senior features reporter at ETF Stream



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SPDR Bloomberg 15+ Year Gilt UCITS ETF (GLTL)

This issue's ETF of the month has seen the highest returns and inflows of any UK gilt ETF in recent months

As central banks begin pivoting after more than two years of hawkish interest rate policy, longer-dated UK gilt strategies such as our ETF of the month from State Street Global Advisors (SSGA) have come into view for fund selectors.

The \$679m SPDR Bloomberg 15+ Year Gilt UCITS ETF (GLTL) has welcomed \$327m inflows so far in 2024 as at 27 September, according to data from TrackInsight, more than any other ETF offering UK gilt exposure.

Driving GLTL's strong momentum in recent months has been the Bank of England's much-anticipated decision to cut its key policy rate by 0.25% in early August, a move which saw GLTL claim the top spot as the strongest performing UK gilt ETF in the

STAT ATTACK

Ticker	GLTL
AUM	\$679m
YTD flows	\$327m
Three-month return	8.7%
Constituent count	28
Effective duration	16.9 years
Data as at 28 August	

one and three-month periods to 27 August, with gains of 5.8% and 8.7%, respectively.

GLTL's edge owes to the fact it provides the longest duration exposure to UK gilts of any product in the UCITS ETF roster, with an effective duration of 16.9 years.

It achieves this by physically replicating the Bloomberg Sterling 15+ Year Aggregate Gilts Bond index comprised of 28 UK sovereign issuances with maturities of

at least 15 years, weighted by market cap. Henry Cobbe, head of research at Elston Consulting, highlighted GLTL as a top performer and a potential tool for investors looking to add duration within their UK gilt allocations. He added: "Through this year, we have been recommending to our clients – UK investment managers and financial advisers investment committees – to extend bond portfolio duration gradually in anticipation of the BoE to pivot and start cutting interest rates.

"For the same rationale as we recommended our clients to go into very short – under one-year duration – ultrashort bonds and floating rate notes in a rising interest rate environment back in November 2021, it made sense this year to extend duration in this falling rate environment."

While not focusing on sovereign issuance, Alan Miller, CIO at SCM Direct, noted his firm has reallocated 3% of its assets from short duration to longer maturity sterling-denominated corporate bond ETFs.

"Recently, the UK yield curve has exhibited a relatively flat shape, with long-term bond yields only slightly higher than those of shorter-term bonds," Miller continued.

"This flattening suggests future interest rate cuts by the Bank of England, which could cause the yield curve to shift downward. In such an environment, longer-maturity bonds become more attractive, offering higher yields and the potential for significant capital gains."

"GLTL's edge owes to the fact it provides the longest duration exposure to UK gilts of any product in the UCITS ETF roster, with an effective duration of 16.9 years."



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Fund Fights

Two gold ETCs with contrary sustainable angles

Fund Fights is a series where ETF Stream analyses the strengths and weaknesses of similar ETFs. This month, HANetf's RMAU and Tabula IM's BARS go head-to-head

ESG investors looking to access commodities have never had it so good, with HANetf and Tabula Investment Management offering two exchange-traded commodity (ETC) routes for more sustainable gold exposure.

August saw the precious metal hit a fresh all-time-high of more than \$2,500 an ounce, with wrapped gold products enjoying three consecutive months of inflows and July marking their strongest month of inflows since August 2022, according to data from the World Gold Council. With markets pricing in a potential Federal Reserve rate cut in September, sustainability-conscious investors may continue to look to the commodity through issuers' increasingly creative offerings.

HANetf's RMAU

The Royal Mint Responsibly Sourced Physical Gold ETC (RMAU) is Europe's longer-standing ESG gold wrapper, amassing \$944m assets under management (AUM) since inception in February 2020. RMAU is physically backed by post-2019 LBMA good delivery bars and from March 2022, the ETF halted exposure to Russian gold and retroactively switched out all 60 of its existing underlying bars,

following the invasion of Ukraine. All underlying is also compliant with LBMA Responsible Gold Sourcing Standards. In June that year, RMAU incorporated 'responsibly sourced' branding into its name after becoming the world's first ETC to be backed by recycled gold.

As at 20 August 2024, RMAU's underlying was 51.5% comprised of recycled gold, predominantly from the 'swarf' gold dust discarded while engraving Royal Mint commemorative coins. The ETC also received \$170m seed funding from Quintet Private Bank as part of its project to extract gold from used smartphones and laptops.

Tabula's BARS

A recent challenger has entered in the form of the SMO Physical Gold ETC (BARS), which has made impressive early inroads with \$474m since launching in April, as at 21 June. BARS marks Tabula's first venture outside of fixed income ETFs and sees

the firm partner with Single Mine Origin (SMO), a company dedicated to conducting 'mine to vault' due diligence on mining companies, mining sites and refiners to ensure gold is sourced from a select list of mines adhering to ESG criteria.

This includes each mine being independently audited to verify they provide social, environmental and cultural support to communities, with underlying gold not being of Russian origin, not being recycled gold of unknown provenance and mercury not being used in the extraction process.

Gold can also only be sourced from mining companies aligned with SMO's internal governance framework and international standards such as World Gold Council Responsible Gold Mining Principles. Where new securities are issued, Tabula noted BARS may temporarily be backed by non-SMO bars, however, the underlying will still meet LBMA delivery and responsible gold standards, meaning sustainable provenance will always remain at least on par with RMAU.

Comparing ESG gold

Both ETFs take different angles to offering more ESG conscious gold exposure, with RMAU adhering to LBMA responsible sourcing standards but its key sustainable selling point being its recycled gold mechanism, which HANetf argues is a less carbon-intensive route to sourcing gold versus newly mined metal.

BARS, meanwhile, relies on SMO's due diligence methodology, which SMO advertises as enabling traceability down to a single mine, backed by regular visits of mining sites by its personnel and proprietary ESG data spanning emissions, energy intensity and water usage.

At the very least, RMAU offers an innovative route for repurposing discarded gold that may otherwise have been wasted, while BARS provides investors the assurance their gold exposure is sourced from mines that lead on minimising negative environmental and social impacts.

The key challenge for fund selectors is verifying the claims made by each provider – such as how much carbon is saved by relying on recycled gold or the accuracy of SMO's due diligence and ESG data.

STAT ATTACK

	RMAU	BARS
Launch	Feb 2020	April 2024
AUM	\$871m	\$474m
TER	0.25%	0.29%

Data as at 26/6/24

ETF Buyers Club

The ETF Buyers Club is a community for investors active in the world of ETFs and is the first peer-related group of its kind. Each month, a member of *ETF Stream's* ETF Buyers Club will analyse some of the most important issues facing ETF investors

The smart home revolution: Investment opportunities in the Internet of Things

The dawn of a new era in home automation

By Bruno Schneller

As we progress through 2024 and look towards the future, the concept of the 'smart home' continues its evolution from a visionary idea to a tangible reality. This in-depth analysis explores how advancements in affordable technology, an increasing emphasis on sustainability, and innovative home automation products are catalysing a vibrant sector poised for exponential growth.

Amidst this transformation, the integration of on-device AI, the Internet of Things (IoT) and the upcoming shift towards 5G technology are setting the stage for a new wave of consumer-centric technologies.

Key drivers of the smart home surge

Economic and technological foundations:

- **Affordable technology:** The proliferation of low-cost semiconductors has been crucial. Microprocessors like the ESP8266/ESP32 and ARM Cortex have laid the groundwork for affordable smart home devices, sparking a significant increase in availability and adoption.
- **Network stability:** Enhanced wifi through mesh networks and improved fixed net-

work connections ensure that smart home devices function seamlessly, providing a flawless user experience devoid of connectivity issues.

Industry Standards and Ecosystem Development:

- **Matter standard:** The adoption of the Matter standard by the Connectivity Standards Alliance, which includes industry giants like Apple, Google, and Amazon, has significantly enhanced device interoperability, fostering a unified ecosystem where devices from various manufacturers can communicate effortlessly.

Connectivity and digital infrastructure: The backbone of IoT

Expanding Digital Networks:

- **5G and beyond:** The transition from 4G to 5G represents a significant leap, enhancing the IoT ecosystem with higher data speeds and increased network capacity. This shift is expected to expedite the adoption rate of 5G, setting the stage for even more advanced 6G technologies in the future.

The Industrial IoT (IIoT) and industry 4.0:

- **Transformation in manufacturing:** IIoT is a major component of the Fourth Industrial Revolution, transforming man-

ufacturing processes through enhanced connectivity and automation. Smart factories equipped with IoT sensors and AI capabilities can drastically improve efficiency and reduce downtime through predictive maintenance.

Market dynamics: Comprehensive analysis and growth forecast

Surging demand and expanding markets:

- **AI-driven demand:** The integration of generative AI technologies is expected to reverse the downturn in smartphone sales and propel a significant upgrade cycle. For instance, Apple's introduction of advanced AI features in its devices is setting a new standard that competitors and adjacent industries are rushing to match.

Strategic opportunities for energy management:

- **Energy conservation initiatives:** Increasing emphasis on energy efficiency serves as a compelling application for smart home technology, enabling consumers to optimise their energy usage effectively, aligning with broader environmental objectives.

Navigating the investment landscape: Opportunities and risks

Identifying and seizing Investment opportunities:

- **Diverse investment portfolio:** Investors should consider a mix of established firms and emerging startups within the smart home domain. This approach not only provides exposure to stable earnings but also positions investors to capitalize on innovative breakthroughs.
- **Sector-specific trends:** Keeping abreast of developments within specific niches, such as security or energy management, can provide targeted opportunities for substantial growth.



Challenges and risk management

- **Security concerns:** With the expansion of the smart home ecosystem, securing IoT devices becomes increasingly critical. Investors need to scrutinise the cybersecurity measures adopted by companies within this sector.

Emerging Trends and the Future of Smart Home Technology

Technological advancements:

- **Integration with AI and Big Data:** Future advancements are expected to leverage artificial intelligence and big data analytics to enhance the functionality and personalisation of smart home systems.
- **Next-Gen interoperability:** Continued enhancements in standards like Matter will further drive the seamless integration of new devices into the smart home ecosystem.

Long-Term Strategic Vision: Beyond Immediate Gains

Sustainable and adaptive technologies:

- **Smart Grids and renewable integration:** Looking ahead, smart home systems are likely to integrate more closely with smart grids and renewable energy sources, promoting energy independence and sustainability.
- **Health and wellbeing:** Advanced sensors and health monitoring technologies are becoming integral to smart homes, offering significant potential for enhancing residents' health and wellbeing through environmental adjustments.

Capitalising on the IoT revolution in smart homes

The ongoing transformation in the smart home landscape represents a confluence of innovation, investment opportunity, and

consumer demand that spans well beyond 2024. For investors, effectively navigating this sector involves a deep understanding of technological shifts, market dynamics, and strategic capital deployment.

This era not only promises significant financial returns but also offers the chance to be at the forefront of shaping the future of residential living through the power of IoT. Engaging thoughtfully and strategically with the smart home revolution opens up a unique opportunity to participate in pioneering the next wave of technological advancement in home automation, especially as we transition from 5G to 6G technologies, heralding a new age of ultra-connected, intelligent home environments.



Bruno Schneller is managing director of Erlen Capital Management

Is it time to get more active in the US?

A deep dive into US active equity ETFs

By Steve Goldin

There are lots of new active ETFs being launched and a recent report from Morningstar highlighted that active ETFs are approaching a 10% share of the overall market

Parala typically uses passive ETFs to reflect desired asset class, market, factor and sector exposures in its portfolios. However, our investment technology is also used by investors to identify manager skills and provide forward-looking rankings of actively managed investment products with an ability to identify 'all-weather' and time-varying manager skills with the latter linked to the business cycle.

Having a sophisticated model like Parala's is useful for investment decisions and can also help investors understand individual ETF's characteristics, risk factor exposures, business cycle sensitivities and sources of added value which is the goal of this article.

While the ETF wrapper itself does not boost an investment manager's alpha-generating skills, there are some "features with benefits". Firstly, many of the recently launched active ETFs have lower management fees than traditional mutual funds. Secondly, large fund houses can offer systematic strat-

egies at low cost which provides investors with potential performance benefits from deep security level and/or factor research. Thirdly, active ETFs provide the flexibility for fund managers to include qualitative judgement and/or ESG research within their security selection.

The active ETFs below were selected to highlight different investment approaches within US equities provided they had a sufficient length track record for analysis. Collectively, they represent the three "features with benefits" although two of the ETFs have fees more typical of actively managed mutual funds. Since four of the five ETF offerings include ESG features, the MSCI USA ESG Leaders index is included in the analysis to approximate any differentiated performance attributable to a passive benchmark exposure incorporating ESG criteria.

Investment strategies with distinct levels of active risk

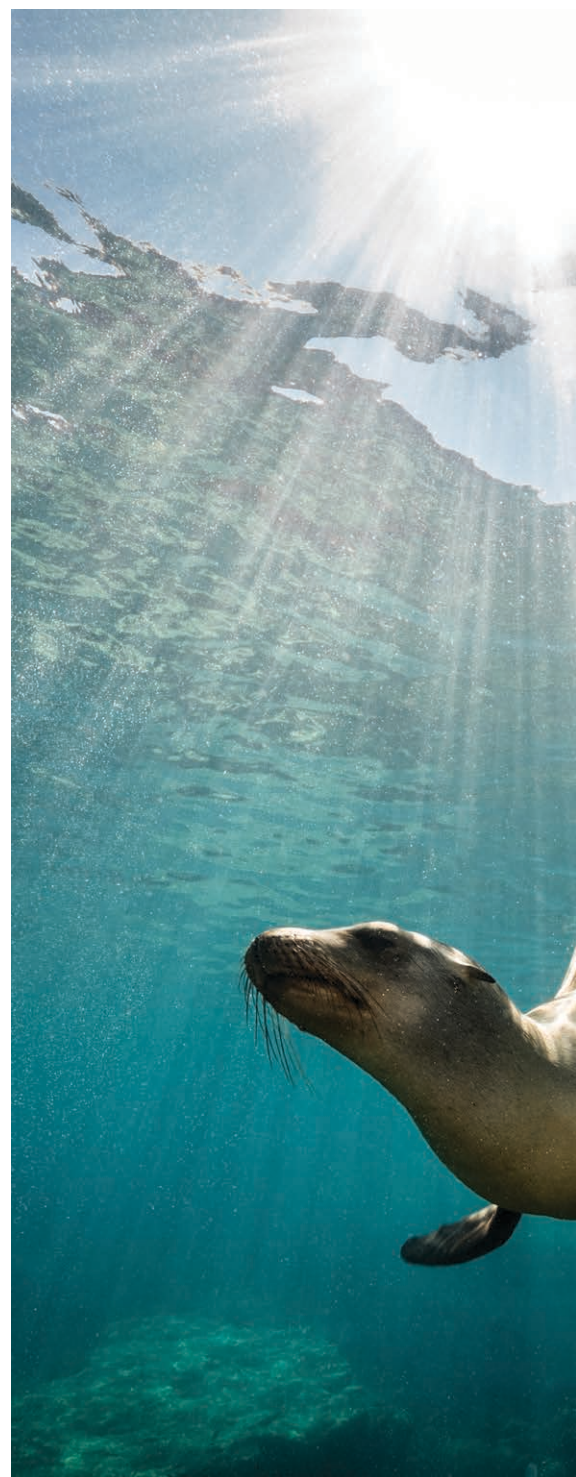
There are three types of strategies being employed across these five ETFs:

1. Research-based security selection to add value. Sector weights are kept close to the benchmark. This includes the Fidelity Sustainable Research Enhanced US Equity UCITS ETF and the JPM US Research

CHART 1: ACTIVELY MANAGED US EQUITY UCITS ETFs IN OUR ANALYSIS

Ticker	Name	AUM (\$m)	TER	ESG Criteria	Inception Date
FUSR	Fidelity Sustainable Research Enhanced US Equity UCITS ETF	\$351	0.20%	Yes	Jun-20
UINC	First Trust US Equity Income UCITS ETF	\$302	0.65%	No	Apr-16
JREU	JPMorgan US Research Enhanced Index Equity (ESG) UCITS ETF	\$9,530	0.20%	Yes	Oct-18
5HED	Ossiam ESG Low Carbon Shiller Barclays CAPE US Sector UCITS ETF	\$76	0.75%	Yes	Jun-18
OUFU	Ossiam US ESG Low Carbon Equity Factors UCITS ETF	\$35	0.45%	Yes	Jun-19

Source: Bloomberg as of 12 August 2024



Enhanced Index Equity (ESG) UCITS ETF. Notice that both offerings include the word 'Enhanced' so they must be good.

2. Low carbon factor-based research and portfolio construction to add value. Sector weights may deviate significantly from the S&P 500 to provide lower than market benchmark levels of carbon exposure. The Ossiam ESG Low Carbon Shiller Barclays CAPE US Sector UCITS ETF and Ossiam US ESG Low Carbon Equity Factors UCITS ETF are examples of this approach.

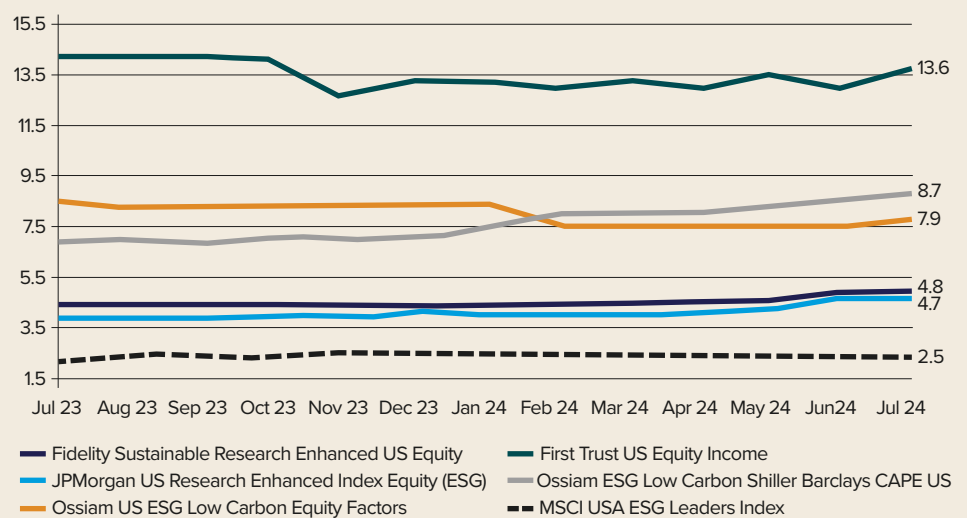


CHART 2: ACTIVE SECTOR WEIGHTS RELATIVE TO THE S&P 500 INDEX

Sector	Fidelity Sustainable Research Enhanced US Equity	First Trust US Equity Income	JPMorgan US Research Enhanced Index Equity (ESG)	Ossiam ESG Low Carbon Shiller Barclays CAPE US	Ossiam US ESG Low Carbon Equity Factors
Communication Services	-0.3	-5.9	-0.4	16.3	1.8
Consumer Discretionary	-0.6	-5.3	1.3	13.9	3.9
Consumer Staples	-0.4	1.2	-0.8	18.4	-0.4
Energy	0.1	16.4	0.0	-3.7	-2.9
Financials	1.0	29.6	-0.1	13.6	17.0
Health Care	1.1	-6.4	0.1	-12.3	-7.5
Industrials	-1.1	-6.5	-0.6	-8.5	-1.1
Information Technology	-0.6	-26.9	0.5	-30.6	-17.2
Materials	0.4	2.4	-0.2	-2.2	-0.7
Real Estate	0.4	1.2	-0.1	-2.3	2.7
Utilities	-0.4	0.3	0.0	-2.5	4.4
Not classified	0.3	0.0	0.3	0.0	0.0

Source: Bloomberg as of 12 August 2024

CHART 3: ROLLING THREE-YEAR ANNUALISED TRACKING ERROR RELATIVE TO THE S&P 500 INDEX



Source: Parala Capital LLP with ETF performance data from Bloomberg

3. Higher income investment objective to add value. The tilt toward income-generating securities without tight sector controls means the weights deviate significantly from the S&P 500. The First Trust US Equity Income UCITS ETF reflects this type of investment strategy.

The ETFs with the lowest tracking error relative to the S&P 500 index are the Fidelity and JP Morgan ETFs. They both seek to add value through security-level research and their sector weights are kept close to

the benchmark. ETFs with higher levels of tracking error include both Ossiam ETFs with their overweight in financials and underweight in healthcare and information technology.

There are other ETFs in the market that seek to reduce carbon exposure while controlling for active sector risks relative to a market benchmark, but this is not a feature of the two Ossiam ETFs. With an annualised tracking error relative to the S&P 500 of over 13%, the clear ‘category’ winner with

its income-seeking investment objective and overweight in financials and energy and underweight in five sectors led by information technology, is the First Trust Equity Income ETF. Lastly, you can see that employing ESG in the selection criteria adds around 2.5% tracking error as illustrated by the MSCI USA ESG Leaders index.

Beta measures the level of systemic risk of an investment strategy relative to a market benchmark like the S&P 500. The chart below shows us the market beta of the five

ETFs over consecutive rolling three-year periods. A strategy with a beta of one has a systematic risk equivalent to the S&P 500 which is about what we see for the MSCI USA ESG Leaders index. We can see from the below chart that the five ETFs all have lower market betas than the S&P 500.

What this means in practice is that these ETFs have other risk factor exposures that are not captured by the market benchmark, and we will take a closer look at what those risk factor exposures are shortly. Also noteworthy is that the First Trust US Equity Income ETFs market beta exposure declines over subsequent rolling three-year periods.

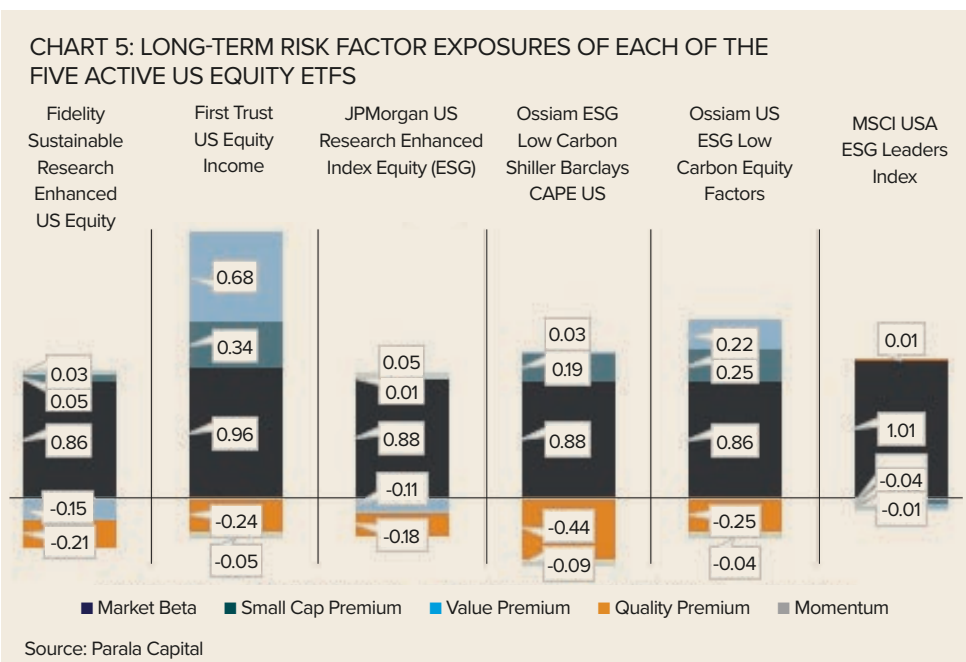
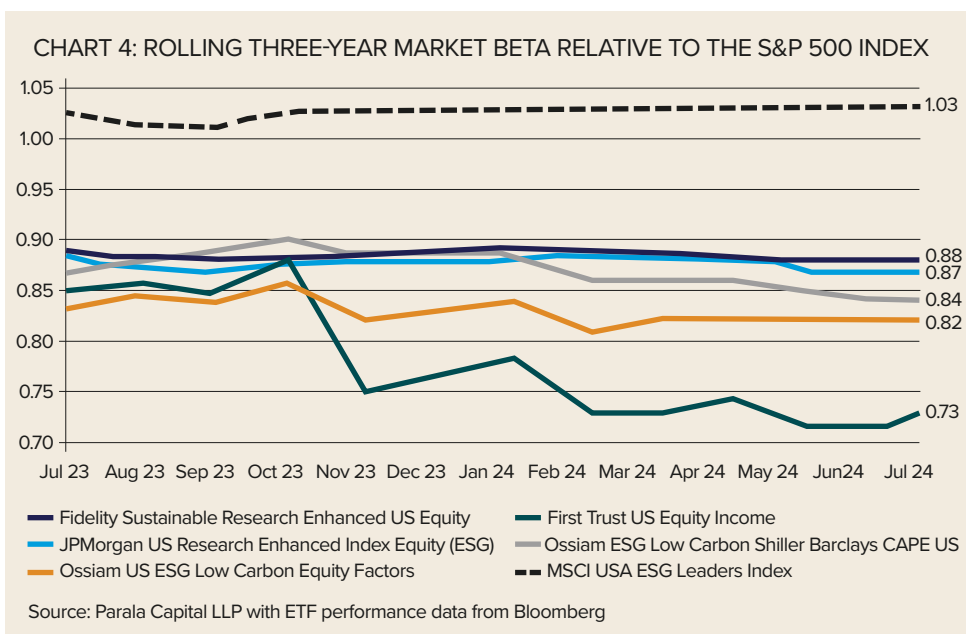
Deeper analysis

We can now engage in a deeper analysis to see which combination of factors best explains each ETFs returns. We can see that all the ETFs have different risk factor exposures. The Fidelity and JP Morgan ETF have similar risk factor exposures which is not surprising given they both impose tight sector risk limits relative to the S&P 500. Therefore, the main differences in their respective performances will come from their “all-weather” and time-varying alpha skills since they also have the same stated management fee.

The fund with the largest exposure to the value premium is First Trust US Equity Income which is unsurprising given its focus on income. The ETF with the next largest exposure to the value premium is the Ossiam US ESG Low Carbon Equity Factors ETF.

Interestingly, its sibling, the Ossiam ESG Low Carbon Barclays Cape US ETF has a much lower exposure to the value premium which is explained by its higher exposure to NASDAQ-type growth companies including an overweight in the communications sector (think Google, Netflix and Meta) and lower exposure to traditional value sectors. Perhaps most interesting is the negative exposure of all the ETFs to the quality premium (high-quality stock returns minus low-quality stock returns). This is surprising given asset managers in the financial media frequently mention their focus on quality.

That may be the case, but clearly the returns generated by these ETFs have a negative correlation with the quality premium. Lastly, the Fidelity and JP Morgan ETFs have the lowest exposure to the small cap premium whereas First Trust US Equity



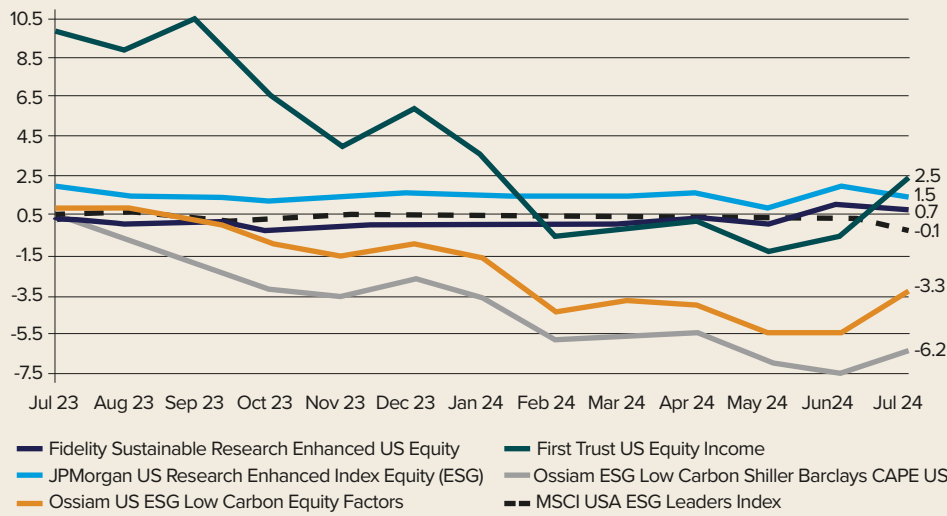
Income and the two Ossiam ETFs have a reasonably large exposure to the small cap premium. The First Trust and two Ossiam ETFs are underweight information technology whose market capitalisation has grown substantially which at least partially explains why they have a higher exposure to the small cap premium.

With the caveat that we are measuring alpha over a relatively short time span during a period of high dispersion, we can see that the First Trust US Equity Income has the highest average rolling three-year annualised alphas and the Ossiam US ESG Low Carbon Equity Factors and Ossiam ESG Low Carbon Shiller Barclays CAPE US ETFs have the lowest.

When comparing the Fidelity and JP Morgan ETFs, the two ETFs with similar beta risk factors, sector exposures and the same stated management fees, we see differences in their levels of alpha which likely comes from differences in their “all-weather” and time-varying skills (i.e. alpha). The JP Morgan ETF generates higher three-year annualised rolling alphas overall observations.

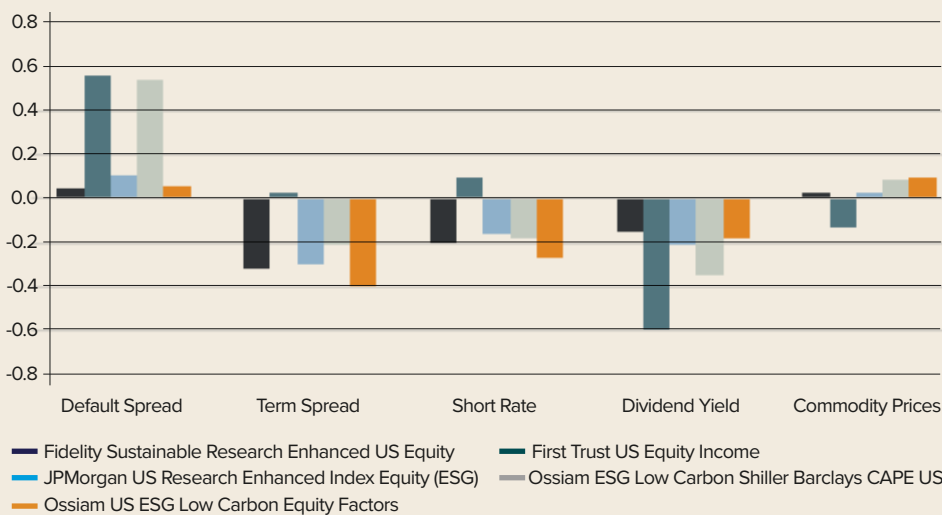
We will look deeper into the correlation between their alpha skills and the business cycle in the next section which will help explain why JP Morgan may have done better given the economic conditions over the last few years. When evaluating the risk and return behaviour of these actively managed

CHART 6: ROLLING THREE-YEAR ALPHA RELATIVE TO THE S&P 500 INDEX



Source: Parala Capital LLP with ETF performance data from Bloomberg

CHART 7: US ACTIVE ETF ALPHA SENSITIVITIES TO BUSINESS CYCLE VARIABLES



Source: Parala Capital LLP

UCITS ETFs, Parala’s model captures not only each ETF’s exposure to risk factors including market beta, small cap, value, quality and momentum risk premiums but also the fact that the performance of the risk factors themselves are sensitive to the business cycle.

Each ETF also has an important residual component of its return which is independent of the risk factors but is correlated with the business cycle. We can call this component of the return time-varying alpha because it varies over time and is associated with navigating changes in the business cycle.

It may be due to differences in each ETF’s active sector weights and/or security selection within each sector. We identify these

relationships using important business cycle variables like the default spread, term spread, short-term interest rate and commodity prices.

Fidelity and JP Morgan ETFs have similar beta risk factor exposures and the main difference in their performance may come from differences in their alpha skills. The chart below shows the sensitivity of each fund’s alpha skills to important business cycle variables. We can see that Fidelity Sustainable Research Enhanced US Equity and JPMorgan US Research Enhanced Index Equity (ESG) have different sensitivities to these important business cycle variables which lead to differences in their time-varying alphas.

For example, Fidelity Sustainable Research Enhanced US Equity alpha skill has a higher negative sensitivity to term spread and short-term interest rates than JPMorgan US Research Enhanced Index Equity (ESG) and a lower negative sensitivity to changes in the dividend yield which is a proxy for changes in stock valuations but also captures slow moving cyclical trends in the economy.

With a sophisticated investment model, these alpha sensitivities can be monitored over time allowing investors the ability to tilt toward funds that are likely to do better given the state of the economy and avoid those that are likely to fare worse. For example, if you expect the default spread (credit risk) to increase, the First Trust US Equity Income and Ossiarn ESG Low Carbon Shiller Barclays CAPE US may perform better than the other ETFs in this analysis given their higher positive sensitivity to the default spread.

Conclusion

Over the last decade, investors have embraced indices, ETFs and passive investing at the expense of active management. However, active ETFs are becoming an increasing segment of the ETF market. Is it time for investors to get more active with their US investment allocations?

Being active can be good for one’s health and well-being but it does take more time and effort. Active ETFs cover a range of strategies seeking to add value from security level research, combining risk factors, incorporating ESG and qualitative judgement.

For investors that embrace the ETF wrapper, the proliferation of active ETFs just increases the tools in the toolkit. However, not all ETFs track public indices so transparency may be more limited. It may be more challenging to gain a clear understanding of the investment objectives, risk limits, constant and time-varying risk factor exposures, economic sensitivities and sources of alpha. These are important considerations to ensure that the active ETFs fit within an investor’s overall portfolio and add value.



Steve Goldin is managing partner at Parala Capital, which provides institutional investors and asset owners with

asset allocation advice using advanced quantitative technology based on the academic research of its founding partners

Features & Analysis

The Patient Investor

What does AI-driven stock selection mean for passive investors?

Active stock pickers are already using AI to gain an edge

By Justin Reynolds

Investor interest in AI has so far focused on the big returns yielded by tech stocks. But might the large language models (LLMs) made famous by ChatGPT also help with stock selection? Can AI-powered technology give active investors an edge, and if so what are the implications for passive investors?

Waves of technology have of course repeatedly transformed the financial industry. Machine-driven analysis of historic trading data has helped funds identify undervalued securities and replicable trading patterns since it was pioneered by Jim Simons back in the 1980s.

Sophisticated stock screening apps are readily available to private investors and index funds themselves, from simple trackers to the most exotic thematic ETFs, were made possible by computing power.

But LLMs bring something new: The capacity to simulate human intelligence through the synthesis and interpretation of vast reams of data. Wealth managers are rolling out the first generation of AI systems able to

process disparate information to identify winning trades, including financial statements, economic statistics, political developments, market sentiment, container ship movements, corporate website traffic, legal cases and even weather forecasts.

JP Morgan's custom 'LLM Suite' AI tool helps research analysts with writing, idea generation and summarising documents through access to third-party models.

'Truffle Sniffer', an AI tool developed by litigation finance specialist Legalist, analyses civil suits to identify attractive investment targets, scanning court records, judges, litigation classes and pre-trial rulings to flag stocks likely to benefit from certain outcomes.

Some firms are introducing 'agentic' AI systems that pick stocks according to specified investment styles. Rather than following Warren Buffett in spending five to six hours each day reading financial documents, investors can let AI take the strain of analysing data 24/7 to spot the kinds of 'diamonds in the rough' with strong fundamentals and growth potential that the great man laboured to find.

The AI-powered LQAI ETF developed by SoftBank-backed Qraft Technologies can

already pick stocks and produce monthly holdings reports autonomously.

Powerful AI systems are not only available to deep-pocketed fund houses. Many private investors now use ChatGPT to find stocks and conduct due diligence. Prompted with questions about a company's history, current activities, financials and press coverage, the free tool can produce investment narratives for specified companies and indicate how their stocks might perform.

Indeed, right now private investors may be in a position to adopt AI more readily than financial services companies wary of using consumer chatbots running on third-party servers that may compromise client data regulations.

Putting AI to the test

A University of Chicago study, *Financial Statement Analysis with Large Language Models*, published earlier this year, offered intriguing academic evidence for ChatGPT's capacity to beat professional analysts.

The researchers fed the system balance sheets and income statements for more than 15,000 companies dating from 1968 to 2021. Each sheet and statement was stripped of dates and company names, and included only the standard two years of data, with no information given about the longer-term history of the company.

The tool was then prompted to write economic narratives predicting changes in company earnings. Even with this scarce information, the model's accuracy was 60% compared to 57% for human predictions, implying, as the paper put it, that without "any narrative or industry-specific information, the LLM outperforms financial analysts in its ability to predict earnings changes".

The research builds on previous studies indicating that computer models can outperform the average analyst when predicting near-term earnings. Extrapolation over relatively short periods plays to the machine's strengths with its capacity to follow rules and regressions and ignore the biases encouraged or confirmed by the richer information to which humans have access.

More surprising, perhaps, was the mod-

"Right now private investors may be in a position to adopt AI more readily than financial services companies wary of using consumer chatbots running on third-party servers that may compromise client data regulations."



el's capacity to construct alpha-generating long and short model portfolios based on the companies for which it forecast significant changes in earnings, its test portfolios outperforming the broad stock market by 37 basis points (bps) a month on a capitalisation-weighted basis, and 84bps a month on an equal-weighted basis.

The preliminary results indicated that “trading strategies based on GPT's predictions yield a higher Sharpe ratio and alphas than strategies based on other models”. The strong equal-weighted performance showed the model was a competent value investor, adept at forecasting the earnings of smaller stocks.

It is important to note the model was focused on short-term earnings forecasts. Understanding long-term earnings trajectories has more to do with fine judgements about nebulous matters that cannot be simply extrapolated – the structural advantages of businesses against changing economic, cultural, technological and political conditions, the weighing of risk versus reward over long horizons.

AI's capacity to do this kind of thinking will be a true test of its claims to emulate human

intelligence. Concerns about the limitations of LLMs have already been highlighted by their tendency to ‘hallucinate’, to generate false content by overlooking information that would have been spotted by a human.

A recent Stanford University study of the responses generated by three state-of-the-art generative AI models to 200,000 legal queries found hallucinations were “pervasive and disturbing”. When asked specific, verifiable questions about random federal court cases ChatGPT 3.5 hallucinated 69% of the time.

Perhaps such tendencies are inherent features of the technology itself rather than bugs that will simply be ironed out. Generative AI models are probabilistic machines trained to give the most statistically likely response. Like humans, they generalise from the particular, but without human contingencies such as common sense, context, nuance or reasoning. Trained on legacy data it is unclear how models might anticipate and respond to black swan events.

The hard logic of passive investing

Whatever its ultimate capacity, AI is another valuable weapon in the experienced active

investor's armoury. It is unclear, though, what implications its use has for their passive counterparts.

The logic of index investing holds. The index represents the return of the average investor. By definition, not every fund manager can beat the market. Fund managers compete against each other for limited alpha whether they use AI or not.

As the use of AI becomes pervasive the stocks it highlights will trigger buying orders that will push up their prices and erase the advantage. New technology simply makes the pricing of assets more accurate, making it harder to beat the index.

There may be a welcome consequence for passive investors. As the market becomes ever more efficient funds will rely more on lower fees for differentiation.

Investors prepared to put in the work that successful active investors have always been prepared to do will reap rewards by making intelligent use of AI. For the rest of us, the fundamentals driving the continued success of index investing remain.

Justin Reynolds is a freelance journalist and editor of The Patient Investor blog

Volatility incoming: What next for tech ETFs?

Stock price gains driven by underlying earnings paint a bright picture

By Lauren Gibbons

Technology stocks have continued to outperform earnings coming in above expectations this year, yet cracks in investor confidence have begun to show in recent months following a period of market volatility.

The tech-heavy Nasdaq saw its worst single-day performance since 2022 in July, falling 3.6% on 24 July following lacklustre earnings from heavyweights Tesla and Alphabet. The index has recovered in the month since, but further questions are now being asked about whether overexuberance in the sector has dissipated.

The meteoric rise of tech stocks has been reflected in ETFs capturing the sector, but also broader exposures like the S&P 500. The Amundi MSCI Semiconductors ESG Screened UCITSETF (CHIP) has risen 45.3% in 2024 and returned 144.6% between January 2023 and 27 August 2024.

Despite the Nasdaq's dip in July, the index has delivered a 20.2% in the year to 28 August, outpacing the S&P 500's 18.6% gain.

Nvidia – the poster child of the early build-out of the AI theme – surged 239% in 2023 and continued its ascent with an additional 150% gain in the first half of 2024.

The boom of generative AI has driven tech's latest growth, with investor focus increas-

ingly shifting toward companies involved in AI software and computer chip production.

Momentum has not stopped in recent months, with Q2 earnings growth for the tech sector standing at 20%, compared to 5% for non-tech sectors – surpassing expectations of 18% and 2% at the start of the earnings season, according to a report from BlackRock.

With Q2 earnings highlighting the sector's continued pace coupled with market jitters seen in July, the question remains whether prices keep rising or if investors will start pulling their cash.

Against this backdrop, *ETF Stream* spoke to fund selectors about whether tech stock prices can keep rising, if we are in a tech bubble and how best to use ETFs that capture tech within a portfolio.

Prices can keep rising, but costs present barrier

The decision to either withdraw funds from tech ETFs or continue investing hinges on whether investors believe tech stocks can sustain their growth.

Peter McLean, portfolio manager at Stonehage Fleming told *ETF Stream* he believes prices can keep rising on the basis that current valuations, although elevated, are justified by strong earnings. This is seen with companies like Nvidia where the majority of stock price gains have been driven by

“Certain products are evolving and being developed, with AI starting to be integrated into some existing services. However, I have not seen much evidence yet that these AI services are truly justifying huge price increases.”



underlying earnings rather than speculative valuation increases. “If we take the case of Nvidia, around 97% of its share price growth of 2023 has come from underlying earnings as opposed to valuation,” he said.

Meanwhile, some investors may doubt that tech stock prices – especially AI stocks – can continue to rise due to the limited integration of generative AI into daily life, partly because of the high cost associated with it.

Stephen Kemper, chief investment strategist at BNP Paribas Wealth Management said the price of AI integration does not seem justified given how expensive it is, with cost being a significant barrier to the wider adoption of generative AI. “Certain products are evolving and being developed, with AI starting to be integrated into some existing services. However, I have not seen much evidence yet that these AI services are truly justifying huge price increases,” he said.



The cost of generative AI is neatly outlined when comparing the cost of a ChatGPT search versus a Google search, with the former being up to seven times more expensive than the latter.

This could pose an even greater obstacle to the growth of generative AI, especially given the expectation that technological advancements in, for example, phones will continue, while prices remain stable.

“With high-end smartphones from Apple and Samsung – they have been priced around \$1,000 for some time, but with each new model, you are paying the same amount for better features,” Kemper added. “The same pattern might apply to AI, we will see more advanced capabilities at similar price points.”

Dot-com bubble part two?

A concentration of the biggest names in tech might hark back to some features of the

dot-com bubble, however, Alberto García Fuentes, head of asset allocation at ACCI Capital Investments, said we are not witnessing ‘part two’ of the dot-com bubble.

Tech companies today heavily contrast with the late 90s tech bubble, where companies invested heavily without profitability.

“These are very solid businesses,” McLean added. “Despite trading at high valuations, it seems justified and does not look like a bubble to us.”

Echoing his views, Kemper said: “That is probably where the comparison with the dot-com bubble stops making sense because nothing was profitable then. Today, [tech companies] are making a fortune of money.”

Fuentes pointed out that the cash flow of tech companies today also furthers their distinction from the tech companies of the dot-com bubble. McLean concluded that people might be hasty to make comparisons to the

dot-com bubble because when people see companies like Nvidia achieving massive share price gains – around 750% since early 2023 – they might instinctively draw comparisons.

“I think it is a case of people perhaps anchoring a little bit to prior examples rather than focusing on the fundamentals of the companies involved today.”

Capturing tech in a portfolio

McLean and Fuentes both blend different investment types within a global portfolio to ensure balanced exposure to technology.

For McLean, this is achieved through an S&P 500 ETF, given that about 30% of the S&P 500 is tech-focused.

“While we recognise the potential challenges facing the tech sector, we aim to create a diversified global portfolio by also investing in smaller and medium-sized companies, as well as more defensive sectors like healthcare,” he said. “This strategy helps mitigate risks while still capturing growth opportunities.”

Meanwhile, Fuentes said when tech company valuations are slightly “tighter” he will combine a tech ETF, such as the iShares S&P 500 Information Technology Sector UCITS ETF (IUIT) with an equal weight strategy to avoid overconcentration risks.

Conversely, Nathan Sweeney, CIO of multi-asset, said he has reduced exposure to US technology and instead increased exposure to areas of the market that will benefit from interest rate cuts.

“However, while investors are disappointed about technology stocks in the short term, we do remain positive over the longer term,” Sweeney added.

The final word

Overall, AI is a long-term theme and along the way there is likely to be periods of high sentiment towards the space.

McLean said the market is likely to be cyclical over time. “It seems we have moved past the initial phase of optimism and excess sentiment, and now we are entering a more volatile period.”

“The best strategy as an investor is to have an amount of allocation to the technology sector, but it truly well diversified and have other global themes and sectors that can create a very robust portfolio.”

Lauren Gibbons is a reporter for ETF Stream



Invesco's Mellor: Investors understand synthetic ETF 'reality'

Are there still misconceptions around synthetic ETFs?

Demand for synthetic ETFs has grown significantly over the past few years as investors become increasingly familiar with the swap-based structure.

According to data from Invesco, synthetic ETFs have seen \$19bn inflows over the past two and a half years versus \$7bn the three years previously, as at June 2024.

Synthetic ETFs offering exposure to US equities have been particularly popular among ETF investors due to the potential significant performance advantage on offer.

As a result, Christopher Mellor, head of EMEA ETF equity product management at Invesco, speaks to *ETF Stream* about changing attitudes towards synthetic ETFs and the drivers behind the increased adoption in recent years.

Are there still misconceptions about synthetic ETFs?

There is a willingness of investors to look beyond some of the fears and understand

the reality of what swap-based ETFs are doing. The truth is they deliver potentially significant superior performance on certain benchmarks such as the US where investors could receive approximately an annual 0.25% extra performance pick-up on an index such as the S&P 500. This is a performance advantage that is worth doing the due diligence on.

The swap model for ETFs have significantly changed since the Global Financial Crisis (GFC). Before 2008, they typically operated a fully-funded swap model which meant cash coming into the ETF was passed to the swap counterparty. There was typically just one counterparty that would promise to pay the performance of the index and post collateral for protection.

What Invesco has been a pioneer of is the unfunded multi-counterparty swap model which is now used across synthetic ETFs where the cash is used to buy a basket of equities that are wholly owned by the ETF and then the issuer swaps the performance



of the basket in return for the performance of the index. This means counterparty exposure is limited to the difference between the performance of the basket the ETF owns versus the performance of the underlying index. If the index outperforms, investors will have an exposure to the counterparty, however, to reduce this, the ETF resets the swap when it goes past certain limits to bring the value of the basket and the value of the index back to neutral.

**Why is adopting synthetic ETF approach to US equities so powerful?**

A swap-based approach has a significant performance advantage. It results from a piece of legislation, section 871m of the HIRE Act introduced in 2017, which is designed to ensure swap counterparties pay a withholding tax equivalent to index swaps they are writing.

However, built into the legislation is an exemption for indices if they meet certain

criteria. Specifically, they have to have a futures market and they need a dividend yield that is no more than 50% above that of the S&P 500. If a counterparty is writing a swap on any major US benchmark such as the S&P 500, MSCI USA or MSCI World, for example, they know there is not going to be a withholding tax claim made on them. Therefore, if they earn gross performance on their hedge, they are able to pass through the majority of that to the ETF.

The withholding tax rate on US equities is 30% for a non-tax exempt investor. An Irish-domiciled physical ETF can reduce to 15% but synthetic ETFs allow investors to improve this to 0% withholding tax. If the dividend yield is 2%, that 30% improvement in tax is worth 0.6% a year, a significant improvement on the portion of investors' portfolios where there is a large weighting within global benchmarks. This is a huge chunk of a portfolio which sees a

“Another big cost that is often overlooked is tracking error. If an ETF is not efficiently tracking the benchmark, perhaps it has a sampling approach, this can potentially lead to additional costs for investors.”

meaningful improvement in performance that can be achieved purely through an efficient structure rather than through asset allocation.

Why do investors need to look beyond the headline fee?

Ultimately, investors should care about their total cost of ownership which is made up of several factors. The total expense ratio (TER) is obviously the first cost to consider but another big potential cost can be those of replicating the index such as trading, rebalancing and reinvestment costs. Another big cost that is often overlooked is tracking error. If an ETF is not efficiently tracking the benchmark, perhaps it has a sampling approach, this can potentially lead to additional costs for investors.

The other two key factors are withholding tax and securities lending. If an ETF lends its securities, it can improve performance and if there is a superior withholding tax rate as we have mentioned for synthetic ETFs and certain domiciles, this has a big impact on performance. Different exposures and different regions will have a different interplay for all of those factors. For US exposures, withholding tax improvements massively outweighs the impact of transaction costs, securities lending revenues or the headline fee. If investors are analysing two ETFs – one with a 0.05% fee and one with a 0.03% fee – the two basis points difference is dwarfed by the 25bps of performance difference offered by the

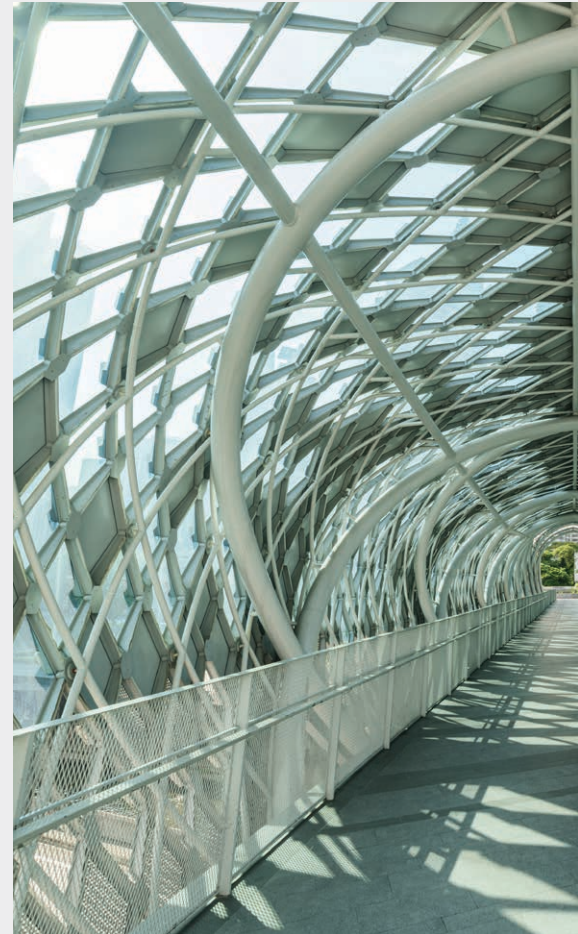
superior withholding tax rate for the swap-based approach.

What flows have you seen into synthetic ETFs?

The performance advantage in the US has had a big impact on investor behaviour. The Invesco S&P 500 UCITS ETF has grown to more than \$25bn assets under management (AUM)¹, the largest synthetic ETF in the world, following almost \$4bn net new assets in 2023. We have also seen strong demand for our MSCI USA, MSCI World and Nasdaq 100 ETFs.

Other than the US, are there any areas where a synthetic approach is best?

In terms of performance advantage, on-shore Chinese equities is another area where investors could consider a synthetic approach. While China has been out of favour with investors recently, if they are looking at China exposure then synthetic could be the way to go. The 300 largest China A-Shares have averaged 250bps of annual outperformance over the last five years while in the mid-cap space, it rises to 780bps. This is driven by the structure of the Chinese market which makes it very difficult for long-short hedge funds to hedge their market exposure when putting on trades because they cannot access the futures market or stock lending. They end up taking the index swap route with an investment bank which are the same



counterparties that the ETF transacts with. The difference is the hedge fund adopts a short exposure while the ETF adopts a long exposure. The key point is that the investment banks cannot write that hedge fund business unless they have an offsetting long exposure. This means that the balance between supply and demand is often skewed towards demand and so the banks are able to charge the hedge funds large fees which can in turn be passed onto the ETF because of the role it plays in providing them with A-Shares inventory.

[Discover Invesco’s synthetic ETF range](#)

Investment risks – for more information, please see next page. For complete information on risks, refer to the legal documents. An investment in these funds is an acquisition of units in a passively managed, index tracking fund rather than in the underlying assets owned by the fund. Applies to all: Value fluctuation, use of derivatives for index tracking, synthetic risk, concentration risk, equity, and currency hedging.

STANDARDISED ROLLING 12-MONTH PERFORMANCE (%)

	Apr '23 - Apr '24	Apr '22 - Apr '23	Apr '21 - Apr '22	Apr '20 - Apr '21	Apr '19 - Apr '20
S&P China A 300 Index (USD) Net Total Return	-12.43%	-2.03%	-20.58%	51.32%	-4.57%
S&P China A MidCap 500 Index (USD) Net Total Return	-17.13%	4.41%	-16.92%	33.37%	-3.56%

Past performance does not predict future returns. Source: Invesco, Bloomberg 30 Apr 2024. Data in USD. Returns may increase or decrease as a result of currency fluctuations.

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Value fluctuation: The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

Use of derivatives for index tracking: The Invesco S&P 500 UCITS ETF's ability to track the benchmark's performance is reliant on the counterparties to continuously deliver the performance of the benchmark in line with the swap agreements and would also be affected by any spread between the pricing of the swaps and the pricing of the benchmark. The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Concentration risk: The Fund might be concentrated in a specific region or sector or be exposed to a limited number of positions, which

might result in greater fluctuations in the value of the Fund than for a fund that is more diversified.

Equity: The value of equities and equity-related securities can be affected by a number of factors including the activities and results of the issuer and general and regional economic and market conditions. This may result in fluctuations in the value of the Fund.

Currency hedging: Currency hedging between the base currency of the Fund and the currency of the share class may not completely eliminate the currency risk between those two currencies and may affect the performance of the share class.

Synthetic risk: The fund might purchase securities that are not contained in the reference index and will enter into swap agreements to exchange the performance of those securities for the performance of the reference index.

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Data as at 24 June 2024, unless otherwise stated.

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rent net asset value when buying units / shares and may receive less than the current net asset value when selling them.

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Why high-fee legacy ETFs still house billions in investor assets

Time to take a nuanced view of the entire cost picture

By **Jamie Gordon**

Innovation and downward fee pressure are the hallmarks of Europe’s 24-year-old ETF industry, yet investors willingly park billions of dollars in legacy ETFs charging uncompetitive fees – often while lower-cost equivalents are available from the same asset manager.

Just looking at European investors’ two favourite equity Europe – the MSCI World and S&P 500 – both have high and low-fee ETF iterations offered by the same asset manager.

In fact, BlackRock, Amundi and DWS all boast high-fee core equity ETFs housing at least \$3bn asset under management (AUM) apiece, while carrying a total expense ratio (TER) between two and three times higher than ETFs from the same provider, tracking the same index.

A prime but far from standalone example of this is \$7.3bn iShares MSCI World UCITS ETF (IWRD), which debuted in 2005 with a fee of 0.50% ahead of BlackRock’s acquisition of Barclays Global Investors’ (BGI’s) ETF business four years later. Within months of the buy-up, BlackRock debuted the now \$81.3bn iShares Core MSCI World UCITS ETF (SWDA) with a TER of 0.20%.

While this is still double the TER charged by what is now the lowest-fee UCITS ETF

tracking the MSCI World index, it is less than half that of its older sibling, IWRD, whose fee is also more than double the 2023 asset-weighted average fee of 0.22% for an equity ETF, including thematic and active strategies, according to data from Bloomberg Intelligence.

Why pay over the odds?

Despite this, investors regularly opt for high-fee products, meaning other considerations are given priority ahead of fees. Kenneth Lamont, senior fund analyst at Morningstar, noted funds can track the same index but offer different investment propositions.

In fact, Amundi has a suite of MSCI World tracking ETFs launched between 2006 and 2024 domiciled in different jurisdictions, with different replication methodologies and likely serving different clients. Each ETF houses at least \$3bn, with TERs ranging from 0.12% to 0.38%.

Peter Sleep, investment director at Calanish Capital, agreed that nuances such as physical and synthetic replication represent “real economic differences” between products, however, he argued justifications for fee disparities are often less meaningful.

“Often the reasons for the fee premium are bogus, for instance one ETF is income and is therefore more expensive and the

other is accumulation and cheaper,” Sleep said. “The issue of high fee and low fee ETFs has been around for some time and in a lot of cases may have been deliberately created by the ETF sponsors to protect high fee income products.”

Commenting on the launch of the \$961m iShares Broad \$ High Yield Corp Bond UCITS ETF (HYUS) in 2022, Sleep called the launch “a clever revenue protection exercise” for appealing to fee-sensitive investors, while \$5.5bn remains in an equivalent BlackRock ETF with a fee 30 basis points (bps) higher.

A justified decision

Looking at the investor perspective, there are legitimate cost considerations beyond fees which support a case for remaining in high-fee legacy ETFs.

“Fees are just one consideration when choosing an ETF,” Lamont said. “Tax advantages or replication costs can outweigh fee differences, as seen with swap-based versus physically replicated S&P 500 ETFs.”

He added when switching funds, potential brokerage costs, tax liabilities and the need to perform thorough due diligence might outweigh potential fee savings.

Countering this, Sleep said large-scale investors can contact their authorised participant and arrange an in-specie transfer – or back-to-back redemption and creation – to allay concerns surrounding bid-ask spreads, tax or brokerage costs.

While acknowledging those looking to short an ETF may prefer higher-fee and more liquid ETFs, Sleep argued investor complacency is the driver of assets housed in costly ETFs.

“The main reason the higher fee ETFs remain is largely customer inertia. At the margin there may be some tax issues or maybe some investors value the higher on-screen

HIGH VERSUS LOW FEE ETFS

High fee legacy				Low fee alternative			
ETF	Fee	AUM	Launch	ETF	Fee	AUM	Launch
iShares MSCI World UCITS ETF (IWRD)	0.50%	\$7.3bn	2005	iShares Core MSCI World UCITS ETF (SWDA)	0.20%	\$81.3bn	2009
Amundi MSCI World UCITS ETF (CW8)	0.38%	\$8.8bn	2009	Amundi MSCI World UCITS ETF (MWRD)	0.12%	\$3.1bn	2024
Xtrackers S&P 500 Swap UCITS ETF 1C (XSPU)	0.15%	\$10bn	2010	Xtrackers S&P 500 Swap UCITS ETF 1D (XSXD)	0.06%	\$10bn	2022
Amundi S&P 500 UCITS ETF (500U)	0.15%	\$7.4bn	2010	Amundi S&P 500 II UCITS ETF (SP5)	0.05%	\$13bn	2014

Source: ETF Stream



liquidity, but I am unconvinced. There has been enough extreme volatility over the last three to four years to realise enough losses to offset any gains on these ETFs and it is not that these ETFs have been super profitable.”

However, it is hard to contest some of the use cases for scaled, high-fee ETFs targeting niche exposures. “For ETCs, sector or single-country funds, which are often used tactically, trading costs can matter more than annual fees,” Lamont added.

Supporting this, he highlighted the \$3bn Gold Bullion Securities ETC (GBS) which remains popular due to low trading costs, despite its 0.40% fee being almost four times that of Europe’s cheapest gold ETCs.

Lamont also argued fund size plays a “crucial” role for the cost and access to niche ex-

posures including single-country emerging market ETFs.

“Larger funds often achieve better tracking fidelity and a new, cheaper entrant might underperform due to lack of scale.

“Access restrictions and platform availability can also limit investor choices, with smaller or newer funds often having less exposure and higher switching costs.”

Such arguments go some way to explaining why long-standing single country ETFs with fees ranging from 0.74% to 0.85% continue to house hundreds of millions of dollars while some with fees as low as 0.10% struggle to reach scale for economic viability.

Similar eccentricities also exist for specialist, longer-term allocations such as future themes, where choosing the right – and a scalable – in-

vestment strategy is a stronger determining factor in investor outcomes than fees.

Lamont concluded: “While fees are important – the most reliable predictor of future fund performance we have – there are many legitimate reasons why investors may remain in more expensive equivalent funds.”

Sleep suggested regulations such as Consumer Duty should mean UK consumers should be directed to lower-cost products, where possible. “Ultimately though, it is up to the ETF buyer to ensure that she gets the best price,” he said. “For all the regulation, caveat emptor remains important in finance and not something you wear around your neck.”

Jamie Gordon is Features Editor at ETF Stream

Is ChiNext 50 the new Nasdaq-100?

The city of Shenzhen is often touted as the Silicon Valley of China, so it is only natural that its flagship innovation index – the ChiNext 50 – is widely compared to the Nasdaq-100. But how does that comparison stack up and where does ChiNext 50 fit in the context of a wider asset allocation?

There is no doubt that Shenzhen is a remarkable growth story. A fishing village before the 1980s, it was designated as China’s first Special Economic Zone in 1980 and is now its third largest city. Shenzhen is the birthplace of tech giants like Huawei and Tencent, drone maker DJI and global battery manufacturer CATL.

Shenzhen and its close neighbour Hong Kong were ranked as the second-largest global innovation hotspot in 2019¹ and the government has a clear strategy to keep advancing Shenzhen’s position as a hub for innovators and entrepreneurs, including a goal to double per capita GDP between 2020 and 2035².

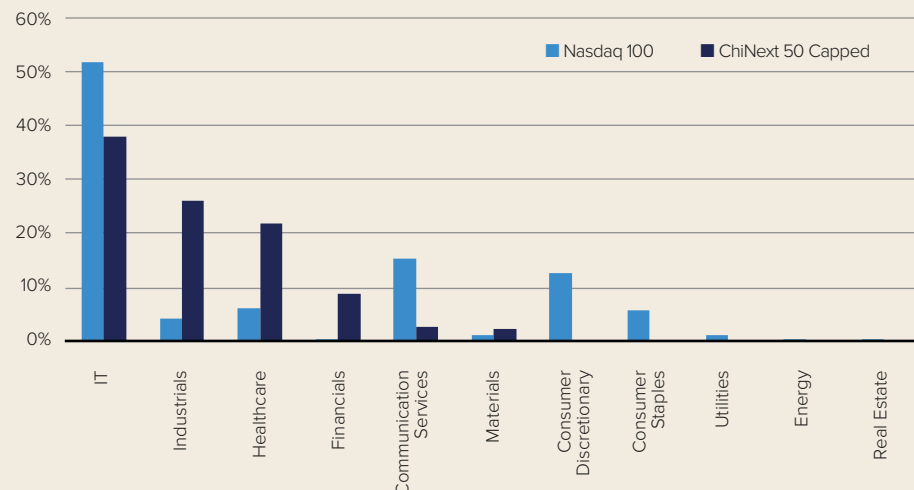
As Shenzhen has grown, the Shenzhen Stock Exchange (SZSE) has grown along-

side it as an important source of financing. In 2009, the exchange launched a dedicated board for innovation – ChiNext – as part of a national strategy to encourage independent innovation. When the exchange launched a strategic benchmark, the ChiNext 50, in 2014, comparisons with the Nasdaq-100 were inevitable.

A common philosophy but some different growth engines

By definition, innovation is about finding new ways to do things – it cannot be put in a box or confined within traditional sector boundaries. Both the Nasdaq and ChiNext exchanges epitomise this philosophy: they are focused on growth and innovation, but they are not restricted to tech stocks.

CHART 1: COMPARING NASDAQ-100 AND CHINEXT 50 CAPPED INDEX: GICS SECTOR BREAKDOWN



Source: Bloomberg, as of 28/06/2024



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CHART 2: ABSOLUTE RETURN OF INDICES



Source: Bloomberg, data as of 28/06/2024, since common inception of CNT50UN Index and CSIN0300 Index, 31/12/2014. Past performance does not predict future returns. See below for rolling 12-month performance over the last 10 years for both indices.

As a result, the Nasdaq-100 and ChiNext 50 indices can therefore capture innovation across multiple ‘growth’ sectors. Typically, they also have low allocations to sectors that are traditionally lower growth, like utilities, energy and real estate.

However, as Chart 1 shows, there are some notable differences. One standout is ChiNext 50’s higher weightings to industrials. This highlights the importance of trends like industrial automation, electric vehicles and renewable energy in China’s new economy.

ChiNext 50 also has a higher weighting in healthcare, reflecting China’s growing leadership in areas like medical devices and vaccine development. By contrast, Nasdaq-100 is more concentrated in the technology sector – no real surprise given the domination of established tech giants like Alphabet, Microsoft and Apple and the recent rally in AI stocks like Nvidia.

ChiNext 50’s largest stocks are arguably more diverse, with the current top three constituents including EV battery maker CATL, medical device maker Mindray and online financial data provider EastMoney.

The two indices provide an interesting picture of variations in regional growth drivers between China and the US, including government strategic priorities. However, another common feature is R&D spend, often regarded as an important driver of innovation and economic growth.

The average R&D spend of companies in both indices is many times the average in broader regional indices like the S&P 500 or CSI 300.

A generational divide

Something we cannot ignore is age. The Nasdaq-100 is now almost 40 years old (a millennial) and is clearly a large-cap opportunity. Meanwhile, ChiNext 50 is a youthful 10-year old with a high proportion of mid-cap stocks and an average market cap of around \$10bn (compared to around \$250bn in the Nasdaq-100). Can the history of Nasdaq-100 tell us anything about the future of ChiNext 50?

Since its inception in 1985, the Nasdaq-100 has outperformed the S&P 500, albeit with higher volatility and a ‘restart’ after the burst of the dot.com bubble in 2000. In the past



decade, it has continued to outperform and shown significantly higher earnings growth than the wider US equity market.

Can we expect a similar story for ChiNext 50? So far, the Chinese index has had a slightly erratic start, significantly outperforming the CSI 300 over some time periods but slightly underperforming it since its inception.

However, a P/E ratio of 21 and strong consensus earnings growth estimates for 2024 and 2025 suggest potential for improving valuations. The rapid evolution of the Chinese economy – underpinned by structural reforms, policy support and ambitious strategies for many growth sectors – also cannot be ignored.

Different roles in an innovation-focused portfolio

Both Nasdaq-100 and ChiNext 50 are part of the same story of global innovation and reflect

CHART 3: ROLLING 12-MONTH PERFORMANCE OVER THE LAST 10 YEARS FOR BOTH INDICES

	Jun 23 - Jun 24	Jun 22 - Jun 23	Jun 21 - Jun 22	Jun 20 - Jun 21	Jun 19 - Jun 20	Jun 18 - Jun 19	Jun 17 - Jun 18	Jun 16 - Jun 17	Jun 15 - Jun 16	Jun 14 - Jun 15	YTD (last EoM)	FY 24 - Jun	Dec 22 - Dec 23	Dec 20 - Dec 23
ChiNext 50 Capped Index USD TR	-23.57%	-30.41%	-24.65%	70.95%	73.84%	-13.21%	-12.72%	-25.51%	-27.36%	98.30%	-13.99%	-13.99%	-24.23%	-43.33%
CSI 300 Total Return Index	-7.91%	-12.41%	-12.58%	27.49%	11.05%	11.25%	-2.39%	18.54%	-28.33%	-	1.94%	1.94%	-9.36%	-30.18%

Returns may increase or decrease as a result of currency fluctuations. Source: Bloomberg, Invesco, Performance as at 28 June 2024.



many of the same megatrends. While Nasdaq-100 could be viewed as core technology exposure, ChiNext 50 represents more targeted exposure to the new Chinese economy, emphasising EVs, industrial automation and health-tech in addition to tech innovations like AI.

For investors who see these as the future drivers of growth, it could indeed be the new flagship index for growth innovation.

Invesco ChiNext 50 UCITS ETF

Our Invesco ChiNext 50 UCITS ETF is the first ETF in Europe that provides investors with targeted access to this dynamic ChiNext 50 index, comprising of China's largest and most liquid companies in the tech sector, and other innovative industries.

Discover our ETF

An investment in this fund is an acquisition of units in a passively managed, index tracking fund rather than in the underlying assets owned by the fund.

¹World Intellectual Property Organisation, 2019 (<https://tind.wipo.int/record/46726?v=pdf>)

²Shenzhen 14th Five-Year Plan for National Economic and Social Development and the Outline Plan of the Long-Range Objectives Through the Year 2035

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The value of investments, and any income from them, will fluctuate. This may partly be the result of changes in exchange rates. Investors may not get back the full amount invested.

As a large portion of this fund is invested in less developed countries, investors should be prepared to accept a higher degree of risk than for an ETF that invests only in developed markets.

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EMEA 3755299/2024

Unpacking the benefits of J.P. Morgan AM's Research Enhanced Index ETFs

'Numerous small, refined active decisions that collectively generate alpha'

Active ETFs have been capturing the headlines as the growth catalyst for the European ETF market this year. JP Morgan Asset Management's (JPMAM) Research Enhanced Index (REI) ETFs have captured a vast share of this market and are continuing to attract the attention of investors.

The JPM US Research Enhanced Equity (ESG) UCITS ETF (JREU) – managed by Raffaele Zingone and Piera Elisa Grassi – is a firm favourite among investors, pulling in \$3.6bn of inflows in the first five months of 2024 and now stands at \$10bn of assets under management, over double the next highest-ranking ETF, according to data from Bloomberg. Against this backdrop, *ETF Stream* talks to Grassi about why the REI ETFs are so successful, what REI is, how these ETFs generate alpha and where the products sit within a wider portfolio.

What do you think makes the ETFs so successful?

I would say the secret lies in the fact that we have combined a set of strategies that are part of JPMAM's DNA.

The content of the ETF is something we've been doing for a long time and we have innovated by delivering these strategies through the ETF vehicle. It is the combination of tradition – our decades of experience in this type of work – and the innovation of the ETF vehicle that allows us to deliver these strategies to many more clients. Simply put, our REI strategies offer a compelling alterna-

tive to passive investing. We stay very close to the index in terms of risk but combine strong risk management and best-in-class fundamental research to deliver positive risk-adjusted returns over time.

The active ETF "power" is that clients can look at our track record and see that the story matches the numbers.

Can you briefly explain what Research Enhanced Indexing is?

We focus on combining best-in-class fundamental research with risk management. Over the past three decades we have honed our approach to fundamental research. Our process consists of over 90 equity research analysts, spread across the globe. They hold local responsibility while maintaining global connectivity. Each analyst covers 20 to 30 securities in great detail within one sector and one region.

This in-depth analysis provides the raw material for me and my team to construct portfolios. Our portfolios are, in many ways, similar to the reference index – neutral in terms of region, sector, and style. However, where we take active positions is through small, deliberate deviations at the stock level from the index, refining it with the fundamental ideas generated by our analysts. This bot-



tom-up approach allows us to maintain around 40% active share spread across the investment universe.

The alpha component makes REI ETFs different from traditional passive ETFs. How do you generate alpha?

As we mentioned, the portfolio in many ways resembles the index. We do not take macro views. While some active managers might use macro-driven tools to generate alpha, our approach is different. We utilise our analysts' recommendations, based on long-term fun-



“While some active managers might use macro-driven tools to generate alpha, our approach is different. We utilise our analysts’ recommendations, based on long-term fundamental research at the stock level to drive alpha and this approach is highly diversified”

How do investors use the REI strategies?

Our strategy is a beta-one core strategy. Whether you are looking at global or US exposure, it fits nicely into the asset allocation because our level of alpha does not interfere with the client’s overall asset allocation. Often, our strategy is used as an alternative to passive investing or for clients who want to stay active but avoid high levels of tracking error.

You are co-managing several developed markets REI ETFs, looking at the current market environment, which exposure has currently the best outlook?

Global equities offer a balanced way to maintain US exposure while spreading risk. As we move towards the end of the year we expect earnings power to broaden beyond just the ‘Magnificent Seven’ to include many other companies in the index.

How will these strategies stay ahead of competition as the active market expands in Europe?

We have been experts in REI for over 30 years and since 2018 investors have been able to access these investment strategies via the ETF wrapper. Overall we have 10 core active ETF building blocks across a variety of regions, meeting a variety of ETF needs, and we look forward to building on this.

damental research at the stock level to drive alpha and this approach is highly diversified.

For instance, when comparing JPM Global Research Enhanced Index Equity (ESG) UCITS ETF (JREG) to the MSCI World index, which might have 1,400 securities, our portfolio typically holds around 700 to 750 securities.

Each of these positions is carefully selected, with active positions—both positive and negative—reflecting our analysts’ insights. Our diversification is so comprehensive that no single theme drives performance. It is never about betting on value versus growth or small

cap versus large cap. Instead, it is about making numerous small, active decisions based on company fundamentals that collectively generate alpha.

Risk management is crucial for us and how that risk breaks down is equally important. The vast majority of our risk comes from idiosyncratic, bottom-up ideas. When you look at the 70 basis points of risk we take, most of it is explained by stock-specific factors.

We ensure that no single name dominates that risk as it is spread across the portfolio. This diversification is what makes our performance sustainable over time.

Beyond Beta

Investigating the smart beta, factor & ESG investment revolution

Liquidity transformation: The final frontier

Treating ETFs as a liquidity transformation mechanism is a dangerous path

By Mark Northway

Liquidity risk is insidious. It can be hedged, managed, or transformed, but it cannot be eliminated and it should never be ignored. When markets function normally liquidity risk tends to lie dormant. The flows associated with managing an investment portfolio or structure can be accommodated within the natural volume of transactions, with little to no impact on pricing.

Rating agency models, regulators and trading algorithms take increasing comfort in the empirical norm of apparently infinite liquidity and ever more reliance is placed on the apparent disappearance of tail risks – ‘This time it’s different’.

But tail risks do exist, and they do bite, particularly when large swathes of market participants are reliant on them not doing so. In the case of liquidity risks, regulation has played its part in perpetuating tail risk by conflating volume, liquidity and transparency. There is a flawed belief that high trade flows and a visible order book guarantee frictionless execution and that belief has led to a systematic dismantling of the professional capital that was historically committed to market making.

Investment vehicles and financial institutions offer a wide range of liquidity man-

agement options. In general, UCITS funds do not need to concern themselves with liquidity because the rules attempt to ensure that portfolio liquidity matches the daily liquidity provided to investors.

But there have been spectacular and costly failures, the most notable recent example being Neil Woodford’s eponymous LF Woodford Equity Income Fund.

In non-UCITS retail schemes, liquidity risk raises its head more frequently. In recent years we have seen high profile managers including Schroders, BlackRock, Columbia Threadneedle and BMO gate their property funds reflecting the fundamental mismatch between the fund assets – UK real estate – and liabilities – daily liquidity. Investors’ appetite for daily liquidity clearly overrides prudent fund construction.

The regulator is awake to liquidity risk and has come up with the Long-Term Asset Fund, a hybrid structure with variable notice intended to prevent a liquidity mismatch.

The concept has been slow to gain traction with fund managers, although we are now seeing tentative LTAF offerings from Schroders – diversified private assets – BlackRock – private companies and infrastructure – and Legal & General – real estate and infrastructure.

Arguably, the UK market should not need these hybrid solutions as it has a well-devel-

“The flows associated with managing an investment portfolio or structure can be accommodated within the natural volume of transactions, with little to no impact on pricing.”



oped liquidity transformation mechanism in the form of the investment trust or investment company sector.

These permanent, or long-dated, capital vehicles allow the manager to invest in illiquid, long-dated assets without fund redemptions. At the same time, they deliver daily liquidity to investors, albeit at a discount or premium to NAV depending on demand and the vagaries of MiFID II cost disclosure, via the stock market.

Perhaps the most famous failure of liquidity transformation mechanisms – ignoring individual bank failures such as Silicon Valley Bank – was the Structure Investment Vehicle (SIV) market of the 1990s and early 2000s.

These vehicles bridged the liquidity mismatch between (mostly) private long-date



mortgage-backed securities and short-dated Commercial Paper liabilities, using formal liquidity facilities as a backstop.

The mechanism relied on credit rating agencies correctly assessing liquidity tail risk. They got it spectacularly wrong, and the sector imploded in the Global Financial Crisis (GFC).

It follows that investors need to look closely at the liquidity characteristics of any instrument, whether single stock, index, alternative or structured, and understand the circumstances which might trigger a liquidity shock.

They should also consider whether the specific investment being analysed – think CPPI – might even increase the likelihood of that shock. But market participants have notoriously short memories. We have re-

cently been treated to the simultaneous but directly contradictory headlines that BlackRock has put up the white flag on its last physical frontier ETF due to “persistent liquidity challenges” and that BlackRock could start offering ETFs for private markets following its deal to buy private market data provider Preqin. A triumph of marketing over risk management.

The fixed-income ETF market is also potentially problematic. Bonds generally trade over the counter (OTC) with most non-sovereign issue locked up in buy-and-hold institutional portfolios.

The more esoteric an indexed bond portfolio, the more unsuited it is to daily or intraday liquidity provision. Most notably, ESG or SRI filters can result in naturally illiquid

bond portfolios. To-date, we have seen the ETF absorb the liquidity mismatch but at some point, the market will test the associated tail risk.

An ETF is an instant liquidity structure, offering intraday liquidity against a continuously tradable basket of assets.

It relies on authorised participants being able to execute in the market, or bridge execution risk across a longer period if they so desire. Treating ETFs as a liquidity transformation mechanism is a dangerous path. Illiquid, long-dated assets should only be held in vehicles designed to functioning when the herd is on the run.

Mark Northway is investment manager at Sparrows Capital

Data dashboard: August 2024

Dispersion between single emerging market ETFs as investors rotate out of TIPS ETFs

Data provided by



Data as at 23 August

TOP PERFORMANCE

Ticker Return

TOP 10 BEST PERFORMING ETFs		
Franklin FTSE Brazil	FLXB	10.73
iShares MSCI Brazil	4BRZ	10.59
Xtrackers MSCI Brazil	XMBR	10.54
Amundi MSCI Brazil	BRZ	10.52
iShares MSCI Brazil	IBZL	10.47
FinEx Global Equity	FXRW	10.17
VanEck Space Innovators	JEDG	8.62
First Trust Nasdaq Cybersecurity	FCBR	8.46
UBS ETF Solactive Global Pure Gold Miners	UBUD	7.87
L&G Gold Mining	AUCP	7.80

TOP 10 WORST PERFORMING ETFs		
Amundi S&P 500 VIX Futures Enhanced Roll	LVO	-19.73
Amundi MSCI Turkey	TURL	-12.62
iShares MSCI Turkey	ITKY	-10.08
Melanion BTC Equities Universe	BTC	-9.15
VanEck Oil Services	OIGB	-9.10
Sprott Junior Uranium Miners	URNJ	-8.13
KraneShares ICBCCS SSE Star Market 50 Index	KSTR	-7.82
SciBeta HFE Japan Equity 6F EW	JHEF	-7.44
Fineco AM MarketVector Japan Quality Tilt ESG	JPMQ	-7.38
Fineco AM MarketVector Gbl Clean Energy Transition ESG	EMOVE	-7.10

INFLOWS

OUTFLOWS

Name	Ticker	Inflows (\$m)
iShares Core MSCI World	SWDA	1,254.47
iShares Core S&P 500	CSPX	1,225.87
Xtrackers II EUR Overnight Rate Swap	XEON	921.05
iShares \$ Corp Bond	LQDE	876.35
iShares \$ Treasury Bond 0-1yr	IB01	683.01
L&G Multi-Strategy Enhanced Commodities	ECGH	614.84
Spdr® MSCI World	SPPW	507.97
Spdr® S&P 500 ESG Leaders	SPPY	432.70
Spdr® S&P 500®	SPYL	428.12
JPM US Research Enhanced Index Equity (ESG)	JREU	421.70

Name	Ticker	Outflows (\$m)
Xtrackers MSCI World ESG	XZWO	-1,289.73
Xtrackers MSCI AC World ESG Screened	XMAW	-1,102.83
iShares \$ TIPS	ITPS	-712.41
L&G Multi-Strategy Enhanced Commodities	ENCO	-590.54
SPDR® Bloomberg SASB Euro 0-3 Year Corporate ESG	SPPY	-476.41
iShares JPM EM Local Govt Bond	SEML	-463.99
BNP Paribas Easy S&P 500	OXC5	-427.72
Invesco S&P 500	SPXP	-370.82
Amundi S&P 500 II	SP5L	-369.94
iShares S&P 500 Swap	I500	-363.49

NEW LISTINGS

Name	Fund ISIN
iShares MSCI Japan ESG Enhanced UCITS ETF EUR Hedged (Acc)	CEB3
iShares iBonds Dec 2026 Term € Italy Govt Bond UCITS ETF EUR (Acc)	26TA
iShares Broad € High Yield Corp Bond UCITS ETF CHF Hedged (Acc)	EH1C
iShares Broad € High Yield Corp Bond UCITS ETF USD Hedged (Acc)	EH1D
iShares Broad \$ High Yield Corp Bond UCITS ETF CHF Hedged (Acc)	HYUC
L&G Multi-Strategy Enhanced Commodities UCITS ETF GBP Hedged Dist	ECGD
WisdomTree Core Physical Silver ETC	WSLV



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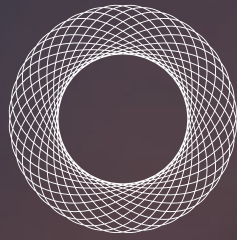
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