Russell Research

Title: **Digging deeper: Institutional ETF Investing in Australia – Insights and Implications.**

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Date: May 2011

Synopsis: The Australian ETF market has gathered momentum over the last two years, gathering AUM across a range of products, investment styles and providers. However, unlike the US or Europe, the growth of these investment vehicles in the local market has largely been driven by retail investors, with most institutions seemingly reluctant to get on board. This research considers whether the Australian ETF market will start to develop in line with global trends and explores current perceptions and uses of ETFs with an institutional portfolio

MAY 2011

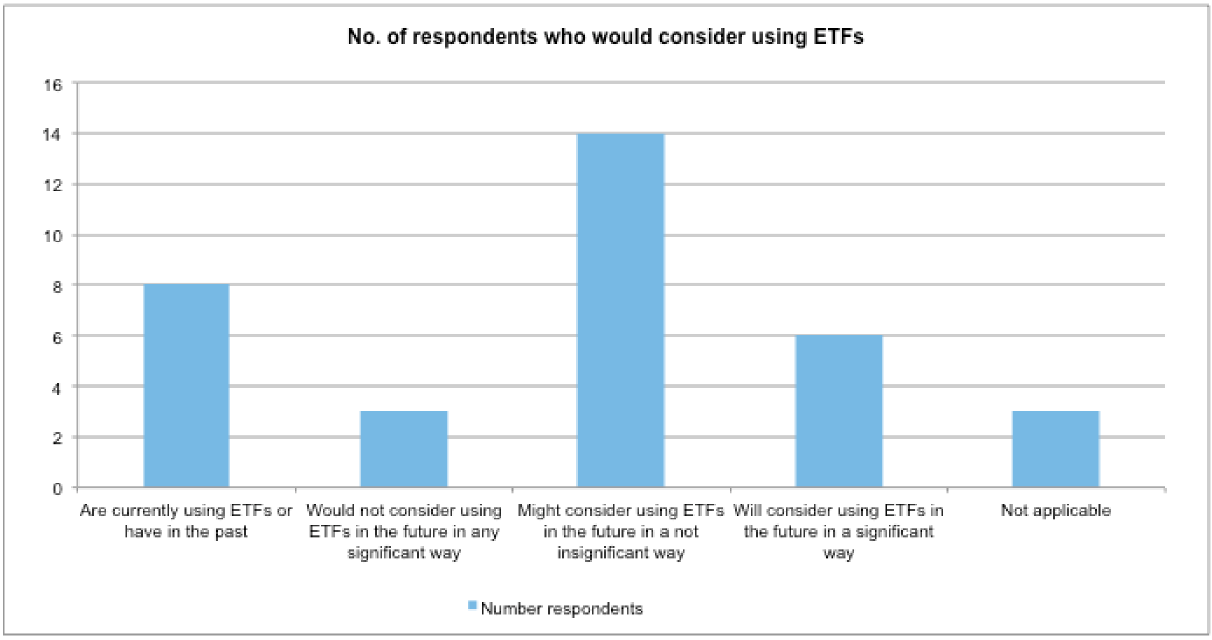
Digging deeper: Institutional ETF Investing in Australia – Insights and Implications.

By: Amanda Skelly – Director, Exchange Traded Funds

The Australian ETF market has gathered momentum over the last two years, having recently hit $4.7bn AUM across a range of products, investment styles and providers. However, unlike the US or Europe, the growth of these investment vehicles in the local market has largely been driven by retail investors, with most institutions seemingly reluctant to get on board. We commissioned Deloitte Actuaries & Consultants Limited to conduct research to enable us to gain a deeper understanding of institutions' perceptions of ETFs and the role they play in an institutional portfolio today, in addition to future opportunities for ETFs in this important market segment. Combined, the respondents directly manage or advise on over 40% of Australian funds under management.

The research confirms the Australian institutional ETF market is still in its early stages and has produced a number of insights which will give industry participants some food for thought as to whether the Australian ETF industry will start to develop in line with global trends of broader institutional adoption. Interestingly, we have uncovered a contradiction between institutional perceptions towards ETFs and their actual usage. The immediate reaction of many was to say there is little or no use for ETFs in an institutional portfolio and they are primarily a vehicle for retail or SMSF investors. However, the deeper we delved into the various uses of ETFs, the more it became clear that ETFs can play a role in the investment programs of all institutions. As shown in the table below, many institutions of various sizes are already using ETFs or are considering using them in a not insignificant way.

Figure 1



INNOVATION WILL DRIVE GROWTH

Large institutions often view futures, direct mandates or low cost managed funds as superior for purposes such as dynamic asset allocation, cash equitisation and transition management. However, when questioned further, several large institutions were able to point to specific instances where they had used or considered using ETFs. The most popular uses were as a strategic or tactical allocation for smaller pools of capital or sub portfolios, a tool to manage temporary investment positions or exposures (particularly where a viable futures market is not available) and as an option for investment platforms offered to retail investors. Tax aware investors also used ETFs where the flow through nature of the investment coupled with the accounting treatment is preferred.

Many larger institutions had also considered more innovative uses of ETFs in non-core parts of their business or for portfolios constructed for specific clients. This is a positive sign for ETFs, indicating that as institutions continue to evolve their offerings to address specific customer needs - be it managing pension assets differently, expanding the types of exposures they are seeking to access or taking a more macro approach to investing - ETFs can play a role.

For smaller institutions, cost effectiveness, tax benefits and limitations on using futures highlight the role ETFs can play as a long or short term investment solution. For them, comfort with existing investment structures and processes and limited knowledge in ETFs have been the main barriers to acceptance.

Innovation will be the key to growth. For the Australian ETF industry, further innovation of product is required. For institutions, innovations in investment processes or philosophy will drive demand for new ETF products.

RETHINKING ETFS VS FUTURES

It is not surprising that most large institutions preferred futures to ETFs for short term exposure due to their low cost and ease of access. The areas where ETFs are being considered as a viable alternative were limited to emerging markets or where investment or operational restrictions prevent their use.

However, certain respondents noted other benefits, such as tax treatment of ETFs (ETFs are held on capital account and all franking credits pass through to the investor). Roll costs and premium/discounts can negatively impact the cost attractiveness of a future. Coupled with the more precise exposure that certain ETFs can provide, we anticipate ETFs can grow as an alternative to futures.

OVERCOMING THE BARRIERS - COSTS, LIQUIDITY AND EDUCATION

The cost of ETFs verses other instruments was a reoccurring theme throughout the research. Yet as many respondents highlighted, and as we have seen from experience, ETFs can, at times, be a cost effective alternative and, along with other investment structures, should be assessed with each unique opportunity on a case by case basis.

For Australian listed ETFs, lack of liquidity and market depth provide significant barriers to institutional take up. The local market is still in its infancy and while the volume in local ETFs is gathering momentum, limited secondary market liquidity may continue to be a deterrent. Many Australian institutions currently using ETFs often turn to overseas exchanges due to their higher levels of liquidity and greater depth. For non-domestic asset classes, this is likely to continue to be a superior avenue for large institutions. But for domestic asset classes that are accessed via the ASX, limited secondary liquidity is not necessarily a major barrier, as large trades can be conducted directly with the brokers for the ETF and attractive spreads and costs can be negotiated.

Lastly, and importantly, the research highlights the need for continued education on ETF uses and benefits. This does not appear to be a function of size of the investor, but seems to be linked to whether an investment decision maker has any interest in understanding the possible uses of ETFs in their business. Limited local ETF availability coupled with satisfaction with existing investment tools and processes are likely the key drivers for this.

THE FUTURE FOR INSTITUTIONAL USE

It is clearly still early days for institutional ETFs in Australia. Increasing institutional awareness and usage are positive signs, although broader acceptance of ETFs is likely to be some time away.

Globally, institutions continue to embrace ETFs. The US and European ETF markets are dominated by institutions incorporating investment managers, pension funds, endowments and foundations. With 48% of US asset management firms and 33% of institutional funds expecting their usage of ETFs to increase by 2013[1], growth is likely to continue. Trends in current usage are similar to those found in this report, where greatest uses ETFs are for tactical adjustments and short term cash management purposes.

Institutions are increasingly realising that ETFs are an additional investment tool that can enhance the portfolio management process. The speed at which adoption of ETFs will take place seems to be strongly dependent on an investment decision maker's familiarity with ETFs, system limitations, and the type and purpose of the exposure needed to be accessed. This, in addition to product innovation, will form a power driver to future Australian ETF market growth.

[1] Greenwich Associates (2011) 'Institutional Demand for Exchange Traded Fnds Continues to Climb, Greenwich report (May)

Disclaimer

First used: May 2011

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Title: **Digging deeper: Institutional ETF Investing in Australia – Research findings.**

Date: May 2011

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Digging deeper: Institutional ETF Investing in Australia – Research findings.

EXECUTIVE SUMMARY

Deloitte Actuaries & Consultants Limited (AFSL 244 576) have been engaged by Russell Investment Management Ltd to research the role Exchange Traded Funds ("ETFs") could play in Australian institutional portfolios and the types of ETFs that might be suitable to meet these needs. This report details the results of that research after interviewing 20 potential institutional investors (and advisers).

KEY FINDINGS

- The majority of large institutions use ETFs, albeit in a small way.
- Emerging Markets and Global Listed Property Trust ETFs were seen as attractive by the most number of respondents.
- A large number of respondents implement temporary investment positions, and where futures are not available ETFs become an attractive choice of tool to obtain a required exposure.
- There was virtually no interest amongst larger institutions and investment managers in ASX listed ETFs. There was more (but not exclusive) focus on listings in the United States, because of market depth and liquidity.
- ETFs might be attractive to smaller institutions, Retail and SMSF investors and not-for-profit endowments and charities for short term exposures, but possibly also for strategic holdings. The accounting / tax treatment for such investors is important, as is the cost relative to alternatives such as managed funds.
- Some larger investment managers and institutions might also find ETFs attractive at a sub-portfolio or wrap/platform level to serve Retail and SMSF investors, or to manage short term or strategic exposures where those sub-portfolios were small.
- ETFs are largely unused by specialist investment managers.
- The cost of most ETFs is a major deterrent to long term holdings by institutions.
- A number of respondents had concerns about risks associated with synthetic ETFs and commodity based ETFs, reflecting similar concerns being expressed by global regulatory institutions in recent weeks.
- Some innovation is occurring in the use of ETFs in investment products, particularly through "top down" style funds actively managing asset allocations and global industry sectors.
- A number of participants expected ETF usage in Australia to increase over the next twelve months.

1 INTRODUCTION

1.1 BACKGROUND

Deloitte Actuaries & Consultants Limited AFSL 244 576 ("we" or "us") have been engaged by Russell Investment Management Ltd ("Russell") to research the role ETFs play in Australian institutional portfolios and the types of ETFs that might be suitable to meet these needs.

We have carried out this work under our contract with Russell dated 20 December 2010.

1.2 SCOPE AND SERVICES

We have interviewed a selected number of potential institutional investors with regards to their views on ETFs.

We interviewed 20 potential institutional investors (and advisers). Interviews were targeted to approximately one hour duration each. The respondents were targeted to cover the following areas:

1. Industry, corporate and public superannuation funds
2. Insurers
3. Endowments/Foundations
4. Investment managers (portfolio managers)
5. Hedge fund managers
6. Investment consultants

This summary report of key comments and themes relies upon the responses of participants in the interviews. We have highlighted key themes and comments observed from interviews in the summary report.

1.3 SYNTHETIC & COMMODITY BASED ETFS

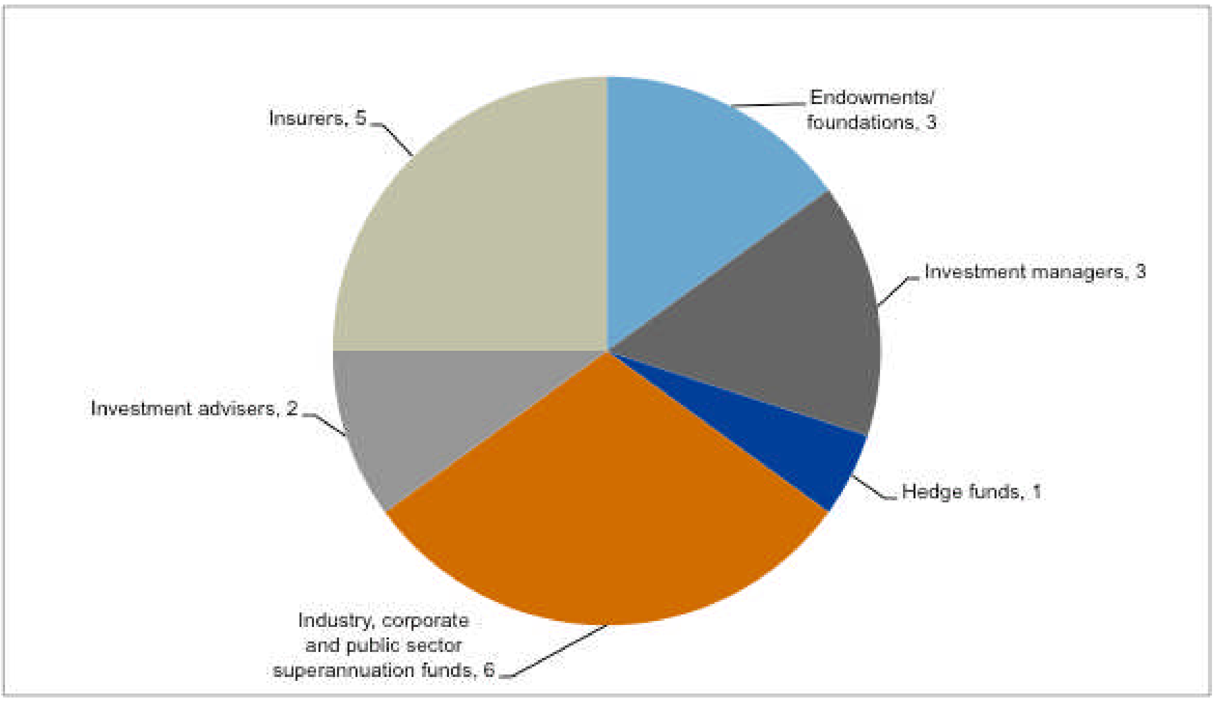
There was virtually no appetite disclosed by respondents for synthetic (and commodity based) ETFs. This lack of appetite can be viewed as related to current regulatory pressures on their use (see Section 4.4). This is an relevant point to note upfront, because it implies that respondents on the whole replied to questions assuming that the ETF in discussion was backed by physicals, not derivatives.

2.1 PARTIES INTERVIEWED

We interviewed 20 potential investors (or advisers) in total. Interviews were targeted to approximately one hour duration each.

The 20 participants represent the range of sectors targeted as per Figure 1 below.

FIGURE 1.



Combined, the participants directly manage or advise on over 40%[1] of Australian funds under management.

It should be noted that there were other parties invited to participate who declined our invitation. Where possible, we enquired as to the reason for non-participation particularly to ascertain whether it was because they had no interest in ETFs. If this was the case, then not including such participants in the research would likely lend a bias to the results (giving a more positive reaction to ETFs).

For parties who directly declined the invitation, we were satisfied that the reasons given were not related to the subject matter being discussed, but rather were independent (e.g. unable to give the time commitment) to an extent such that it did not introduce material bias into the research results.

2.2 INTERVIEW QUESTIONS

Deloitte prepared a list of specific questions for each interview. Details of answers provided against each of these questions are provided in Section 5 of this report. These questions were developed through discussion with Russell. These questions are intended to cover potential uses for ETFs and their alternatives as well as the interest, appetite and any hurdles for the interviewee in using ETFs. They were designed to inform on possible attractive structures, types and features of ETFs.

Many of the questions had multiple parts to them. The reason multiple parts to the questions was used was to provide a number of different ways to approach the discussion of different issues.

[1] Source: Estimate provided by Russell Investment Management Limited based on Morningstar data, APRA quarterly statistics and annual reports.

Some of the questions were designed to overlap in terms of the answers they might give. This was intentional and they were designed this way to encourage free conversations in interviews, and to give more than one opportunity to gain relevant responses.

For this reason, some readers might find that sequentially reading the answers to each of the questions in this report may not be the most effective way to review the responses. We have summarised answers received by interviewees into key themes emerging in Section 3 of this report.

3 KEY THEMES

After collating the survey responses, several key themes emerged. The clearest of these themes is that responses were similar among similar participants. In fact, most participants' responses could generally be combined into three major distinct groups: large institutions and asset consultants, large specialist investment managers and small to medium sized investors.

3.1 LARGE/SPECIALIST INVESTMENT MANAGERS

Large investment managers would typically implement temporary positions, for things like dynamic asset allocation, cash equitisation and transition management. Typically for these temporary positions, they:

- Used futures to manage them. Futures were seen as the most cost effective tool for gaining exposures. They are currently an incumbent part of business processes, and large institutions are familiar with their use, and are able to use them sustainably due to their low cost.
- Where futures were not available within a certain sectors (e.g. Emerging Markets or Global Listed Property Trusts), then other tools were more likely to be considered. ETFs were one option which was considered, as was the use of physicals.

In addition, very low cost index funds were also used for exposures, both in the shorter and longer term. Where index funds were used, there was a trend towards using direct holdings, but only for very large players. Taking this trend into account, ETFs were viewed as taking a step in the wrong direction for medium/long term holdings.

Large investment managers primarily viewed ETFs as a tool which would be attractive to retail and SMSF investors. Generally, responses included comments that large institutions believed they could manufacture ETFs themselves if it were necessary and if the market were seen as attractive.

Some large investment managers did say they might consider using ETFs for exposures to some markets where futures were not available, and/or holding directly was problematic. Emerging markets and Global Listed Property Trusts were mentioned here consistently. Some participants mentioned sector tilt ETFs as something of interest. Generally though, interest was not gauged to be strong. However in some measure of contrast to this, a surprising number of large investment managers had actually used ETFs in the past to gain a short term exposure, for example to Emerging markets or to Global Listed Property Trusts. The clear message that came through was that ETFs are seen as one of the instruments available for managing short term positions and they are assessed against other possible instruments in terms of price and other criteria for relevant transactions.

The specialist investment manager participants managed their funds in a targeted way, and accordingly saw no place for ETFs within their investment style. Some even saw ETFs as a competitive product to their market offering. These sorts of participants generally invested in a selected number of Australian stocks directly, or had a targeted high turnover (hedge fund) trading strategy.

Were large investment managers to use ETFs, some of the key features they would like to see in these would be:

- Cost effectiveness for the exposure (and as compared to other tools).
- Suitability for the time frame of the required exposure (closely related to the cost point above).
- Liquid and deep in their markets.
- Small tracking errors, against benchmark.
- Reputation and track record of the ETF issuer were also issues, but viewed more as a "right to play" rather than a differentiator.

There was some element of product innovation in funds management driving the use of ETFs by large investment managers. One large investment manager stated that they were launching a series of different "top down" style funds which managed asset allocations actively, and also provided active management between global market sectors using the Global Investment Classification Standard. For these particular style funds, it was disclosed that they were actively managed using ETFs listed on foreign exchanges.

With the evolution of “top down” style products where positions on asset allocations were actively taken, or where positions on global industry sector tilts were actively taken, deep and liquidly traded ETFs were viewed as a preferred tool for implementation. The primary criteria for using a locally listed ETF would be that the ETF deliver a similar level of liquidity and market depth. There was appreciation for currency cost savings were they listed on a local exchange, but this was a far smaller consideration than the liquidity and depth.

There was virtually no interest amongst large investment managers for investing in ASX listed ETFs.

The “top down” fund manager expected to continue to increase their use of internationally listed ETFs over the next twelve months. A few respondents expected to, or were open to the idea of increasing their ETF usage over the next twelve months. Some felt this would happen on Retail or SMSF platforms. Other large investment managers stated that they expected no change in their usage of ETFs in the next twelve months.

A small number of large investment managers suggested they might be more likely to find ETFs attractive at a sub-portfolio or wrap/platform level to serve Retail and SMSF investors, or to manage short term or strategic exposures where those sub-portfolios were small.

3.2 LARGE INSTITUTIONS AND ASSET CONSULTANTS

Similar to large investment managers, large institutions would typically implement temporary positions, for things like dynamic asset allocation, cash equitisation and transition management. They would also frequently use futures manage them. Large institutions generally said they were unlikely to use ETFs for temporary positions, or for longer term positions. For temporary positions they continued to cite futures as a preferred tool, and for longer term positions, they would hold assets directly.

In addition, the large superannuation funds in particular are able to take advantage of significant cash in-flows to make asset allocation changes as required.

> *“We will use derivatives... ...usually if we need access to an exposure temporarily. However, we have used ETFs in the past to get some exposure quickly.”*

Similarly to large investment managers, some larger institutions did say they might consider using ETFs for exposures to some markets where futures were not available, and/or holding directly was problematic. Emerging markets and Global Listed Property Trusts again topped the list. Generally they would seek to use the most appropriate tool for the required market exposure.

Were larger institutions to use ETFs, they would look for the same key features listed for large investment managers, but less frequently suggested they would like them to be:

- Liquid and deep in their market.

They more frequently responded that they would like them to be:

- Tax effective.

Exposure for a given cost was normally the primary consideration. Cost was frequently viewed as an external measure associated with the tool, without significant consideration appearing to be given with regards to any different levels of internal costs incurred in execution of a particular tool, though there was acknowledgement by large institutions of the level of expertise required to use derivatives. Some large institutions said that the level of internal expertise for the management of derivatives was an issue they considered. The large institutions interviewed varied in their views on their current levels of internal expertise for using derivatives to manage short term exposures.

One large institution said at the top level they do not hold short term exposures, so they will not use ETFs for pure asset allocation moves, but they do use them for cash management and re-balancing in certain circumstances. In addition, the underlying managers within each asset class may use ETFs rather than futures for equitisation because in certain circumstances the tracking error for the ETFs is lower than futures.

Fees were a consideration for large institutions not just from a cost level, but for those institutions with a fiduciary responsibility it was important that the fees being borne by members were clearly disclosed and optimised. For longer term passive holdings, large institutions tend to use index mandates or funds provided by the major passive fund managers, primarily for cost reasons.

Tax was an issue more frequently raised by large institutions than large investment managers, particularly the characterisation of returns as either income or capital gain.

As for large investment managers, a few respondents expected to, or were open to the idea of increasing their ETF usage over the next twelve months. Some felt this would happen on Retail or SMSF platforms. Others stated that they expected no change in their usage of ETFs in the next twelve months.

As for large investment managers, a small number of large institutions suggested they might be more likely to find ETFs attractive at a sub-portfolio or wrap/platform level to serve Retail and SMSF investors, or to manage short term or strategic exposures where those sub-portfolios were small.

3.3 SMALL TO MEDIUM INVESTORS AND ENDOWMENTS

Small to medium investors were also likely to implement temporary positions. However they were less likely to use futures to implement these positions. The key reason cited for this was a lack of in house capability.

Some investors said that their consistent inflow of funds was enough to rebalance asset allocations as required. Others used a select number of managed funds, with a preference for not changing this manager profile outside of a strategic timeframe of up to 5 years.

Some funds viewed ETFs as a competitive proposition to managed funds for long term investment. The attractiveness of this depended primarily on the relative fees under each option. Generally, the larger the investor, the more competitive they thought the fees they could obtain from managed funds was and therefore the less likely they were to use ETFs for a longer term position.

Smaller participants made favourable comments regarding the attractiveness of ETFs if the fees were competitive, and might be interested in them for both core portfolio uses, and for access to additional markets, or sectors. Active management was also of interest.

For these participants some of the key features they would like to see in these would be:

- Cost effectiveness for the exposure (and as compared to managed funds)
- Small tracking error, against benchmark
- Tax and reporting
- Reputation and track record of the ETF issuer were also issues, but viewed more as a “ticket to play” rather than a differentiator.

Many of these participants mentioned the tax treatment of ETFs as a feature of importance. Some institutions had clients/portfolios where their objectives were to provide an income and to retain the corpus of assets intact and growing in real terms. In these cases the use of derivatives for exposures was considered inefficient because all of profits and losses that emerge from trading these derivatives flow straight through to the income account and impact the tax outcome for the client. As such, this makes ETFs relatively more attractive if they address this issue appropriately.

Particularly for endowments, the reporting of returns as either income or capital gain would play a significant factor in their attractiveness. One respondent mentioned that if they were to use ETFs, it was important that claiming franking credits was as easy as it was for them for managed funds.

Some smaller funds and endowments had not had much experience with ETFs in the past, and would be more likely to consider them if they knew more about them.

Some smaller managers and not-for-profit endowments and charities expected ETFs to become more popular over the next twelve months and that they might start evaluating whether they should use them.

4.1 POTENTIAL USES OF ETFS

The most clearly important feature contributing to ETF use was cost. Most participants cited cost of the primary reason for not using ETFs currently, or for not planning to use them (more) in the future. Many participants took the view that they were after a certain type of exposure and had a number of tools available to them to create that exposure. The tool which met their criteria would be the one selected, and the criterion which was of most importance was cost.

Potential uses for ETFs were varied, but to categorise them, they included the following:

- Short term exposures (particularly for dynamic asset allocation, cash equitisation and transition management and for exposures that were hard to get using futures).
- Long term exposures (of all kinds including Australian equities, international equities, emerging markets and others) – but only if costs were competitive with other tools to gain exposure (i.e. managed funds or physicals).
- Top down fund construction.
- Provision to Retail / SMSF client platforms.
- To give a favourable accounting/tax treatment versus other available tools both in the short and longer term.

4.2 ETFS VERSUS FUTURES

For short term exposures many funds preferred to use futures because futures are:

- Regarded as a cheaper method to gain short term exposures than ETFs or other available tools.
- Already an established part of many participants' processes and procedures.
- Available in depth covering many markets.
- Smaller in their capital requirements than ETFs

However, there were also some downsides to futures, which meant that a number of participants, particularly those of smaller size, were less likely to use them for short term exposures. These downsides included:

- Work was required to balance a basket of futures particularly for multi-market exposures (e.g. global equities) – requiring expertise and an investment in building the capability in house.
- For international equities in particular there was a potential for greater tracking errors than with ETFs.
- One large investment manager saw that there could be a place for them in managing short term exposures in bond funds.
- Some markets did not have a deep and liquid future market with which to gain the exposure.
- ETFs were viewed as simpler, less risky instruments.
- Futures might have unfavourable accounting treatments especially for clients/funds which prefer to receive tax effective income rather than capital gains.

4.3 ETFS VERSUS MANAGED FUNDS

Regardless of term, managed funds were seen as a competitive offering to ETFs. Many participants commented that ETFs were more expensive that managed funds. Other large institutional investors commented that they would be more likely to hold physicals than either ETFs or managed funds. Key positive features of managed funds over ETFs were highlighted to be:

- Price – particularly with passive managed funds.
- Negotiability (particularly on price).
- Transparency of fees.
- More established in practice.
- No tracking error issues, or front running possibilities. Primarily this is in reference to actively managed ETFs where a number of respondents identified concerns on these points.

However managed funds were also commented to have the following downsides:

- Take longer to purchase/invest in than ETFs.
- Do not have the daily positions disclosure requirements of ETFs since they are not listed.

4.4 TYPES OF ETFS WITH COMMENTARY

Comments received on each of the following ETF product structures were as follows:

EMERGING MARKETS ETFS –
a number of respondents commented that these might be attractive. Tools to access these markets were not seen as readily available. Single country exposures were mentioned as of interest by a subset of those who found the emerging market ETFs attractive, however most preferred the simplicity and efficiency of a single MSCI Emerging Markets ETF. Some participants had invested in these types of ETFs. One respondent mentioned that actively managed emerging markets ETFs would be particularly attractive.

> *"We are unlikely to use value based, et cetera for equities or any of the other styles mentioned. We might look at a new asset class or emerging markets"*

GLOBAL LISTED PROPERTY TRUSTS –
a number of respondents commented that these might be attractive. Tools to access these markets were not seen as readily available. Some participants had invested in these types of ETFs.

INTERNATIONAL EQUITIES –
a number of respondents commented that these were attractive. In particular they were seen as competitive by one large investment manager participant in terms of price (when factoring in work required in balancing a basket of futures). This participant had invested in these types of ETFs.

AUSTRALIAN EQUITIES –
Generally these were not rated attractively. Participants mentioned these would more likely be attractive to Retail investors or SMSFs. Some smaller funds were attracted to these if they were price competitive with Managed Funds. Larger funds commented that they were not attractive as they would be too expensive. Not-for-profits, endowments and charities would be more interested if accounting and tax treatments were favourable. There were a few more interested comments when sector tilts were included, when actively managed, if there was liquidity and depth comparable to ETFs listed overseas, or if the costs were significantly cheaper. More detail is provided on these product structures below.

BOND FUNDS –
Some participants viewed these funds as having less likelihood of front running problems associated with them than equity funds. One fund had investigated their use but found them to be cost prohibitive, citing that they only cover Government or Sovereign risks, and that they were too expensive. Another large investment manager said that bond ETF funds might have a place for them in managing tactical asset allocations in certain circumstances.

COMMODITIES –
No interest was shown by any participants. Few participants commented on commodity ETFs either from an attracted or unattracted point of view. One participant mentioned the success of the Australian gold ETF upfront, but that it had now stabilised. There was a recognition from a small number of participants that commodity ETF transparency was an issue. Some respondents also had doubts about whether these were useful for Australian institutional investors. A few respondents mentioned the success of these types of ETFs overseas. One respondent said that they thought these had been successful in the United States because of retail investors, most likely looking to get exposure to a commodity (silver and gold) which is not so easy for them. In fact, they also mentioned commentary about ETFs influencing silver and gold prices.

CURRENCIES –
No interest was shown by any participants. They were mentioned by few respondents. Some respondents mentioned that they would actively seek exposure to foreign currencies, and others that they would actively seek to avoid it. This was in the context of which exchange the ETFs would be listed on and whether they would be giving exposure to Australian and/or international securities.

ACTIVELY MANAGED FUNDS –
Some respondents commented that actively managed funds on the ASX might not be attractive because they would only look for index exposure for short term purposes, and for longer terms they would find the costs prohibitive. One large investment manager thought that these types of funds would be "getting too cute" for their purposes. A small number of participants mentioned concerns with pricing of the shares, and whether it would remain consistently in line with the underlying basket of securities. There were some concerns about transparency, and front running. One respondent mentioned that active funds in emerging markets would be quite attractive.

One respondent mentioned looking at managed beta portfolios, for example, where they would have an index portfolio which was half based on market cap and half based on a growth or value index. So they thought that style-based or strategy/factor based ETFs would be of significant interest to them.

From a trustee perspective the big issue would be churn and therefore trustee run investors might be less interested in active portfolios and would find that index portfolios with style-based biases, that minimised realised capital gains would be quite tax effective.

UNLISTED COMPANIES –
a number of respondents mentioned that they would be interested in vehicles giving them easy exposure to unlisted opportunities e.g. infrastructure.

SECTOR TILTS –
a number of respondents commented that these might be attractive. Tools to access these markets were not seen as readily available.

> *"LPTs and unlisted companies might be interesting... sector tilts... where we might want exposure in quick time"*

LOW COST ETFS (<5 BPS) –
a significant number of respondents commented that these might be attractive. Cost was the most common immediate concern, and interest in low cost options was significant.

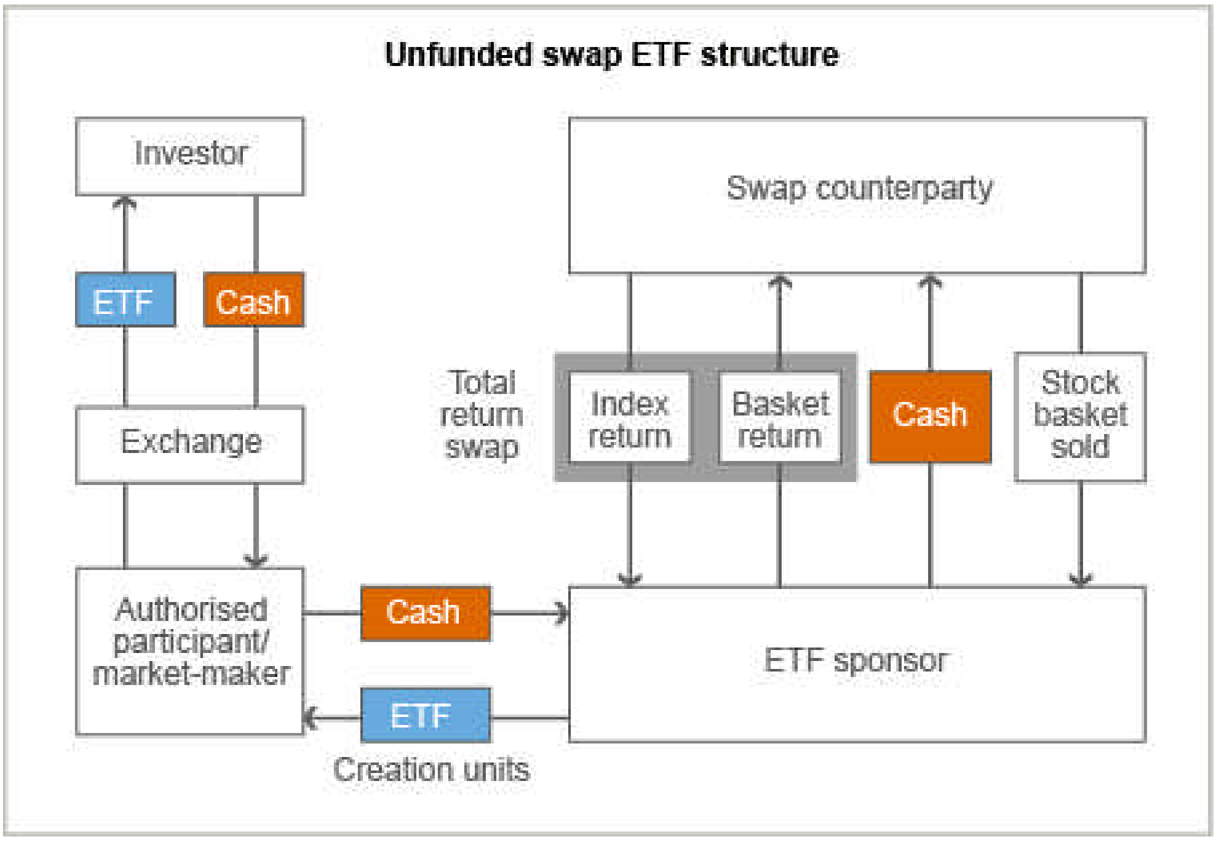
SYNTHETIC ETFS (DERIVATIVE BASED ETFS) –

There was virtually no appetite disclosed for synthetic ETFs. Some respondents mentioned the lack of franking credits available from such ETFs. Some respondents said they would not use derivative based ETFs because of the counter-party risk and tax issues. The only opposing view was from a single large investment manager who said they would be attracted to synthetic ETFs because they could be cheaper.

Note from Deloitte: highlight on topical issue with regards to Synthetic ETFs:

The Financial Stability Board, drawing on analysis from the Bank of International Settlements has recently highlighted some of the systemic risks associated with synthetic ETFs. Economist Srichander Ramaswamy published a paper titled Market structures and systemic risks of exchange-traded funds. In this paper, he highlights contagion risks associated with these structures, from counter-party and liquidity risks. One example is where an ETF is collateral backed by assets that don't affect the return that is delivered to the ETF. This can increase the counter-party risk that ETF holders face to the ultimate swap provider. It the longer term, if products like synthetic emerging market ETFs continue to attract large inflows, then this could lead to some level of asset bubbles in emerging market assets. It is likely than increased regulatory scrutiny will fall on the use of synthetic ETFs in the near future. Figure 2 outlines the synthetic ETF operational structure.

FIGURE 2



Source:

Market structures and systemic risks of exchange-traded fund, Srichander Ramaswamy, Bank of international Settlements.

5.1 QUESTION 1

What are the key issues you currently face in your asset allocation and portfolio construction process? How do you currently address these issues, and where would you like additional solutions?

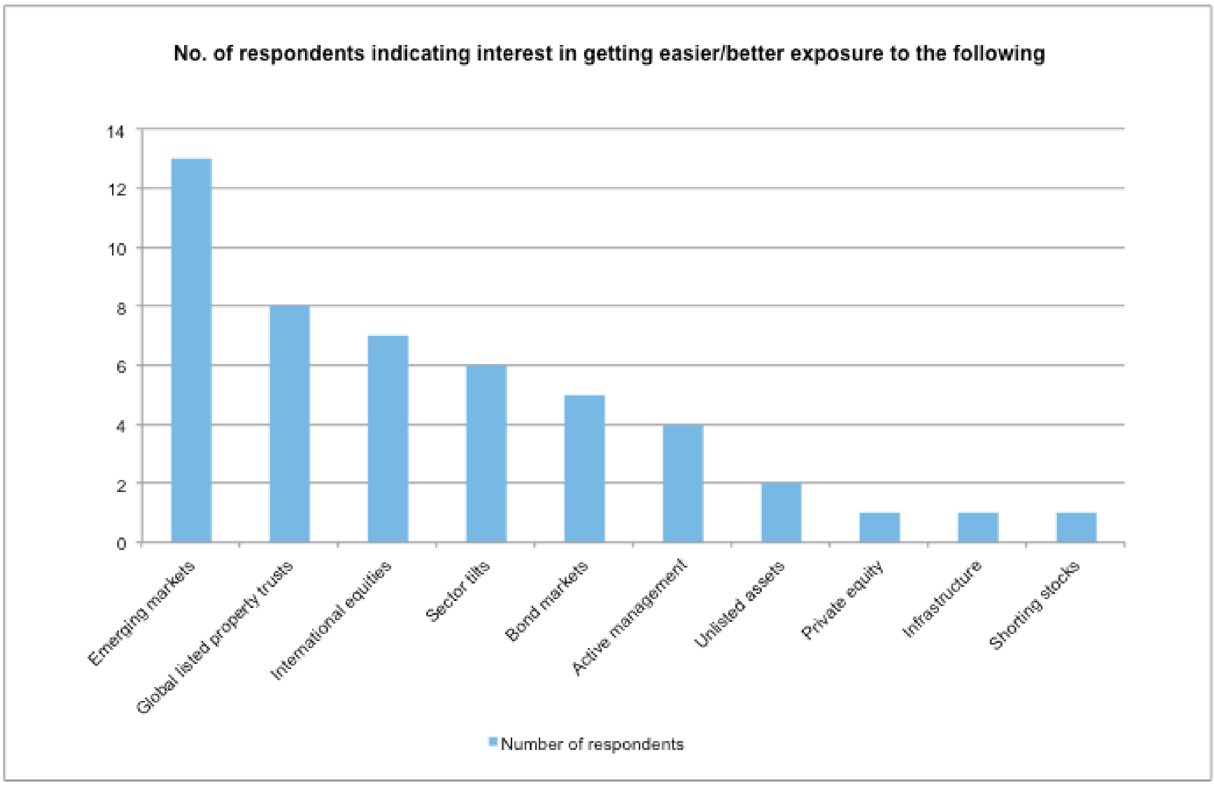
- *Are you (how are you) looking to evolve your portfolio construction process?*
- *Are there exposures you are looking to get easy access to?*
- *What tools do you currently use in the portfolio construction process?*

There were few issues identified in asset allocation and portfolio construction processes other than the problem of generally selecting the right tool to gain a desired exposure. One respondent mentioned that ensuring the efficient use of derivatives to do this around their multimanager portfolios was a current issue they faced.

Currently most respondents would typically implement temporary positions, for things like dynamic asset allocation, cash equitisation and transition management. There were few suggestions of ways they were looking to evolve their portfolio construction process. One participant mentioned that they expected to move away from using unit trusts internationally to holding securities directly. Another participants mentioned new funds they were intending to launch which would use ETFs listed on foreign exchanges to implement a “top down” asset allocation or sectoral approach to active management. These are in addition to the comment around increasing the use of derivatives for the multimanager portfolios.

Respondents mentioned the exposures in Figure 3 as ones they would be interested in looking at tools to gain better/easier access to.

FIGURE 3

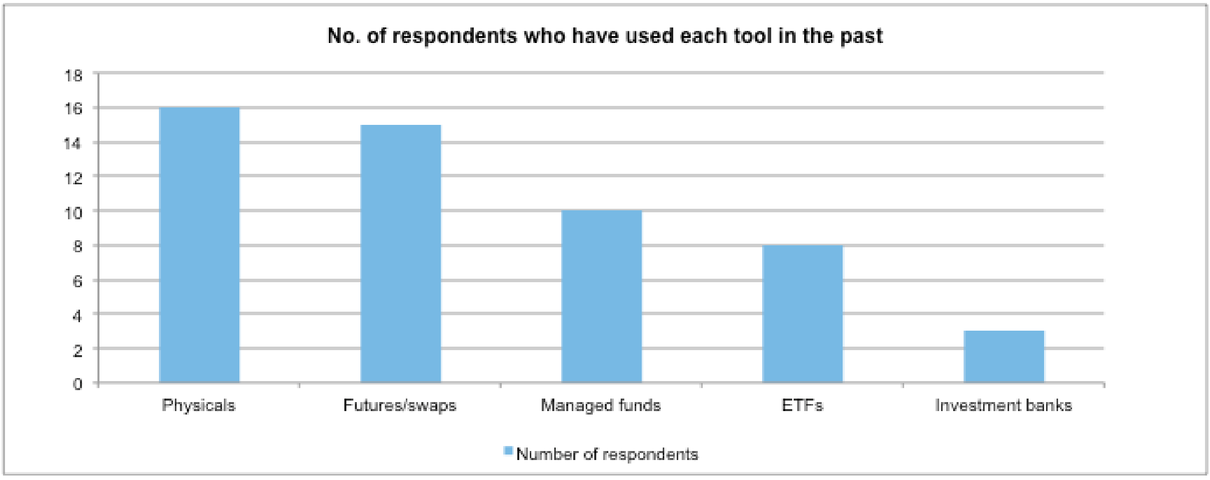


The tool used to gain short term exposures was primarily futures. However, there was a recognition from a number of participants that managing a basket of futures could be difficult in terms of tracking an international index in particular, or if the skill set and experience was not there. For some markets futures were not available, and then physicals became a second option for many. But for markets such as for emerging markets, there are barriers to the use of physicals as well. A number of respondents would then look at either managed funds or ETFs. One participant had no appetite for managing transitions in-house, but rather preferred to engage an investment bank to manage it for them.

> *"We looked at physicals but in emerging markets costs can be prohibitive."*

Long term tools cited were primarily physicals and managed funds, though ETFs were also mentioned by a small number of participants.

FIGURE 4

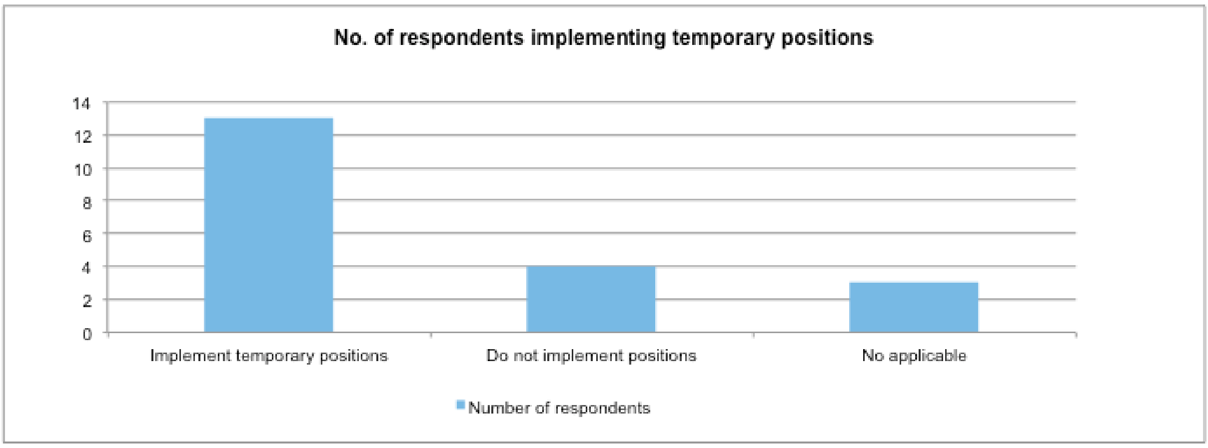


5.2 QUESTION 2

Do you commonly implement temporary positions? If so when and for how long. What instruments do you currently use to implement these? What do you see as the uses of ETFs, and the issues which surround using an ETF structure?

Most respondents did implement temporary positions.

FIGURE 5



Generally, the time frame considered as a short term exposure was anything less than three months, though often this comment was qualified with the comment that the period of time was dependent on how expensive the temporary position was. Purposes included tactical asset allocations, cash-equitisation strategies, completion strategies and transition management.

The tool used to gain short term exposures was primarily futures, though ETFs, physicals, managed funds and investment banks would all also be used or considered, as per the discussion in Question 1.

A small number of respondents replied that they did not implement temporary positions. These respondents all managed their (non-cash) funds through the use of external investment managers, and would only strategically review their allocation on a time frame from one to four years, and would consider transition arrangements only if required because they did not occur frequently. Mention should also be made here of investment managers with a short term trading strategy. Short term trades in fulfilment of a stated long term strategy by hedge fund style managers have not been considered temporary positions for the purpose of this question.

Respondents said variously that ETFs had uses both for short term exposures and strategic allocations.

Many respondents ruled out the use of ETFs completely for strategic allocations as they were viewed as having significantly prohibitive cost differences to alternatives available to them. Generally this was for larger investment portfolios/managers.

> *"(ETFs are)... certainly not attractive in the long term, they are not efficient."*

For others there was a more positive response. Of those who did not rule out ETFs for strategic allocations, they would use them if they were equal to or lower in cost compared to alternatives (on the whole for these respondents the competitive tool was managed funds), with a few exceptions. Those exceptions included:

- the manager running the "top down" funds,
- as part of platforms serving retail or SMSF clients, or at a sub-portfolio level for larger institutions and investment managers,
- where cost would be competitive with other options and ETFs give a preferred income/capital gain treatment for tax purposes. This was particularly a point for endowment/charity fund managers.

> *"...for smaller portfolios ...it is effective to use ETFs both for long term exposure but also for asset allocation moves and transitions."*

A number of different issues surrounding the use of an ETF structure were highlighted by respondents. These included:

- Costs. Some respondents viewed that the (currently higher) level of costs included in ETFs was fundamental to the way ETFs were structured. There was a concern that ETF structures did not allow room for negotiation on fees, which was a positively viewed aspect of the managed fund relationship.
- Capital efficiency. Some respondents said that an important consideration was that ETFs were less capital efficient than futures.
- Synthetic ETFs. Some ETFs are structured synthetically using only derivatives. A number of participants highlighted concerns with these types of structures (see Section 4.4).
- Disclosure and transparency. Some respondents saw a conflict in that they would need transparency to be able to invest in ETFs, but at the same time would be concerned with tracking error and front running risks especially with active share funds.

> *"We have a bias to a passive ETF because we would have no idea what was going on behind the scene with an active."*

If a number of days were taken to change a position, then disclosure requirements could open up the ETF to being front-run. Some respondents said they were concerned by a lack of transparency with ETFs. One respondent particularly mentioned active ETFs as likely having poor disclosure.

On the other hand, for international markets particularly, ETFs were observed by one respondent to have lower tracking error in some circumstances than derivatives.

Another respondent stated that they would require to be informed with regards to the composition of and changes to the funds management team behind the ETF and did not think that information would be disclosed.

An investment consultant speaking about their clients said that it is difficult to look through and see what is really being done by the market-makers behind the ETF and that they believe there would be significant basis risk in highly stressed environments where the market-makers behind the product might have incentive to do the wrong thing at the wrong time to protect their own position.

Some respondents mentioned as an issue, the speed with which disclosures would occur.

Whether the ETF traded at a discount to the underlying securities was a key issue. One respondent thought that dividend reinvestment should be reflected in price. Another respondent had given consideration to a scenario where an ETF trading at a discount might have a register fill up with hedge funds that then agitate to wind up the fund.

> *"...if the discount is high then the register fills up with hedge funds who agitate to wind up..."*

One superannuation fund respondent highlighted transparency of fees as a significant issue, especially given current regulatory focus on trustees to scrutinise fees on investment arrangements.

On the other hand, there were participants who had used ETFs in the past, and had not had any issues with transparency, and others who did not see it is a significant issue.

> *"...we do use ETFs when we need quick exposure to an asset class... (we) have no problems with them from a perspective of transparency, there is enough for what we need and what we use the products for "*

- Liquidity and depth. Particularly for Australian market listed ETFs, lack of liquidity was a key concern. Generally it was a greater concern for the larger investment managers and institutions. One respondent said that larger providers such as i-Shares, Vanguard and State Street are likely to be preferred just because they have the larger products with more liquidity and depth. They said this was probably more important to them than the underlying name. The reason is that they felt that for most ETFs, the assets are in fact segregated from the provider so there is limited counter-party risk.
- Reputation and track record of issuer. Respondents identified this as an issue with regards to an ETF structure, but generally also thought that ETFs were issued by parties with appropriately positive reputations in this area.
- Reporting for tax. A number of respondents raised tax reporting as a key structural issue with ETFs. Income reported as capital gain would be a concern for a number of respondents, and understanding the treatment of franking credits for not-for-profits. However, one endowment respondent said that the use of derivatives for exposures was also regarded as inefficient because all of profits and losses that emerge from trading these derivatives flow straight through to the income account and impact the tax outcome.
- ETFs are new to some. Some respondents said that they had not used ETFs in the past and/or they did not currently have in-house or board knowledge of ETFs and so they would need to take action to get past these barriers before they could use them.

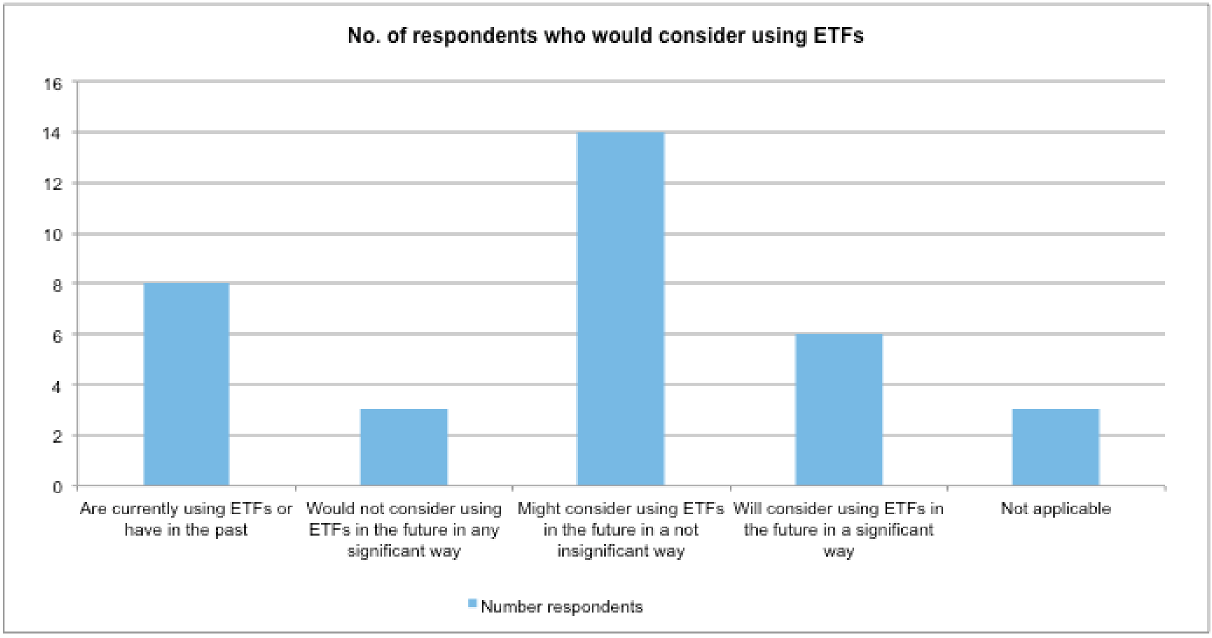
> *"I don't think we have considered them before. We would have to take it to our board."*

5.3 QUESTION 3

Are you interested in using ETFs and in what circumstances? What part of their value proposition resonates with you?

A number of participants were either currently using ETFs is some way, or had done in the past. Others would or would not consider using them as per Figure 6.

FIGURE 6



The value propositions which resonated with those who had used ETFs in the past were:

- Easier to get an exposure to emerging markets/international markets than other options.
- Useful for managing a top-down style fund

The value propositions which appeared to resonate with prospective users of ETFs included:

- Might be easier to get exposures at a reasonable price that other tools cannot e.g. emerging markets, GLPTs, or sector tilts.

> *"...would use ETFs particularly for single country exposure in emerging markets."*

- If cheaper than Managed Funds, then would be considered for ease and speed of use more broadly.
- Efficient tool for SMSF or Retail clients and on platforms serving those clients. Would give an effective way of translating institutional portfolio construction techniques to these accounts.

> *"...the approach to asset allocation would be significantly facilitated in these areas by the use of ETFs."*

- May provide benefits for not-for-profits, charities or endowments in terms of a favourable accounting and tax treatment.

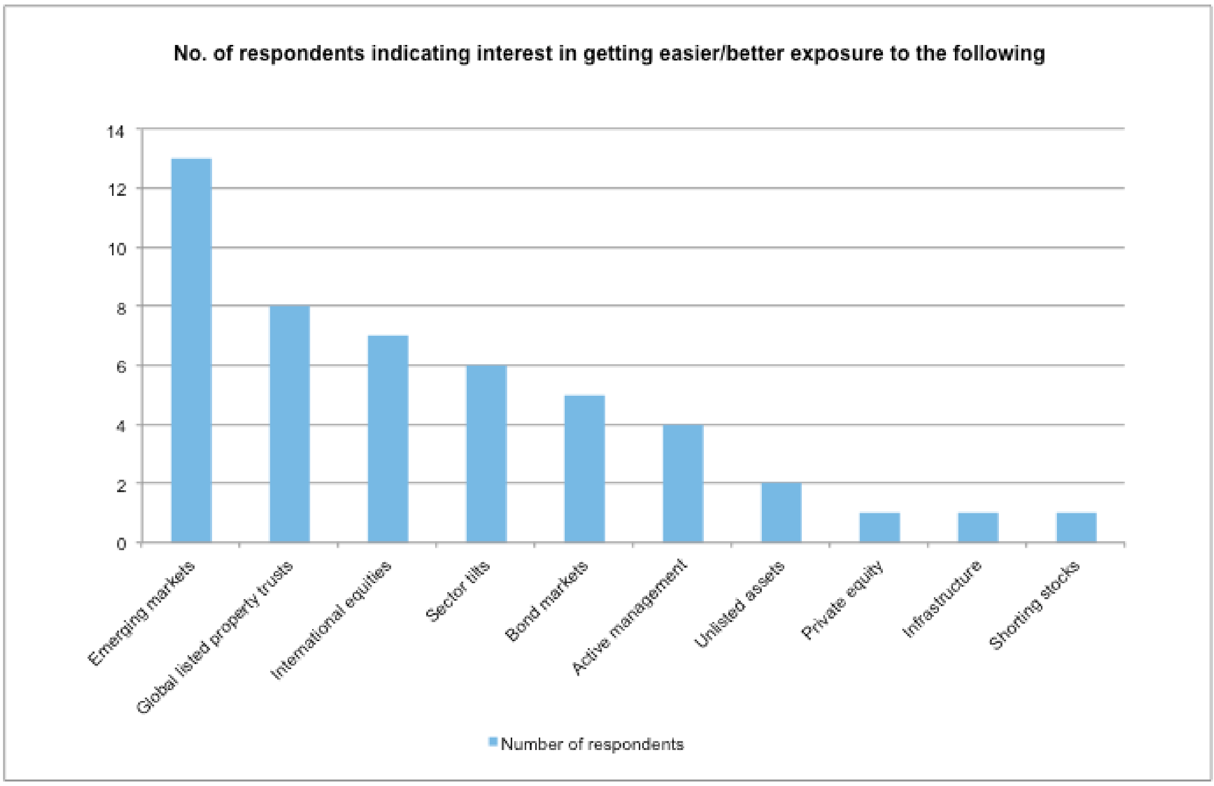
Most respondents particularly mentioned that they would not be interested in commodity, synthetic or currency ETFs (see Section 4.4)

5.4 QUESTION 4

What sort of ETF product structures might be appealing to you? Please suggest an ETF product structure which might be attractive to you.

It is worth initially repeating the Figure 3 from Question 1 here, because the possible ETF product structures are closely related to the exposures they would give.

FIGURE 7



In addition, comments received on each of the following ETF product structures were as per Section 4.4.

5.5 QUESTION 5

Please comment on the below product structures in terms of attractiveness and what your expectation would be for product types as listed:

AUSTRALIAN EQUITIES:
- Style based: Value, Growth
- Strategy/factor based: Momentum, Low Volatility, Cyclical, Defensives, Income focused

AUSTRALIAN BONDS:
- Core bonds with different durations, invested in semi-governments and major corporate
- Inflation linked bonds that invest in Commonwealth government securities

OTHER ASSET CLASSES:
- Developed global
- Emerging global
- Currency
- Global listed infrastructure

ANSWERS AS PER QUESTION 4.

5.6 QUESTION 6

Please comment on why ETFs might be attractive/not attractive to you compared with other institutional investors.

For large investment managers and funds, a number of respondents commented that they could get long term exposures far more cheaply than through using ETFs, for example either directly or with managed funds. These respondents often commented that perhaps retail and SMSF clients would benefit from ETFs more. For shorter term exposures, again derivatives were often cited as a tool they had the expertise to use effectively, and therefore other institutional investors without this capability, or retail and SMSF investors might find them more suitable.

One respondent that ran “top down” style funds commented that ETFs were very attractive to them compared to other institutional investors because they particular suited the style of funds they were running. There was a recognition that this was bespoke to the “top down” style, and also that ASX listed ETFs might not have the depth and liquidity to attract them.

A number of respondents were specialist investment managers and ETFs did not suit their mandate or style. For these there was recognition that ETFs were not attractive to them but they might be suitable for other institutional investors. There was also a participant who commented that they saw ETFs as a competitive product to their investment management services.

One investment manager commented that ETFs did not make sense for them because they were moving to holding securities directly, but had the view that some super funds might use them. A number of respondents commented that if a superannuation fund was big/sophisticated enough to have their own trading desk then they were likely big/sophisticated enough to be able to buy the securities directly rather than use an ETF.

> *“ETFs would probably be more effective for smaller wholesale (investors) who may not have the capability in-house to handle sophisticated derivative programs including use of futures.”*

They viewed that the cost benefit might be there for financial planners as compared to the wrap vehicles they generally have available to them. It depends here on the trailing commissions and fees included in the fund and what disclosure requirements around the fees there were.

A number of respondents commented on the Future of Financial Advice as a key thing to watch in terms of seeing how planners might react to ETFs in the future. Some respondents cited issues with regards to planners not being licensed to “pick stocks”, including ETFs which are listed. This is in contrast with providing advice on an asset allocation level, for which they are more likely to be adequately licensed to give advice.

5.7 QUESTION 7

What ongoing information requirements would you need for you to find ETFs attractive?

Respondents gave the following key informational requirements:

- Full listing of underlying securities/instruments (one respondent said they would require this on a daily basis, but others gave no indication of frequency. One respondent mentioned the speed with which this information would become available as being a key requirement).
- Tracking error.
- Some participants would want to know who the management team behind the ETF was, and particularly if members of that team were leaving/ being poached.

> *"The funds management team is the biggest factor. It would raise an alarm for example if someone from the team was poached."*

- A number of participants said specifically that if the ETF were actively managed, details with regards to management team and methods would be important.
- If actively managed, details on pricing premiums.
- Some participants mentioned that the exchange requirements for transparency and reporting would be sufficient. A number of participants generally mentioned "transparency" as an important requirement.

> *"Transparency is vital for us before investing in an ETF."*

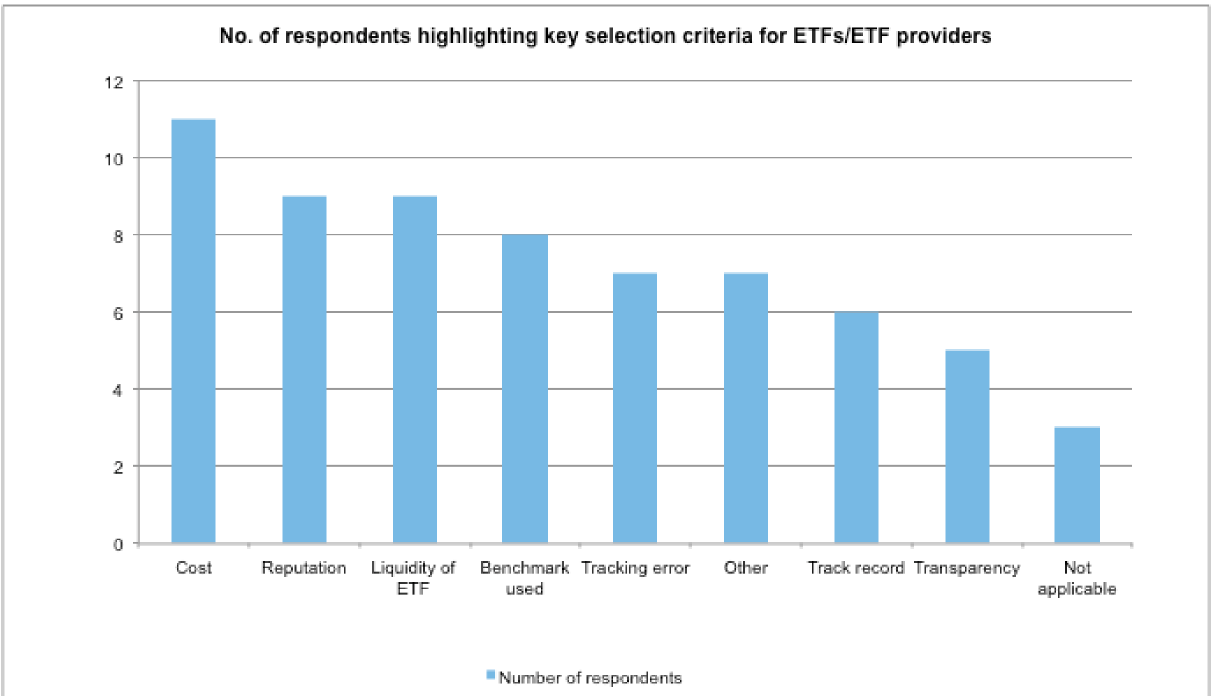
- Indications of liquidity and depth.
- One respondent mentioned the problem of basis risk in highly stressed environments where the market-makers behind the product might have incentive to do the wrong thing at the wrong time to protect their own position. Information with how such a situation might be managed would be useful.
- Fees. A number of respondents mentioned fee transparency as a requirement.

5.8 QUESTION 8

What selection criteria would you likely use to decide on an ETF provider?

The number of respondents mentioning each of the suggested criteria as important for deciding on an ETF / ETF provider was as follows:

FIGURE 8



Some of the respondents gave a broad hierarchy of the criteria they had identified. There was no consistent pattern with this in relation to this specific question, but clearly cost was high on the priority list in a significant number of cases. Liquidity was also a very strongly rated criterion. Reputation was mentioned by many participants, but a number of these also said that along with Transparency, this aspect was more of a "ticket to play" or a minimum requirement rather than a differentiating criteria.

> *"When looking at ETF providers, issues like transparency and tracking error are significant but the most important points are liquidity and volume or depth. In this context, larger providers such as i-Shares, Vanguard and State Street are likely to be preferred just because they have the larger products with more liquidity and depth."*

A number of respondents mentioned that tracking error might not be as important for smaller holdings.

5.9 QUESTION 9

How do you expect ETF product knowledge and usage to change over the next twelve months?

Many respondents gave general comments regarding ETF usage in the market, rather than specifically commenting on their own likely change in usage over the next twelve months. These respondents mostly said that they expected SMSF and Retail investors to start using them more, and that it is likely that global producers of ETF would start offering more ETFs in Australia. One respondent suggested that it was likely that sophisticated superannuation funds would likely increase their usage of ETFs in the next twelve months. There was also a small amount of speculation as to whether the popularity of ETFs overseas (see Question 10), was due to hedge fund managers, and whether that kind of activity might at some stage be emulated in Australia. There was also some discussion of FOFA and the impacts it might have on ETF usage.

Some respondents stated that they expected no change in their usage of ETFs in the next twelve months. One respondent said they would move towards direct holdings and would be unlikely to move towards ETFs. Specialist investment managers did not envisage introducing ETF usage.

A few respondents expected to, or were open to the idea of increasing their ETF usage over the next twelve months. Some felt this would happen on their Retail or SMSF platforms. One respondent said that if they were to become more active in tactical asset allocation, then they might expect to increase their ETF usage. Also, some smaller managers and not-for-profit endowments and charities expected ETFs to become more popular over the next twelve months and that they might start evaluating whether they should use them. The "top down" fund manager expected to continue to increase their use of ETFs.

> *"I would expect our knowledge of ETF products and usage will increase over the next 12 months but not necessarily in our institutional portfolios. It is more likely to happen in our SMSF and SMA client portfolios."*

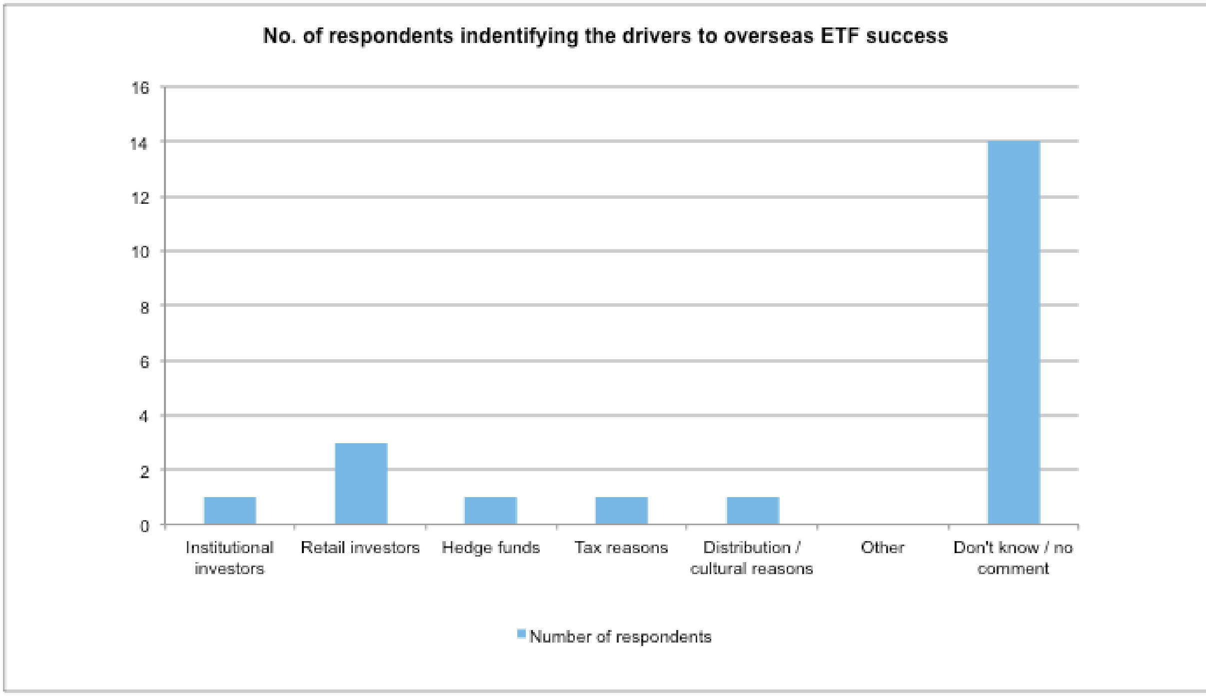
A few respondents commented on the ETF provider market and said that scale would be important and that there is likely an early mover advantage, similar to index management and custody. They imagined that over the next twelve months a few more funds would become available on the Australian market. Only a small number of players will eventually be able to survive.

5.10 QUESTION 10

Currently institutional usage of ETFs is significant globally (particularly US with a 50/50 split of insto/retail flows and in Europe 80/20 insto/retail). Do you have any views on why this is?

Generally, this question had few responses. Many respondents did not comment, or said they did not know why ETFs had been successful overseas. However, those that did comment engaged in a reasonable amount of discussion, which is detailed as follows. Figure 9 details the number of respondents who did not comment or said they did not know, and for those that did respond, what they saw as the key driver to ETF's significant usage overseas.

FIGURE 9



Some respondents replied that overseas use of ETFs was driven by retail investors, who are a good fit for the use of ETFs. Some respondents discussed commodity ETFs as being a major contributor to overseas success, primarily by retail investors. Others discussed distribution network differences between the United States in particular and Australia.

> *"There are also other issues in the US, for example their retail market is broker driven not advice driven like ours."*

There was some discussion of cultural differences, both in the context of how distribution networks were structured and how fees were discussed and evaluated.

Other respondents replied that overseas use of ETFs was driven by institutional investors using platforms to service retail clients. One respondent said that the success in the United States could be the smaller end of the institutional market, where there is a backlash against the mutual fund industry. Other respondents replied that overseas use of ETFs was driven by institutional investors who gained tax advantages from their use.

One respondent discussed the favourable tax treatments of ETFs for endowment funds in the United States.

A small number of respondents replied that overseas use of ETFs was driven by hedge funds, of which there are not so many in Australia, so they did not expect the same sort of ETF success.

One respondent made the additional comment that they thought it likely that the success observed overseas was likely to be mimicked in Australia.

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This report describes the work we have carried out, detail with regards to the responses received from interviewees and the key themes and comments observed from interviews.

We have not provided analysis of the ETF structure or product.

We have not provided advice or an opinion in respect of the attractiveness of ETF products in the institutional (or any other) markets, rather only summarising opinions and commentary received from interviewees with whom we met during the course of providing the Services.

We have relied on the accuracy and completeness of all data and other information (qualitative, quantitative, written and verbal) provided to us for the purpose of this report. We have not independently verified or audited the data but we have reviewed it for general reasonableness and consistency. It should be noted that if any data or other information is inaccurate or incomplete, our advice may be incorrect or inappropriate for you and may need to be revised.

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