Russell Investments

Russell Research

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

Author: Amanda Skelly – Director, Exchange Traded Funds

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

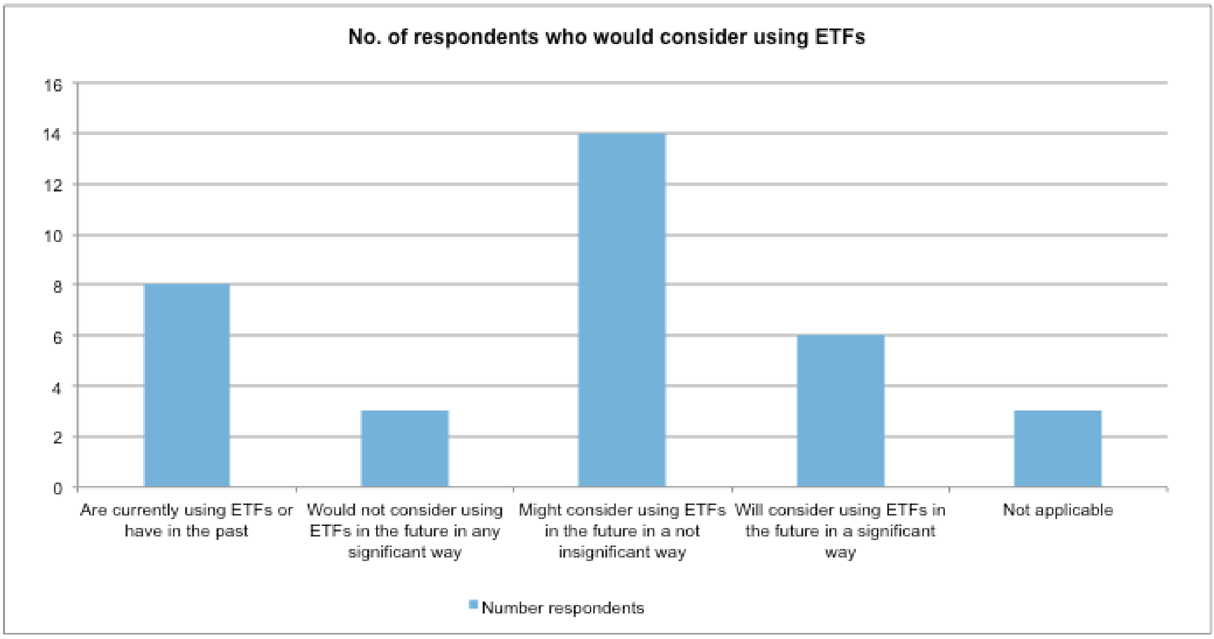
Digging deeper: Institutional ETF Investing in Australia – Insights and Implications.

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

Issued by Russell Investment Management Ltd ABN 53 068 338 974, AFS License 247185 (“RIM”).
This document provides general information only and has not been prepared having regard to your objectives, financial situation or needs. Before making an investment decision, you need to consider whether this information is appropriate to your objectives, financial situation or needs. This information has been compiled from sources considered to be reliable, but is not guaranteed.

First used: May 2011

R_RPT_RES_InstETFs_EcecSum_V1F

MKT 3006 0511

For more information about Russell:

Call:
+61 2 9229 5111

Visit:
www.russell.com.au/institutional

ABOUT RUSSELL INVESTMENTS

Russell Investments improves financial security for people by providing strategic investment advice, world class implementation, state-of-the-art performance benchmarks, and a range of objectively researched, institutional-quality investments.

Russell serves individual, institutional and adviser clients in more than 47 countries.

Founded in 1936, Russell is a subsidiary of Northwestern Mutual. The firm, headquartered in Tacoma, Washington, US, has principal offices in Amsterdam, Auckland, Hong Kong, Johannesburg, London, Melbourne, New York, Paris, San Francisco, Singapore, Sydney, Tokyo and Toronto.