



# Exchange-Traded Funds: Threat or Threatened?

Exchange-traded funds (ETFs) remained resilient during the market crisis of 2008 and are expected to reach \$1 trillion in 2010. Whether you're currently offering ETFs, contemplating ETFs, or seeking to understand advisors' usage trends, a close examination of this marketplace will answer: are these products a threat or are they threatened?

This report examines the ETF landscape, including manufacturing and assembly, advisor usage, and asset-gathering potential. It also includes actionable recommendations for implementing an ETF strategy.



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## INSIDE LOOK:

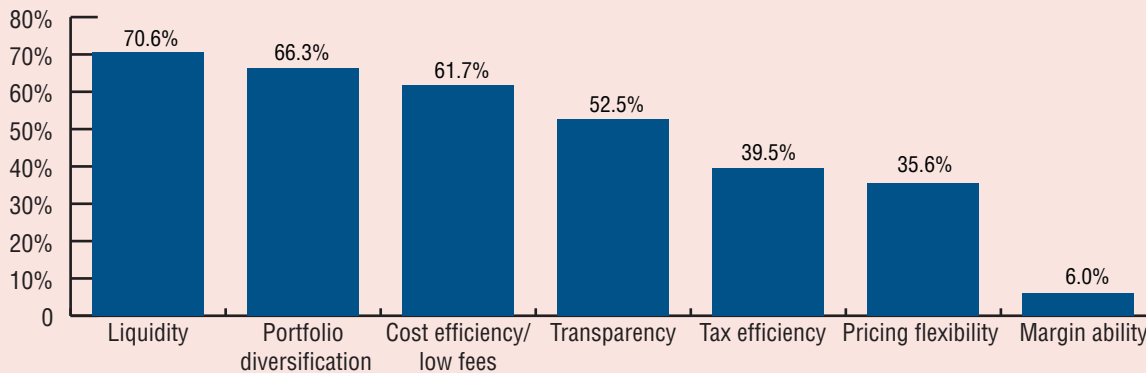
### Key Findings:

- While close to half of advisors use ETFs, their allocation remains small at just 5%.
- ETF product development is strong: more than 2/3 of the sponsors plan to develop five to 10 new ETFs during the next year.
- Asset managers who align their product development with advisor usage trends will have the greatest success in the ETF market.
- Training and education will be necessary to increase advisor usage of ETFs going forward.
- ETFs will erode some of the money going into mutual funds given increased demand from gatekeepers, advisors, and investors.

### Exclusive data in this report:

- Advisor usage of ETFs in portfolio construction
- Best practices from leading ETF sponsors on educating advisors and investors
- Economics and profitability of ETFs compared to mutual funds
- Checklist of key tasks involved in assembling and distributing an ETF
- ETF market size and analysis

Sample Report Exhibit: Very Important ETF Attributes for Financial Advisors, 2009



Sources: Cerulli Associates, in partnerships with the College for Financial Planning, the Financial Planning Association, the Investment Management Consultants Association, and Morningstar

### This report helps asset managers and ETF sponsors:

- Create products that meet investor and advisor demands
- Structure, educate, and compensate wholesalers
- Understand how advisor wealth tier and channel impact ETF usage
- Gauge the future of ETFs in 401(k) plans
- Assess the viability of niche, alternative, and copycat ETFs
- Approach managed account gatekeepers
- Create training programs to best educate advisors
- Target advisors most likely to expand ETF usage

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Table of contents, exhibit list, user examples, and sample pages are attached

## REPORT ROADMAP

1. Overview and market sizing of the ETF landscape, plus reasons to stay, leave, or enter
2. Developing, creating, and operating an ETF
3. Trends in advisor usage and wholesaling strategies of ETFs



## Exchange-Traded Funds: Threat or Threatened?

### USER SCENARIOS:

The following are examples of how this report can be applied to business planning and strategic decision-making:

**Scenario 1:** A large ETF sponsor is interested in expanding their lineup of ETFs. They are considering creating some alternative ETFs but need more background before they commit resources to this project.

*The Cerulli Report: Exchange-Traded Funds: Threat or Threatened?* answers the following questions:

- What success have other ETF sponsors had with niche or alternative ETFs?
- Do advisors employ a tactical versus strategic approach to using ETFs?
- What are the average expense ratios on alternative ETFs?
- How are other firms educating advisors on using ETFs?

**Scenario 2:** A smaller ETF sponsor is trying to improve their distribution strategy. Currently they are unsure where to target their distribution efforts. *The Cerulli Report: Exchange-Traded Funds: Threat or Threatened?* answers the following questions:

- What types of advisors are most likely to use ETFs?
- How are ETFs typically used in portfolio construction?
- What aspects of ETFs should the sponsor highlight in marketing materials?
- How are other ETF sponsors using and compensating wholesalers?

**Scenario 3:** A mutual fund manager does not have any ETFs, but is thinking of expanding their product line to include them. They need a resource that will guide them through the product development process. *The Cerulli Report: Exchange-Traded Funds: Threat or Threatened?* answers the following questions:

- What is the profile of the typical financial advisor that has adopted ETFs?
- What are the steps to launching an ETF?
- At what point does an ETF become profitable?
- Are copycat ETFs viable?

For more information on how to apply this report to your firm's unique needs, please contact our Marketing & Business Development team at +1 617-437-0084, [CAmarketing@cerulli.com](mailto:CAmarketing@cerulli.com).





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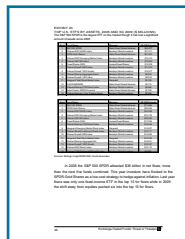
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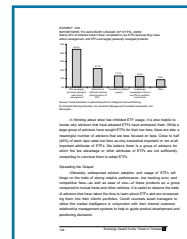
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## REPORT THESIS AND SCOPE

Enthusiasm about exchange-traded funds (ETFs) has spread in recent years as assets in this product vehicle mounted. Many asset managers with retail third-party distribution capabilities are contemplating whether to build ETFs to combat the potential loss of marketshare among their mutual funds and garner new assets. Other asset managers are resolute that they will not enter the ETF market, unless perhaps active ETFs gain traction, instead remaining focused on their expertise—active management.

The scope of this report is shaped by the following question: what is the opportunity for ETFs in the retail third-party distribution channel in the United States? The report also includes a short review of the European ETF marketplace. This is Cerulli Associates' first report to focus exclusively on this topic, and it will serve as an important foundation as we expand our research in this area in the months and years ahead.

### **Some of the topics that this report analyzes include:**

- Assessing the principal challenges associated with ETF growth
- Understanding how the use of ETFs is influencing the retail third-party market
- Sizing the ETFs market in the U.S. as well as Europe
- Analyzing the economics and profitability of ETFs
- Synchronizing product development with the needs of financial advisors
- Evaluating the potential for active ETFs
- Reviewing the use of specialty and alternative asset classes among ETFs
- Examining advisor usage of ETFs in portfolio construction
- Studying gatekeeper and platform processes for reviewing ETFs
- Identifying distribution and marketing challenges
- Developing training programs to support advisor adoption of ETFs

### **Some of the key questions that this report answers include:**

- Is pursuing a product development plan that focuses on creating clones

of established ETFs a viable strategy?

- Will financial advisors abandon actively managed products in favor of index mutual funds and passive ETFs?
- What is the profile of the typical advisor that has adopted ETFs?
- Will 401(k) plans be able to accommodate ETFs in the near future?

## **Beneficiaries**

The analysis and strategies presented in this report should help various types of firms operating within the financial services industry:

- New and established ETF sponsors—interested in understanding advisor usage of and attitudes about ETFs in order to optimize their product development and distribution strategies.
- Partners of ETF sponsors (both established and potential) including exchanges, authorized participants, third-party marketers, custodians, and other ancillary players that are involved in ETFs—wishing to review the ongoing evolution of the ETF business.
- Asset managers and other product assemblers—assessing the opportunity and threats posed by ETF asset growth.
- Retail distributors: broker/dealers and RIAs—attempting to better understand the dynamics associated with the growing ETF market.

## **Report Roadmap**

The majority of assets residing in ETFs are controlled by the three top sponsors. The framework of this report is based on the assertion that because the ETF opportunity is just beginning to take hold in the retail third-party marketplace, market size data tells only part of the story. We evaluate the opportunity based on the calculus of current market size, advisor usage of and perspective about ETFs. This report is divided into three principal

sections. These segments examine the ETF landscape, manufacturing and assembly, and asset gathering.

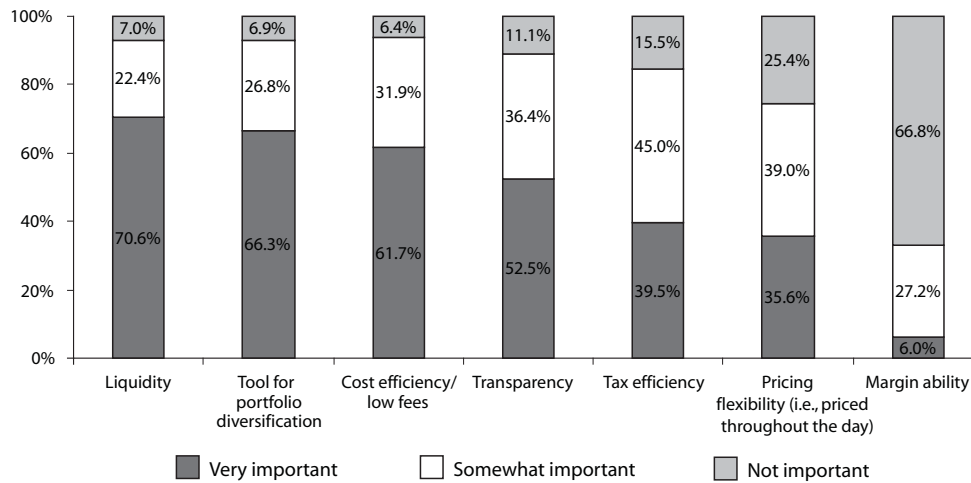
- The first section lays the foundation for the rest of the report by briefly reviewing the history of ETFs and laying out the principal opportunity for and challenges associated with ETFs. It reviews the size and scope of the ETF market in the U.S., and also presents a brief overview of the European ETF market. Cerulli also presents a stay-, leave-, or enter-based framework for asset managers and ETF sponsors to evaluate their plans for ETFs based on their current situation.
- Next, the report assesses the factors and variables associated with manufacturing and assembling ETFs. This section examines the investment management considerations of ETFs including profitability data. It looks at the operations and logistical elements of running ETFs from securing an exchange listing to trading-related issues. We also dedicate a chapter to product development studying passive versus active ETFs as well as the viability of copycat ETFs.
- The third section studies the opportunity and challenges to gathering assets in ETFs, focusing on two of the most critical drivers of demand for ETFs: advisor adoption and gatekeeper acceptance. We devote a chapter to advisor adoption, demonstrating how advisors are using ETFs in portfolio construction, the types of products they are using, and for which client segments, presenting a profile of the typical user of ETFs. This section offers insights into how gatekeepers evaluate ETFs and related challenges among managed accounts as well as 401(k) platforms. This section also discusses distribution and marketing challenges, including wholesaler compensation.
- The report culminates with a Prognosis that summarizes our outlook for ETFs and presents recommended next steps for implementing a retail third-party ETF strategy.

**SAMPLE SECTION**  
**from**  
**THE CERULLI REPORT**

**EXCHANGE-TRADED FUNDS: THREAT OR THREATENED?**

**EXHIBIT 4**  
**FINANCIAL ADVISORS' RANKING OF ETF ATTRIBUTES, 2009**

Liquidity, diversification and low fees are highly valued by most financial advisors, margin ability is not.



Sources: Cerulli Associates, in partnerships with the College for Financial Planning, the Financial Planning association, the Investment Management Consultants Association, and Morningstar

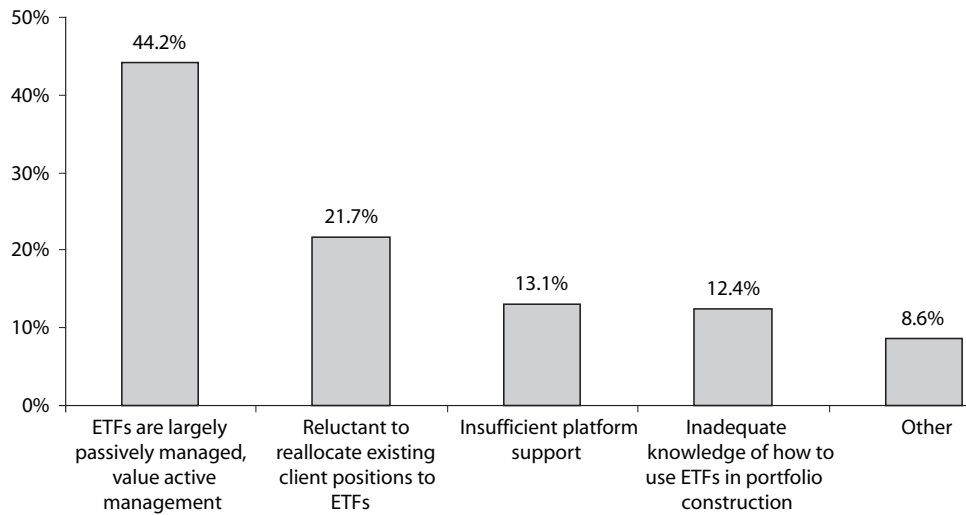
## Challenges to Growth

In the midst of much ado about the market crisis, it is important to put the reported growth of ETFs, and what some have referred to as the “demise” of other products in perspective. During the market crisis, total assets under management in the U.S. declined by \$8.1 trillion, falling from \$39.6 trillion at the end of 2007 to \$31.5 trillion at the end of 2008. Despite this precipitous drop, year-end 2008 assets remained above their 2005 level of \$30.8 trillion.

When examined in the context of the entire addressable market, as measured by traditional market sizing methods, total assets in ETFs are undersized. Although asset managers’ core packaged product—long-term mutual funds—were shredded as negative market action and net outflows drained more than \$2 trillion in assets in one year, as markets recovered in 2009, long-term equity mutual funds began to capture new flows. Yet ETFs survived the market crisis and, as we will discuss later in the report, may be one of the few beneficiaries of the market meltdown.

## EXHIBIT 100 INHIBITORS TO ADVISOR USAGE OF ETFs, 2009

Nearly 45% of advisors haven't been compelled to use ETFs because they value active management, and ETFs are largely passively managed products.



Sources: Cerulli Associates, in partnerships with the College for Financial Planning, the Financial Planning Association, the Investment Management Consultants Association, and Morningstar

In thinking about what has inhibited ETF usage, it is also helpful to review why advisors that have adopted ETFs have embraced them. While a large group of advisors have sought ETFs for their low fees, there are also a meaningful number of advisors that are less focused on fees. Close to half (45%) of bank reps rated low fees as only somewhat important or not at all important attributes of ETFs. We believe there is a group of advisors for which the fee advantage or other attributes of ETFs are not sufficiently compelling to convince them to adopt ETFs.

### Spreading the Gospel

Ultimately, widespread advisor adoption and usage of ETFs will hinge on the traits of strong relative performance, low tracking error, and competitive fees—as well as ease of use—of these products as a group compared to mutual funds and other vehicles. It is useful to observe the traits of advisors that have taken the time to learn about ETFs and are incorporating them into their client's portfolios. Cerulli counsels asset managers to utilize this market intelligence in conjunction with their internal customer relationship management systems to help to guide product development and positioning decisions.