2023 Outlook for ETFs

Innovation and Growth continue

By Frank Koudelka, Jeff Sardinha and Ciarán Fitzpatrick

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Section 1

Introduction

Innovation has been a recurring theme of ETFs since the birth of SPDR launched the ETF market thirty years ago.[1] Today, ETFs are in the midst of their third distinct iteration, a phase we call "ETF 3.0".

The first phase, ETF 1.0, began in 1993 and largely encompassed the broad beta marketplace driven by capitalization-weighted, or cap-weighted indices (Exhibit 1). Innovations included expansion to jurisdictions around the globe and into more asset classes, including international equity, fixed income, precious metals and commodities.

The second phase, ETF 2.0, started in 2003 with the introduction of smart beta or factor-based indices. This was really the beginning of active management (active-lite) and the use of quantitative (quant) investing within the ETF investment vehicle. Not only was this important in expanding end investor choices, but, from a market entry standpoint, it encouraged new participants into the market. And that brings us to ETF 3.0 which started in 2008 with the approval of the first active ETF and continues today. This is where we are seeing the next leg of innovation and growth in the marketplace.

Indeed, growth has been a recurring theme of ETFs too. Annual net flows have been positive for the entire history of ETFs and only twice have assets dipped year-to-year: in 2008 during the Financial Crisis Great Recession and in 2022 during the start of what is becoming known as the Great Transition.[2] Unlike mutual funds, ETFs have grown in bull and bear markets, setting a record for net inflows with a total US$1.3 trillion in 2021's bull market as well as recording the industry's second largest annual inflows during 2022's bear market. In comparison, global mutual funds lost US$1.3 trillion in outflows in 2022.[3]

[1] SPY: The Investing Market's "Aha!" Moment | SPDR® (ssga.com)

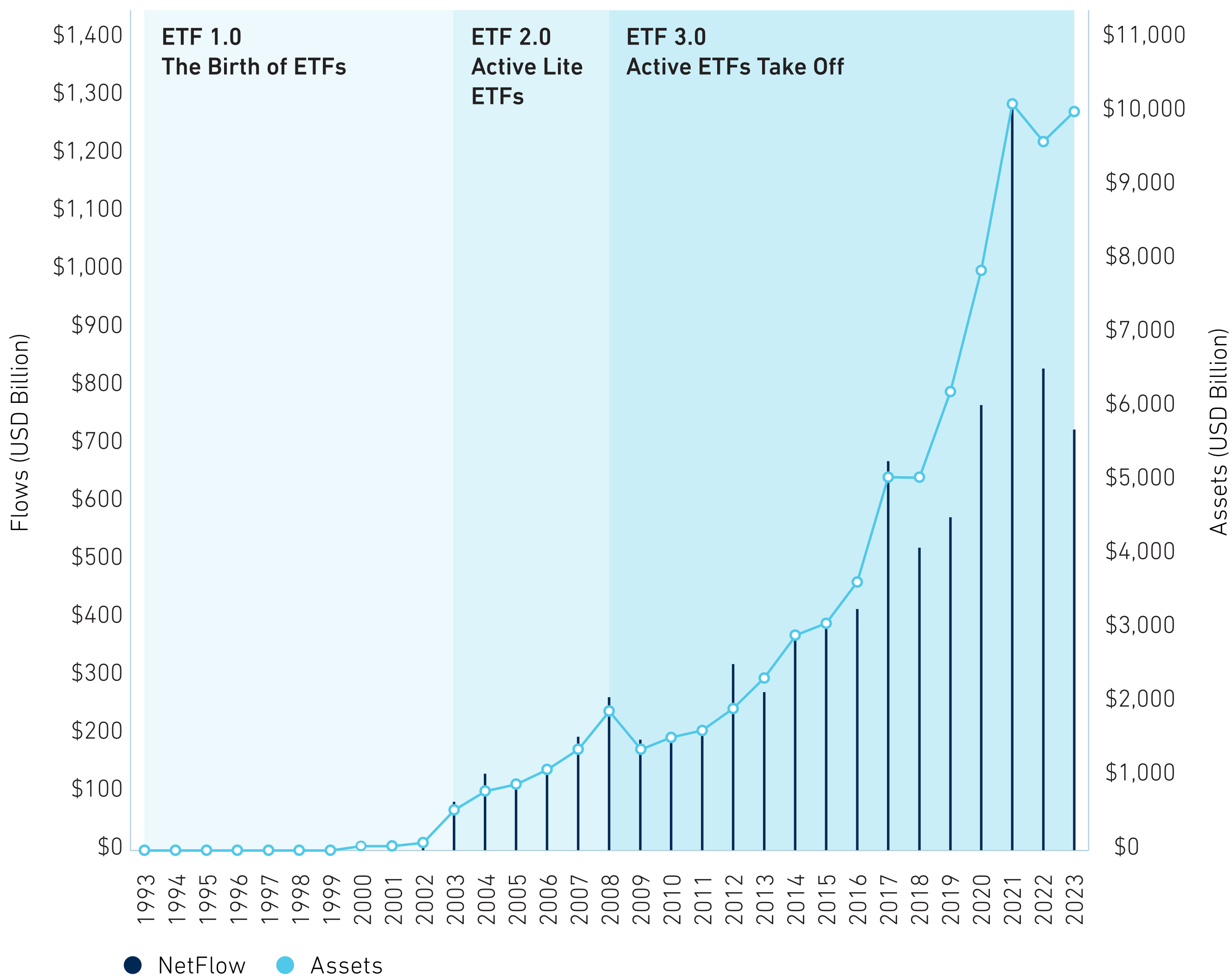
[2] The End of an Era: Have We Entered A Great Transition? | State Street

[3] ETFGI Global ETF and ETP Insights as-of December 31, 2022.

Exhibit 1

Global ETF ETP flows and assets

As of January 31, 2023



Source: ETFGI Global ETF Insights as of 01/31/23, 2023 Flows Annualized

In this report, we start by looking back at 2022 and highlight key developments. We also revisit our predictions made at the start of 2022 in *Future Focused: Insights into Global ETFs Trends* to see how they fared. Then, we look ahead at the key trends we expect to shape the market in 2023 and outline our specific predictions.

Section 2

2022 in Review

Active ETFs were a key theme in 2022. Regulatory tailwinds in Canada (Client Relationship Model 2 or CRM2) and the United States (Rule 6c-11), as well as a continued movement to fee-based advice have led to outsized flows and new market entrants (Exhibit 2).

Half of ETF-flows went to active ETFs in Canada (versus 27 percent of assets under management (AUM) and 16 percent of flows in the US (versus 5 percent of AUM).[4]

Canada also has the ability to launch ETFs as a share class of existing active mutual funds and does not require active managers to disclose holdings daily, two innovations that have enabled asset managers to launch products in several investment wrappers and allow investors to determine which best fits their individual needs.

The US has had its own innovations with the approval of semi-transparent active ETFs and the ability to convert an existing open-end mutual fund to an ETF. More importantly, 34 of the top 50 asset managers now offer active ETFs directly or as a sub-advisor.

Additionally, the South Korean market has continued to launch more active products as the regulatory market softened. Initially, South Korean regulators only approved active bond ETFs in 2017 but expanded to equity in 2020. In 2022, active ETFs made up 14 percent of assets and 33 percent of flows.[5]

US$375B

The US Active ETFs market is the largest at more than US$375 billion.

34

of the top 50 asset managers in the US offer active ETFs.

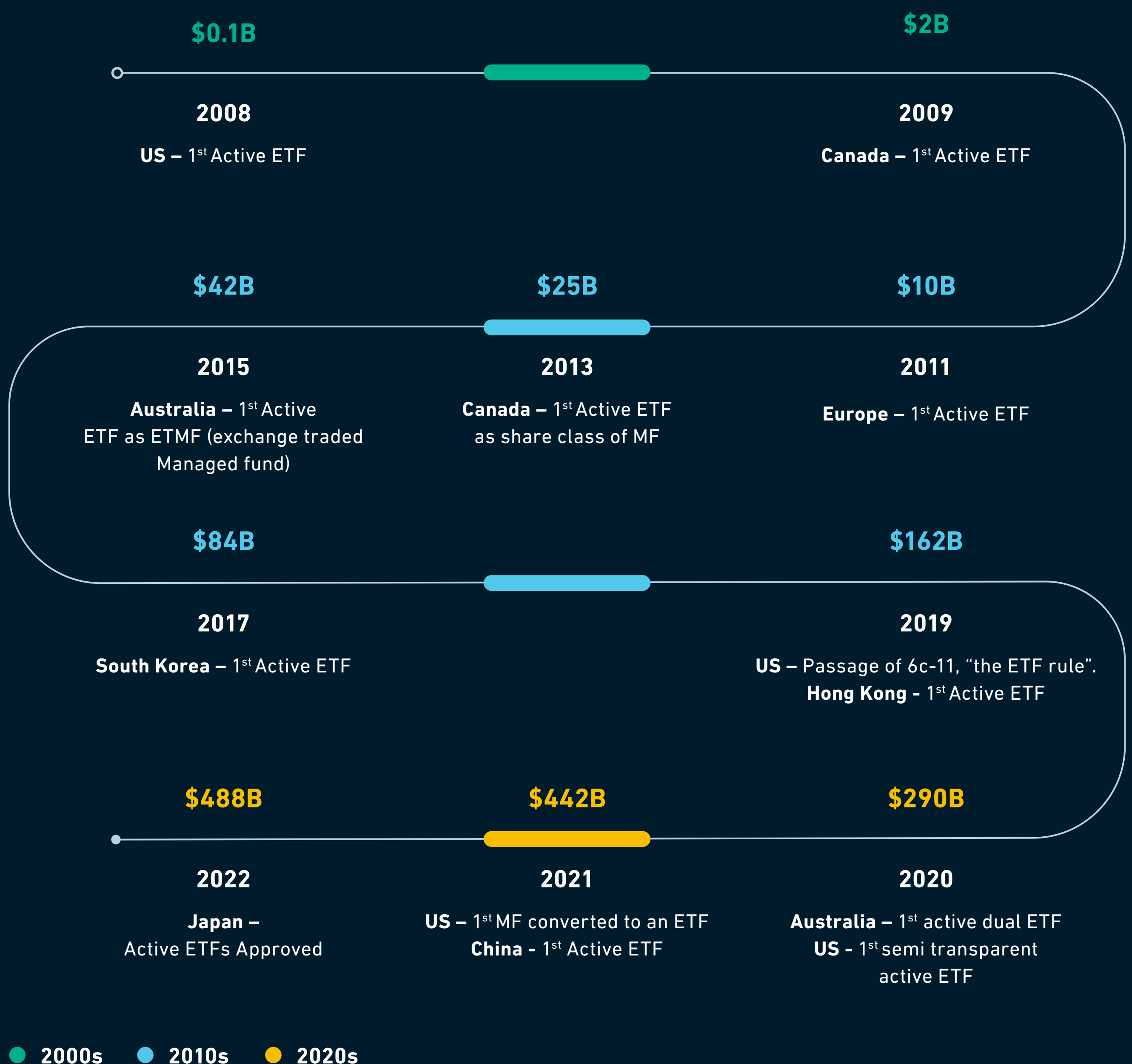
[4] ETFGI Canada ETF and ETP Insights as-of December 31, 2022 and ETFGI US ETF and ETP Insights as-of December 31, 2022.

[5] ETFGI Asia-Pacific ETF and ETP Insights as-of December 31, 2022.

Exhibit 2

Active ETF innovation timeline

Broadening geographies and structures

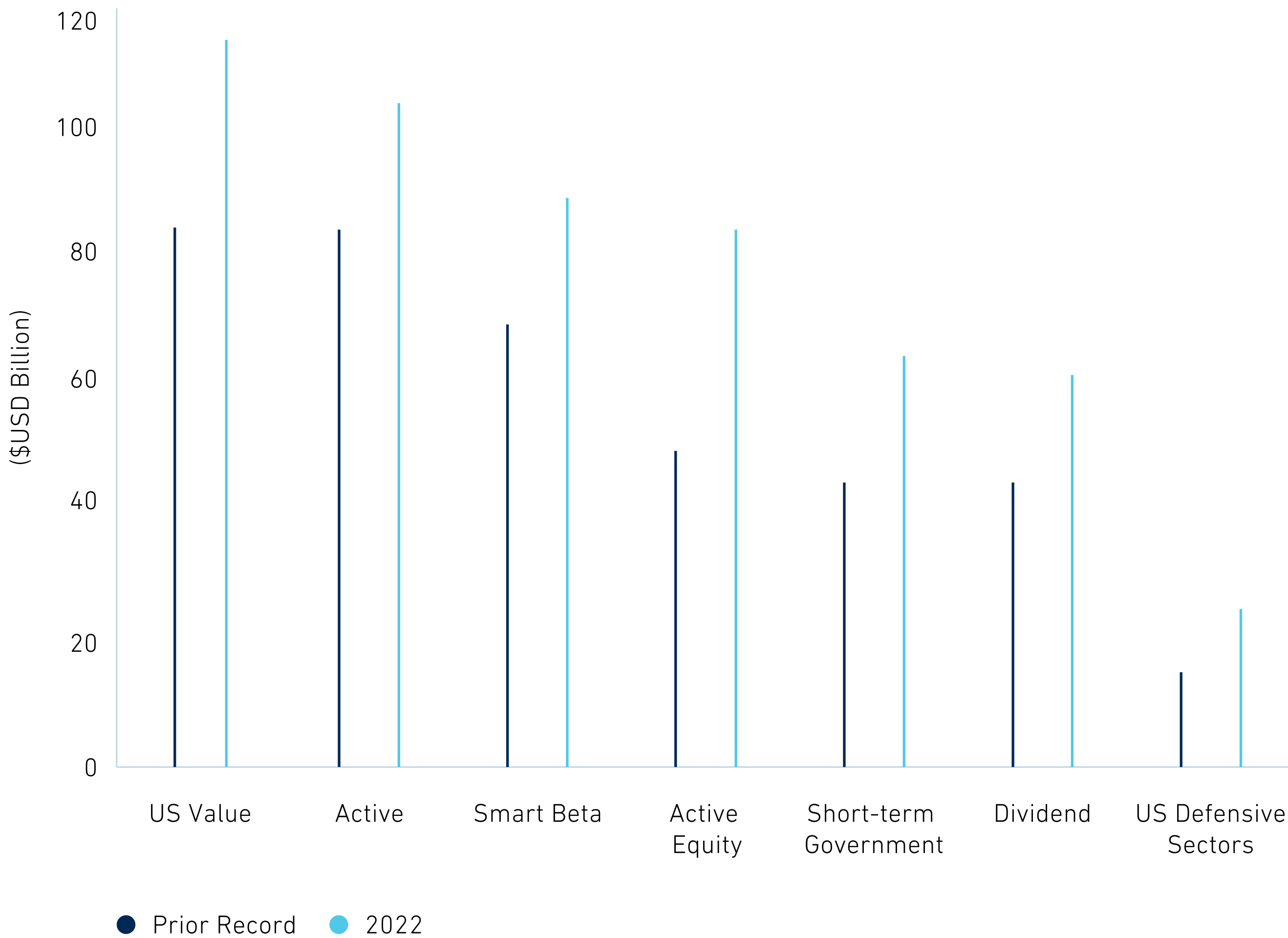


Source: ETFGI Global Active ETF Insights as of December 31, 2022

At the same time, many different market categories set records. According to the 36 markets State Street Global Advisors tracks, seven had annual record-setting flows in 2022 (Exhibit 3).

Exhibit 3

Record category annual ETF fund flows



Source: Bloomberg Finance, L.P., State Street Global Advisors, as of December 31, 2022. **Past Performance is not a reliable indicator of future performance.**

So what did we get right in 2022? In our previous paper, *Future Focused: Insights into Global ETFs Trends*, we outlined a number of key predictions and today, with the benefit of hindsight, we find we were close to the mark. For example:

We expected the US ETF market would see its first new US$100 billion issuer since 2020. **And we were right**. JP Morgan became the seventh US issuer to exceed US$100 billion in AUM.[6]

We expected active ETFs to make up 70 percent of new launches in North America. **We were close**. Active ETFs accounted for 349 of the 549 (64 percent) new ETFs launched in Canada and the US.[7]

We predicted ESG ETFs would account for 70 percent of European ETF flows. **We were close**. ESG ETFs accounted for 63 percent of European ETF flows.[8]

We predicted the first cryptocurrency ETF would originate in Asia. **We were correct**. Several cryptocurrency ETFs launched in Australia (spot Bitcoin and Ethereum) and Hong Kong (futures Bitcoin).[9]

We expected global active ETFs to exceed US$200 billion in net inflows. Unfortunately, **we weren't close**. Global active ETFs came it at US$123 billion in net inflows. North America overperformed, while Asia-Pacific and Europe underperformed.[10]

[6] https://www.etf.com/channels/jpmorgan-etfs.

[7] ETFGI Canada ETF and ETP Insights as-of December 31, 2022; ETFGI United States ETF and ETP Insights as-of December 31, 2022.

[8] ETFGI Global ESG ETF Insights as-of December 31, 2022.

[9] https://www.cboe.com.au/news/media-releases; https://www.hkex.com.hk/News/News-Release/2022/221216news?sc_lang=en

[10] ETFGI Global Active ETF and ETP Insights as-of December 31, 2022

Section 3

What Is in Store for 2023

In the first quarter of 2023, growth in ETFs showed no sign of slowing. According to State Street Global Advisors, ETFs had US$40 billion of inflows in the US in January, nearly double that month's historical average.

Flows were led by the US$21 billion into non-US equities (ninth-best ever); US equities had outflows. Meanwhile, bond ETFs added US$20 billion of inflows, led by the US$7 billion into investment-grade (IG) corporates (third-best ever).[11] While many different forces are at work in the market, we outline our key predictions for 2023.

1 Active ETFs will see outsized growth

Active ETFs are leveling the playing field for traditional mutual fund asset managers by providing a more cost effective and accessible vehicle to deliver products. The trend will accelerate across North America, expand markets in Asia Pacific and gain momentum in Europe (Exhibit 4). Expect more global names to enter the market and the innovation to continue.

In the US, we expect to see the first mutual fund to Collective Investment Trust (CIT) and ETF conversion, solving the issue of a mutual fund that has retirement and taxable accounts. We do not believe the first active ETF as a share class of a mutual fund will be approved this year.

[11] Investors Put 2022 in the Rearview and Double January's Average ETF Inflow (ssga.com)

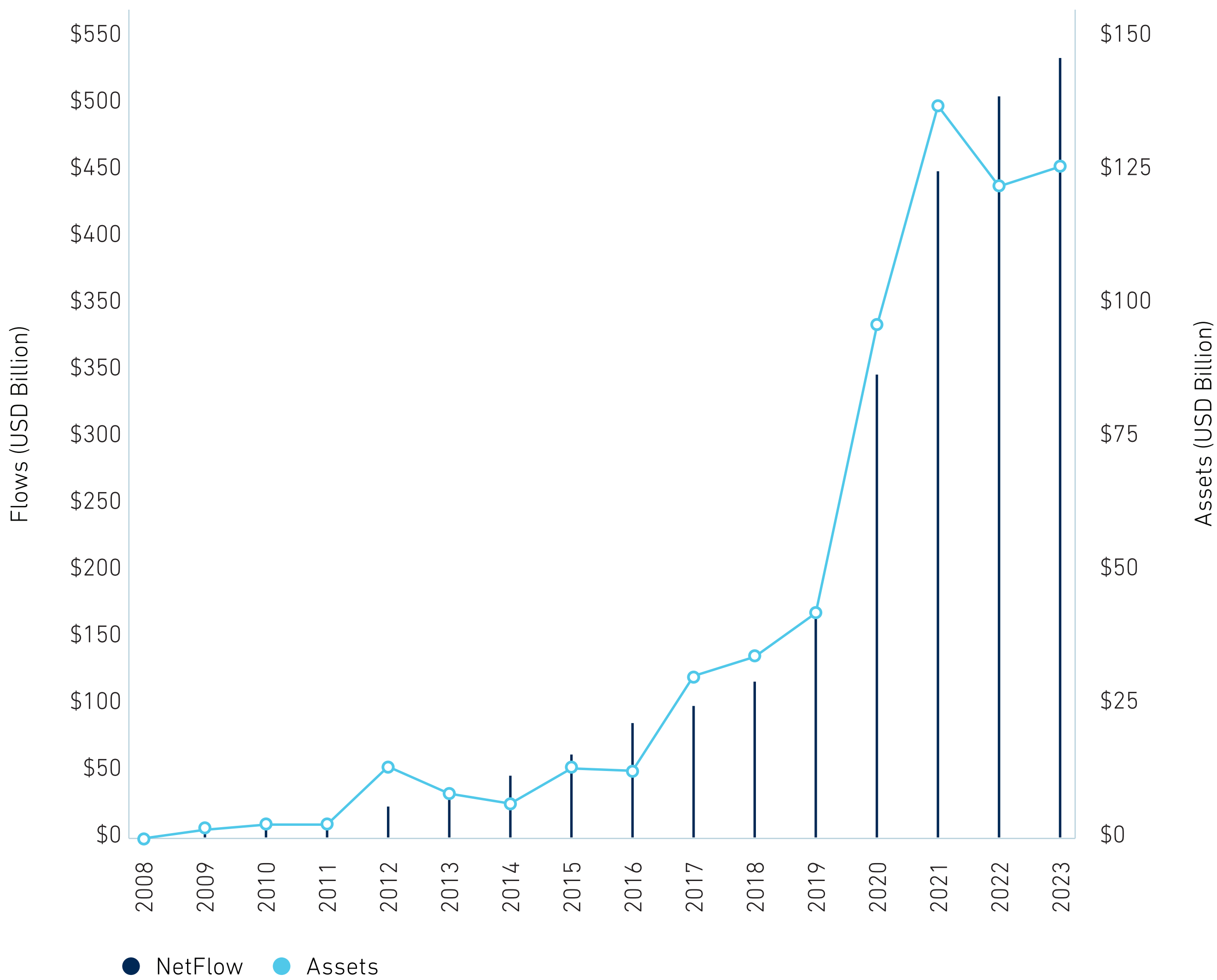
In Asia-Pacific, we expect that active ETF markets in Australia and China will recover from a slowdown (largely performance-based) last year. We also anticipate the continued expansion of active ETFs in South Korea and the first active launch in Japan.

In Europe, we expect additional large players to enter the market and active ETFs to emerge with a growing percentage of flows as compared to AUM.

Exhibit 4

Global active ETF flows and assets

As of January 31, 2023



Source: ETFGI Active ETF Insights as of 01/31/23, 2023 Flows Annualized

As pressure on active mutual funds increases (Exhibit 5) we expect to see the number of mutual fund conversions to ETFs accelerate.

Overall, we predict around 50 mutual funds will convert to ETFs in 2023.

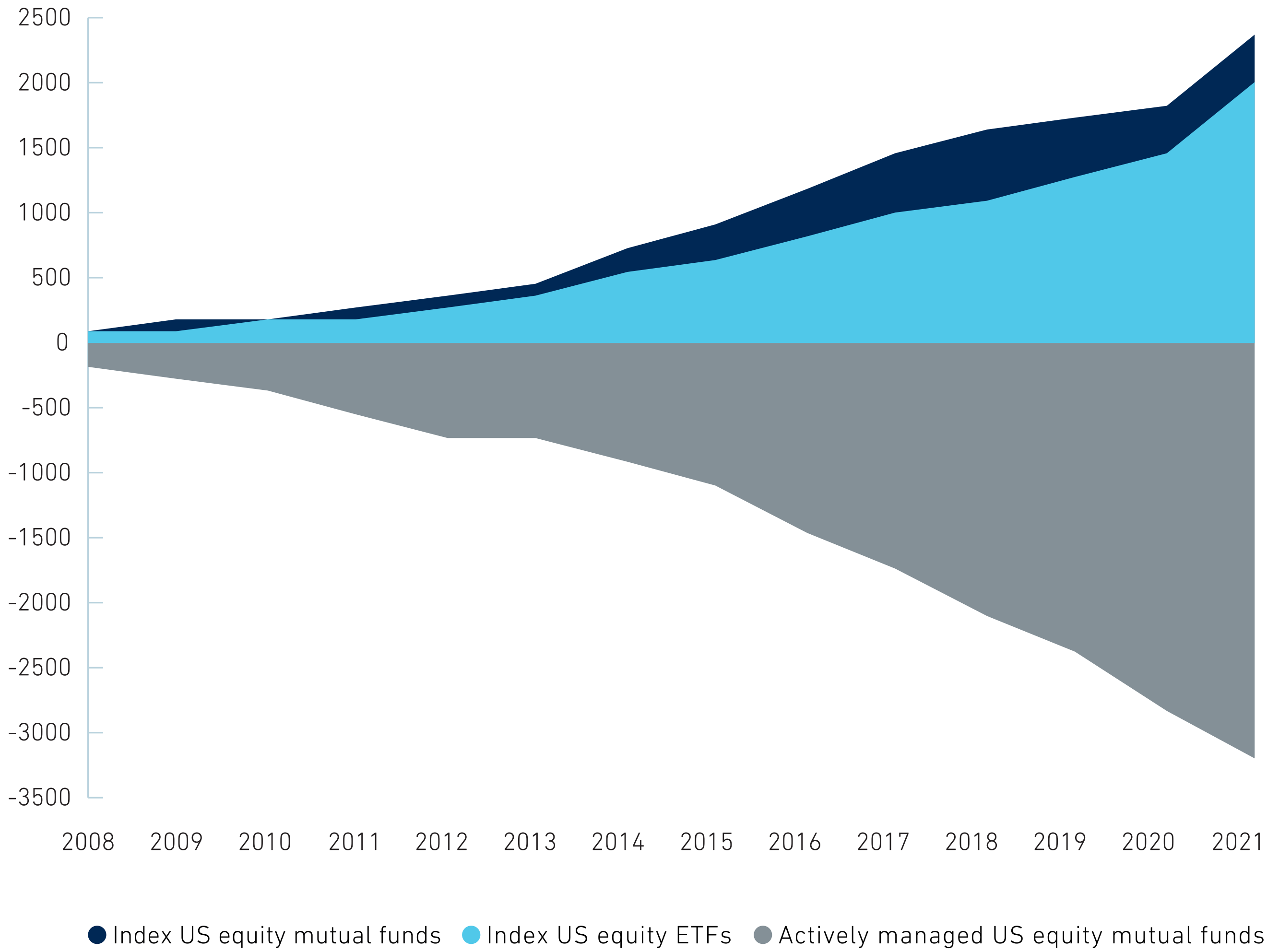
Exhibit 5

Declining market share

Active MFs are bleeding assets to index MFs and ETFs

Most outflows from active US equity MFs have gone to ETFs

Cumulative Flows [1] (2008-2021, $B)



[1] Equity mutual fund data include net new cash flow and reinvested dividends, Source: 2022 Investment Company Fact Book, Broadridge, Morningstar US Fund Fee Study 2021

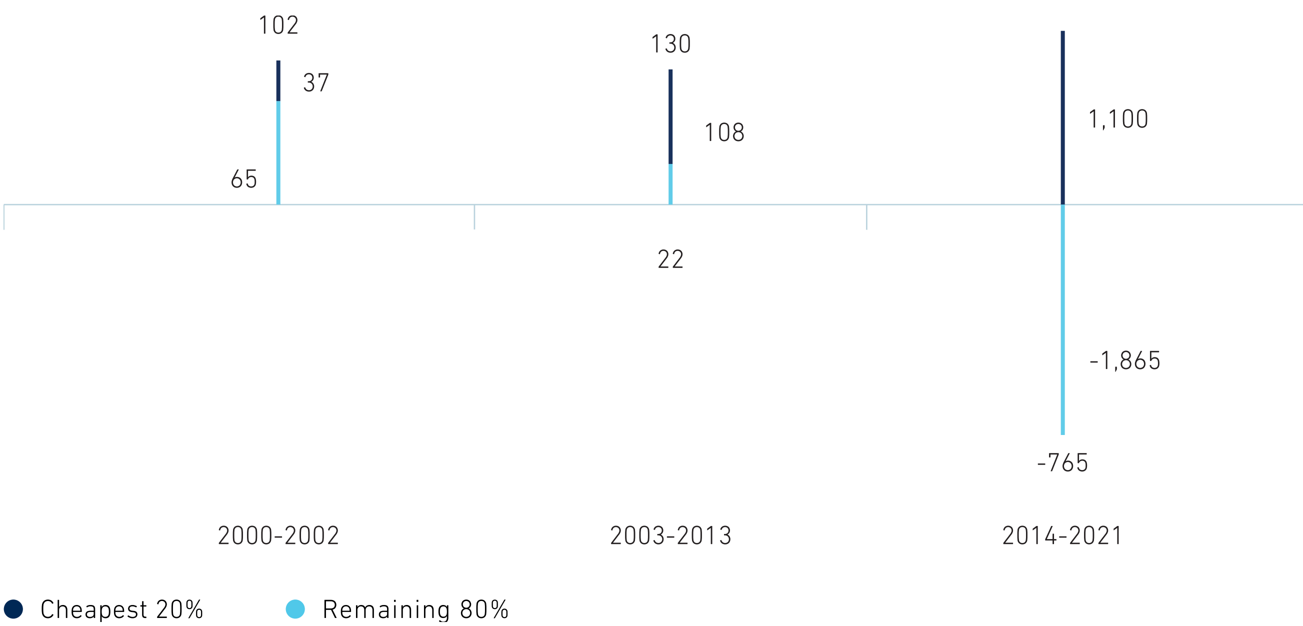
Exhibit 5 (continued)

Heightened expectations

Active MFs Investors demanding better fees, liquidity, transparency

The shift into low fee-ranked active funds accelerates

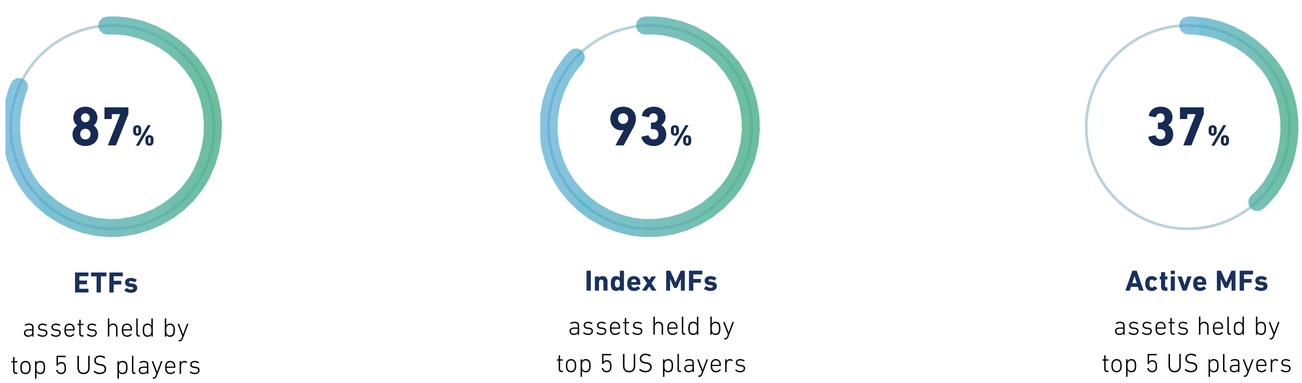
Average Annual Flow of US Active Funds (2000-2021, US$B



Market concentration

Indexed assets are highly scale-driven, blocking out new entrants – even well-funded ones

Index funds are highly concentrated, blocking new entrants



2 Fixed income will shine

Yield is back! After years of zero-interest rate policy, central banks have been driving up interest rates to tame inflation. This created shocks to the fixed income ETF market early last year. But the flows accelerated during the second half of the year and ended at over 25 percent of the total. We expect allocations to fixed income ETFs to exceed 33 percent this year with yields rising.

Active fixed income ETF managers should see outsized inflows, with the added advantage of being more nimble to swap out bonds as rates change. The innovation of single bond ETFs and more precise targeted strategies will be an accelerant to growth as investors look to the liquidity of the ETFs provide to more easily gain access to the less liquid fixed income marketplace.

3 Growth of ETFs in Europe will accelerate

Growth in retail investment, a ban on inducements, and a European consolidated tape will all combine to create substantial tailwinds to fuel growth in the European ETF market.

Growth in retail investment: COVID-19 showed a spike in European retail investors directing their capital towards ETFs with the emergence of savings plans that are made up of a range of ETF products. The retail investment market in ETFs has lagged well behind institutional investment across Europe, whereas retail investments in ETFs in the US outweighs institutional investment. The German market is leading the charge for retail investment in ETFs with over 4.9 million people invested in ETF savings plans, a 150 percent increase since 2019.

In 2023, so far, we have already seen a number of large ETF managers partner with retail and digital platforms to offer their ETF strategies to the retail market in a push to drive the growth in this segment across Europe. All ETF issuers now have a platform strategy team as part of their sales and distribution strategies and we expect to see more ETFs follow suit in offering their ETF strategies through digital platforms throughout 2023. This will help drive the next wave of European ETF growth.

Ban on inducements: Europe has seen a number of different regulations over the years, such as Markets in Financial Instruments Directive [MiFID II] and Retail Distribution Review [RDR] in the United Kingdom, target the removal of inducements and commissions paid to brokers and advisors (Exhibit 6). While this has led to a level of growth in ETFs in Europe it has not been the silver bullet that the market hoped for.

The European Commission is now seeking to potentially ban inducements across the European Union relating to the purchase and sale of fund shares. This change will encourage retail investors towards ETFs and away from more expensive fund structures that may not be as suitable as an ETF in their investment strategy. A ban on inducements can only be a positive development in the growth of retail investment in the European ETF market which currently lags behind institutional investment.

Exhibit 6

Global regulatory trends

Fees/performance transparency and active ETFs approvals

Australia – The **Future of Financial Advice (FOFA)** regulation eliminating most retrocession payments in 2012 and **dual registry** in 2020 enabling listed and unlisted funds, resulting in ETF assets rising from AU$10 billion to AU$126 billion, a CAGR of 29 percent. Active ETFs make up 18 percent of AUM.[1]

China – The CSRC approved **actively-managed ETFs** with the first launches in 2021. Currently, active ETFs must have a set correlation to an index. Active makes up 8 percent of AUM.[1]

South Korea – The SFF approved **actively-managed** fixed income ETFs in 2017 and equity in 2020. Currently, active must follow the 70/30 rule. Active makes up 16 percent of AUM.[1]

Canada – Implemented the **Client Relationship Model 2 (CRM2)** regulation requiring advisors to provide investor reporting on fees and performance in 2016, resulting in flows to ETFs being approximately 60 percent higher than those of mutual funds and active ETFs making up over 25 percent of AUM.[2]

[1] ETFGI Asia-Pac ETF 12/31/22, [2] ETFGI Canada ETF 12/31/22
[3] ETFGI Europe ETF 12/31/22, [4] Refinitiv European Fund Review 12/31/22
[5] BlackRock: Four Big ETF Trends 2018

Europe and the UK – Implemented the **Markets in Financial Instruments Directive (MiFID II)** requiring increased fee transparency and banning some retrocessions in Jan 2018, resulting in ETF investments across Europe gaining €493 billion of inflows,[3] while long-term mutual funds have experienced €422 billion of net inflows since that time.[4]

US – The SEC enacted the **ETF Rule (6c-11)** reducing time/expense to launch and expanded basket flexibility. Additionally, the approval of **semi-transparent active** and **MF to ETF conversions** has expanded the toolkit for active managers. Active ETFs make up 5 percent of AUM.

Japan – The TSE announced the approval of **actively-managed ETFs** beginning in 2023.

Hong Kong SAR – The HKEX and SFC have approved **actively-managed ETFs** launched as a share class of a fund beginning in 2019.

Bond ETF – The growth rate of bond ETFs is exceeding that of equities as global regulatory reform has reduced bank and broker/dealer inventory and market making at the same time corporations are issuing record levels of debt.[5]

European consolidated tape: 2023 should see a significant push for the long awaited consolidated tape in Europe and recently 14 major exchanges across the EU have committed to work together to develop a solution. However, the consolidated tape will require regulatory review and approval before it ever gets over the line in Europe. While this may well lead to a delay in an actual launch of the tape in Europe, in 2023 we expect to see more regulatory engagement with entities such as the European Fund and Asset Management Association [EFAMA] and Capital Markets Union which will take the project to the next stage. The development of a consolidated tape in Europe will need to be an iterative process as opposed to a big bang given the size of the initiative, and looking at the model in the US will help build out a solution. Getting the tape over the line in Europe will be another huge driver of growth for the European ETF market.

US$10T

At the start of 2023, there were more than 11,000 ETFs globally with almost US$10 trillion in assets.

4 ESG will have pockets of growth

ESG-related products are becoming a larger component of the overall ETF market. This will continue with an expansion of products in existing markets and expanding jurisdictions offering ESG ETFs for the first time. Growth will not be equal across markets.

In the US, ESG will struggle to regain its emerging foothold with investors. Driven by outsized market gains in 2020-21, ESG growth looked like the proverbial hockey stick. But, 2022 was a gut check with political headwinds from oil-producing states and performance headwinds, with the energy sector outperforming all other sectors of the market. We expect ESG launches to continue apace, but flows will remain muted as investors outweigh performance and yield.

In Asia-Pacific, ESG strategies will continue to expand. Most of the growth is expected to come from Australia, China and Taiwan, three jurisdictions that have been very aggressive in product development. ESG remains small, with only a quarter of US and a tenth of European assets under management. We expect product development to continue but assets and flows to remain low.

In Europe, ESG strategies have quickly become the dominant driver of growth, driven primarily by Sustainable Finance Disclosure Regulation [SFDR]. That will continue, but the naming convention rules will be needed to bring clarity to ensure the proper classifications. We still expect 60 percent of the flows will be to ESG ETFs.

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