# Exchange Traded Funds

*Industry Overview, Trends & Operating Model Considerations*

# Contents

# Introduction

Exchange Traded Funds have emerged as one of the most prominent and fast-growing investment vehicles in the North American market, offering investors accessibility to virtually every asset class, sector, region, country, commodity, currency, factor, theme, derivative, and strategy. The presence of ETFs in the market reflects a growing sentiment for cost-effective, tax-efficient, liquid, and transparent investment options for individual and institutional investors alike.

As ETFs continue to grow in popularity as a product, market participants need to understand key trends in the space, differences by region/market, typical challenges/opportunities, different operating models to launch & service ETFs, the underlying operational workflow, and corresponding best practices to remain competitive and modern in this fast-growing environment.

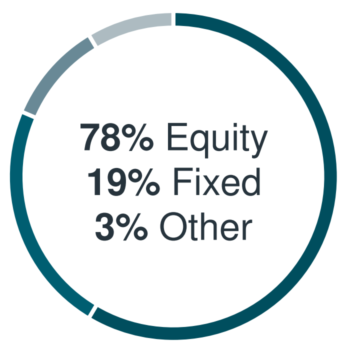
# North American & Global ETF Market Overview

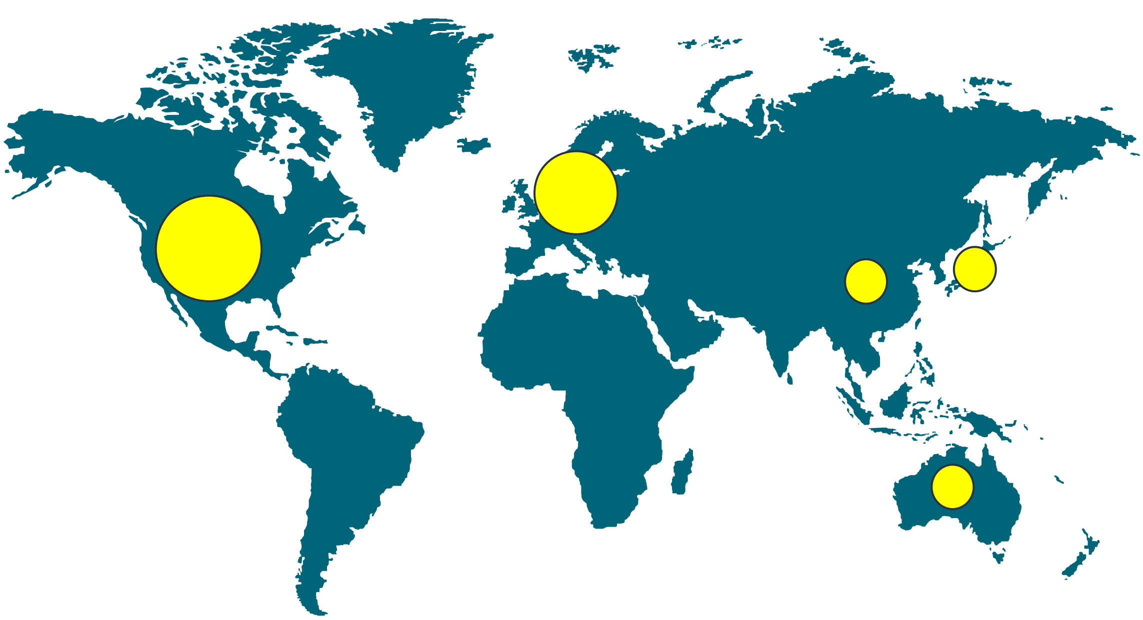
As of the end of 2023, the Global ETF Market is estimated to be valued at ~$11.2T (~$2T increase from 2022)! The North American ETF market alone makes up over 77% of the AUM (~$8.5T), with Europe (~17%) & APAC (~5%) making up the remainder. Prominent domiciles within Europe & APAC include Ireland (~$1.2T), Japan (~$0.5T), and Luxembourg (~$0.3T).[1]

The regional differences in AUM can be mainly attributed to the relative overall market size, regional considerations, and product maturity and popularity in the respective regions.

Despite the rise of popularity in multi-asset, thematic, and alternative ETFs, most of the market is still comprised of traditional equity (78%) and fixed income (19%) strategies, with other strategies making up the remaining 3% [1]







1 Lipper Alpha Insights
2 Morningstar ETF insights

# North American ETF Market Trends *(1/2)*

## Rise Of Active ETFs

While passive (index tracking) ETFs still account for the majority of the market (~95%), investors are increasingly adopting 'research led' actively managed ETFs that aim to outperform indexes through investment manager research.

Year-over-year, actively managed funds have seen an increase in popularity, as shown in 2023 where a record-setting 22% of net inflows into US ETFs were from actively managed ETFs.[2]

## Vanguard ETF Patent Expiration

Since 2001, Vanguard has owned a patent providing them the exclusive right to structure ETFs as a distinct share-class within existing mutual funds. This provided increased tax-efficiencies to their mutual funds due to the ability to redeem in-kind instead of selling securities that would trigger capital gains.

This patent expired in May 2023, resulting in an influx of Issuers (~12) filing for permission to provide this multi-share class structure for their ETFs, however, approvals are not expected until at least Q1 2025 as the SEC has expressed concerns centered around avoiding conflicts of interest among a funds share classes to ensure they have the same rights and obligations as each other class. Due to a potential influx of volume, this could lead to changes in the near future in regulations and a review on taxation of these products.

The implication of this product structure being widely available has broad impacts across the industry. This includes increased innovation due to reduced barriers to entry and increased competitive pressure potentially leading to an uptick in acquisitions. This could also lead to slowing down of the conversion of mutual funds as there is general wariness that some investors prefer mutual funds and adopting the Vanguard structure allows the advantages of ETFs while allowing investors to choose their preferred share class.



*1 Lipper Alpha Insights*
*2 Morningstar ETF insights*

# North American ETF Market Trends *(2/2)*

## Mutual Fund to ETF Conversion

Asset managers looking to launch an ETF traditionally have had two options to introduce their offering – they can either set up a completely new fund, or alternatively, they can convert one of their existing mutual funds to an ETF. By converting a mutual fund, one can launch an ETF with significant AUM, while also bringing along the performance history of the fund, which is an important consideration for attracting new investors.

This benefit, along with the continued gain in popularity of ETFs as a viable investment product, and the underlying characteristics that differentiate them from traditional mutual funds have led to significant growth in the number of mutual fund conversions. In 2023, there were ~40 mutual fund conversions in North America (compared to ~518 new launches), with experts speculating that this number will continue to grow year over year. To put it into numbers, in 2023 there was a net $598B inflows into ETFs, while mutual funds saw an outflow of $450B.2

These conversions are driven largely by the inherent benefits ETFs hold over mutual funds, with the largest one being the tax efficiency. Year-end capital gains distributions in mutual funds can trigger a sizable tax bill even when the investor hasn't sold shares, while one of the attractive aspects of ETFs is most don't distribute capital gains at the end of the year. ETFs also generally provide more diversification and accessibility to investors, providing exposure to virtually every asset class, sector, region, country, commodity, currency, strategy, etc., without some of the accessibility issues that come with mutual funds. ETFs also have transparency requirements where there are daily disclosures of the underlying ETF holdings (or in the case of Semi-Transparent ETFs, an indicative disclosure of holdings), where most mutual funds only disclose holdings quarterly. ETFs also provide more liquidity to investors, where they can trade ETFs during exchange trading hours at a quoted price, unlike unlisted managed funds.

There are legal considerations before completing a conversion. To start, shareholders need to be brought in early to secure necessary consent since it will result in a shift in ownership arrangements for direct investors. Many mutual funds are unlisted, so it is also important to consider the implications for compliance (e.g., daily disclosures) of ETFs vs. Mutual funds. ETFs also have a different technical & business workflow when compared to mutual funds; so, another important consideration is designing an operating model with the right technology, operational capabilities, vendors, and market relationships to manage the product to ensure successful ETF operation.

# Considerations by Region

There are major differences in the treatment of ETFs across different regions that need to be considered by global issuers stemming from differences in regulation, tax treatment, market structure, product offering, and investor preference.

The U.S. market is characterized by higher liquidity, greater tax efficiency, and a broader range of innovative products. The European market, governed largely by the UCITS framework, offers easier cross-border marketing within Europe and a growing focus on ESG and thematic investments. Japan's ETF market is growing, with increasing variety and a focus on local needs, but it still lags behind the U.S. and Europe in terms of market maturity and product diversity.

Through the first half of 2024, there has also been a boom in the Taiwan ETF market as investors look for exposure into the artificial intelligence supply chain that may cause a change in regulation in that region shortly.

### Tax Efficiency

The U.S. benefits from greater tax efficiency compared to other regions due to the 'in-kind' creation and redemption process that minimizes capital gains distribution. In domiciles such as the UK & Japan, ETFs are traditionally cash orders that trigger a taxable event when an ETF is created or redeemed.

### Disclosure Requirements

All regions have strict requirements centered around transparency; however, The U.S. and Japan have traditionally had more stringent requirements with detailed daily disclosure requirements for holdings, performance and risk when compared to the UK.

### Approval Process

The SEC has a much more stringent and lengthy approval process for new ETFs and while the adoption of 6C-11 allows ETFs to come directly to market without delay or cost of exemptive order, the overall process is much more cumbersome (especially for semi-transparent, actively managed, multi-asset or derivative ETFs) when compared to European ETFs that are either Lux or Ireland domiciled, taking on average only 3-6 months for product approval.

### Market Liquidity

Given the maturity of the U.S. market, Authorized Participants (APs) and market makers play a very active role of ensuring liquidity and tighter bid-ask spreads when compared to the UK/Japan.

### Product Innovation & Adoption

Given the maturity of the U.S. market, there is typically a wider range of ETF types offered and higher adoption/knowledge among retail and institutional investors alike.

# Typical Challenges & Opportunities for Issuers

As ETFs continue to grow in popularity, the volume of funds and AUM continue to grow, and Issuers continue to launch differentiated products, there are several common challenges and opportunities surrounding daily ETF operations.

## Incumbent Tech & Disjointed Data

ETF processing requires the consumption of creation and redemption activities in the IBOR/ABOR, which impact a manager's holdings and cash positions. This is often a manual process that places a burden on operations. Many order management providers are also not flexible enough to manage ETF workflows, so firms that have not recently upgraded their OMS will lack the essential functionality needed to offer ETF products.

Many firms end up needing to re-configure legacy systems or switch systems altogether to address these technology issues. ETF Issuers need to ensure their tech stack can support all asset classes and corresponding trade generation while supporting configurable compliance. One of the key functionalities related to ETFs is supporting the functionality to automate the processing of in-kind/Cash-in-lieu (CIL) orders intraday (known as bursting). Implementing a scalable OMS/IBOR/ABOR capable of automating in-kind and CIL orders streamlines operations and gives PMs a more accurate & timely view of their daily holdings.

Connectivity to counterparties (e.g., custodians, administrators, brokers, investors, etc.) are table stakes for ETF managers, and data management practices are crucial to assess the health of the firms' connectivity and infrastructure. To support managers in identifying how they can improve their data and connectivity, a focus should be placed on leveraging an open, vendor-neutral architecture, prioritizing data integration, while having a real-time trading engine to connect to executing brokers.

## Benchmark Rebalancing

To effectively mirror other indexes (such as the S&P 500 and Russel 5000), and reduce tracking error, ETF managers need to continuously monitor the benchmark to manage changes to ETF exposure. Issuers should be leveraging dynamic platforms that allow for streamlined rebalancing of standard or custom benchmarks without the need for manual adjustments/trade entry (e.g., CRDs Security Selection Model and Manager Workbench).

## Evolving Compliance

Expectations for ETF managers' risk and compliance requirements have evolved over the past few years. This has been accelerated with the recent ESG focus for global investors, introducing more stringent compliance standards. Technology which can check compliance rules across any aggregation (security, asset class, portfolio, strategy, firm level, post-trade, etc.) can alleviate the burden on ETF Managers.

# Operating Model Comparisons (1/4)

Issuers can approach setting up/revamping their ETF operations or launch brand new ETF funds in a variety of ways. They can buy, partner, build or outsource some (or all) of the key business areas and functions required to set up and maintain front-to-back day-to-day operations.

**In-House Build -** The issuer can build their ETF operations by developing the required expertise, relationships and technology in-house.

## Pros

### Full Control & Flexibility
Full control of ETF operations and not dependent on any other third-party vendors or service providers

### Customization
Ability to customize processes and technology to exact requirements without constraints that may come through partners/vendors

### Brand Identity
Ability to build differentiated service unique to the Issuer brand without dependence /standardization that comes with working with a servicer or white label

## Cons

### Investment
Significant investment is required to build the surrounding operations and technology required to service ETFs.

### Costly Brand-Building
Significant investment is required to establish and promote a new ETF brand in a competitive market.

### Extended Time-To-Market
Developing in-house ETF operations can delay product launch due to complex and lengthy setup processes

### Expertise Challenges
Establishing an in-house model requires specialized knowledge and skills that may not be readily available within the organization

### Risk of Tech Obsolesce
The rapid pace of tech advancement poses a risk of the operating model becoming outdated quickly

### Time to Scale
Scaling an in-house ETF model can be time-consuming and challenging

# Operating Model Comparisons (2/4)

**Partner with an ETF Servicer or White Label** - The issuer can partner with an ETF Asset Servicer, white label and other outsourcing partners to provide required functions to service ETFs.
Example servicers include BBH, Citi, BNY Mellon, HSBC, and sample white labels include TIDAL, Goldman Sachs, Waystone, or Hanetf.

## Pros

### Time-To-Market
Enables faster launches by leveraging partners established infrastructure, market relationships & ETF expertise.

### Focus on Core Competencies
Allows firms to focus on primary strengths & differentiators to the market (e.g., inv strategy) while op workflow managed by partner.

### Scalability
Offers capacity to efficiently scale ETF operations as business needs grow without significant technological, resource or financial investments.

### Reduce Risk
Leveraging partners' ETF expertise, infrastructure and relationships reduces risk in going to market and daily support of product through changes in regulatory requirements

### Access ETF Experience
Ability to leverage deep ETF expertise, technologies, and access to critical market participants

## Cons

### Unwinding Arrangements
Unwinding may be complex and costly, which can disrupt fund management and introduce complications.

### Loss of Control/Dependency Risk
Loss of control over outsourced functions and reliance on performance of partner may affect fund standing

### Lack of Differentiation
Full-suite white label service may lead to limited differentiation offering

### Limited Customization
Predefined structures, technology and processes constrain the ability to customize to Issuers needs and may be costly/prohibitive

### Service Quality & Comms.
Outsourcing to 3rd party vendors may lead to challenges in level of support and communication required to launch and regularly service ETFs

### Product Launch Bottlenecks
Reliant on provider's internal schedules and resource availability, which could impact the speed and efficiency of market entry.

# Operating Model Comparisons (3/4)

**Partner with an ETF Manager** - The issuer can partner with an established ETF manager, leverage their platform, and co-develop and distribute co-branded ETF products.
Examples of other Issuers who have done this include Cboe & AGFs and Blueprint & Chesapeake's co-branded ETF products

## Pros

### Leverage SMEs & Relationships
Ability to tap into the manager's expertise and established industry relationships to facilitate smoother execution.

### Low Execution Risk
The manager's established experience and proven processes ensure a smoother and more reliable implementation of the ETF..

### Scalability & Flexibility
Ability to efficiently scale or change ETF operations as business needs evolve.

### Access to Tech & Infrastructure
Ability to utilize the manager's existing infrastructure & technology to service ETFs.

### Limited Investment & Time
Minimize barriers-to-entry (e.g., infrastructure, regulatory approvals, etc.) and reduce time to launch.

## Cons

### Partner Search Difficulty
Finding the right partner can be timely, costly, and risky if the manager's vision or market approach does not match with the desired vision for the ETF launch..

### Reduced Control & Branding Risk
Reduced control over operations and branding increases the risk of operational misalignment and impact to reputation

### Fee Sharing
Sharing fees can reduce overall profitability and creates dependency on the partner's performance for success.

### Vision Misalignment
Risk of operational/strategic misalignment with partners leading to delayed launches, increase operational cost, etc

# Operating Model Comparisons (4/4)

**Buy** - The issuer can purchase an established ETF platform with existing assets, track records, brand and distribution capabilities.
Issuers who have done this include LGIM, Janus Henderson, New York Life, and VanEck.

## Pros

### Time-To-Market
Reduces time to market by purchasing existing, established, and proven operations

### Scale Quickly
Ability to leverage the established brand reputation, existing client base, and accumulated assets to scale

### Leverage SMEs
Ability to benefit from acquired ETF expertise without needing to develop skills in-house..

### Low Execution Risk
Reduces uncertainties associated with launching a new fund as the acquisition involves an operationally established product.

## Cons

### Deal Time
Involves substantial due diligence, negotiation, and regulatory approval which may delay the acquisition.

### Large Investment Required
Involves a substantial financial outlay to acquire the fund and its assets.

### Lack of 'Live' Opportunities
May limit the ability to pursue current or emerging opps. as the acquired fund has set strategies and holdings.

### Integration & Onboarding
Aligning with the acquired fund's operations, systems, and processes may disrupt the funds management and require significant integration investment

### Other Considerations
There are other major considerations an Issuer should consider before selecting an approach. They need to consider the capabilities of the offering, including the technology platform, experience with ETF product types/asset classes, geographical coverage, long-term vision, differentiators from competitors, the BAU support model, scalability, and relationship with ETF market participants. Any partnership's existing client base also needs to be considered, and the associated experience working with different types of issuers clients (e.g., institutional, retail, active, passive, etc.), the volume and AUM supported, and more.

# How Can Alpha Help


## Alpha’s Dedicated ETF Practice

Alpha has a dedicated ETF Practice that continues to support our global clients with thinking about and implementing new ETF strategies. Our ETF team is made up of experienced industry experts who have worked at firms that pioneered ETFs across multiple markets and is supplemented by Alpha’s core specialisms. Our practice offering is thoughtfully designed to support our client partners throughout the ETF lifecycle; advising firms who are yet to agree on the strategic investment in launching ETFs; all the way through to designing and implementing ETF specific operations and distribution operating models.

### Strategic Advisory and Exec. Decision Support

Alpha can provide senior leadership with the necessary information to make investment and go-to-market decisions based on the evaluation of the market entry opportunities and alignment to the enterprise’s growth strategy. This would include supporting financial modeling and business case creation, advising on product and distribution strategy and performing a high-level product review to identify potential products offered. Alpha can facilitate ETF-specific education sessions, provide industry perspective, support in the preparation for executive committee meetings and facilitate introductions with key market players where applicable (i.e. peer ETF providers, ETF service providers, outside counsel, etc.).

### Operational Readiness

Alpha can help teams become ready for any operational changes by providing industry-leading expertise and identifying end-to-end changes and impacts to the operating model related to changes in the ETF ecosystem. Alpha can assess the current operating model, identify gaps to industry best practice, help design a target model to align on the strategic vision and build out a roadmap to plan future execution. Alpha can also support managers with selecting strategic partners including RFP drafting, distribution and management, along with the subsequent short-listing, scoring, and commercial/contract negotiations backed by Alpha’s proprietary accelerators and industry benchmarking.

### Distribution Readiness

Alpha can help define a fit-for-purpose distribution operating model and go-to-market sales strategy to efficiently scale assets. This includes defining buyer/internal persons, aligning on go-to-market strategies, developing future state organization structures, defining an ETF content dictionary, assessing the distribution architecture and gaps to industry best practice, documenting sales/flow data challenges and outlining ETF-specific website requirements to confirm the current state ability to satisfy listing requirements.

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Alpha

The Alpha Group provides a comprehensive range of services across the asset and wealth management industry. Our team of 1000+ consultants work around the globe to help our clients solve their business, operational and technology challenges. This report is based on Alpha knowledge and industry experience. We would like to thank all our colleagues for their expert contributions.



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