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Financial Services Practice

The Second Act Begins for ETFs

A Disruptive Investment Vehicle Vies for Center Stage In Asset Management

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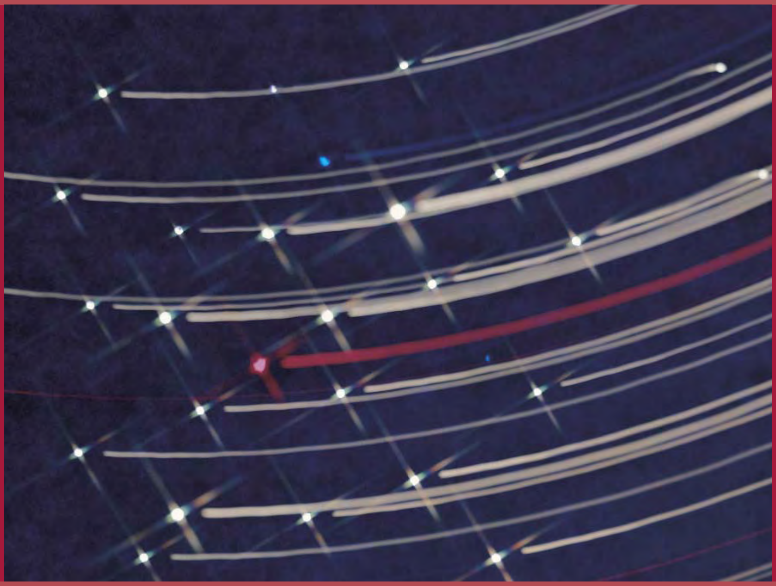
Introduction

Not since the advent of index funds, hedge funds, or possibly the mutual fund itself, has the asset management industry witnessed an innovation as profound as exchange-traded funds (ETFs). This disruptive investment vehicle has given individual investors access to asset classes and strategies once out of reach, attracted assets at an industry-leading clip and turned the passive investment arena into a hotbed of competition. Now, as ETFs mature, they are poised to move into a second act, which will present both greater strategic challenges and new opportunities for growth.

The ETF story is one that most players in the industry – big and small managers, institutional and retail managers, independent advisors and brokerage houses alike – are watching with fascination and some trepidation. Few asset managers without ETF offerings understand precisely how ETFs will affect them. Many are locked in internal debates over whether they should be playing offense or defense. Most have adopted wait-and-see strategies and are hedging their bets with precautionary ETF product filings. However, the risk of an overly hesitant approach is that the market will evolve so quickly that players end up pursuing opportunities that have passed or defending core businesses after the ramparts are breached. McKinsey research underscores this dynamic, suggesting that the ETF industry has reached an important inflection point and is entering a new phase. Act II for ETFs will be characterized by significant shifts in product design, distribution and potentially regulation.

Most importantly, the formula for success in ETFs is changing. While Act I was characterized by "plant the flag" strategies designed to claim first-mover advantage, in Act II winners will make more considered choices about where to compete. They will also reinforce and expand their capabilities to address new challenges and adjust their business models in ways that leverage unique strengths and build competitive advantage.

This report focuses on what makes ETFs a powerful force in today's market, and on why all asset managers should be paying close attention. We examine how the ETF market has changed and consider the implications of the impending transition to Act II. We close with a look at the emerging ETF business models and the new prerequisites for success.



Act I: Rapid Growth of a Disruptive Product

Asset managers have reason to be excited by the growth prospects for ETFs. In December 2010, almost 18 years after the introduction of the first ETF product, U.S. ETF assets topped $1 trillion. Since 1995, U.S. ETFs have generated consistently positive annual net flows through both up and down market cycles. Between 2000 and 2010, exchange-traded products (ETP)[1] assets under management (AUM) grew over 30 percent per year (Exhibit 1, page 4). To put this in context, consider that conventional U.S. mutual funds grew on average 5 to 6 percent annually over the same time frame. In fact, in the last decade, no other significant segment of the U.S. asset management industry has grown as quickly and consistently as ETFs – not managed accounts, IRAs, or even the booming defined contribution (DC) market. At just under 10 percent of all U.S. mutual fund assets today, ETFs are clearly here to stay.

[1] ETPs defined to include ETFs, ETCs (exchange-traded commodities) and ETNs (exchange-traded notes).

Exhibit 1

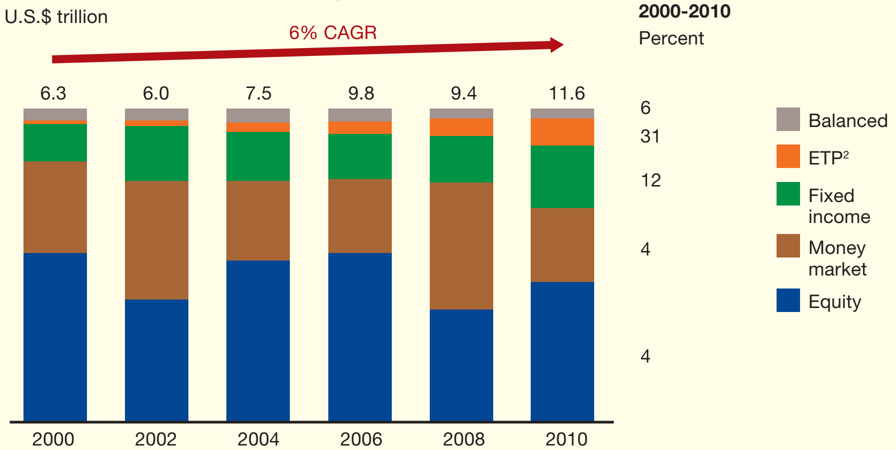
Exchange-traded product (ETP) growth in the U.S. significantly outpaced all other asset management categories over the past 10 years

U.S. mutual fund assets under management (AUM)[1]

U.S.$ trillion

CAGR 2000-2010

Percent



[1] Excludes funds of funds and variable annuity subaccounts

[2] ETP defined to include ETFs, ETCs (exchange-traded commodities) and ETNs (exchange-traded notes)

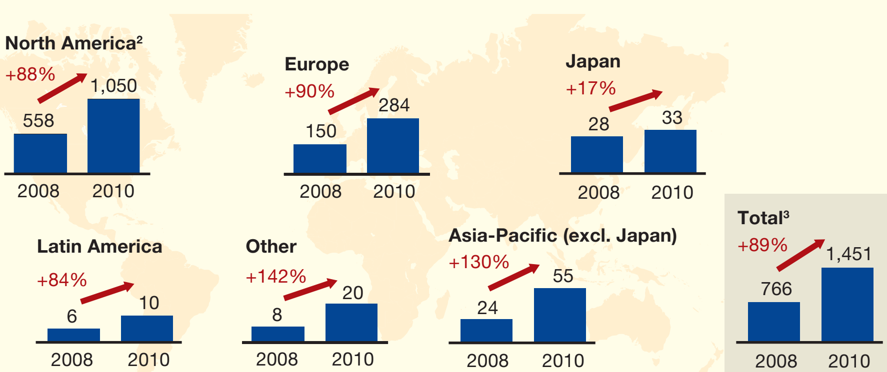
Source: McKinsey analysis; Strategic Insight

Exhibit 2

Global ETP growth has been strong despite challenging market conditions

ETP[1] AUM

U.S.$ billion



[1] ETP defined to include ETFs, ETCs and ETNs.

[2] U.S. and Canada only

[3] Totals may not sum due to rounding

Source: McKinsey analysis; BlackRock, "ETF Landscape" Year-end 2010; industry reports

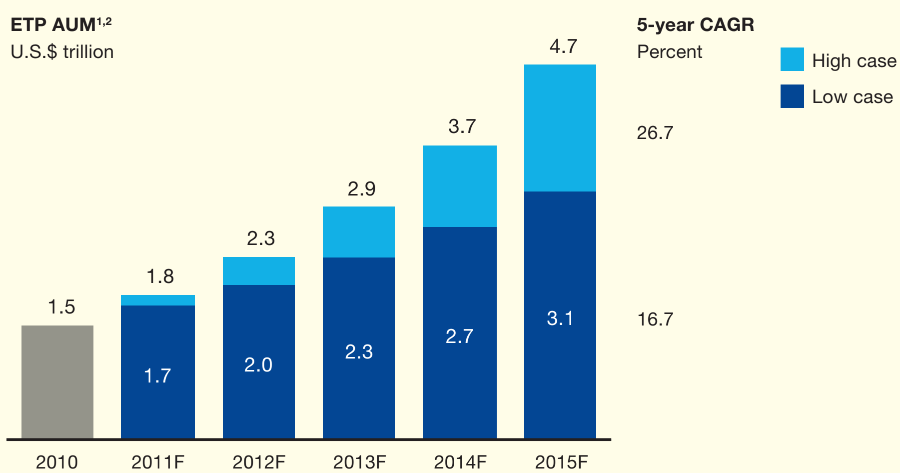
Global trends are equally impressive. Between 2008 and 2010, European ETF markets grew at rates comparable to those in the U.S., while Asia-Pacific (excluding Japan) ETF markets grew by more than 100 percent, albeit off much smaller asset bases (Exhibit 2). The outlook for global ETF markets remains strong, with growth rates expected to rival or even surpass the U.S. in the years ahead. Based on current projections, total global ETF AUM could grow from approximately $1.5 trillion today to between $3.1 trillion and $4.7 trillion over the next five years (Exhibit 3).

While the growth prospects for ETFs have gained the attention of the industry, many firms remain cautious because of competitive intensity in the market (roughly 70 percent of global ETF assets are controlled by the top three players), low fees and a focus on passive management. While caution is prudent, it is not in itself a strategy. All asset managers should understand that ETFs are disrupting the industry across multiple dimensions:

- **Expanding investor access.** ETFs have democratized access to an array of asset classes and strategies. Retail and small institutional investors can now obtain cost-effective and direct exposure to hard commodities such as gold, oil, natural gas and copper, which were once too expensive and

Exhibit 3

Strong global ETP growth to continue through 2015



[1] Includes estimates for Americas, Europe, Asia (excluding Japan) and all other regions (e.g., Japan, Mideast, etc.).
[2] Includes all exchange-traded products (e.g., ETF, ETN, ETC) and baseline steady-state growth (no shocks to system).
Source: McKinsey analysis; ETF Landscape Year-end 2010; industry reports

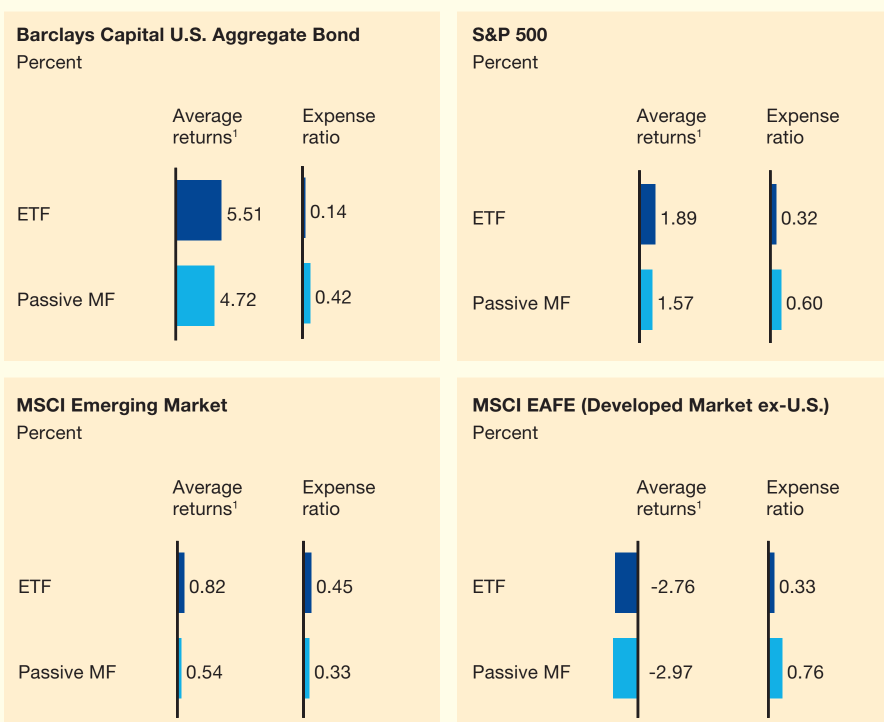
impractical to own. They can invest directly in foreign currencies, short sell entire indices and replicate hedge-fund-like strategies that were once the exclusive domain of large institutions. They can execute asset allocation strategies with an array of indices that section the global markets with increasing granularity. They can even buy ETFs that offer built-in leverage and two- or three-times returns without the need for a margin account.

- Allowing advisors to monetize advice. ETFs are changing the way retail advisors work with clients, replacing the stock-picking advisor of the past with the "ETF asset allocator" of today. This trend is especially ev-ident in fast-growing fee-based segments where advisors charge an

Exhibit 4

ETFs often produce better sustained investment performance than other retail fund vehicles

Pre-tax investment returns and expenses for 4 selected benchmarks

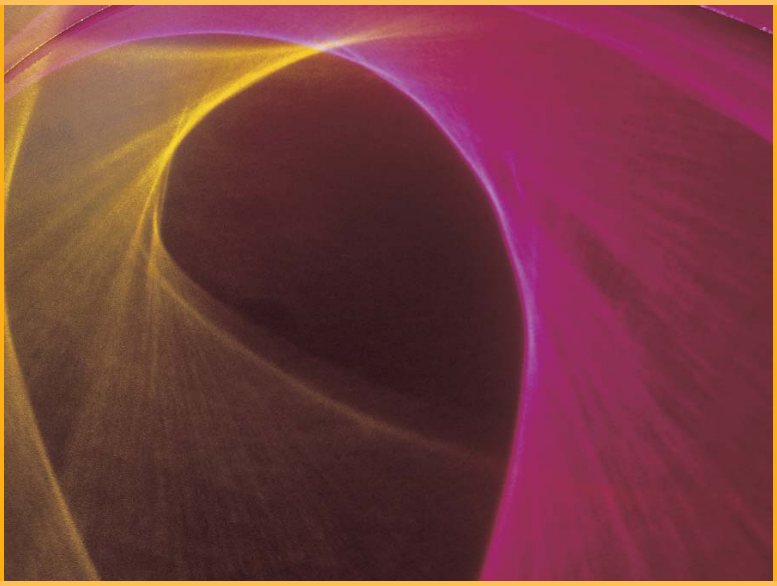


[1] 3-year load-adjusted annualized return, simple average as of December 31, 2010

Source: Strategic Insight; Federal Reserve Flow of Funds asset-based management fee and therefore have added incentives to ensure clients are invested in low-cost vehicles. ETFs also enable advisors to offer services that were previously impossible or impractical to provide, such as tactical asset allocation and cost-effective exposure to a broad array of asset classes (e.g., emerging markets, commodities, alternatives).

- A superior product design. For many investors, ETFs offer a stronger overall value proposition than traditional passive mutual funds. The most frequently noted benefits of ETFs include lower expense ratios, tax advantages and transparency, but these benefits are only part of the story. ETFs also trade like equities, enabling investors to trade with stop and limit orders (unlike conventional mutual funds, which trade at end-of-day net asset value). In contrast to mutual funds, many ETF issues also offer the flexibility of options trading, which facilitates more sophisticated trading and risk management strategies. A significant but less-discussed advantage of ETFs is that they can produce better investment performance than equivalent conventional index funds (Exhibit 4). This outperformance is driven in part by lower expense ratios, but more significant is reduced cost of flow, the expense associated with cashing mutual fund shareholders into and out of funds, that is, providing shareholder liquidity. Several academic studies have shown that cost of flow can adversely impact conventional mutual fund performance by as much as 50 to 140 basis points annually. It is worth noting that ETFs are not without some drawbacks: they are often subject to trading commissions; bid/ask spreads associated with trading ETFs increase an individual investor's transaction costs; and ETF tax features are not advantageous for all investors.

The changes described above are significant and have had a tangible impact on the asset management industry. However, the implication of these changes is not yet broadly understood and accounted for by asset managers. As more players turn their attention to the ETF market, there are signs that a turning point is approaching, and that asset managers will need new strategies, new capabilities and new models to thrive in the next act.



The ETF Plot Thickens

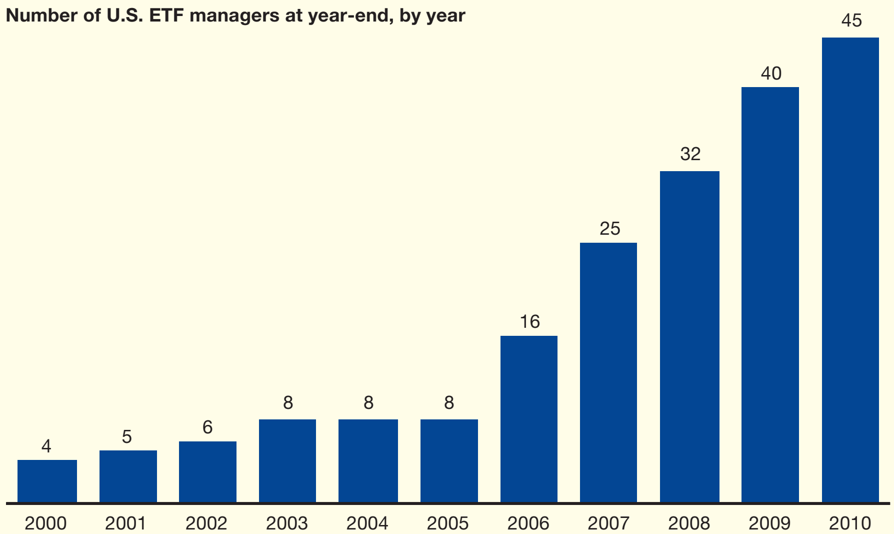
Until recently, ETF manufacturers enjoyed the luxury of relatively smooth sailing, with consistent growth and few failed product launches. But the ETF market has evolved in the last five years, and in many respects looks quite different than it once did. Several developments suggest that the market is approaching a critical juncture:

- **Competitive landscape.** For most of the past two decades ETFs were a relatively quiet market controlled by three large players. However, any hopes that this would remain a select niche have disappeared. ETFs are now a hotbed of competition with an expanding and aggressive array of competitors (Exhibit 5, page 12).
- **Product proliferation.** Rapid growth in products, coupled with a rising number of failed launches, suggests that the passive ETF market is getting closer to saturation, with much of the low-hanging fruit already plucked. In 2009, nearly three-quarters of all launches "failed" (i.e., did not gather significant assets within two years), compared to a less than one-in-ten failure rate in the 2003 vintage (Exhibit 6, page 10). Many of today's ETFs have too few assets to break even economically (Exhibit 7, page 11) and, as a result, sponsors have been reexamining product portfolios and rationalizing line-ups. From 2000 through 2007, 10 ETFs were shuttered. In the following three years, more than 150 ETFs were shut down. As success becomes less certain for ETF launches, sponsors are taking a fresh look at the value proposition they offer investors and advisors, and seeking fresh sources of growth, from new product categories (e.g., "active") to new distribution channels (e.g., DC) to new geographies (e.g., Asia, Europe).

Exhibit 5

The number of ETF competitors has grown tenfold over the last decade

Number of U.S. ETF managers at year-end, by year

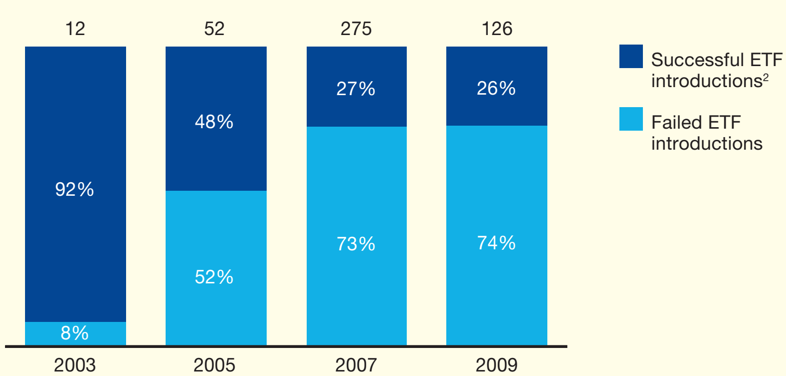


Source: McKinsey analysis; Strategic Insight

Exhibit 6

Succeeding with a new ETF product has become far more challenging

Success of new ETF[1] introductions by vintage
Number of ETFs, percent

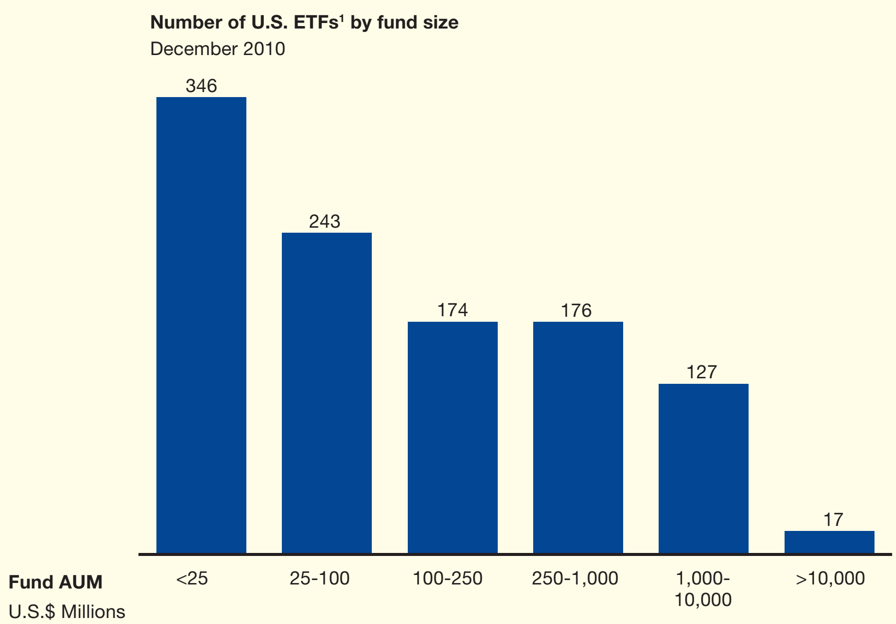


[1] ETFs defined to include ETFs and ETCs.
[2] Successful ETFs defined as those reaching $100 million in AUM at any point during their year of introduction or the year after.
Source: McKinsey analysis; Strategic Insight

- **Intensifying price competition.** Price pressure is increasing in "vanilla beta" products (e.g., S&P and MSCI broad indices) and other product categories with large pools of assets. For example, head-to-head competition between similar ETF products has grown significantly and price is often a key differentiating feature. Some of the latest broad index products charge fees of just five basis points, undercutting the leading incumbents. This focus on price is leading sponsors with low-cost value propositions to attempt to press their advantage against higher-priced competitors. Incumbents will need to think carefully about responding too forcefully and igniting price wars, especially as the link between ETF price cuts and asset flows is not straightforward.
- **Regulatory uncertainty.** ETF innovation, particularly for active strategies, entered regulatory purgatory in March 2010 when the Securities and Exchange Commission (SEC) announced a review of its policies on ex-

Exhibit 7

The large number of sub-scale ETFs should drive continued product portfolio rationalization



[1] ETFs defined to include ETFs and ETCs.

Source: McKinsey analysis; Strategic Insight emptive relief, an important prerequisite for bringing most new ETFs to market. The SEC is particularly concerned with the use of derivatives within the Investment Company Act of 1940 mutual fund structure that is common to most ETFs. As derivatives could be an important design element for the next generation of ETFs (e.g., risk-managed or active strategies), the SEC's temporary halt on derivatives-based applications has crimped the industry's product development pipeline. At the same time, it has created a unique advantage for those sponsors who obtained exemptive relief before the SEC's review, as those approvals remain in effect. Many smaller sponsors with these approvals now find themselves prime acquisition targets. With financial regulatory reform consuming so much of regulators' attention, it is difficult to predict precisely when clarity on exemptive relief will arrive. When it does, the pace of innovation will rebound.

- **Shrinking seed funding.** Initial investment capital to launch ETFs in the U.S. historically came from market makers in exchange for the privilege of acting as specialist for a newly listed fund. In Act I, market makers rarely encountered an ETF they would not seed. However, the economics of market makers' business models have been under pressure from broader financial industry forces, which is driving consolidation. While the number of market makers has dwindled, the number of planned ETF launches has continued to rise. Compounding this challenge, the success rate of new ETF products has steadily declined, which means that many seed investments fail to pay off. While larger ETF sponsors are less affected by this trend due to their size and long-standing relationships with market makers, the environment is growing more challenging for smaller ETF sponsors, who find it increasingly difficult to obtain market maker capital for new products.

Some recent attempts to enter the ETF market have not yielded the degree of success the aspiring entrants expected. Even market leaders are feeling the effects of a shifting competitive landscape, and their responses could accelerate the pace of change.

As a result of these trends, some recent attempts to enter the ETF market have not yielded the degree of success the aspiring entrants expected. Even market leaders are feeling the effects of a shifting competitive landscape, and their responses could accelerate the pace of change.

These developments herald the ETF industry's transition from a first to a second act. The plot of this next act will likely include several important twists and turns, including shifts in barriers to entry, rapid global expansion, evolution of new business models and the rise of new products and distribution channels. Act II could have far-reaching implications for every asset manager, whether or not they currently compete in ETFs.

The Curtain Rises on Act II

As the ETF market enters its second act, market leaders and new entrants alike face some difficult choices. Industry leaders will need to sharpen their client focus, develop geographic expansion plans and hone pricing propositions, all while keeping new entrants at bay through innovation. New entrants, many of whom have, in a sense, "purchased options" on the ETF business, must figure out how to make those options pay by better understanding investors' unmet and evolving needs and linking these insights to coherent product design, pricing and distribution strategies.

ETF growth continues

While there may be bumps in the road, the outlook for global ETF growth remains strong. Based on current projections, total global ETF AUM could grow from approximately $1.5 trillion today to between $3.1 trillion and $4.7 trillion over the next five years. Five trends will support this growth:

- Renewed focus on investment cost. ETFs benefit from a growing focus on investment costs. Poor fund returns in recent years have prompted investors and advisors alike to question the benefit of active management versus cheaper passive products (a large fraction of which are ETFs). While the active-passive pendulum will undoubtedly continue to swing with market cycles, a slow and steady long-term trend toward passive strategies has taken root in the U.S., with ETFs as the main beneficiary.

- **Fee-based advisory growth.** A trend toward fee-based advisory models, where advisors are compensated on total assets under management as opposed to commission, is also aligning clients' and advisors' focus on low-cost products such as ETFs. In addition, scrutiny of investment fees has grown as regulators worldwide step up financial oversight in the wake of the financial crisis. In markets such as the U.K. and Australia, regulations on pricing are driving a transition to fee-based advisory; if U.S. ETF adoption patterns are any indicator, this should be a boon for ETF players in those markets. In the U.S., proposals to limit 12b-1 fees could further level the playing field for ETFs versus conventional funds. Limitations on mutual fund distribution fees would mean less money for conventional fund promotion, and could therefore support accelerated ETF growth.
- **Regulatory emphasis on transparency.** All indicators suggest that regulators will continue to demand greater disclosure from all asset managers, especially in matters of pricing. As ETFs offer comparatively simple pricing structures compared to many other asset management products, they should have an advantage over traditional funds in an era of greater transparency.
- **Rising investor awareness.** ETFs have delivered impressive growth despite still relatively low awareness and adoption among investors, advisors and institutions – implying that significant growth potential remains. About 15 percent of institutional investors say they are not familiar enough with ETFs or do not use them at all. Another 35 percent say they are familiar with ETFs, but do not own or use them. In the retail channel, 40 percent of advisors say the same. Awareness and adoption of ETFs will continue to rise as more well-recognized fund names enter the market with both passive and active ETF products.
- **Waning reluctance from distribution.** For several years, wealth managers have been putting pressure on conventional fund managers to receive a larger share of revenue streams as product distributors. As most ETFs do not currently pay fees to the distribution channel, they allow fund managers to essentially distribute "for free" and avoid some distribution-induced margin pressure. While this free ride is attractive for the moment, it hampers ETF growth in large segments of the market. Wealth managers are also starting to take seriously the threat to their business model and press for a piece of the ETF revenue stream from manufac-

turers. We believe that wealth managers will ultimately succeed in these efforts to capture part of the ETF value chain and that this will support broader ETF growth.

- Increased institutional appetite. While hedge funds and money managers have been focused on ETFs for some time, other institutions such as defined benefit (DB) and DC plan sponsors, endowments and foundations are just starting to show meaningful interest. ETFs offer institutions several benefits including the flexibility to easily maintain benchmark exposure while switching managers or deciding how to deploy cash (i.e., cash equitization). More importantly, ETFs also fit naturally into core-satellite strategies that are popular with institutions. Larger institutions can often also realize cost savings with ETFs, thanks to their ability to generate extra yield through ETF lending.

Given growing competitive pressure, incumbents and new entrants alike will need to carefully consider where and how to compete..

Underlying the growth of ETFs are four factors that will change the industry landscape significantly in Act II: an increasingly competitive market for passive investments; growth in active ETFs; globalization of the marketplace; and new competitive models.

Passive ETF market becomes more competitive

The leaders in the passive ETF business today are strongly positioned, with established brands, product liquidity, distribution reach and scale. However, they will face growing competition from a few groups of players, such as large conventional asset managers with strong brands, players with proprietary distribution or platforms, and niche-focused, innovative boutique managers.

Given growing competitive pressure, incumbents and new entrants alike will need to carefully consider where and how to compete, with a strategic eye on both market selection and innovation:

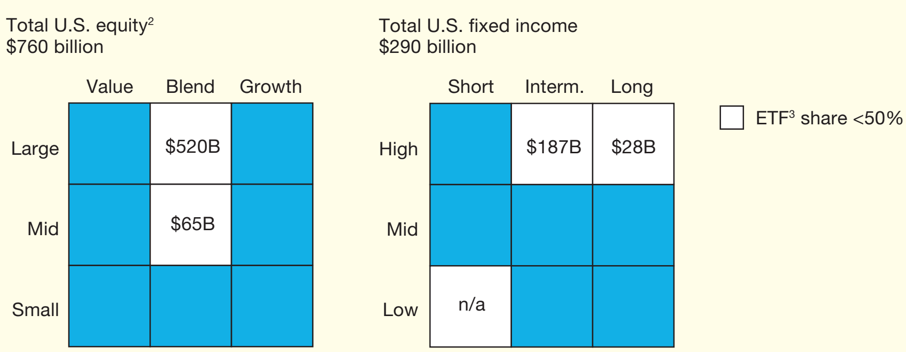
- Market selection: Most passive market growth will be centered in a few mainstream product categories where ETFs have yet to gain significant share (Exhibit 8, page 18). While there are only a few such categories, including large and mid-capitalization blend equity and high-grade fixed-income, they represent the most significant concentration of assets. New entrants' ability to tap these asset pools will be limited as industry heavyweights with at-scale platforms, low-fee products and strong distribution capabilities will likely capture most of this white space with enhanced distribution strategies that access new channels (e.g., non-fee-based advisors, DC) for growth.

- Focused innovation: Smaller players still have opportunities to break into the passive ETF market through product innovation, as many investor needs remain unmet. To cite an example from the recent past, many commodities ETFs using derivative-based (as opposed to physically-based) strategies suffered ill-effects from *contango,* a phenomenon whereby forward prices exceed front-month prices. In their simplest implementation, these ETFs use futures to replicate underlying commodity price trends by systematically purchasing the front-month contract and "rolling" this over to the next month prior to expiry. When the underlying commodities are in contango, these funds are forced to buy ever-more expensive contracts and therefore systematically bleed assets. They are also prone to front-running. A next generation of commodity ETFs has been developed to mitigate these vulnerabilities by altering roll strategies and, so far, these ETFs have done well in terms of both performance and asset gathering.

Exhibit 8

White space remains in a select few mainstream passive product categories

AUM in passive investment strategies by Morningstar category,[1] June 2010



[1] Includes only funds classified by Morningstar in equity and fixed income categories shown in the style boxes. Excludes other funds such as sector funds that are classified by industry (e.g., pharma, telco) or fixed income funds classified only based on maturity (e.g., long-term U.S. bonds).

[2] Includes funds and ETFs with both equity and fixed income category.

[3] ETFs defined to include ETFs and ETCs.

Source: McKinsey analysis; Strategic Insight Simfund MF; Morningstar

Active ETFs could change the plot

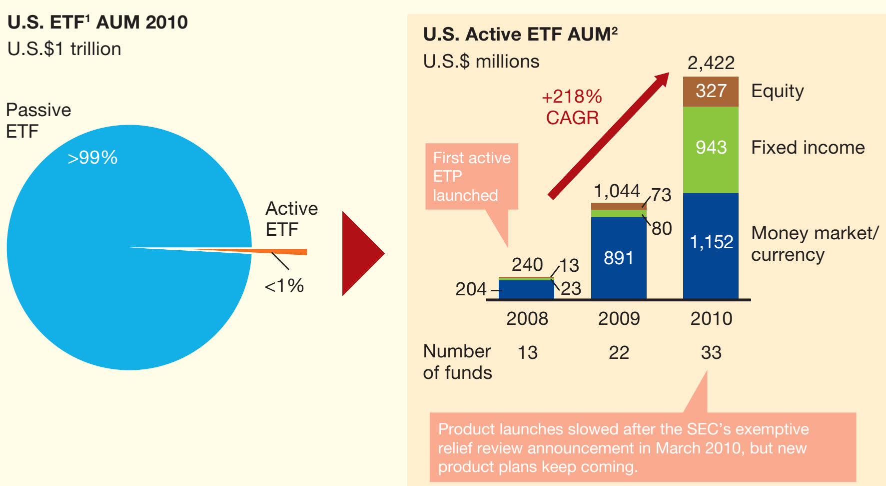
While active ETFs are a nascent product category representing approximately 1 percent of all ETF assets today (Exhibit 9), they have the potential to change the narrative in traditional asset management and initiate a new growth curve for the industry as a whole – not just passive ETF leaders. It is impossible to predict the ultimate size of the active ETF industry or its growth trajectory, but prudent managers should consider the risks and opportunities that would arise if active ETFs were to take off. Consider that if active ETFs were to follow the same growth pattern that passive ETF products followed, they would constitute approximately 10 percent of all actively managed U.S. long-term mutual fund assets within a decade and exceed $1 trillion in AUM (Exhibit 10, page 20).

Many traditional asset managers are aware of the disruptive risk that active ETFs could pose. Indeed, sponsors have filed more than 800 applications for new active funds with the SEC. Many are from traditional managers without ETF products who are simply preserving their options in case the market expands.

Industry trends are increasingly favorable for growth in active ETFs. In particular, there are four conditions that could spur rapid growth acceleration:

Exhibit 9

Active ETF market is small today, but rapidly growing



[1] ETFs defined to include ETFs and ETCs.

[2] Includes currency ETPs offered by Wisdom Tree.

Source: McKinsey analysis; Strategic Insight; ICI

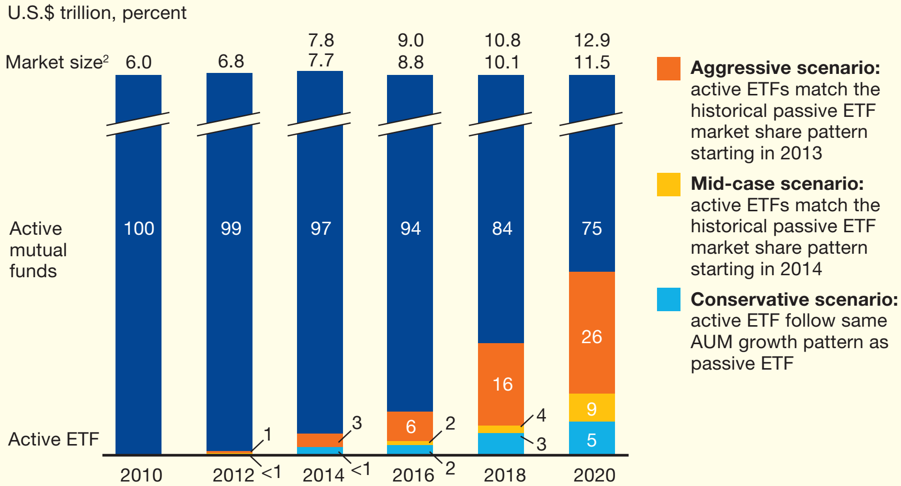
1. **Standardized approach.** Building an active ETF is far from straightforward. Intellectual property remains a crucial dilemma for active portfolio managers, who are reluctant to share their investment strategies through a transparent ETF for fear that other managers could copy the strategy and reduce their ability to generate alpha. Perhaps more worryingly, portfolio managers of larger funds face the risk of being front-run by the market when making large securities purchases or sales. A number of innovative proposals have been suggested for how to protect a manager's intellectual property and prevent front-running. These solutions range from pooling multiple ETFs together for creation and redemption orders (thereby masking individual ETF holdings) to "black box" encryption that uses factor-based models to identify proxy securities baskets. Regulators have yet to signal willingness to endorse a method.

2. **Track records.** The first active ETFs qualify for Morningstar ratings this year (2011) as they complete a three-year track record. As more active ETFs reach this milestone, it should increase their visibility with advisors

Exhibit 10

Scenarios: If active ETFs follow an adoption pattern similar to passive ETFs, they could be extremely disruptive

Mutual fund and ETF share of total U.S. actively managed investment products market[1]
U.S.$ trillion, percent



[1] Assumes 50% of net flows into active ETFs come from active mutual funds; annual active market appreciation 6% for active ETFs and 5.5% for active mutual funds.

[2] Top line represents total market size for scenario 1, bottom line represents total market size for scenario 3.

Source: McKinsey analysis; Strategic Insight; ICI; FRC; Federal Reserve Fund of Flows; 2009 McKinsey/U.S. Institute Asset Management Benchmarking Survey and retail investors and spur adoption, assuming that investment performance is satisfactory.

3. **Big brand participation.** As widely recognized and respected brand name managers make moves into the active ETF domain, their endorsement will increase the credibility of active ETFs and accelerate demand and adoption. A concerted move toward active ETFs over the last 12 to 18 months by one of the world's largest fixed-income managers was a milestone for active ETF evolution, prompting many managers to reexamine and ramp up their active ETF strategies. Several other recent product announcements by high-profile managers (both traditional and ETF managers) are strong evidence of a renewed focus on active ETFs.
4. **Clarity on fund conversions.** While the SEC's hold on exemptive relief requests has slowed the formation of new active funds, resolution is likely in the short to medium term. Beyond this hurdle, an important potential catalyst for active ETF growth is the development of a practical method and precedent to convert existing conventional mutual funds into ETFs. This could enable an asset manager looking to expand into the ETF space to maintain performance track records and achieve "instant scale" at launch. Several fund conversion proposals are currently under consideration by smaller players, but if a large asset manager were to convert a well-established four- or five-star fund, it could become a watershed event.

If active ETFs do take hold, we expect they will start from the fixed-income side of the market. Fixed-income funds are less vulnerable to front-running and therefore face less transparency risk. One segment of traditional fixed-income funds that may be particularly exposed to active ETFs in the near term is the $3 trillion money market fund business. Money market funds lost their safe haven allure when several funds "broke the buck" during the 2008 credit crisis, reminding investors that maintaining a $1 net asset value (NAV) was not guaranteed. This realization has opened a window of opportunity for variable NAV products with risk profiles similar to money market funds, but significantly lower expense ratios and markedly higher investment yields. Pioneer products in this category have already started gaining traction in the market. However, for ETFs to compete effectively with and match the scale of money market funds in the retail market, the current low to no-commission environment among broker-dealers would have to remain in place for ETFs, since customers would be moving money in and out of these products frequently.

New business models

As the ETF market becomes bigger, more diversified, global and even more competitive in Act II, the asset management industry will need to adapt. We expect competitors will gravitate to one of several business models. Some represent natural extensions of existing trends, while others do not yet exist or are only nascent today:

- **At-scale mainstream index players** will focus principally on providing access to vanilla beta categories for a broad swath of institutional and retail investors. Initially, players pursuing this model will compete based on a combination of brand strength, product quality and cost; however, as the battle plays out and investors and advisors become better informed and more comfortable with ETFs, cost, liquidity and distribution accesss will likely trump brand as the longer-term determinant of success in vanilla beta categories. Leading mainstream providers will pursue economic scale advantages over their rivals to simultaneously protect margins and ensure competitive price points. Building and maintaining scale will require strong distribution capabilities (e.g., wholesaling talent, sales support infrastructure, marketing skills); vanilla beta providers with the best distribution engines will be rewarded with a self-reinforcing cycle of virtuous growth: *more assets, greater scale, lower cost, lower prices, more assets.* Those who overlook the importance of distribution will likely experience the inverse, a vicious cycle of persistently challenging economics and decline. Brand will play a marginal role for vanilla providers, facilitating distribution and potentially buffering the effect of price compression, primarily in the early days of Act II. Ultimately, as scale becomes more and more crucial, only a few players will succeed at this model, with smaller competitors being acquired or squeezed out.

Vanilla beta providers with the best distribution engines will be rewarded with a self-reinforcing cycle of virtuous growth: *more assets, greater scale, lower cost, lower prices, more assets.* Those who overlook the importance of distribution will likely experience the inverse.

- **"Store brand" players** could materialize to address the threat that ETFs present to traditional (i.e., commission-driven) retail distribution channels. Unlike mutual funds, ETFs pay little to no distribution fees to the brokerage houses and advisors who sell them to their clients. The only revenue distributors usually generate from ETF sales are small trading commissions as the funds are bought or sold in client accounts. To the extent that ETFs are purchased in lieu of traditional mutual funds, this presents a challenge to distributor economics. Even if ETFs do not cannibalize mutual fund assets or flows, they can still be seen as "free-riders" in the distribution channel. There have already been some initial responses to this threat in the discount brokerage space. Distributors who lack – and decline to build – manufacturing capabilities but who hope to capture their share of ETF economics will likely explore two avenues: negotiate revenue-sharing agreements with ETF manufacturers (similar to some recent deals) or consider private-labeling ETFs under their own brands. Private-labeling would pave the way for the store brand model and enable distributors to extract value from their proprietary customer access.

- **Category specialists** will focus on designing specialized passive – and, in time, active – ETF products to satisfy profitable niches of unmet investor demand. Such niches will include ever-narrower slices of international or sector exposure, more exotic commodities, levered or inverse funds, and a wide variety of alternatively weighted indexes. As small to mid-sized ETF sponsors strive to develop unique market positioning and brand identity, many have concentrated on consolidating leadership positions within product categories. This trend toward increased specialization will likely continue as ETF sponsors seek to balance their quest to uncover new pockets of investor demand with the need to maintain business focus, cost-effectiveness and a distinctive brand on a crowded ETF product shelf. As this trend plays out, successful specialists in some larger categories could become acquisition targets of larger sponsors seeking to augment and diversify product portfolios.
- **Alpha seekers** will focus on delivering active, alpha-generating strategies through ETFs. In a sense, these players will be attempting to recharacterize ETFs as the modern mutual fund. The success of this model will depend in large part on whether the active ETF market takes off. Until recently, only a few small start-up sponsors have focused on this model, but if active products gain traction, we would expect a host of traditional active fund managers to rapidly avail themselves of shelved active ETF product filings in a bid to take center stage.

Winning in Act II

In Act I of the ETF story, a sponsor's success was primarily determined by how quickly it could bring a product to market and by its proprietary manufacturing capability, product innovation and brand strength. These were critical components of a "plant the flag" strategy to rapidly generate products and be first to market in as many categories as possible. This was the right strategy for the time, as first movers reigned supreme. Product innovators were typically rewarded with the lion's share of the markets they pioneered and this advantage was sustained as the market grew. Most ETF innovation in Act I was centered on passive products, so sponsors with existing index fund businesses had a natural advantage over rivals who lacked easy access to proprietary manufacturing capabilities.

As the ETF narrative moves into its second act, the formula for success will change. While product innovation and branding will continue to play an important role, innovation is likely to shift increasingly to distribution challenges and successful sponsors will need to develop several new capabilities.

- **Client-centric and distribution-oriented product development:** ETF manufacturers will no longer be able to launch products with the expectation that most will succeed. With an ever more crowded product shelf and stiffening competition, new products must stand out and deliver compelling value to succeed. Sponsors will have to develop a deeper understanding of investor and advisor needs, and incorporate these insights into product design, pricing strategies and distribution approaches for a compelling overall value proposition.
- **Balanced product portfolios:** In the long run, successful sponsors – especially smaller and niche-focused players – will need to build balanced product portfolios to manage the risks of asset concentration in a few big products. While a blockbuster product is always nice to have, it can also

Strategic questions for incumbents, attackers and new entrants

As the requirements for success in the ETF market change, incumbents, attackers and new entrants should consider a range of questions, including:

Established incumbents

- What strategic posture should we adopt in response to growing price competition?
- How can we leverage our market insights, experience and scale to maximum competitive advantage?
- Which channels and customer segments should we prioritize to preserve market leadership?
- How do we sustain a robust product innovation pipeline in an environment where new products are more likely to fail?
- How should we approach globalization? Which markets, products and channels do we target? Do we buy or build?
- How do we balance our focus between pursuing remaining opportunities in a maturing passive space and capturing nascent active ETF opportunities?

Attackers

- What niche capabilities would differentiate us from incumbents and other attackers?
- What is the best combination of organic growth and M&A for achieving profitable scale?
- What mix of products, distribution channels and customer segments will enable us to challenge incumbents?
- How can we build a balanced product portfolio to reduce asset concentration risks and ensure market share gains through market cycles?

New entrants

- Is it too late to enter the passive ETF market? What unique angles could we take and what would it take to succeed?
- Should we create and/or exercise an “option” on the active ETF market? Should we lead or follow, step in or jump in?
- What critical capabilities would we need to aggressively build share in our chosen markets and segments?
- Can these capabilities be organically built? What role should M&A play?

expose managers with smaller product portfolios to severe revenue and earnings volatility. Winning managers will, over time, construct product portfolios that are less vulnerable to the inevitable market cycles that favor or disfavor particular asset classes, styles and strategies.

- Global capabilities: In the U.S., Act I for ETFs was predominantly a domestic story, but in Act II the narrative will take on a global dimension. Large U.S. sponsors and even some mid-sized players will increasingly look to less mature overseas markets, expanding into Asia and Europe via organic growth, innovative distribution partnerships and joint ventures, and outright acquisitions. The migration of ETF competition will not be one-way, however: U.S. sponsors can expect to see European manufacturers landing on American shores over the next few years. Although European ETF growth rates are higher than those in the U.S., the latter still has the world's largest concentration of ETF assets ($1 trillion). Further, the U.S. is an important gateway to many other markets, as numerous foreign regulators model local standards on U.S. regulations. In addition, the U.S. compliance bar is relatively high, which means that funds meeting U.S. regulatory standards can usually pass muster in many overseas markets as well.

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ETFs have already made their mark on the asset management industry, growing with consistent rapidity and disrupting the marketplace. Now, signs point to a turning in this market. Growth will continue, but the sources of growth and the capabilities that distinguish leaders from laggards are shifting. All asset management executives should keep a close watch as the ETF market evolves so they are well prepared for what promises to be an exciting second act.

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