ASK AN EXPERT Q&A:

3 European ETF trends coming from the US

Exchange-traded funds have seen interesting and innovative developments in the US recently. Learn how those trends could influence European markets today and in the years ahead.

It's commonly understood that fund trends in the U.S. eventually cross over to European markets. We sat down with one of our ETF experts, Tony O'Brien, chief commercial officer for Ireland at U.S. Bank, to discuss what he's seeing in the U.S. right now and how it might affect asset managers in Europe.

Q: How are ETF trends in the U.S. and Europe connected?

When you look at the ETF space, what happens in the U.S. generally tends to happen in Europe 2-3 years later. In Europe, there's always a lot of interest in what's going on in the States as it gives managers sort of a crystal ball into what might be coming down the road.

The world is more connected now that it's ever been, and macro-economic factors impacting the U.S. echo in Europe. In turn, investment products that reflect the U.S. environment will eventually find their way to Europe in one shape or form. At a more granular level, investors themselves are becoming more global in their outlook. Demand for particular products and strategies on one part of the globe gets reflected more easily elsewhere.

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Q: What are some of main the U.S. ETF trends showing up Europe right now?

Here at U.S. Bank, we're a leading service provider both in the U.S. and in Europe, so we're able to take a broad look at what's happening on both sides of the Atlantic. There's a wealth of information in what we see that can provide insight and value for managers.

Three of the most notable trends we're seeing right now are:

- More actively managed ETFs
- More ETF platforms
- More ETFs based on single stocks or variations of single-stock exposure.

Q: How are actively managed ETFs affecting the marketplace?

Almost everything that's being launched in the U.S. right now fits into that actively managed bucket. The debate had been about whether your active ETF is transparent or non-transparent – does it show its portfolio to the market or not? That debate seems to be over, in that many new ETFs we see are totally transparent in what they're holding. We're also seeing a lot of sectoral ETFs based on an index where the index itself is actively managed, albeit according to strict rules. With this type of product, everyone has access to the index, so the fund's holdings are fully available.

This is something we're already familiar with in Europe. But I think we're going to see more managers packaging strategies in ETFs and not being shy about showing the market the exact makeup of those strategies. They won't feel as protective of their "secret recipe" if you will.

This development, in a sense, short-circuits a long-standing discussion in Europe around whether regulators, including the Central Bank of Ireland, will allow non-transparent ETFs or whether they'll force ETFs to reveal their portfolios. It seems managers, on their own, are becoming more comfortable with revealing their portfolios like in the States.

One of our clients, for example, recently launched a European ETF, and every evening they publish the portfolio composition file (PCF) to the market making it easy for authorized participants (APs) to hedge. But at the same time, it delivers a really strong product for private wealth managers and institutional investors.

So, to summarize, I think there will likely be more active strategies coming to Europe. They'll likely be brought in by U.S. managers. And they'll likely be transparent.

Q: Why are ETF platforms so popular in the U.S., and will we see more of these vehicles in Europe?

A lot of the ETFs we service in the U.S. are on a platform, a framework known as a multiple series trust (MST).

Typically, if you're an asset manager in the United States, the route to market is to set up some sort of registered fund product, such as an investment company under the Investment Act of 1940 or even a trust under the Securities Act of 1933. This can entail a lot of commitment in terms of registration, capital, corporate setup, regulatory considerations and time. It can be quite an undertaking to build and will involve costs in terms of people, expertise and cash.

There is an alternative. If you're a smaller asset manager – maybe not as well capitalized – or even a manager of any scale with a unique strategy but limited time to capture that first-mover advantage, there's an easier way of handling this. You can go to a firm, like U.S. Bank, which has a corporate or trust vehicle for clients already in place. Then they can simply launch additional sub-funds for you with your branding and strategy but housed within their platform. So effectively, you end up renting space for your ETF on someone else's vehicle.

This is what we're referring to when we talk about an ETF platform. In the U.S., they've been tremendously popular and successful because they allow smaller asset managers who have really interesting and innovative strategies an easy and quick route to market. They simply rent a sub-fund, or a series, from somebody else who's already laid all the groundwork.

Q: What are the upsides and downsides of ETF platforms?

It's quicker and cheaper, but you don't have any control over the platform. You don't have people on the board. You don't have any say in service provider selection. And unfortunately, it doesn't make distribution any easier either – there aren't really any shortcuts to this. All it does is give you the ability to put your brand on a sub-fund and get it out into the market.

We've seen a number of these emerge in Europe, and I'm sure this trend will continue. Over time, we'll likely see more U.S. platform operators look to set up similar ones in Europe and vice versa. At U.S. Bank, we're well equipped to help with this in both directions, as we have a strong infrastructure, network and reputation in both the U.S. and in Europe.

Q: Do you think we'll see more ETFs based on single stock exposure emerging in Europe?

Another U.S. trend that stands out, based on the what we're seeing right now, is the high number of single-stock-leveraged products. It's interesting to think about how that might translate into Europe.

In the U.S., these products are set up in a pretty straightforward way – the same as any other ETF. But in Europe, these products aren't amenable to a UCITS structure. There are already a couple of firms leading the charge with these products in Europe, and I think we will see more of them.

Q: How could funds like this be set up?

Since this type of product rarely meet the UCITS diversification requirements, we'll probably see them set up as Section 110 special purpose vehicles. Section 110 is part of a finance act in Ireland (Taxes Consolidation Act, 1997) that, in an ETF context, can be used to issue notes to the market that are based on assets or asset classes that are not UCITS eligible – such as a portfolio of a single stock, or sometimes a single stock leveraged multiple times. These notes look and feel like the shares issued by a traditional ETF, but they're not UCITS.

This connects to another mini trend we're seeing in Europe, which is the ongoing push for more retail distribution. The European market still remains much more of an institutional market for ETFs, but that's slowly changing. We're seeing more app-style distribution channels targeted for different audiences – apps that curate, for example, pre-selected ESG funds or Sharia-compliant products. These can deliver certainty to their investors that any investments selected on the platform have been pre-screened to their own tastes.

Single-stock products are ideal for these types of distribution channels. As more of these channels come online and gain prevalence, we'll likely see more single-stock type products coming to Europe and being set up as Section 110 special purpose vehicles. It may take a few years, but it's definitely something to keep an eye on.

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