

FTfm | Exchange traded funds

# Dilemma for mutual fund managers

## COST LEVELS

Faced with losing business, should traditional groups embrace ETFs, asks **Kevin Burke**

With exchange traded funds garnering the bulk of new sales and attracting increasing interest from financial advisers, staying on the sidelines may no longer be an option for traditional mutual fund firms.

As a result, leaders at many fund complexes have tough decisions to make – either jump into a market that is foreign to them or continue to lose potential assets.

"This should be a huge thorn in the side of mutual funds' senior leadership," says Bruce Harrington, managing director of Cambridge, Massachusetts-based Cogent Research.

The big question for fund managers is whether the challenges of entering the market will generate new sales or cannibalise existing ones. Another consideration is the economics. ETFs have much leaner profit margins and success is predicated on volume.

Still, more investors are

warming to these largely index-based vehicles as a low-cost alternative to conventional mutual funds.

ETFs, which are baskets of securities that trade intraday on exchanges like a stock, are known for offering low fees, tax efficiency, liquidity and transparency.

Those attributes of ETFs have resonated in a big way with fee-sensitive US investors who endured a painful bear market in 2000-2002 and are facing another grim market today.

A string of scandals that hit the fund industry in the past few years have also soured many investors' attitude to active management.

Of the \$16.5bn (£8.3bn, €10.6bn) in net new mutual fund sales in the first quarter of the year, \$6.8bn came from ETFs alone. That represents 41 per cent of net new money, says Financial Research Corporation.

In 2007, ETFs represented 39 per cent of overall fund flows, with \$147.8bn in net sales compared with \$229.3bn for traditional mutual funds, FRC says.

"If you're Oppenheimer Funds, Franklin Templeton or some of the other big adviser-sold firms, you have to consider this seriously," Mr Harrington says.

Meanwhile, new ETFs continue to be churned out at a

breakneck pace that shows no signs of slackening. The Securities and Exchange Commission is loosening restrictions on the approval process, making it easier to bring newfangled ETFs to market.

In 2007, the US ETF industry added 270 products along with \$187bn in new assets. While ETFs still make up only a fraction of the total fund industry, their asset growth has been strong over the past decade. They now represent 74 per cent of net new assets under management, compared with 11 per cent in mutual fund assets.

ETF purveyors view the products as a superior way of delivering investment returns. "ETFs are to funds what CDs were to vinyl. They're the future," says Lee Kranefuss, chief executive of Barclay's Global Investor's intermediary and ETF business. "It causes indigestion for many people in the mutual fund world."

FRC predicts ETF assets will grow an average of 22 per cent a year to more than \$1,500bn by 2012, while active and passive mutual funds are expected to grow by an annual average of 10.5 per cent to \$13,000bn.

And in a weak market that has brought fund expenses into relief, ETFs offer a compelling value proposition.



**Lisa Cohen: 'a low-margin product is the future'**

The average expense ratio for equity mutual funds is 1.41 per cent compared to 0.53 per cent for a stock ETF, according to Morningstar.

The huge success of ETFs in the retail market has forced mutual fund companies to make some tough decisions about the future of their business.

"At some point, mutual fund companies have to face the issue," says Jeffrey Ptak, director of ETF research at Morningstar. "It's reasonable to expect they'll launch their own ETFs or acquire an ETF company."

Some fund companies have already gone down that route. In January 2006,

Invesco (formerly Amvescap) bought PowerShares for an estimated \$230m. In January 2007, Dreyfus entered a co-branding partnership with WisdomTree Investments.

More recently, Northern Trust entered the fray with a series of country-specific ETFs, something the company views as a natural extension of its institutional index business, where it has a very large footprint. And Security Benefit purchased Rydex Investments

Other fund companies are delaying a push because traditional mutual funds are more profitable than ETFs. "There is a reluctance to accept that a low-margin product is the future of the business," says Lisa Cohen, president of consulting firm Momentum Partners. Taking the plunge is not for the faint-hearted, she adds. "It's a tough business decision. It's a make-it-up-on-volume business."

It is a question of striking the right balance between the risk of losing market share by maintaining the status quo and cannibalising existing business by going the ETF route.

Financial advisers have expressed a keen interest in using ETFs more frequently in client portfolios. Since more than 80 per cent of funds are sold through some

type of intermediary, senior management cannot ignore demand from customers.

"There's a downward trend in the use of open-ended funds," says Cogent's Mr Harrington. "As firms continue to roll out actively managed versions, ETFs will only pose a greater threat to traditional mutual funds."

Indeed, the momentum behind the ETF phenomenon has become difficult to ignore, as shown by the industry's largest trade group finally acknowledging that it has gained a sphere of influence.

In January, the Investment Company Institute formed a permanent ETF committee, a signal that the products are elbowing in on traditional mutual fund turf.

The SEC has granted approval for actively managed ETFs, which analysts predict will boost acceptance among advisers and drive down fees for investors.

"The convenience of ETFs is very seductive for advisers," says Jonathan Steinberg, chief executive of WisdomTree Investments. "Most retail investors want advice. And a fee-based compensation model aligns the provider with advisers and their clients."

*Kevin Burke is a reporter on Ignites, an FT publication*