Investment culture in Europe stunts growth in ETF market

Different paths: ETFs started out as retail products in the US and as institutional ones in Europe © AFP

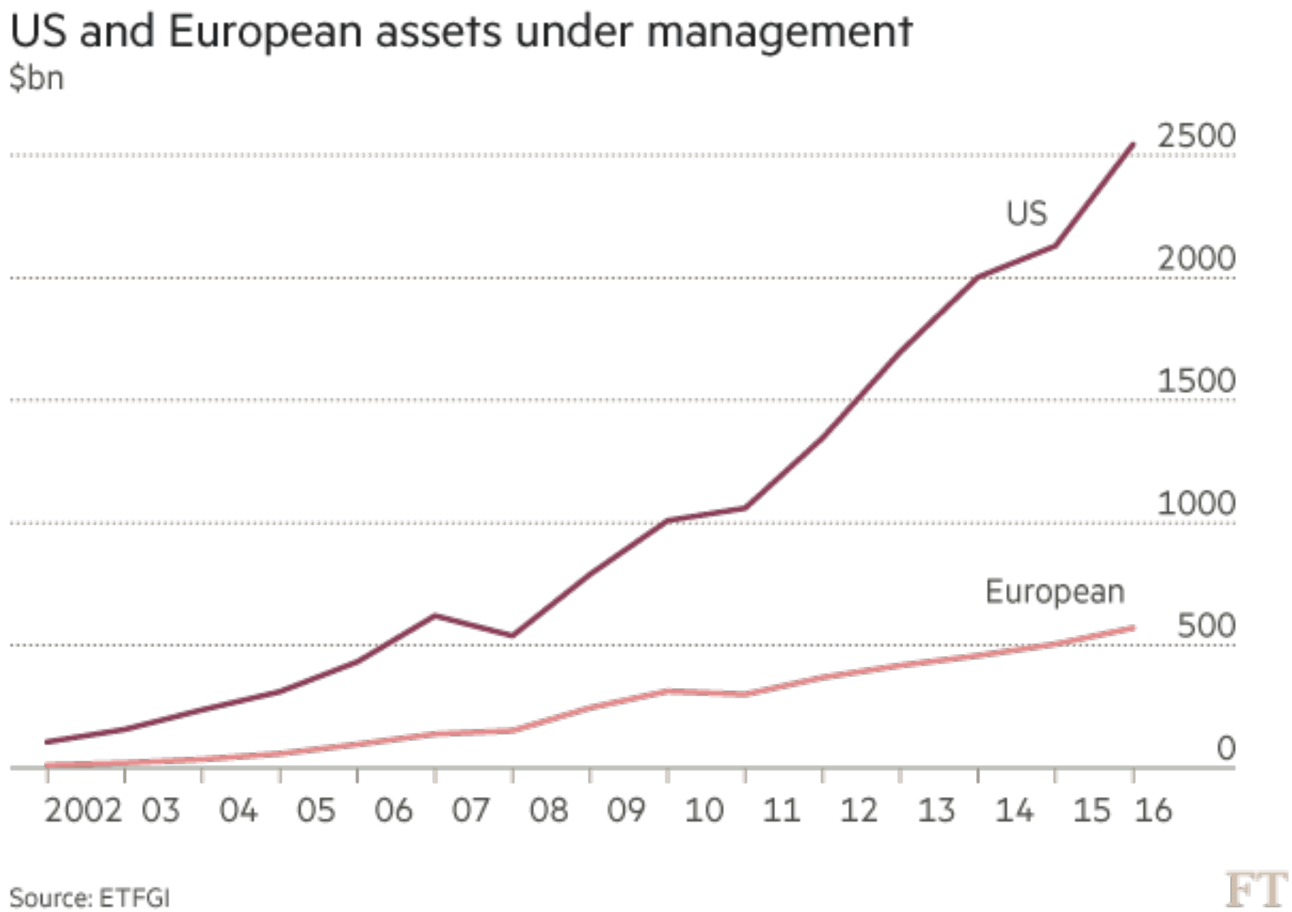
Europe's exchange traded fund industry has a lot of catching up to do if it is to match its US counterpart for size and reach.

At the end of 2016, European ETFs mustered $571bn in assets under management, against a US tally of $2.54tn, according to data from ETFGI, a consultancy. ETFs have also achieved greater penetration in the US. "Eighteen per cent of mutual fund assets are invested in ETFs in the US, while in Europe it is below 4 per cent," says Andreas Zingg, head of ETF distribution for continental Europe at Vanguard, the ETF provider.

In the past three years, 90 per cent of net fund flows in the US have been into passive funds. "It is remarkable what is happening in the US," says Jose Garcia-Zarate, associate director for European passive fund research at Morningstar. "In a sense, passive has become the default option for both institutional and retail investors." That has not happened yet in Europe, he adds, certainly for retail investors. Retail demand is a crucial missing ingredient in Europe.

The trends are favourable for that to change, but there are structural and technical barriers that probably mean Europe can never be as perfect a market for ETFs as the US. Some ETF providers believe Europe can grow at an even faster rate than the US has, helped by the maturity of financial markets. More think catching up is possible and expect ETFs eventually to become a staple in retail investors portfolios.

Cultural differences are among the factors limiting ETF reach in Europe. The US has long had an equity culture, while in continental Europe people have traditionally bought savings products via banks.



The pension landscape has also influenced attitudes. "In Europe, we don't manage our own pensions, as US investors do via their [defined contribution] 401k plans," says Jean-René Giraud, chief executive of TrackInsight, an ETF selection platform.

Manooj Mistry, head of passive asset management, Emea, at Deutsche Asset Management, says the US and European markets have evolved differently. "ETFs started out as retail products in the US, and as institutional ones in Europe."

The way funds are sold to retail investors is another major difference between Europe and the US. In most continental European markets banks are the dominant force and commission remains the main driver. This means passive funds have been neglected as they rarely pay commission to financial intermediaries and "banks are unwilling to market low-fee vehicles", says Mr Garcia-Zarate.

In the US, fee-based advice is widespread, providing an incentive for advisers to keep fund costs low. Regulation is slowly pushing in the same direction in Europe, with commission payments banned or restricted in the UK, Switzerland and the Netherlands. Restrictions will apply more widely when the EU directive known as Mifid 2 comes into effect in January 2018. "Regulators are pushing people more towards passive investing in Europe," says Julian Ide, chief executive of ETF provider Source.

Europe's ETF market, however, is handicapped by multiple listings, leading to fragmented liquidity and higher costs. ETFGI records 6,976 listings of 2,216 exchange traded products across 25 exchanges in Europe at the end of December. In the US there were 1,969 listings of exactly the same number of products on three exchanges.

Europe also suffers from lack of transparency on pricing. All trades in the US have to be reported to a publicly available source, but in Europe, 70 per cent of ETF trades are over-the-counter and are not reported.

Mifid 2 will help in that respect as it will require reporting of OTC trades, “which means the price at which an ETF trades will be available to all investors”, says Rachel Lord, BlackRock’s head of Emea iShares and index investments.

US investors also still enjoy tax advantages if they invest in ETFs, which do not apply in Europe. But despite the challenges, the drivers behind ETF take-up are much the same in Europe as in the US.

First is the prevailing low-yield environment that favours passive over active management as investors seek value for money by achieving the best combination of return, risk and cost. The regulatory focus on transparency is also supportive, as are industry trends, particularly the growing adoption of model portfolios and “robo” advice that produce standardised investment advice.

“In that type of world [model portfolios], there is less single security selection and ETFs show up better on that radar screen,” says Rory Tobin, co-head of SPDR, the ETF arm of State Street Global Advisors.

BlackRock predicts European ETF assets under management will pass $1tn by the end of 2020, and Ms Lord expects ETFs to rise from the 10th of retail investors’ assets they currently represent to up to half — the same level as for US investors.

Widespread retail investor adoption of ETFs is still some way off in Europe but the addition of ETFs to investment platforms may well be key, says Mr Giraud. Also, the fact that they can be traded on exchanges means there is less administration involved than in fund transactions. “That is important as it unlocks the barriers banks put in place to keep control.”