Research @ Citi Podcast, Episode 5: How ETFs Will Earn More of Your Assets

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Transcript:

Lucy Baldwin (00:00)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Rob Rowe (00:22)

Hi everyone, and welcome to our Research @ Citi podcast. My name is Rob Rowe. I'm the U.S. Regional Director of Research, and my guest today is Scott Chronert, who spearheaded our recent Must C, entitled *Sizing the ETF Opportunity: From Passive Revolution to Active [Evolution]* — our Must C publication, which we do have a public version of, so if you want to access it to a reach out to someone at Citi and we will get you a copy of it.

Scott, in terms of sizing the ETF opportunity, and I think behind this, is where we're seeing a secular shift between ETFs and mutual funds. But both of us have been in the industry for a long time. You know, when I went through the piece, I was thinking about the very first mutual funds that developed in the industry — it reminded me of all the passive index funds that then transformed, and then the move into ETFs or equity-traded funds, and now there's this other transformation which you've been writing about. Tell us what's going on in the industry. What is the context here in terms of these transformations? It seems like the industry always goes through an evolution.

Scott Chronert (01:37)

Yeah, I think that's spot on, Rob. And if you go back and look at the history of our markets in our industry, it tends to be entrepreneurial, very innovative, and we follow the path of technology over time. And, you know, trying to identify when a new emerging concept or construct is going to take hold is really interesting and often difficult. I like to remind that I've been writing on U.S. listed ETFs now since 2012, but 20 years ago, in my old sales and trading days, I was actually approached by one of the ETF sponsors as to whether I'd want to come run their institutional sales force. For the life of me, I couldn't figure out why I'd want to do that. It was like it was a nascent, small little thing going on, and it was a side show versus the much bigger, you know, stock selection world that we were living in at the time. You fast forward to now, and you know, ETFs become a much different, much different, profile in the marketplace. I also like to point out, you know, again, back in 2012 when we first launched, I was viewed as the enemy. You'd go in to see a mutual fund manager or any portfolio manager with "Hey, let me talk to you about why you ought to use ETFs in your market timing and portfolio construction." And you were the enemy. You were — you couldn't get out, you were ushered out of that meeting pretty quickly. So, my point here is that the world changes, the investment landscape changes, ETFs have come to the fore now as an increasingly important investment tool and with lots of implications that I think resonate with both traditional institutional investors all the way to retail investors.

Rob Rowe (03:13)

And I mean, one thing is, I think ETFs, because we've been in kind of a low vol, low rate environment up until now, but you know, post GFC, I always felt like the proliferation of ETFs were associated with being a passive investment. In other words, you were essentially just going after the market Beta. You weren't really trying to do Alpha generation, and maybe the challenge was that there wasn't a lot to do in terms of active management. But that's changing now, isn't it?

Scott Chronert (03:45)

Yeah. I mean, the way we put it out there — this is not proven but I feel pretty comfortable talking about it — is that if you think of the post-GFC world, the Fed was taking interest rates down to near zero, we went down the QE path. What you had to remember is that during that following decade, you know, the broader markets were struggling to grapple with economic growth and they were struggling to grapple with earnings growth. Along the way, what we now consider the [Magnificent] Seven stood out. They were outgrowing everything else in the marketplace, and against a low interest rate backdrop, you can assign whatever valuation you wanted. Well, my spin on this is that that perpetuated the focus on passive investing because so many active managers were struggling with that low-growth environment that the Fed was trying to stimulate. So, one thing led to another, and that era of passive investing really began to take hold, and a lot was discussed in terms of: Can active managers outperform consecutively or continuously? And, you know, that's for a whole different discussion, but it led to the growth in passive as an alternative to active, and then increasingly led to the growth of passive instruments via ETFs into trading tools that you could work into other means of managing a portfolio.

Where we're going now, in our view, is the other side of the pandemic, the global lockdowns, if you will, that has now ushered in a new era of, let's call it, you know, higher-for-longer inflation, and inflation concerns, higher-for-longer interest rates. What we're suggesting is that that might actually be marking a change in terms of this passive-versus-active landscape. And the setup going forward might just be down a more traditional active path.

Rob Rowe (05:41)

And so how does that transform the industry? I mean, you know, I think you talk a lot in there about ETF wrappers. Why would mutual funds be motivated to take on an ETF wrapper? Why would they be motivated to transform more into an ETF?

Scott Chronert (05:57)

Yeah. Okay. Great question. So, the starting point here is, you know, we'd like to say, among the prognostications that we've made that, you know, have had mixed actual impact, is that probably five years ago, we said, “Hey, look at, we think that the ETF industry is hitting its mature stage.” Right? And by mature, we meant that every passive index in the land had been replicated. And so, the toolkit that you could access was already broad, where would you go next? And, but again, entrepreneurial industry, you began to see movement down a more active path, whether it was smart Beta, whether it was thematic, whether it was ESG. Now it's becoming even more traditionally active. But the way we think about this, Rob, and is going to be through this notion of, let's call it being “wrapper-agnostic”. What I mean by that is that if you're an asset manager or a mutual fund complex, your IP, your proprietary, you know, intellectual property, if you will, is really your investment acumen. And the investment acumen comes from your investment process, your portfolio managers, the analysts that support them. If you step back and think about it as a traditional asset manager

or mutual fund complex, why should you be held to one wrapper to deliver your IP? So, so, that's what you've got, right? That's your leverage point into the marketplace. So, you want to be able to deliver it via whatever format might be most amenable to your investor base and whether it's a mutual fund, whether it's an SMA — separately managed accounts — and now increasingly ETFs. And so, what's happening is that more and more investment managers are taking a step down the ETF path. It may be in response to outflow pressures on the mutual fund side of their business, but it really is that, hey, look, we should be wrapper-agnostic in terms of how we deliver our capabilities from an investing perspective. And so that is underscoring, from both an offensive and defensive reason, why we're seeing more and more asset managers pushed down actively managed ETFs as a potential next big thing in this industry.

Rob Rowe (08:12)

And, and, remind me again, Scott, what are the advantages to the investor in the street in terms of being in an ETF versus a mutual fund? Is it, you know, just that you have a lot more enhancements on the ETF side? Is it liquidity? What are the advantages there versus staying in a mutual fund?

Scott Chronert (08:29)

Yeah. So, I think what's probably marketed first and foremost is this tax efficiency. And without getting into the details of the create/redeem process, the methodology by which you create more shares of ETFs is such that you're able to minimize your taxable gain situation, okay? And so, the tax efficiency of ETFs is put out there first and foremost. Second, you lose a lot of the distribution expense that comes with mutual funds and their traditional marketing approaches. And so, you tend to get a lower expense ratio, in part because you've simplified the structure. And then the third part, that I think is relevant, but for many longer-term investors, maybe not, is the intraday tradability. So, you have the ability to buy your investment product — in this case, an ETF. It may be a circumstance where the market opens down one day, and you think it's an opportunity, but if you wait to the end of the day close when mutual funds get marked and priced, you may have missed the opportunity in that intraday volatility. So now, the last part of this is from a marketing perspective and where the world tends to be taking us, it's actually much easier, in our view to be marketing an ETF that has a ticker, that you could monitor on the exchange every day, keep track of its performance much more cleanly in real time versus a traditional mutual fund, which again is being marked for its performance at the end of the day. All of these kind of play to the ETF as an alternative that has a lot of attributes. And, you know, we have to keep in mind, a lot of this is a function of the improvement in trading technology over the past couple of decades that really, at the end of the day, is underscoring a lot of the shift.

Rob Rowe (10:20)

And Scott, can you give me a sense of the size here and the scale that we're talking about? I mean, how large is the mutual fund industry? How large are ETFs? How much do you think of this secular change may happen in the short-to-intermediate term?

Scott Chronert (10:33)

Yeah. So, the flow pattern over the past ten years, Rob, has been very clear: out of mutual funds, into ETFs. I'm not going to pretend that it's one for one, but they're divergent trends. The way we're looking at the math here is that your aggregate U.S. mutual fund industry is somewhere around 25 trillion in AUM, about 6 trillion of that’s money market funds. So, we would say ex money market funds, you're looking at a $19 trillion mutual fund industry. By

comparison, ETFs have grown to now in the U.S. listed world, about eight-and-a-half trillion, and there's another one-and-a-half or two trillion in non-US ETF AUM. What we're arguing here and is the main feature of the note is that the way this is setting up, we think that the ETF industry can grow another 6 to 10 trillion in terms of flows away from mutual funds and into ETF wrappers, okay? So essentially, what that means is that ETFs for all the growth they've had in the past 20 years, may only be halfway through their life cycle.

Rob Rowe (11:44)

I see. And again, remind me how large is the mutual fund industry do you think right now?

Scott Chronert (11:49)

Right about 20 trillion, ex money market funds.

Rob Rowe (11:50)

20 trillion, okay.

In terms of that change, you mentioned in the Must C, there's a large section on a lot of retirement plans from DCs — defined contribution — to IRAs. You mentioned that as a stronghold for the mutual fund industry, but that may change also. But that sounds to me from what I read that it might be a more longer-term situation. But why is that a stronghold?

Scott Chronert (12:19)

Yeah. So essentially, when you go down the retirement path, that tax benefit you get with ETFs isn't quite as relevant because retirement assets, for the most part, are tax-exempt until they're distributed. So, the way we're seeing this right now is that the 401(k) industry, in particular, seems pretty well established with an infrastructure that's going to be more difficult for ETFs to naturally penetrate. We do think, however, that there are a couple of forces at work, that eventually will be such that ETFs will attract more of the retirement opportunity. Those forces are going to be really twofold. One is the transfer of wealth generationally, which you can usually do from a tax-efficient perspective. The second is the way we're living our lives. You're seeing more individuals leave their jobs more quickly after a shorter duration in the position. Usually what happens is that if you were in a 401(k) plan, you leave your firm — either on your own or because corporate changes took place — you get distributed your 401(k), which you can then go reallocate into an IRA, which does have the ability to self-manage. So, I guess what we're saying here is that over time, yes, the 401(k) stronghold for mutual funds will gradually change, but that will be measured in years, not weeks and months. But it is tied to what we think is this very fascinating underlying demographic shift where the younger cohorts of investors are growing up in an ETF world. They're much more comfortable with the flexibility and tremendous array of opportunities that ETFs provide as a way of allocating portfolios.

Rob Rowe (14:15)

One question, prior question, I wanted to ask too, Scott, from the prior discussion on the development, is: Do we have a sense of how many ETFs are currently actively managed?

Scott Chronert (14:26)

Well, the number is growing rapidly, and it gets a little bit complicated because you can get into dual-class. But, right now you've got over 3,000, 3,200, 3,300 U.S. listed ETFs, right? And that's including equities and fixed income, Rob. I don't have the number off the top of my head in terms of the number of actively managed, but that active definition can

sometimes come into the discussion. What I would say, however, is that on the fixed income side, more products tend to be actively managed as a function of the way they're constructed. On the equity side, the push is towards active, but you've got a lot of embedded AUM in these passive strategies. So, if we're measuring the number of actively managed ETFs in the hundreds, their percentage of aggregate AUM is still quite small.

Rob Rowe (15:20)

It almost sounds like a cultural shift in terms of folks not staying in jobs as long and then shifting around a lot. And I think you also mentioned a conversion from 401(k) to IRAs, right, where this could also be an area where you could see a shift into ETFs. Are there other demographic considerations that we think about in terms of the retirement community that could motivate one way or the other in terms of ETFs?

Scott Chronert (15:47)

Yeah. I think, like I said, the main one here is the longer-term, you know, age differential. When you look at the cohort of individuals that own mutual funds, they tend to be, let's call it, that Baby Boomer cohort.

Rob Rowe (16:00)

Sure.

Scott Chronert (16:01)

So, what ends up happening, is that if they've held mutual funds over the years, they have had embedded gains in those. If they sell the mutual funds now to hand off the assets to their heirs, you're going to be taxed, right? If you hold until you actually generationally pass, then you pass at then-market value until your heirs get the assets at a different starting point. I don't want to get too much into tax angles on this.

Rob Rowe (16:26)

Got it.

Scott Chronert (16:28)

But you do have that kicking in as the bigger, let's call it generational move. And then, under the surface, like I said, I think what's happening is that increasingly the ETF sponsors, they're looking at that 401(k) opportunity, and they're saying “Hey, look, why can't we be part of this? We can provide a more interesting, diversified toolkit in terms of investment options than is typically being delivered by current 401(k) plans.” So, under the surface here, there is flexibility, and the magnitude of more targeted exposures you can get via an ETF, versus what's traditionally offered through 401(k) plans, that all over time is going to be part of the push to “Hey, I want more of these ETFs and maybe lesser of these more defined investment opportunities that you, the 401(k) sponsor, are offering to me.”

Rob Rowe (17:27)

Fantastic, Scott. Well, listen, thanks so much. This is another very big secular shift going on in our industry. It'll be interesting to see how it plays out. I think it'll make more active managers in a sense out of all of us. We’ll see. Thanks again, Scott.

Scott Chronert (17:43)

Thanks, Rob. Appreciate the time.

Lucy Baldwin (17:45)

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