Two-step plan to conquer Europe and then beyond

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As hedge funds fall left, right and centre, and traditional fund managers struggle with ongoing outflows, one sector of asset management is flourishing.

The number of European exchange traded funds has risen by nearly 40 per cent this year to 523, while exchange traded commodities have more than doubled to 123.

Assets continue to flow into these structures, as investors ask themselves why they would pay higher fees for active managers to lose money for them.

But the proliferation of ETFs means an investor looking for passive exposure to a major index has to choose between different providers or different venues, and should also take into account that some ETFs buy the basket of underlying stocks, while others use swaps to replicate the returns of the relevant index.

US company XTF hopes to take advantage of this potential confusion. It claims to be the only provider of quantitative ETF ratings in the US and is eyeing the European market.

“We have to realise not all ETFs are created equal and not all listings venues are equal in terms of the liquidity and access they provide,” says Alexander von Perfall, chief network officer at XTF.

This line echoes the wording of a recent advertising campaign from the world’s largest ETF provider, Barclays Global Investors, but BGI’s ETF expert, Deborah Fuhr, is dubious about the usefulness of a ratings system.

“What people want to know is what benchmark they want to track, and qualitative things such as domicile, whether it has UK distribution, what currencies it is available in, the assets under management,” she says.

“It comes down to these qualitative factors, as opposed to star ratings, which are not very meaningful if it’s not tax-efficient.”

Nevertheless, XTF is going ahead with its plan to rate European ETFs. However, this will be a complicated process because, unlike US funds, ETFs compliant with Ucits III, the European fund directive, are allowed to use swaps to replicate an index. So XTF has a two-step plan.

First comes a relatively straightforward catalogue of the ETFs available, including their cost and tracking error.

This information is already available from a number of sources, although most of them are themselves ETF providers, such as BGI and Deutsche Bank, which runs db x-trackers.

“Providers see the benefits of having a third party platform serve as a data aggregator,” says Mr von Perfall. “They see the utility of having a third party aggregate and redistribute data to financial advisers.”

This confidence is based partly on experience in the US, but also on initial talks with ETF providers in Europe, on whom XTF will have to rely heavily for data.

Although the initial phase, in which tracking error and cost ratio (including market impact), will mimic the American rating system, the next stage will be much more difficult and will rely heavily on the providers being prepared to work with XTF.

“We know how to deal with full replication ETFs – we can rate almost the entire BGI iShares straight out of the gate, for example – but the onus is on trying to find a way to rate both full replication and swaps-based ETFs [to make them comparable],” says Mr von Perfall.

The challenge with swaps-based ETFs is to incorporate counterparty risk in the ratings. This not only involves identifying the counterparties, but also discovering the value of the swaps, which changes daily, as well as what collateral is held and how it is managed.

“There is no easy way to solve the valuation of swap-based ETFs other than working with the providers,” admits Mr von Perfall.

He expects the initial phase of information aggregation to be sufficiently welcome to providers that they will then be prepared to work with XTF to make the next stage, analysing the risk of swaps-based ETFs, feasible.

“Swap-based exposures will need information about OTC derivatives and all changes to creation and redemption baskets,” he says. Although this close relationship might be seen to impinge on the independence of XTF ratings, Mr von Perfall is optimistic it will not be an issue.

“It does create a dependency, but as long as our ratings are rules-based and there is transparency around those rules, we don’t believe it is an unhealthy dependency.”

Current users of ETFs, mostly institutional in Europe, seem underwhelmed by the prospect of ETF ratings.

Johanna Schroder, head of diversified growth at Schroders, which uses ETFs to gain exposure to various markets, conceded ratings could be beneficial but seemed unenthusiastic about the prospect, since she relies largely on cost as a differentiator.

This lacklustre response may not intimidate XTF, because its intention is to widen the potential market for ETFs to include retail investors. Currently European retail investors remain blind to the products, partly because they still look to active managers to provide them with outperformance, but mainly because distributors have not embraced them as they do not pay commission.

“Deutsche Börse and the ETF providers are keen to expand their client base,” says Mr von Perfall. “At the moment, there is €30bn [£26bn, $38bn] in the German ETF market. That is 90 per cent institutional.”

If the ETF providers could achieve the same success in the retail market as they have in the institutional market, they would be sitting pretty.

Although XTF would be the first to offer ratings that include measures of counterparty risk, it is not the first to rate European ETFs. Both Lipper and Morningstar have paid careful attention to these popular vehicles.

“We tag them with the ETF label, but we rate them with the same quantitative method as other open ended funds,” says Christopher Traulsen, director of fund research, Europe, at Morningstar.

“In the US, we have an ETF research group tied into the equity qualitative research group.”

This offers insights into whether Morningstar feels the markets tracked by ETFs are under- or overvalued, rather than the quality of the ETF itself.

Lipper also looks at ETFs in a quarterly report, but again does not go into the detail of how swaps-based ETFs manage their risk.