# Europe’s ETF Future

Does the long-established US fee-based advice environment portend a coming surge of ETFs/ passive funds in Europe under MiFID II?

*December 2015*

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# Summary

1. Two **key drivers** dictate the short-run dynamics between investment managers and distributors as it relates to engaging end-investors: **balance of fees earned and ultimate control of end-investor relationships.**

2. The long-established incentive structures in Europe to distribute full fee **"building block" mutual funds centered on product retrocessions are dissolving**. While taking place at varying rates across the globe, the direction is clear – fees are headed down.

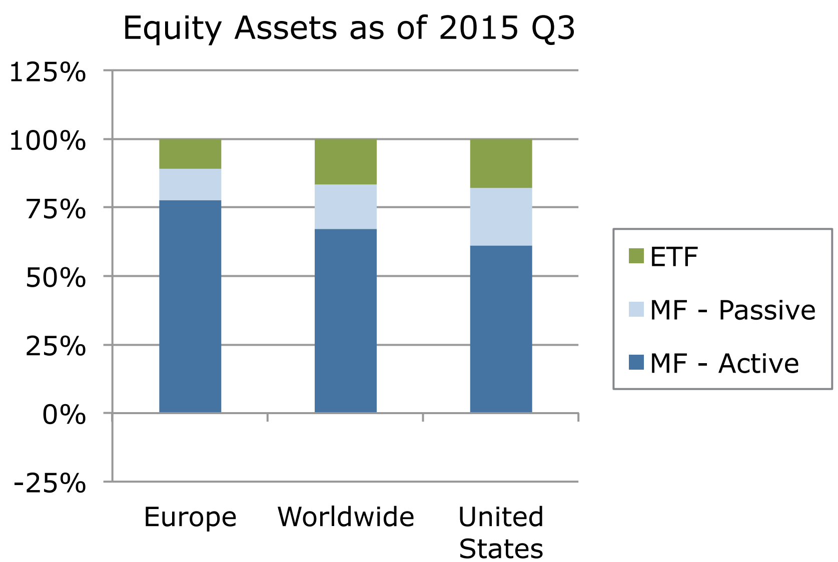
3. Basic **market access**, once only available through actively managed full fee "building block" funds, **is now cheap and ubiquitous through passive mutual funds and ETFs**.

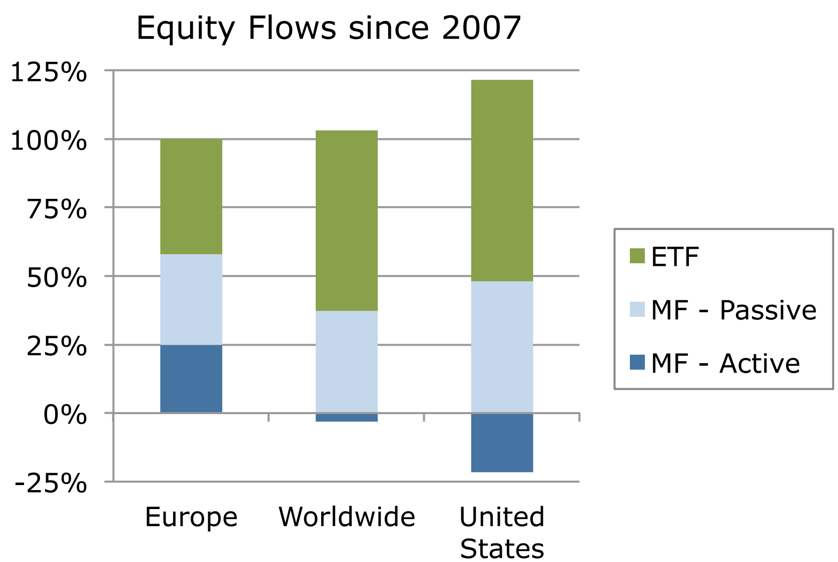
4. If **product trends in the U.S. are any indication of what Europe should expect in 'an advice for fee' environment, the shift from active 'building block' mutual funds to passive funds and ETFs is set to explode in adoption.**

5. The U.S. wealth management industry, driven by market forces, shifted from product dependent 'transaction' to 'fee-based' advice compensation models beginning 15 years ago. In Europe regulators forced the change in a fraction of the time – the impact on traditional asset managers is just beginning to be felt.

6. Investment **managers must find ways to differentiate themselves and reposition their value to distributors**. Building block funds will not suffice into the next decade. Exceptional specialist strategies offering robust alpha, liquid alternatives and multi-asset solutions are the way forward for active managers.

# Equity by region – US has led the march towards ETFs



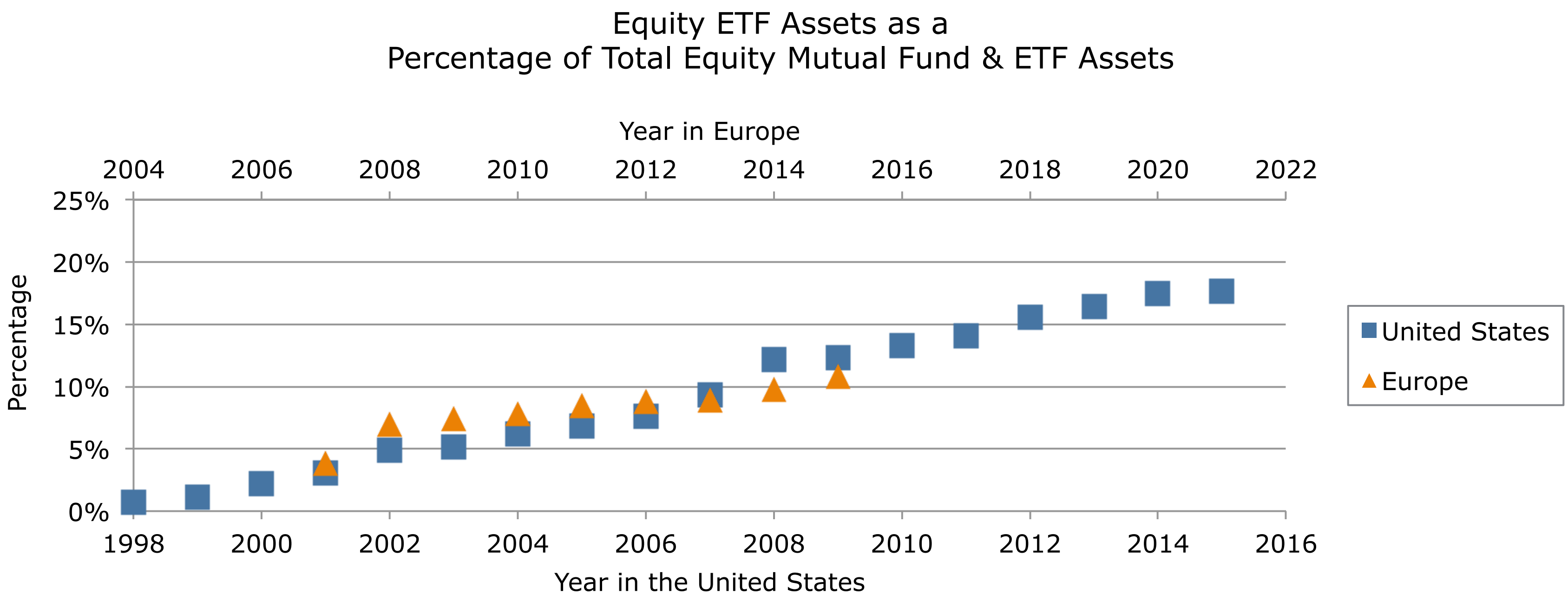




- US actively managed ‘equity’ mutual funds currently make up 61.2% of the total US ‘equity’ mutual fund & ETF universe by assets ($8.6 trillion). European actively managed mutual funds make up a larger portion (77.7%) of the smaller European ‘equity’ mutual fund universe by assets ($2.6 trillion - a third the size of the US ‘equity’ market).
- The United States has led the way in ETF adoption. ETFs have accounted for 73.5% ($978.1 billion) of the $1.3 trillion in US ‘equity’ flows since 2007 (separate accounts excluded). European ‘equity’ ETFs account for 42.1% ($164.8 billion) of the $391.7 billion in European flows in the same period.
- **Actively managed ‘equity’ products have accounted for 24.9% of total ‘equity’ net flows since 2007 in Europe, -3.2% Worldwide and -21.6% in the US.** The US has a higher portion of their assets in ETFs than Europe does, but is this driven by a fundamental difference between the regions or is the US a leading indicator? It’s the latter.



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

# The six year lag




- Over the past 17 years the percentage of total combined ‘equity’ mutual fund & ETF assets that are ETFs in the United States has grown steadily (approximately 1% per year) from 0.7% in 1998 to 17.7% today.
- When the European percentage of mutual fund & ETF assets in the global broad category ‘equity’ ETFs is graphed with a six-year lag the trends align. Europe’s adoption rate in 2015 parallels that of the United States in 2009.
- **What is the value of advice? – how end-investors end up paying for it determines fee distribution. Fee for advice models drive down fees for underlying building blocks.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors © 2015 Propinquity Advisors LLC*

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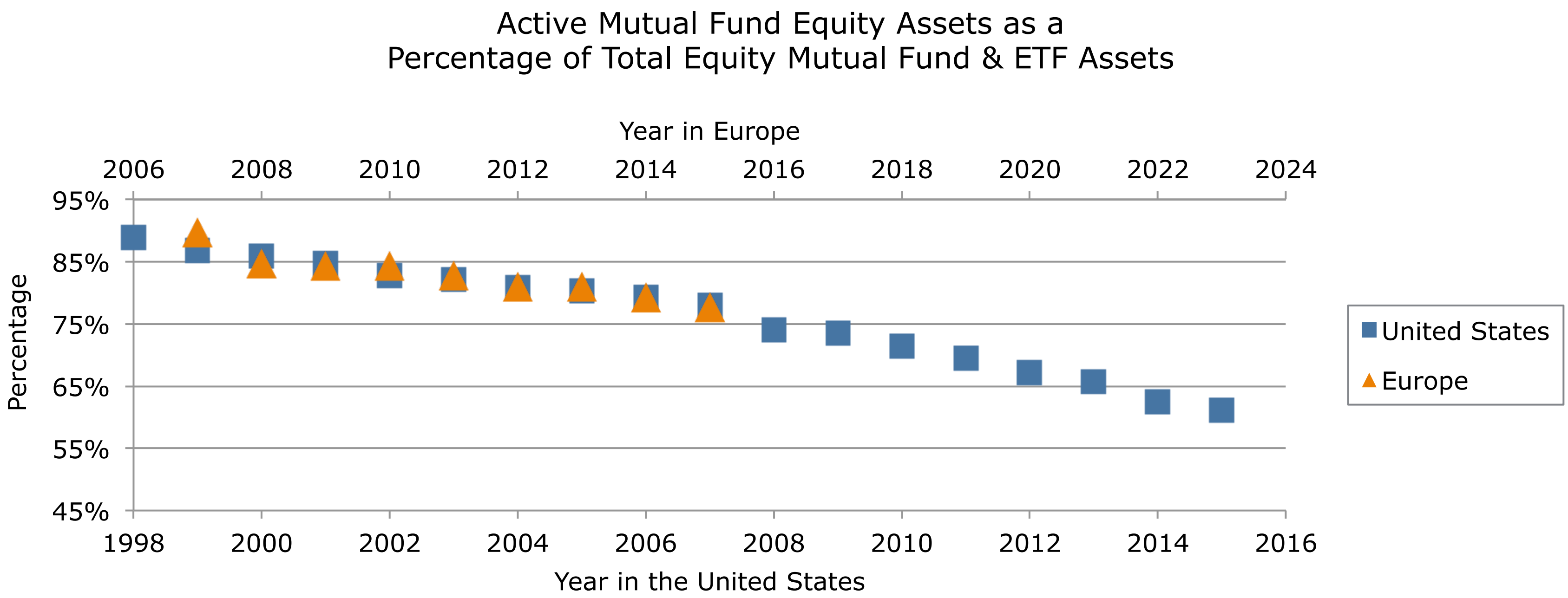
# The eight year lag




- An even stronger relationship occurs comparing active mutual fund 'equity' assets as a percentage of total mutual fund & ETF 'equity' assets. Europe is operating on an eight year lag. **If the United States is used as the leading indicator, Europe's future active 'equity' mutual funds will make up less than 70% of total 'equity' mutual fund & ETF assets by the beginning of 2020 (down from 77.7% today).**
- **This trend is driven by economic incentive structures –** if you want to know what distributors are inclined to do, take a look at how they are paid. With full transparency to total fees paid, end-clients will continue to demand cheaper products. **There is increasing incentive for distributors to offer more services and to charge higher fees for the advice in a bundled environment while paying less for the underlying building blocks of investor portfolios. But only to a point…**

*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 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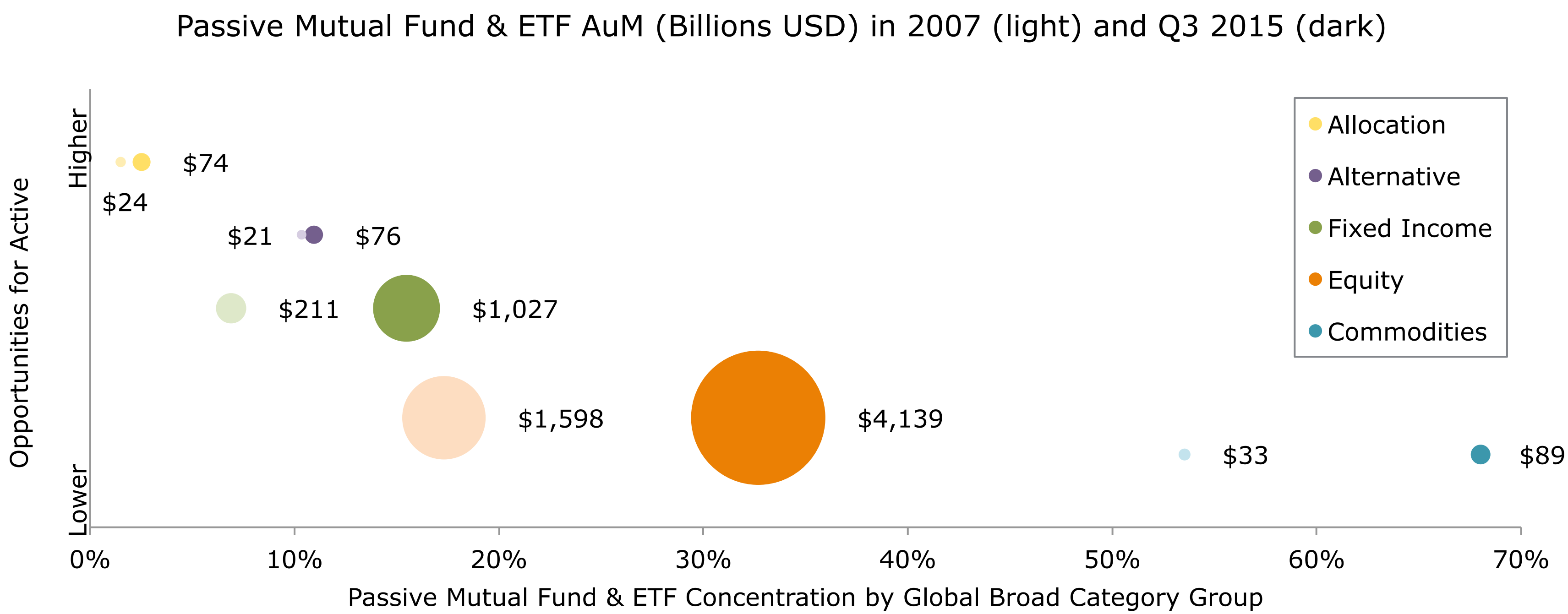
# An evolving fee regimen


- Incentive structures dictate commercial relationships between investment managers and distributors. Relationships between these two entities are no longer as clear and singularly aligned as they were pre-2008.
- Since the disruption to retrocession-logic (brought on by the free market in the US and regulation in Europe) **the commercial incentive structure has changed**. Distributors are rethinking their business models to reflect the shift from both transaction-based sales and product-derived retrocessions.
- The US market is now largely driven by a fee-based environment. As Europe is now experiencing with the 'cleansing' of share classes, share classes for active funds in the US have expanded to reflect demand for institutional share classes. Demand for 'load' (sales charge) funds has fallen off a cliff. Still largely transaction-based, Asia-Pacific as a whole is approximately 10 years behind this transition – regulatory changes have a remarkable way of speeding up the clock.
- Commercial and investment decisions are more bound than ever. The contemporaneous investment challenges to active management through the bull market have added to the pressure on active funds. **103.2% of worldwide net flows into 'equity' since 2007 have been towards ETFs and passive mutual funds as opposed to -3.2% into active mutual funds.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

# Where are opportunities for active managers?




- The marker size illustrates the Worldwide passive mutual fund and ETF AuM (as shown in the data labels, billions USD). The markers further to the right have a higher percentage of assets in passive mutual funds & ETFs (x-axis).
- 'Commodities,' 'equity' and 'fixed income' have seen the highest increases in passive mutual fund & ETF concentration since 2007.
- Investment managers offering active strategies need to be highly aware of their positioning – particularly into those areas in which 'activeness' (our term: Degrees of Investment Freedom) are highest. Opportunities certainly exist in 'fixed income' and 'equity' but they are away from narrow 'building blocks' towards differentiated alpha and solutions.



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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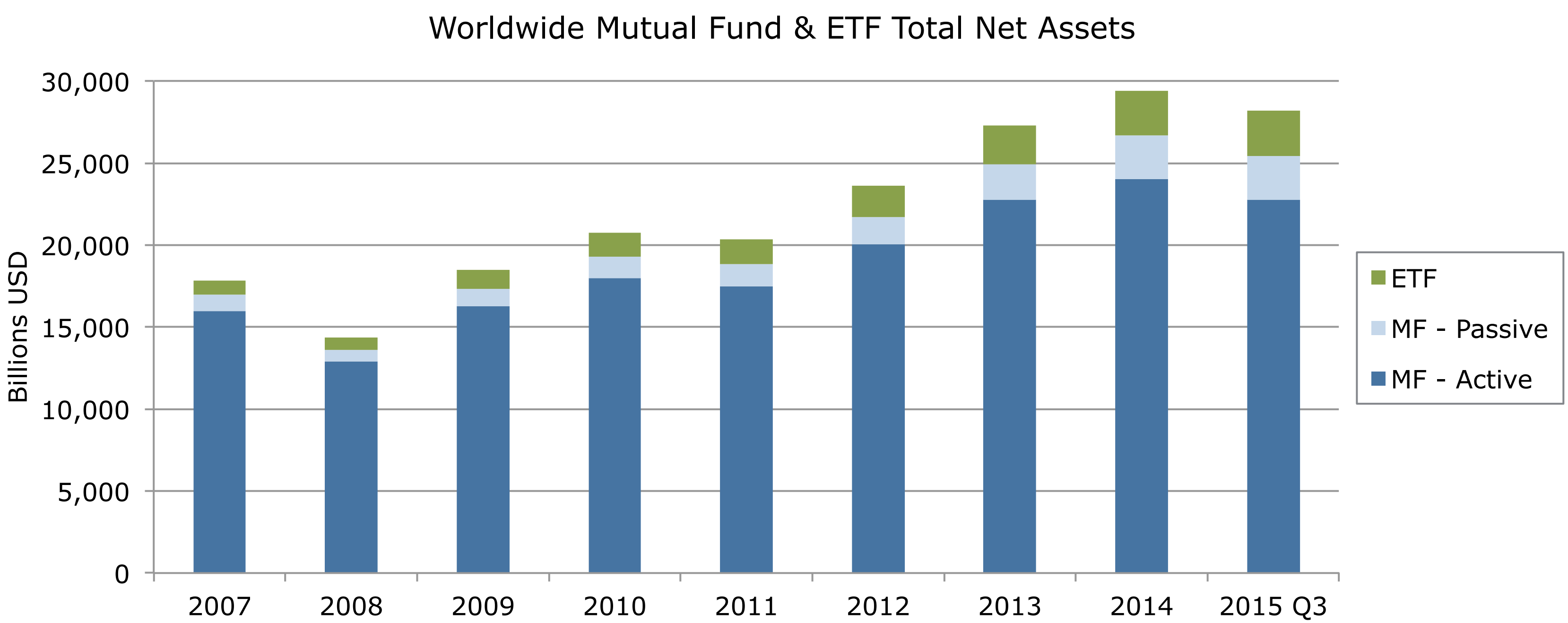
# Active or passive?

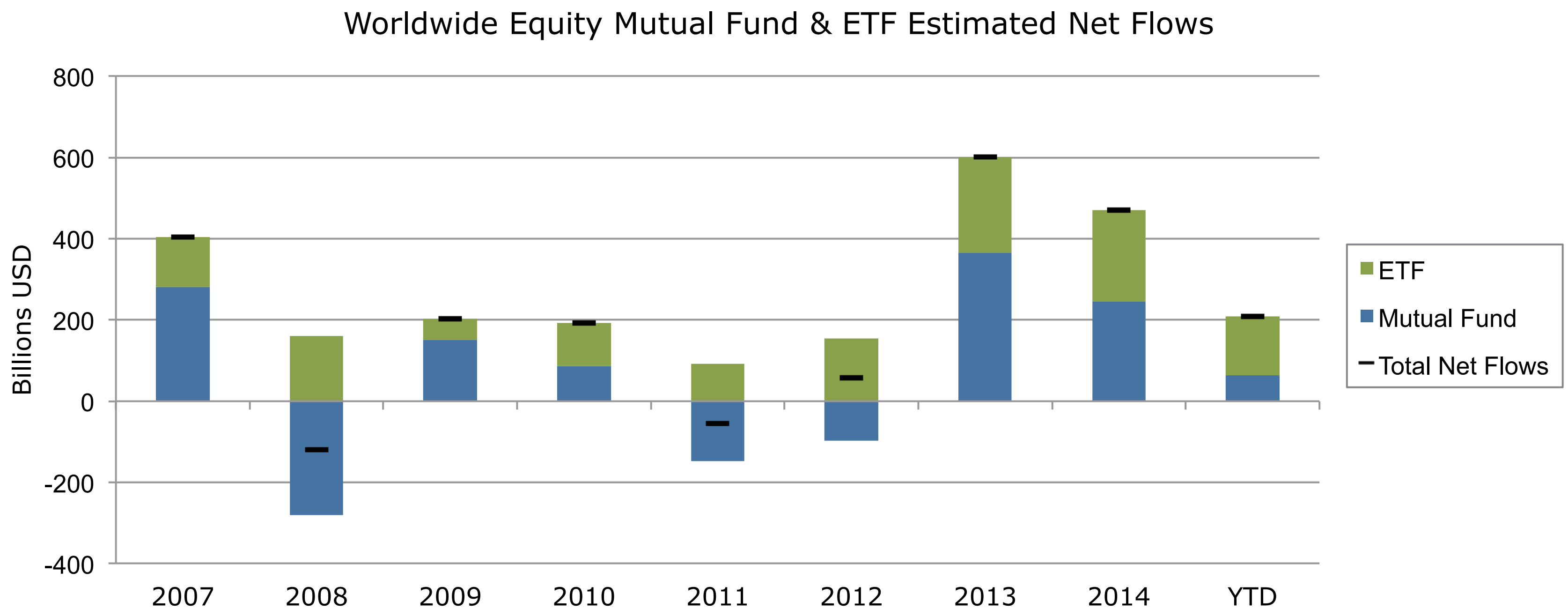



- The Worldwide mutual fund & ETF universe has grown from $17.9 to $28.2 trillion (1.6x) since 2007. Actively managed mutual funds made up 89.4% ($16.0 trillion) of all assets in 2007, but today make up 80.7% ($22.8 trillion).
- This trend has emerged because inflows for ETFs and index mutual funds remain strong even when the market, and consequently active mutual funds, do poorly. **Passive mutual fund and ETF assets are more insolated**.
- This steady increase in passive mutual funds & ETFs illustrates that this trend is controlled by forces more steadfast and reliable than market movements **– there is a fundamental change occurring driven by a combination of shifting incentive structures and near-term challenges to active vs. passive performance through the extended bull market.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors © 2015 Propinquity Advisors LLC*

# Years of negative flows for active equity




- The 'equity' mutual fund universe has grown from $8.5 to $10.6 trillion (1.2x) while the 'equity' ETF universe has grown from $754.4 to $2,097.7 billion (2.8x).
- 'Equity' ETFs have positive inflows for all seven periods above totaling $1.3 trillion since 2007. Mutual funds have totaled $669.5 billion in net flows over the same period, but experienced outflows in 2008, 2011, and 2012.
- **Active mutual funds, for all global categories, have received 58.1% of inflows since 2007 even though they claim 80.7% of assets. Relative to their asset base, active funds have been underperforming in terms of flows for almost a decade.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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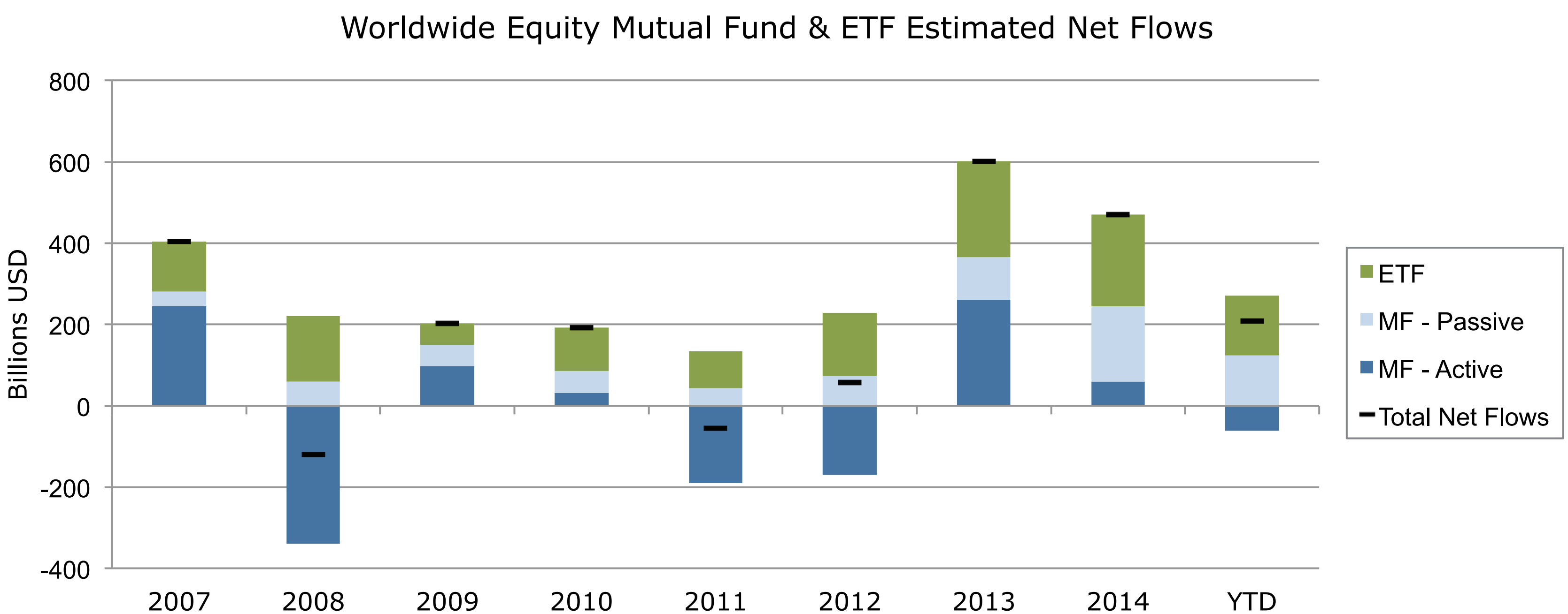
# Are active equity managers in trouble?




- **Actively managed 'equity' funds account for 67.3% of the total 'equity' assets in the worldwide mutual fund & ETF universe ($8.5 out of $12.7 trillion); however, they have accounted for -3.2% of the flows since 2007 ($63.1 billion in outflows out of $1,965.3 billion in inflows).**
- In every period above, ETFs & index mutual fund flows are positive while active mutual funds have experienced outflows in 2008, 2011, 2012, and 2015 YTD.
- **In 2012 and 2015 YTD 'equity' as a whole maintained positive inflows. Investors have not been fleeing 'equity', they are abandoning building block active funds for cheaper passive ETF & mutual funds.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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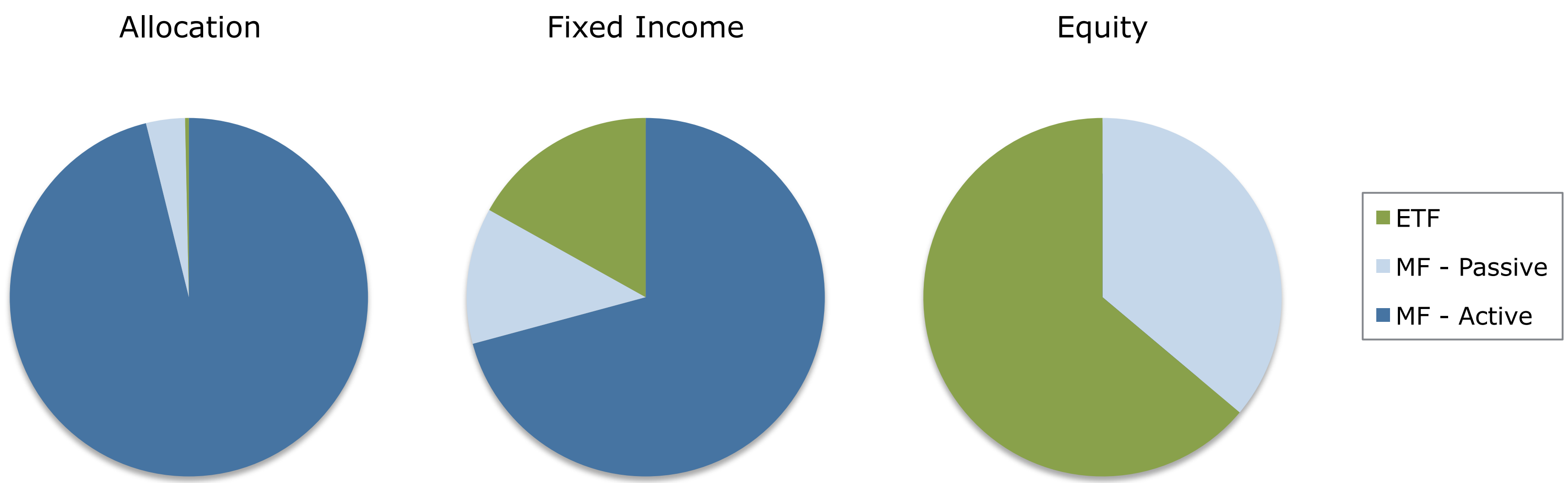
# Point of entry – Worldwide net flows since 2007




- 65.9% of Worldwide ‘equity’ flows (into mutual funds and ETFs collectively) since 2007 have gone into ETFs. The largest, most efficient segments are dominated by a few large players. The SPDR S&P 500 ETF makes up 52.5% of the assets in the ‘US ETF Large Blend’ Morningstar category.
- Despite Worldwide trends away from active funds, ‘allocation’ flows since 2007 have been dominated by active mutual funds (96.1%). ‘Fixed income’ occupies the middle ground with active mutual funds accounting for 70.8% of net flows since 2007.
- For ‘equity’ Worldwide active mutual fund net flows since 2007 were -3.2% of total flows. This negative value is not pictured on the ‘equity’ chart. The chart illustrates the divide between the positive net flows for passive mutual funds and ETFs.



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors © 2015 Propinquity Advisors LLC*

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# Periodic Table of Worldwide Active Mutual Fund Flows (Billions USD)

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | YTD |
|---|---|---|---|---|---|---|---|---|
| Money Market $480 | Money Market $905 | Fixed Income $503 | Fixed Income $364 | Fixed Income $105 | Fixed Income $559 | Equity $261 | Allocation $261 | Allocation $151 |
| Equity $252 | Commodities $2.2 | Equity $117 | Allocation $99 | Alternative $36 | Allocation $88 | Allocation $226 | Fixed Income $232 | Alternative $88 |
| Allocation $109 | Property $1.1 | Allocation $52 | Alternative $56 | Allocation $32 | Alternative $43 | Alternative $94 | Money Market $95 | Fixed Income $56 |
| Fixed Income $95 | Convertibles ($9.2) | Alternative $41 | Equity $42 | Commodities $8.9 | Money Market $10 | Fixed Income $23 | Alternative $89 | Property $8.7 |
| Commodities $3.2 | Alternative ($36) | Convertibles $18 | Commodities $19 | Property $0.2 | Commodities $2.6 | Convertibles $18 | Equity $61 | Convertibles $1.8 |
| Convertibles $2.2 | Allocation ($59) | Commodities $17 | Convertibles $1.3 | Convertibles ($6.4) | Convertibles $2.2 | Property $6.4 | Property $14 | Commodities $1.6 |
| Property $0.6 | Fixed Income ($77) | Property $1.2 | Property ($0.5) | Money Market ($46) | Property $1.3 | Commodities ($6.3) | Convertibles $7.7 | Money Market $1.1 |
| Alternative ($6.8) | Equity ($336) | Money Market ($301) | Money Market ($483) | Equity ($223) | Equity ($168) | Money Market ($16) | Commodities ($3.7) | Equity ($58) |

- Worldwide active mutual fund assets have grown from $15.9 to $22.9 trillion from 2007 to Q3 2015 (1.4x).
- Worldwide active mutual fund estimated net flows increased from $608.5 to $803.9 billion from 2013 to 2014 (1.3x). Year to date flows have reached $295.0 billion, which is not on pace to match 2013 or 2014.
- **The slow, but steady movement of 'allocation' and 'alternative' indicates changes in market demand for active strategies.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

# Periodic Table of Worldwide Passive MF & ETF Flows (Billions USD)

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | YTD |
|---|---|---|---|---|---|---|---|---|
| Equity $159 | Equity $222 | Equity $105 | Equity $160 | Equity $138 | Equity $228 | Equity $340 | Equity $411 | Equity $270 |
| Fixed Income $32 | Fixed Income $36 | Fixed Income $101 | Fixed Income $74 | Fixed Income $67 | Fixed Income $118 | Fixed Income $57 | Fixed Income $167 | Fixed Income $113 |
| Alternative $10 | Alternative $20 | Commodities $38 | Commodities $19 | Alternative $11 | Commodities $20 | Alternative $12 | Allocation $8.5 | Alternative $18 |
| Commodities $8.7 | Commodities $16 | Alternative $24 | Alternative $9.1 | Commodities $6.9 | Allocation $3.6 | Allocation $5.0 | Alternative $7.7 | Allocation $6.4 |
| Allocation $4.0 | Money Market $11 | Allocation $3.9 | Allocation $2.8 | Allocation $2.5 | Alternative $2.0 | Convertibles $0.9 | Convertibles $1.2 | Commodities $4.0 |
| Money Market $3.2 | Allocation $0.8 | Convertibles $0.2 | Convertibles $0.3 | Money Market $0.4 | Convertibles $0.2 | Money Market ($1.9) | Money Market $0.5 | Money Market $2.5 |
| Convertibles <$0.1 | Convertibles <$0.1 | Money Market ($6.0) | Money Market ($0.9) | Convertibles $0.3 | Money Market ($0.3) | Commodities ($42) | Commodities ($1.1) | Convertibles <$0.1 |

- Worldwide passive mutual fund & ETF assets have grown from $1.9 to $5.4 trillion from 2007 to Q3 2015 (2.9x), which more than doubles the growth rate of the worldwide active mutual fund market over the same period.
- Worldwide passive mutual fund & ETF estimated net flows increased from $373.0 to $593.8 billion from 2013 to 2014 (1.6x). Worldwide flows through the first three quarters of 2015 are $413.0 billion. Passive mutual funds & ETFs, unlike active mutual funds, have already passed 2013 flow totals.
- **For active mutual funds 'equity,' 'fixed Income' and 'money market' exhibit an ebb and flow related to global market movements**. ETF flows display a higher consistency than mutual funds in terms of which categories receive the highest flows. This can be partly attributed to ETFs being used as less expensive building blocks, which is slowly **pushing mutual funds out of 'equity' and into 'allocation' and 'alternative.'**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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# Periodic Table of Worldwide Mutual Fund Flows (Billions USD)

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | YTD |
|---|---|---|---|---|---|---|---|---|
| Money Market $489 | Money Market $913 | Fixed Income $543 | Fixed Income $397 | Fixed Income $126 | Fixed Income $605 | Equity $367 | Fixed Income $313 | Allocation $156 |
| Equity $282 | Commodities $2.0 | Equity $150 | Allocation $102 | Alternative $36 | Allocation $91 | Allocation $230 | Allocation $269 | Fixed Income $94.8 |
| Allocation $114 | Property $1.1 | Allocation $56 | Equity $86 | Allocation $33 | Alternative $43 | Alternative $96 | Equity $244 | Alternative $85.9 |
| Fixed Income $107 | Convertibles ($9.4) | Alternative $42 | Alternative $56 | Commodities $9.3 | Money Market $12 | Fixed Income $58 | Money Market $89 | Equity $63.7 |
| Commodities $3.2 | Alternative ($37) | Convertibles $18 | Commodities $19 | Property $0.1 | Commodities $3.1 | Convertibles $18 | Alternative $80 | Property $9.0 |
| Convertibles $2.2 | Allocation ($57) | Commodities $17 | Convertibles $1.2 | Convertibles ($5.8) | Convertibles $2.0 | Property $6.5 | Property $14 | Commodities $3.1 |
| Alternative $1.0 | Fixed Income ($73) | Property $1.1 | Property ($0.5) | Money Market ($47) | Property $1.2 | Commodities ($6.2) | Convertibles $7.8 | Convertibles $1.8 |
| Property $0.7 | Equity ($280) | Money Market ($305) | Money Market ($487) | Equity ($147) | Equity ($96) | Money Market ($21) | Commodities ($3.2) | Money Market ($6.1) |

- Worldwide mutual fund assets have grown from $17.0 to $25.5 trillion from 2007 to Q3 2015 (1.5x).
- Worldwide mutual fund estimated net flows increased from $756.2 to $1,079.0 billion from 2013 to 2014 (1.4x). Flows through the first three quarters of 2015 have reached $467.9 billion, which is not on pace to match 2013 or 2014.
- 'Fixed income' is no longer the mutual fund flow champion it was after the financial crisis. 'Allocation' has been making headway due to a shifting market incentive structure.



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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# Periodic Table of Worldwide ETF Flows (Billions USD)

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | YTD |
|---|---|---|---|---|---|---|---|---|
| Equity $123 | Equity $161 | Fixed Income $61 | Equity $107 | Equity $92 | Equity $155 | Equity $234 | Equity $227 | Equity $146 |
| Fixed Income $16 | Fixed Income $30 | Equity $52 | Fixed Income $40 | Fixed Income $47 | Fixed Income $73 | Fixed Income $22 | Fixed Income $83 | Fixed Income $70 |
| Alternative $10 | Alternative $21 | Commodities $37 | Commodities $19 | Alternative $12 | Commodities $19 | Alternative $11 | Alternative $7.8 | Alternative $19 |
| Commodities $8.7 | Commodities $16 | Alternative $24 | Alternative $8.8 | Commodities $6.5 | Alternative $1.8 | Convertibles $0.9 | Allocation $1.3 | Commodities $2.5 |
| Money Market $3.0 | Money Market $11 | Convertibles $0.2 | Convertibles $0.3 | Money Market $0.7 | Allocation $0.2 | Allocation $0.9 | Convertibles $1.0 | Money Market $2.3 |
| Allocation <$0.1 | Allocation <$0.1 | Allocation <$0.1 | Allocation $0.1 | Convertibles $0.3 | Convertibles $0.2 | Money Market ($1.9) | Money Market $0.4 | Allocation $0.9 |
| Convertibles <$0.1 | Convertibles <$0.1 | Money Market ($6.1) | Money Market ($0.9) | Allocation <$0.1 | Money Market ($0.8) | Commodities ($42) | Commodities ($1.7) | Convertibles $0.1 |

- Worldwide exchange traded fund assets have grown from $858.1 to $2,751.8 billion from 2007 to Q3 2015 (3.2x), which more than doubles the growth rate of the worldwide mutual fund market over the same period.
- Worldwide exchange traded fund estimated net flows increased from $225.3 to $318.7 billion from 2013 to 2014 (1.4x). Worldwide flows through the first three quarters of 2015 are $240.2 billion.
- ETFs, unlike mutual funds, are on pace to match the flow levels from 2013 and 2014. **This is another indication that the march towards ETFs is not due to short-term market movements, but a fundamental shift in the industry.**



*Data Source: Morningstar Direct.*
*Analysis: Propinquity Advisors* 

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# About

*Propinquity provides strategic research and advice to investment management companies seeking to measure, optimize and thoughtfully grow their businesses. In support of our clients' objectives, Propinquity conducts original research into the evolving themes driving the direction of the investment management industry. Propinquity assists its clients in understanding the drivers of these themes and positioning their capabilities and products in the global distribution markets.*

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# Notes

**Definitions**

- Worldwide mutual fund universe – a collection of funds whose investment type, as defined by Morningstar, is ‘open-ended.’
- Worldwide ETF Universe – a collection of funds whose investment type, as defined by Morningstar, is ‘exchange-traded fund.’
- ‘Fixed income’ – For purposes of this report and related analytics, we have combined the Morningstar global categories ‘fixed income’ and ‘tax preferred’ into a single category – ‘fixed income.’

**Data**

- All data was pulled between October 26, 2015 and November 30, 2015 from Morningstar Direct.
- All data uses September 30, 2015 as an end date.
- Values in the periodic tables are rounded to the nearest billion, but are rounded to the nearest hundred million if the value is less than $10 billion and greater than -$10 billion.
- ‘Miscellaneous’ and ‘unclassified’ funds flows are not pictured in the periodic tables, but both categories are included when reporting total assets.