Nordic ETF Trends 2016

Supplement | Distributed with Nordic Fund Selection Journal #05, 2016

tell MEDIA GROUP

INCREASED INSTITUTIONAL USE OF ETFS ACROSS THE NORDIC REGION

The active versus passive debate has been going on for a long time and the general take is that there is a place for both. However, the growth of ETFs will hopefully ensure that there is no place for the closet indexers going forward.

For this inaugural ETF supplement, we have focused on gaining insight from product providers as well as investors. Earlier this fall we gathered experts from BlackRock/iShares, Deutsche Asset Management and Vanguard to a roundtable in London where we among other things covered product development and the recent growth of ETF use among institutional investors. A summary of the roundtable discussion starts on page 10.

Also, as outlined in our story on institutional investors (see pages 20–23), the argument sometimes heard that ETFs mainly would be a tool for less sophisticated ones falls short when taking a closer look at how some Nordic investors are using the vehicle. Finland's largest pension insurance company Varma is a veteran when it comes to allocating through ETFs and its head of listed securities Timo Sallinen notes that ETFs already were being used when he started at Varma some ten years ago.

What our research into how institutional investors across the Nordic region are using ETFs also reveals is that the product is increasingly used for strategic positions and not only as a tactical asset allocation vehicle.

Niklas Tell
Tell Media Group

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NEWS

Bonds, liquidity and ETFs

At a time when institutional investors are finding it difficult to trade individual bonds, ETFs may be an interesting alternative route for gaining exposure. This was a topic discussed at the Tell Media Group ETF roundtable in September as well as the conclusion of recent study on fixed income ETFs.

Text: Niklas Tell

In a new report headlined "Institutional Investors Embrace Bond ETFs", Greenwich Associates has found that institutional investors are experiencing longer execution times, increased execution costs and more difficulty sourcing bond securities and completing trades.

"Bond ETFs are emerging as an important alternative and institutions are incorporating the funds into their process of rotating sector allocations, increasing or reducing risk levels and adjusting duration," says Andrew McCollum, Greenwich Associates consultant and author of the report.

Fixed income ETFs and liquidity was also a topic discussed in the ETF roundtable, which is summarised on pages 10–17. Mark Fitzgerald, head of product at Vanguard in Europe, says that it is important to understand the difference between a fund and an ETF.

"There is a different liquidity dimension in an ETF. For the big and liquid ETFs some 99 per cent of trading takes place in the secondary market – effectively investor to investor rather than investor to fund. When a traditional fund has inflows or outflows, it will create and redeem shares but for a liquid ETF, there is no activity in the underlying fund," he explains.

Brett Pybus, who leads the iShares EMEA fixed income product strategy team, agrees and says that this is something that is being appreciated by big investors.

"As ETFs have become bigger, it has become viable for them to put through block-size trades. Over the last 12 to 18 months, this has been tested a couple of times when we've had different crises in the market. What we have seen has been a spike in trading on the exchange but very little activity of creation or redemptions in the underlying ETFs," he says.

Some of the key findings in the Greenwich Associates study point in the same direction, saying that institutional investors are executing larger ETF trades today. In 2015, only 19 per cent reported executing a trade of USD 50 million or more. In 2016, that share had jumped to 31 per cent of investors. Also, a third of institutional investors in the study say they are considering replacing individual bond positions with bond ETFs in the next year.

On the question whether ETFs can become too big, Brett Pybus from iShares says it is important to put size into perspective.

"If we look at high yield, ETFs represent some 2 to 2.5 per cent of the market. The data doesn't support the argument that ETFs in fixed income are too big or that ETFs drive volatility in fixed income. What they do offer is transparency and price discovery," he says.

Mark Fitzgerald from Vanguard agrees. "It's important to take a step back and see the bigger picture. If you look at the bond market as a whole, mutual funds maybe account for some 10 per cent of the market and passive funds is a fraction of that and ETFs are a fraction of that fraction. Also, considering that the majority of trading in ETFs is happening in the secondary market, I would say that the fear is overblown," Mark Fitzgerald says.

Furthermore, Brett Pybus argues that fixed income ETFs have a positive impact on liquidity. "If you look at the data for when we have 'air-pockets' of liquidity in fixed income, we see that in the cash market everyone disappears but in ETFs we see almost the opposite. Trading actually increases as investors are trading what they can trade," he says.

Investors' need for liquidity has played a major role in driving institutional adoption of ETFs, according to the Greenwich Associates study. It also says that ETF usage rates have climbed to their highest levels in sectors experiencing liquidity challenges, including high-yield and investment-grade corporate credit. Beyond liquidity, institutions cite a range of additional ETF benefits, including ease of use, operational simplicity, quick access and speed of execution. As a result, they are employing the funds in an expanding list of applications ranging from managing cash positions and rebalancing to transitioning among investment managers. "As a result of these trends, institutional use of bond ETFs will remain on a strong growth trajectory in years to come," says Andrew McCollum.

Erik Rotander from Deutsche Asset Management adds that it is also worth considering what you rather would own in times of stress. "If you own an ETF, your underlying portfolio will be the same regardless if you sell on day one or day ten. It's the same basket of underlying bonds that's sold. In a mutual fund, you can think of a scenario where the portfolio manager will sell the more liquid part of the portfolio first. If you sell on day ten, you will face a much different set of holdings being sold by the fund," he concluded.

Q&A WITH THREE ETF INVESTORS

TEIS KNUTHSEN
Chief investment officer, Saxo Privatbank

What are the most important product development trends when it comes to ETFs?
"Smart beta, risk factors and a general migration towards physical replication strategies."

How are you currently using ETFs - tactical asset allocation versus strategic?
"Both. I have been overweight minimum volatility strategies for a few years and use that to fund my overweight of equities versus bonds. But this year, for instance, I have closed my underweight of emerging markets by shifting into emerging markets minimum volatility."

To what extent are investors turning to ETFs to get factor exposures? Also, if ETFs are more of a tactical tool, isn't it somewhat contradictory to use this for factor exposures as academic research strongly discourages trying to time factors?
"If you combine an MSCI World ETF with MSCI World Min Vol, you have established a de facto active strategy using passive products at passive prices. I don't necessarily agree that you can't time factors, as they combine risk premiums with a behavioural factor. A pick-up in global growth is very likely to lead to value and small cap outperforming versus minimum volatility. Anyway, it seems that while risk/return is efficiently priced between the major asset classes, it also seems to be the case that risk isn't well priced in equities since the efficient frontier has been downward sloping for several years. If that is first and foremost a behavioural thing, then it can be permanent, which again suggest that you can use risk factors to lift risk/return ratios."

What are your thoughts on ETFs and liquidity?
"I think that works fine."

Given the number of available ETFs, how do you select?
"Keeping friends close and enemies even closer. Know what you want before you buy (UCITS, physical, listing, denomination etc)."

The general use of ETFs is growing but what does the future hold? Do you see any emerging trends?
"More indexing, more ETFs. Hopefully, fewer and better active investors. More digital distribution models."

What are the main challenges for investors in Denmark looking to invest in ETFs?
"1) Taxes. 2) That the market is captive. 3) That private clients have yet to want to disrupt the business model."

KIM PESSALA
Chief investment officer, Evli Bank

What are the most important product development trends when it comes to ETFs?
"More active investment strategies are launched in ETF structures. Traditional fund managers are feeling more pressure, especially index huggers."

How are you currently using ETFs?
"At Evli asset management we use ETFs mostly for tactical asset allocation. For long-term passive investments, we often use index funds."

To what extent are investors turning to ETFs to get factor exposures? Also, if ETFs are more of a tactical tool, isn't it somewhat contradictory to use this for factor exposures as academic research strongly discourages trying to time factors?
"It's true that lately there have been a lot of new smart beta ETFs launched. We believe that factor investing is a long-term strategy where one shouldn't time factors. We don't use ETFs to get factor exposure; instead we use our own factor funds that replicate ERI Scientific Beta's indices."

What are your thoughts on ETFs and liquidity?
"During market stress, ETF liquidity can be very poor and hence expensive, because the ETF market price may differ significantly from the theoretical price."

Given the number of available ETFs, how do you select?
"We mostly use Morningstar and Bloomberg tools to evaluate the effectiveness of ETFs. We look at the tracking difference, which, for instance, measures tracking error, spread, costs etc."

The general use of ETF:s is growing, but what does the future hold? Do you see any emerging trends?
"As long as active managers struggle to perform, we will see more flows into ETFs."

What are the main challenges for investors in Finland looking to invest in ETFs?
"When comparing ETFs and mutual funds, we don't see any difference or challenges that would be a disadvantage for ETFs."

Any other comments on ETFs?
"The challenge for especially smaller ETF's is to create sufficient market liquidity. Lately we have seen that some markets are very expensive to trade in ETFs, like country or sector ETFs."

SAMU LANG
Chief investment officer,
Taaleri Wealth Management

What do you see as the most important product development trends when it comes to ETFs?
"The creation of products with alternative weighting methodologies compared to traditional market-cap weighted indexes. Also educational content and tools for the investment community on the usage of ETFs on portfolio construction and the push away from the traditional market-cap based relative investing."

How are you currently using ETFs?
"Both for tactical and strategic asset allocation, totally depending on the investment strategy and/or the client mandate. We have advisory clients with an opportunistic tactical mandate were we identify opportunities, select products and take care of execution with strict stop-loss and take-profit targets. We also have passive or systematic mandates were we use ETFs as the core building blocks to build the strategic allocation for clients. After this, we decide on the rebalancing rules, in other words, the method and the frequency of the balancing. Strategies can, for example, include fixed weight based on client allocation or risk-parity methodologies."

Considering the growing interest in risk factor investing, to what extent are investors turning to ETFs to get factor exposures? Isn't it somewhat contradictory to use this for factor exposures as academic research strongly discourages trying to time factors?
"This depends pretty much on how you construct your investment strategy. If you build your core portfolio with factor products and use strict rule-based rebalancing, then it's obviously contradictory to use the same building blocks for short tactical trades. I think it's essential to separate the portion of the portfolio one uses for shorter tactical trades. Timing the market is difficult regardless if you use factor products or something else, especially if you do it spontaneously and emotionally. If you do it in a predefined universe using well defined technical indicators and stop-loss levels, there's a possibility to add value."

What are your thoughts on ETFs, liquidity and volatility?
"Liquidity is getting better all the time. This is more important than the industry appreciates, since there are a lot of small trades and tranches of small trades going around that aren't really feasible to execute OTC. Portfolio-management wise, with good contacts and experience, you can nowadays find really competitive prices even compared to the underlying of the actual ETF-product."

Given the number of available ETFs, how do you select them? Which tools or search methodologies are available?
"We have our in house selection methodologies using data from various sources, for example Bloomberg."

The general use of ETFs is growing but what does the future hold? Do you see any emerging trends?
"I see more consolidation going forward. The core building blocks around well-known benchmarks will go to the biggest providers because of intense cost competition but at the same time, some niche players will likely emerge that offer totally different products when compared to the traditional benchmarks."

What are the main challenges for investors in Finland or in the Nordic region looking to invest in ETF:s?
"Well, you always want tighter spreads and the Eurozone to be a less fragmented market place. Withholding taxes can also be an issue in some cases and the largely stupid rules that force UCITS funds to invest only in UCITS ETFs."

Do you have any other comments on ETFs?
"I have been using them for over ten years and seen the growth, the financial crises, different structures and a lot of good and also misleading discussions around ETFs. I still feel they are the best product to build your cross-asset allocation mandates regardless of the strategy used."

2 220	US$539 BILLION	54
Number of ETFs/ETPs in Europe	Assets invested in ETFs/ETPs listed in Europe	Number of ETF/ETP providers

Source: ETFGI's July 2016 global ETF and ETP industry insights report. Numbers as of the end of July 2016.
ETFGI is an independent research and consultancy firm focused on trends in the global ETF/ETP industry.

Slow-down in product growth as investors turning more sophisticated

On September 1, **Tell Media Group** invited representatives from **BlackRock/iShares**, **Deutsche Asset Management** and **Vanguard** to a roundtable to discuss current trends in the ETF space. Nordic Fund Selection Journal editor Caroline Liinanki and Tell Media Group founder Niklas Tell moderated the discussion.

Text: Niklas Tell Photo: Christer Salling

MARK FITZGERALD – VANGUARD, CAROLINE LIINANKI – TELL MEDIA GROUP, BRETT PYBUS – BLACKROCK, ERIK ROTANDER – DEUTSCHE ASSET MANAGEMENT, NIKLAS TELL – TELL MEDIA GROUP.

The discussion, which was held at Grange St. Paul's Hotel in London, started with Niklas Tell asking the participants to highlight the most significant product development trends when it comes to ETFs.

MARK FITZGERALD: In general, I think the growth of ETFs will be about greater adoption of existing building-blocks rather than growth by new products. When it comes to product development, I think we will see more on factor ETFs, even if we have seen a lot already. A lot of the time, product development also lags what is happening in the markets. Last year, it was all about European equities and currency hedging. This year it's about fixed income and gold. Even if we try to stay ahead of the market, very often the industry lags what is happening.

BRETT PYBUS: I think adoption rather than growth of products is especially true when it comes to fixed income ETFs. An ETF is set up as an equity product so there are obstacles you need to overcome, such as guideline constraints. It's about bringing fixed income ETFs into the fixed income ecosystem.

ERIK ROTANDER: Also, the product was born on the equity side and an equity manager is used to think about sectors and an ETF as a convenient tool. Fixed income managers are much more conservative. When I joined the business five years ago, people said that fixed income will be the next evolution and now I think that we're seeing that happening. As an industry, we like to talk about new clever products, smart beta and factors. But the bulk of the assets are still in plain beta products and that's where we see the largest growth.

BRETT PYBUS: One of the questions I get asked a lot – especially given what is happening on the equity side with smart beta – is what are we doing in fixed income. I think it is fair to say that the industry is a bit behind in that regard. There are few products that are as developed in fixed income as on the equity side. This is in part because there's more research to do and, versus equities, there's less of a common understanding of what fixed income smart beta is on the client side. It's, however, worth remembering that the relative size of the fixed income ETF universe is still very small, regardless of how you measure it: relative equity ETFs, active fixed income funds or versus the cash bond market. There's still a lot of room to grow the existing product set.

ERIK ROTANDER: Fixed income managers like their bonds and use, for instance, Bloomberg analytics to do the yield and spread analysis. If someone comes and talks about ETFs, they see that as outsourcing. People need to get over that hurdle. Just because you buy an ETF doesn't mean you're not using your normal investment process. You can still do your macro calls. I have seen two watershed moments for fixed income ETFs. One was when Draghi announced QE and said, almost as an afterthought, that the ECB also may look at covered bonds. Clearly some clients picked up on this and wanted to buy covered bonds to get ahead of the ECB and get sector beta for three to six months. But what do you do when it's a new market and none of your normal brokers have access? Well, there are ETFs on covered bonds and they are liquid. Another example is Spain. When the spread was at its widest, fixed income manager did their analysis and saw that Spain was cheap. They just wanted the beta exposure and then an ETF is perfect. This has opened many doors for fixed income ETFs.

CAROLINE LIINANKI: WOULD YOU SAY THAT PRODUCT DEVELOPMENT WHEN IT COMES TO ETFS IS FAIRLY QUICK COMPARED TO SETTING UP A TRADITIONAL FUND?

MARK FITZGERALD: It depends on the mandate. If it's a building block – another equity or fixed income ETF – then it can be done within a few months, if adding to an existing umbrella. You still need to get seed money and get it authorised but it's fairly mechanical. However, if you are trying to do something different it will take more time. What we have done with factors is that they are active, they're not following a benchmark. That's different and even the discussions with the regulator are different.

BRETT PYBUS: I think that's a good distinction. If you're trying to do another index, product development is relatively easy. If you move into things that are closer to active but in an ETF, then you have to put more thought into other issues such as transparency. We've already seen a rapid development so there's a huge array of products but I would question if it's more products that we need. I think, just as in the traditional active space, too much proliferation of products in Europe is unhelpful for investors.

ERIK ROTANDER: I think product growth is slowing down and people are looking to close funds.

MARK FITZGERALD: Yes, that's actually a trend – closures of less successful funds. That's actually something that the industry hasn't been very good at.

CAROLINE LIINANKI: ARE YOU SEEING CLOSURES IN SPECIFIC AREAS?

MARK FITZGERALD: I just see that closures have increased.

BRETT PYBUS: I think that it's a natural cycle. You have boom years where a lot of new funds are being launched and after a while you have to assess if the products are actually viable.

MARK FITZGERALD: With some 90 per cent of assets sitting in some 100 products, it's only natural if less successful funds are being closed.

NIKLAS TELL: WITH THE PROLIFERATION OF FUNDS, WOULD YOU SAY THAT ETFS HAVE FALLEN IN THE SAME TRAP AS ACTIVE FUNDS? WHEN THE INDUSTRY FORMED, FUNDS WERE A VEHICLE FOR INVESTORS TO GET A GOOD DIVERSIFIED PORTFOLIO SO THEY DIDN'T HAVE TO PICK STOCKS. THEN FUNDS BECAME INCREASINGLY

BRETT PYBUS
BlackRock
A member of the product strategy team within BlackRock's global fixed income portfolio management group. Having joined in 2013, he focuses on model-based fixed income in the UK and leads the iShares EMEA fixed income product strategy team.

"It's not that [investors] have stopped buying cash bonds or stopped using swaps – they just add [ETFs] as another tool so they have more flexibility"

– *Brett Pybus, BlackRock*

GRANULAR – FROM A GLOBAL EQUITY FUND INTO SMALL CAP, MID CAP, LARGE CAP AND INTO DIFFERENT STYLES SUCH AS VALUE AND GROWTH OR INTO SPECIFIC SECTORS. SO, WITH THE GRANULARITY AVAILABLE IN ETFS I ASSUME THAT YOU ARE NOT TARGETING INDIVIDUAL INVESTORS BUT RATHER PORTFOLIO MANAGERS CREATING PORTFOLIOS FOR END CLIENTS?

MARK FITZGERALD: I think it also depends on industry participants. For some smaller providers, it will make sense to target niche areas. For larger providers, it's about knowing your client base and what they need and demand.

ERIK ROTANDER: And have some idea of what you expect to raise. The ETF industry is also fairly young and still growing. Over the years, everyone has been launching new products because no one knew where the industry was going. Now we're at the stage when it's time to reflect on what we have. We have products that have been out there some 3–5 years. If a product after three years still has five million in assets maybe it's time to accept it didn't work.

MARK FITZGERALD: I think we had 51 providers in Europe at the beginning of the year and now 54 now so it's still growing but not at the same pace. At some point that has to peak and we will see consolidation because it's still an expensive business to run. There are some 2400 exchange traded products that you can buy in Europe and the question is if that's too many. If you compare it to the number of funds, which are some 30000, the answer would be no but at the same time, it's doubtful that all 2400 products are at an economical scale. Investors need to be able to see through all of the supply to be able to select the right product for them.

CAROLINE LIINANKI: WHAT ARE SOME OF THE KEY THINGS TO LOOK OUT FOR FROM AN INVESTOR POINT OF VIEW WHEN IT COMES TO ETFS?

MARK FITZGERALD: It depends of course on the exposure they are looking for, how long they expect to hold it and what they are trying to do. When they know that, then it's the old list of TER, liquidity, spread, issuer support etc. It's the total cost of ownership argument.

ERIK ROTANDER: Yes, that's very important – to have a clear idea what you're trying to achieve. You could have your MSCI World as your equity exposure and hold that for 20 years or you can break it down to country and sector exposures and be active with those ETFs almost as you would with single stocks.

BRETT PYBUS: We're absolutely seeing that investors are becoming more sophisticated on which beta instrument they use and for which purpose. It's usually not only a discussion about ETFs. It can be index funds and if the investor is big enough, it could be a segregated mandate. It's much more of a holistic beta conversation today. That's partly because of an increased institutional use of ETFs, especially when it comes to fixed income.

ERIK ROTANDER: We all get excited about the ETF wrapper but to many clients, it's about getting access to a passive investment strategy. If it comes in a round bottle or in a carton, they don't really care – index, mandate, derivative, program trade or ETF. At Deutsche Asset Management, we're organised so that the passive division cover index funds, mandates as well as ETFs, which makes us wrapper agnostic and that helps when dealing with clients.

MARK FITZGERALD: I think that's important because sometimes it's as if ETFs are discussed as being a completely different unknown instrument. It's just a wrapper. Investors still need to look through that to understand what you are getting, what you are paying and how you get in and out.

NIKLAS TELL: IS TRANSPARENCY AND LOOKING THROUGH THE WRAPPER GETTING MORE DIFFICULT WITH NEW PRODUCTS, SUCH AS SMART BETA: PRODUCTS WHERE THE UNDERLYING IS NOT AS TRANSPARENT AS THE S&P 500 INDEX?

MARK FITZGERALD: There are hardly any active ETFs but one of the problems is transparency.

ERIK ROTANDER: You have that with traditional active funds as well so that is more about the strategy than the fact that it is delivered through an ETF.

BRETT PYBUS: Not every strategy belongs in an ETF. If it's a strategy where the value is in the picking of individual stocks, why would you want to reveal that on a daily basis?

ERIK ROTANDER: Also, if I'm an investor looking for a concentrated active portfolio, I buy the skill of that fund management team over the long-term. Then I really don't need to know every holding each day.

MARK FITZGERALD: Going back to your original question on product development trends – there has been a lot written about active ETFs but I'm not sure that it necessarily is the right wrapper. It depends on the process and what's actually happening within the fund. Then, what is the best way to buy that fund and in many cases I suspect an ETF isn't the right answer.

BRETT PYBUS: So from a client perspective – what benefit do they get from being able to trade an active strategy intra-day?

ERIK ROTANDER: Maybe you're able to save some money as you could bypass a certain distribution platform by buying on exchange.

MARK FITZGERALD: Distribution is, of course, one of the key benefits of ETFs.

ERIK ROTANDER: Coming back to transparency, ETFs are one of the most transparent products out there. You can go to any major providers' website and see up-to-date information on holdings, stock-lending and collateral. By providing this level of transparency, it can appear that ETFs are complex. Yes, ETFs are complex but all the things that are happening within ETFs could be happening within active funds as well, only you usually don't see it. It's almost as if the industry is a victim of its own transparency.

NIKLAS TELL: WHEN WE TALK ABOUT GROWTH AND INCREASED ADAPTATION OF ETFS, IS THAT EXISTING INVESTORS USING ETFS MORE OR ARE YOU SEEING NEW INVESTORS STARTING TO USE ETFS?

MARK FITZGERALD: I think we will see more investors using ETFs and in Europe, we expect more retail investors will start using ETFs. Right now, it's about 85 per cent institutional investors.

MARK FITZGERALD
Vanguard
Joined Vanguard in December 2013 as head of product, Europe. His current role covers day-to-day responsibilities of product development, Europe, managing the team and key product research and development in Europe.

"With some 90 per cent of assets sitting in some 100 products, it's only natural if less successful funds are being closed"

– Mark Fitzgerald, Vanguard

BRETT PYBUS: Yes, with RDR (Retail Distribution Review) in the UK and with similar developments underway in other European countries, it will be critical to access low cost building blocks as advisors are essentially paid for the asset allocation they provide. ETFs fit this development very nicely.

ERIK ROTANDER: It's very interesting that some 85 per cent of ETF investors in Europe are institutional with the product itself being regulated as a retail product. It's one of the few products where I as an individual investor can invest on the exact same terms as a huge pension fund. That doesn't happen every day.

CAROLINE LIINANKI: WHY HAVE ETFS NOT TAKEN OFF AMONG RETAIL INVESTORS THEN?

MARK FITZGERALD: Historically, in the UK before RDR, there were no incentives for retail advisors to promote ETFs as there are no fees for them in the product. If they don't get a retrocession it wasn't in their interest to recommend an ETF. As this fee structure is removed, it becomes much more transparent.

NIKLAS TELL: IS IT ALSO ABOUT HOW PRODUCTS ARE SOLD? IN THE NORDICS, RETAIL INVESTORS TYPICALLY BUY INDIVIDUAL FUNDS RATHER THAN GET A PORTFOLIO SOLUTION MADE FOR THEM. WHEN IT'S ABOUT MARKETING AND SELLING INDIVIDUAL BUILDING BLOCKS, I ASSUME IT'S EASIER TO PROMOTE A GREAT ACTIVE MANAGER THAN AN ETF?

BRETT PYBUS: When it's about having a story to tell, you are right but we're also seeing more thematic ETFs come to market, which brings the ability to promote a theme beyond standard building block exposures. Globally, however, the overriding trend we're seeing is a shift towards more transparent, lower cost fee structures driven by regulation.

ERIK ROTANDER: Yes, one of the fundamental differences between the US and Europe is that advisors in the US work like a lawyer or accountant – they send you a bill for their services. In Europe, the price for their service is imbedded in the fee of the products.

MARK FITZGERALD: At the end of the day, it's about educating the end investor and letting them know that these products exist. As we said before, ETFs are one of the few products that professional investors use and that are available on the same terms to retail investors.

ERIK ROTANDER: The main challenge is how these products fit the business model of the companies that own the client relationship.

NIKLAS TELL: RETAIL DISTRIBUTION IN THE NORDIC REGION IS DOMINATED BY BANKS AND WE HAVE SEEN A TREND OVER THE LAST COUPLE OF YEARS THAT THEY FOCUS INCREASINGLY ON MULTI-ASSET OR BALANCED SOLUTIONS AS THEIR FAVOURED PRODUCTS FOR RETAIL CLIENTS. DOES THAT MEAN THAT THE BIGGEST OPPORTUNITY TO REACH RETAIL INVESTORS FOR YOU IS TO GET YOUR ETFS INTO THESE MULTI-ASSET OR BALANCED FUNDS?

BRETT PYBUS: That's certainly what we see. The main use is as a building block in portfolios, whether more tactical or strategic in nature.

ERIK ROTANDER: I would say yes to your question. If I want to end up in portfolios of retail investors in the Nordics, I would go via the balanced funds of the big local asset managers. That would be the strategy.

"There's a perception that you pay extra for that liquidity and that flexibility"

– Erik Rotander, Deutsche Asset Management

NIKLAS TELL: ARE INSTITUTIONAL INVESTORS MAINLY USING ETFS FOR TACTICAL PURPOSES?

MARK FITZGERALD: I think it's wrong to only think of ETFs in terms of tactical asset allocation.

BRETT PYBUS: I agree but I think that's often how investors are introduced to the product. Once they have started to use them, they will find other value-add applications for them.

ERIK ROTANDER: You have everything from cash management to strategic holdings and everything in-between.

CAROLINE LIINANKI: WHY WOULD YOU USE AN ETF FOR A STRATEGIC POSITION IN THE PORTFOLIO?

MARK FITZGERALD: It comes down to cost. As the cost of holding an ETF has come down and is at par with a traditional index fund, the ETF gives you the added benefit of flexibility. You are able to move significant amounts of assets if you are looking to shift your allocation.

ERIK ROTANDER: There's a perception that you pay extra for that liquidity and that flexibility. Greenwich Associates survey has shown that the use of ETFs for strategic positions is increasing every year. It comes down to the fact that they are so cost efficient. The competition for the ETF is in many cases the underlying stocks or futures. If you hold individual stocks, you have to do the corporate actions and rebalancing yourself, which everyone isn't happy to do. Investors in the Nordics will in most cases not hold ETFs as core strategic holdings – they use index funds or baskets. They own ETFs as substitutes for futures. If they did futures earlier, they are now using ETFs as they are proven

ERIK ROTANDER
Deutsche Asset Management
Active in the Nordic region since 2005 in a variety of roles. Since 2012, he is responsible for the passive investment product business in the Nordics for Deutsche Asset Management.

> "We all get excited about the ETF wrapper but to many clients, it's about getting access to a passive investment strategy. If it comes in a round bottle or in a carton, they don't really care"
>
> *– Erik Rotander, Deutsche Asset Management*

to be more cost efficient for some indices. The other one is Solvency II reasons. If they have a lot of local equities and there is a correction in the market, they don't want to be a seller. For that reason, ETFs would work as liquidity sleeves.

CAROLINE LIINANKI: ARE NORDIC INVESTORS USING ETFS RATHER THAN DERIVATIVES A RECENT CHANGE?

ERIK ROTANDER: Up until two years ago, institutional investors in the Nordic region used derivatives rather than ETFs. But it has become more expensive for banks to take the other side of these trades, so more expensive for banks to "produce" these products for investors. Then the ETFs have become bigger and more liquid so cheaper to trade and own. Finally, the spread between the rate that investors can invest their cash at and the Libor curve that banks use to price derivatives has diverged.

BRETT PYBUS: In general, investors are looking for new tools to do what they used to do pre the financial crisis. It used to be much easier to move large blocks of assets in the bond markets. That has become much harder, partly because of the same regulations that has made futures less attractive for investors. ETFs on the fixed income side become just another tool for investors. Pension funds can probably get cheaper beta access but an ETF can be very useful if you're doing a transition from say manager A to manager B. Then you do that via an ETF as you finalise the search. Most uses of ETFs are actually fairly straightforward. The biggest hurdle is probably familiarity and the perception that ETFs are very different.

MARK FITZGERALD: If you consider that securities have been around for some 400 years, mutual funds for about 150 years and that we've had ETFs for some 15–25 years depending on where you are located – it's really still very young. It's only in the last few years that assets have started to really grow.

BRETT PYBUS: Most of the adoption of ETFs is about adding it to what investors already are doing. It's not that they have stopped buying cash bonds or stopped using swaps – they just add them as another tool so they have more flexibility.

ERIK ROTANDER: That's why I think it's so interesting to be active in this space because the product is so flexible and it's cross-asset. One day you speak to a CIO about their strategic direction, the next day you speak to a portfolio manager on a particular product and then you speak to a buy-side trader. As we said earlier, an ETF is just another tool in the toolbox. As a portfolio manager, you should know about ETFs and have an idea of when they could be of interest to use.

BRETT PYBUS: One theme that we haven't touched on that we're seeing among institutional investors is about simplifying their portfolios. Instead of holding a huge list of bonds, investors are actively looking at how they can simplify that.

ERIK ROTANDER: Another benefit with ETFs that shouldn't be underestimated is that as an investor, you don't have to interact with the manager. It's anonymity of use. If you have a traditional fund and want to redeem, someone may get back to you to discuss. With an ETF you can just get on with the trade.

MARK FITZGERALD: The really big theme is the shift of assets from active to passive and ETFs are part of that. It's a trend that has been ongoing but gained momentum following the financial crisis where investors were not protected by their active managers in the downturn, so they started to ask what they were paying for. The conclusion has been that what historically was referred to as alpha can be broken down further into different risk premia and the actual alpha is really small, especially after fees.

NIKLAS TELL: ON THE OTHER HAND, INVESTORS IN THE NORDIC REGION SAY THAT GIVEN THE LOW EXPECTED MARKET RETURN, THEY ALSO NEED TO FIND ACTIVE MANAGERS WHO ARE ABLE TO PROVIDE SOME EXTRA RETURN.

ERIK ROTANDER: Overall it's not a question of active or passive. From an investor point of view, it's about what they're trying to do and, having become more cost-conscious, about where they allocate their TER budget. Maybe they won't pay for an active manager on US large caps but are willing to allocate money for an active manager in real estate, insurance-linked securities or frontier corporate debt. It's still a trend that is driven by cost-consciousness and it's about driving down the TER for the overall portfolio.

BRETT PYBUS: Of course the fee debate is also driven by the general yield level. When yields were at 5 per cent there was room to pay managers. Yields being zero or negative in most areas put the spotlight on the issue to a greater extent.

CAROLINE LIINANKI: COST PRESSURE HAS FOR SOME TIME BEEN A TREND IN THE NORDICS BUT ANOTHER TREND IS MORE ATTENTION ON ESG INTEGRATION AND RESPONSIBLE INVESTING. HAS THIS FOUND ITS WAY INTO ETFS AT ALL?

ERIK ROTANDER: ETFs as a product relies on standardisation: that you have an index that's cheap to buy, that market makers can trade and that a lot of clients use as benchmarks. As soon as you start to tweak that, you start to lose some of the benefits of the product. We have started to look at this to see if we're able to combine the customisation of ESG, such as different exclusion lists, with the standardisation required to keep the benefit of the ETF. I don't have the answer yet.

> "ESG is almost like smart beta – everyone uses the term but mean something slightly different"
>
> *– Mark Fitzgerald, Vanguard*

MARK FITZGERALD: I think we see the same challenge with traditional funds. If we look at the Netherlands, you have huge amounts of money invested according to ESG criteria but the vast majority of the assets are in segregated accounts as there are a lot of customisations going on. ESG is almost like smart beta – everyone uses the term but mean something slightly different.

The different flavors of the Euro corporate bond market

2016 is yet again another record year for Fixed Income ETFs. YTD more than 26BEUR of new investments were made in European domiciled ETFs. One of the largest categories this year is EUR-denominated investment grade corporates. Ultra-low government bond yields and the ECB's decision to include certain corporate bonds into their asset purchase program have driven investments.

We can think of standard broad Euro corporate bond indices as no-frills 'plain vanilla' ice cream, but there are also a number of other flavors that can be indulged in via ETFs:

1. Fair Trade Vanilla: The idea behind environmental, social and governance (ESG) themed EUR corporates – also often called 'sustainability' – is to start with the broad EUR corporate universe and screen out bonds from companies that don't adhere to certain defined ESG criteria. Interestingly, the average yield and duration of an ESG EUR corporate index can be in line with a broad EUR corporate index.

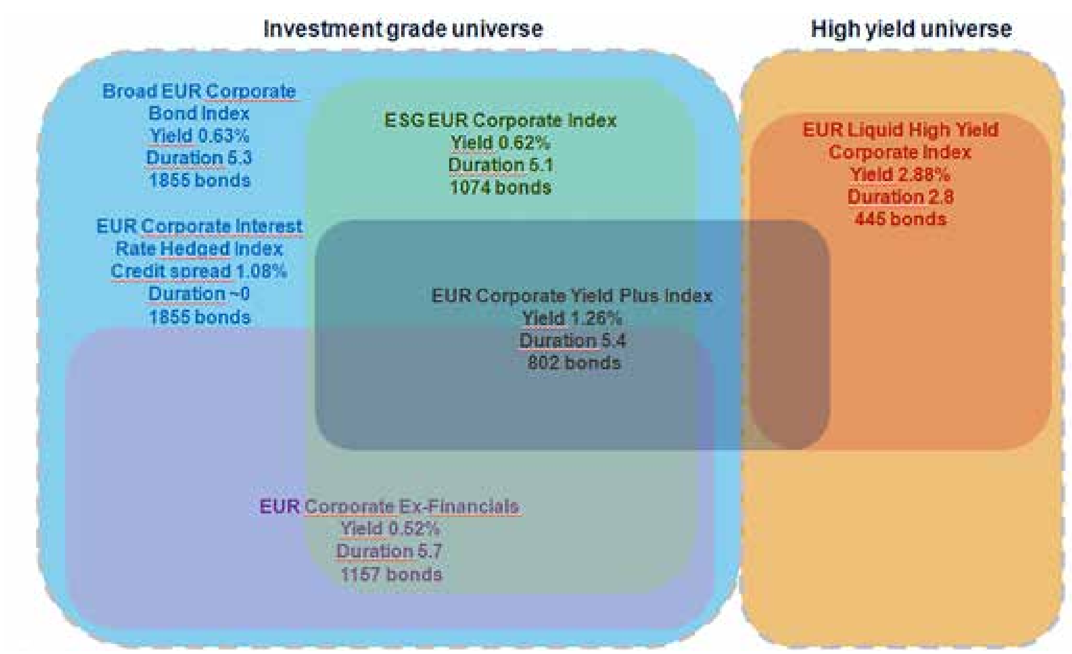
2. Low Fat: Interest rate hedged EUR corporate bond indices combine a long exposure to EUR corporate bonds and short positions in German government bond futures. The future positions are set in order to reduce the duration to zero on every monthly rebalancing. With negative yield on a large part of the German government bond curve, the yield of such an index is currently even above a broad EUR Corporate index.

3. Extra Juicy: A EUR corporate 'Yield Plus' index targets the higher yielding part of the investment grade universe. It may also include down-graded bonds (so called 'fallen angels') as long as the bonds remain BB rated and the total position doesn't exceed 20%. The yield on such an index is currently significantly above a broad EUR corporate index with a similar duration, due to the increased credit risk exposure.

4. Mario's Favorite: EUR Corporate ex-financials indices. The name speaks for itself, and it's the strategy with the largest overlap to the ECB's CSPP program. The yield is typically slightly below that of a broad EUR corporate index.

To sample these flavors via ETFs please contact your Deutsche AM sales representative or go to **www.etf.db.com**.

The EUR corporate bond universe – Illustrative examples only



Source: Barclays, Markit iBoxx, BlackRock Aladdin as of 31 August 2016.
Indices shown are: Bloomberg Barclays Euro Corporate Bond index, Bloomberg Barclays Euro Corporate Bond Interest Rate Hedged Index, Bloomberg Barclays Euro Corporate Ex-Financials Index, Bloomberg Barclays MSCI Euro Corporate Sustainable and SRI Index, Markit iBoxx EUR Corporate Yield Plus Index, Markit iBoxx EUR Liquid High Yield Index
Yield of EUR Corporate Interest Rate Hedged Index is approximated using the credit spread (OAS)

Deutsche Asset Management

INVESTOR INSIGHT

Making its way into core exposures


TIMO SALLINEN, VARMA

Flexibility, diversification and access to more specific exposures are some of the advantages with ETFs pointed out by large Nordic investors as some also are including the vehicle for the more strategic allocations.

Text: **Caroline Liinanki**

The argument sometimes heard among institutional investors that ETFs mainly would be a tool for less sophisticated ones falls short when taking a closer look at how some Nordic investors are using the vehicle. Finnish investors have for years been keen ETF users and this also goes for the country's largest institutional investors, which have been early movers when it comes to embracing ETFs in their equity allocations.

Finland's largest pension insurance company Varma, with EUR 41.2 billion in total assets, is a veteran when it comes to allocating through ETFs. Its head of listed securities Timo Sallinen notes that ETFs already were being used when he started at Varma some ten years ago.

Over recent years, Varma's allocation to ETFs within its equity portfolio has taken off further. "There are many reasons behind that. The supply of ETFs has increased a lot in recent years and as we've increased our investments outside of Europe, we've also begun to use more ETFs," Timo Sallinen explains.

While Varma prefers to invest directly closer to home – especially in Finland and Scandinavia – it also uses external funds and ETFs for equity allocations further abroad. While that is primarily through passive instruments, it also takes active risk. "We use ETFs when we want to take quick exposures for tactical purposes. It can be a certain region or even a single country, but often outside of Europe – we use ETFs quite a lot in Asia-Pacific and the US. It's an easy way to increase or decrease the equity weight," Timo Sallinen explains.

Head of equities Jukka Vähäpesola at the EUR 20.8 billion Finnish pension insurance company Elo notes that while it has invested in equity ETFs for quite some time, its use of the instrument has changed over the years. "First it was for tactical allocations, then it has become more of an alternative for index funds," he says.

Jukka Vähäpesola believes that ETFs are suitable for both tactical and strategic exposures. "It's a low cost and efficient way of getting the market exposure and there's a broad choice of the underlying market," he says.

Asked why anyone really would choose an ETF over an index fund for the more strategic exposures, Jukka Vähäpesola responds that he would put it the other way. "What is the advantage of an index fund? It's not the cost or the liquidity in main markets," he comments.

According to a report by Greenwich Associates about global institutional ETF flows, an emerging trend is that institutional investors are increasingly using ETFs to also obtain core exposures and achieve strategic goals.

A similar development has taken place at Varma. Both traditional index funds and ETFs have a place in its more strategic holdings, primarily for its US equity allocation. "If you want to buy and hold, an index fund is often cheaper than an ETF," says Timo Sallinen. "But then you need to think about how long you want to keep a certain position. If it's strategic, you obviously want to keep it for quite a long time but ETFs offer more flexibility in the shorter term. You always need to compare index funds and ETFs: the costs and what's easy to execute. If you want to increase equity weights quickly, ETFs are a quicker tool than index funds, which always takes some time."

> "The question is what the price is for that flexibility. For us to use an ETF, that can't be high"
>
> – Timo Sallinen, Varma

However, that additional flexibility should not come at too high of a cost. "The question is what the price is for that flexibility. For us to use an ETF, that can't be high," he says.

Furthermore, Timo Sallinen says that allocating to both index funds and ETFs also is a matter of achieving diversification across funds and instruments. "We're a decent sized investor so we can't use one single index fund. We need to have different kinds of index funds and different kinds of ETFs in order to diversify our risks. We can't put all our eggs into one basket," he says.

With the rapid growth of ETFs and the product development having taken place, the instrument also offers investors the ability to get more specific exposures through passive instruments. The head of equities at a large Swedish pension fund, who spoke to Nordic Fund Selection Journal on the condition of anonymity, sees ETFs as a complement to its existing toolbox. While the pension fund uses ETFs to quickly get in and out of markets, it also provides the fund with the additional advantage of getting more detailed exposures than index funds are able to offer.

"An index fund can give you exposure to a country or a sector but you can't get access to a sector within a

> "What is the advantage of an index fund? It's not the cost or the liquidity in main markets"
>
> *– Jukka Vähäpesola, Elo*

country," the Swedish head of equities says. "In order to get that, you could either put together your own basket of stocks or you could buy an ETF where someone else has done the job of putting that basket together for you."

That view is echoed by a large Finnish investor, which also didn't want to be named. The investor explains that it has found ETFs to be efficient tools to achieve more specific exposures, for example factor-specific or geographical exposures.

Not all Nordic institutional investors have, however, been keen on embracing ETFs. The Swedish head of equities notes that the increased emphasis on compliance and control after the financial crisis combined with the physical versus synthetic ETF discussion served as a deterrent. While a physical ETF holds the underlying securities of the index that it is tracking, a synthetic ETF relies on derivatives to execute its investment strategy.

"I think many investors were sceptical to begin with as it felt like an investment bank push," the Swedish head of equities says. "Initially, many investors were also hesitant about possible hidden risks, especially when it comes to synthetic ETFs. After the financial crisis, investors wanted to know exactly what they were investing in and what risks they were exposed to and it was difficult to know that with synthetic ETFs. But the pendulum appears to have shifted towards physical ETFs, which actually owns the underlying securities."

The Swedish pension fund also highlights the positive effect that the introduction of ETFs has had in contributing to the downward pressure on costs across the industry, both when it comes to active and passive management.

When it comes to whether ETFs always deliver what they are supposed to deliver, even at times when markets come under stress, the experience of the Finnish investors appears to be somewhat mixed.

"Some problems might arise with more complicated products, like active or leveraged products or in markets with poor liquidity. When markets get shaky, you have to keep in mind that the liquidity or pricing of a product is always as good as the underlying market. Smaller markets with poor liquidity and higher costs might not always


JUKKA VÄHÄPESOLA, ELO

work in the way they are supposed to. But most of the ETFs do deliver, especially within main markets," Jukka Vähäpesola says.

Timo Sallinen also notes that it depends on the liquidity of the market. "It's very difficult to use ETFs if markets are not liquid enough – it's not easy to execute for the brokers and the price can be bad for investors."

As for additional things for investors to look out for, he adds: "It's very important to understand that counter-party risk. And what kind of product is it: is it synthetic or does it hold physical stocks?"

Some Nordic investors also appear to have the perception that ETFs primarily are a tool for retail investors and not really something that has a place in an institutional portfolio. Jukka Vähäpesola doesn't agree. "They are very suitable for institutional investors too. Just keep in mind that the liquidity is always as good as the underlying market," he says.

// ETFS VERSUS DERIVATIVES

With pressure on costs across the asset management industry, the costs of ETFs have also come down, which make them more attractive on a relative basis compared to some years ago. At least in the past, many larger Nordic investors have shunned ETFs claiming that the derivatives market offers a cheaper route for making tactical allocations.

Asked whether Elo views ETFs as a substitute to derivatives for its more tactical bets and what the pros and cons are with either instrument, Jukka Vähäpesola responds: "It could be, although the purpose of using these two instruments could be very different. ETFs require capital, derivatives don't. Since the ETF costs have come down a lot, the cost argument for futures is not there anymore and liquidity is just as good for both. Only optionality is something that you just can get with derivatives." In addition to ETFs, Elo also uses derivatives for its tactical exposures.

How are investors reacting to climate change?

ADVERTORIAL

By Deborah Winshel, BlackRock's Global Head of Impact Investing

Severe weather, regulations, changing consumer preferences and transformative technology. Regardless of one's stance on climate change, investors can no longer question its impact on their portfolios, nor the need to address it proactively.

Many investors are already engaged in climate-aware investing. Some aim to protect against climate change's impact on their portfolio; others aim to maximize their portfolio's positive impact on the climate, and some do both. What has changed in recent years is the increasing recognition that climate-aware investing is no longer a choice, but a necessity. The physical, technological, social and regulatory changes are too great for any asset owner or manager to ignore.

At BlackRock, we are seeing three main approaches from investors: first, 'Divestment' which excludes carbon producing companies. Second, a low-carbon strategy, which minimizes exposure to current carbon emissions from companies across all industries. Third is 'New Energy', which invests in companies engaged in environment-related technology or services, such as clean energy.

These climate-aware approaches don't have to mean giving up returns. For example, BlackRock's Scientific Active Equities Team has found that global companies that reduced their carbon footprints the most have outperformed carbon-cutting laggards, and that U.S. companies with higher climate scores tend to be more profitable and generate higher returns on assets. The research confirmed our thesis that companies that use resources efficiently, mitigate weather-related risks, and exploit climate opportunities have stronger fundamentals.

> **"Regardless of the approach investors choose, the marketplace for climate-aware investing will continue to grow – as will its importance to well managed portfolios."**

Our BlackRock Impact platform offers different ways to integrate all three climate-aware approaches into a portfolio.

1 Investment: For clients wishing to avoid investing in particular industries – such as fossil fuels production and coal mining – BlackRock continues to build bespoke, screened portfolios for institutional clients from across the world.

2 Low-carbon: For clients who are targeting a portfolio with a lower carbon footprint, BlackRock's Scientific Active Equity team offers a solution that includes measures such as carbon efficiency and green innovation signals in its stock selection process. Alternatively iShares' range of environmental, social and governance-focused ('ESG') exchange traded funds also evaluate and benchmark companies on criteria including carbon emissions and energy efficiency. These funds cover a range of geographic exposures, including the USA, Emerging Markets and Japan.

3 New Energy: iShares offers investors the opportunity to gain global exposure to the world's 30 largest companies focused on wind and solar energy in a dedicated ETF wrapper. On the active side, BlackRock's offering has a fund focused on this area that invests at least 70% of its total assets in the shares of new energy companies from across the world.

Regardless of the approach investors choose, the marketplace for climate-aware investing will continue to grow – as will its importance to well-managed portfolios.

www.blackrockimpact.com

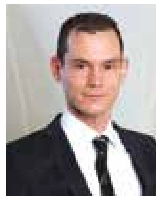
TELL MEDIA GROUP

MALIN TELL
Managing Director
Mobile: +46 70 679 12 75
malin.tell@tellmediagroup.se

CAROLINE LIINANKI
Editor, Nordic Fund Selection Journal
Mobile: +46 70 304 64 65
caroline.liinanki@tellmediagroup.se

JENNIE NYSTRÖM
Event Manager
+46 70 304 30 77
jennie.nystrom@tellmediagroup.se

NIKLAS TELL
Chief Content Officer
Mobile: +46 70 304 35 20
niklas.tell@tellmediagroup.se



PETER SULLIVAN
Senior Reporter
Mobile: +46 70 304 20 52
peter.sullivan@tellmediagroup.se

CHRISTER SALLING
Graphic Designer
+46 18 69 22 22
christer.salling@tellmediagroup.se

OUR BRANDS

FBNW is an online information and community platform covering the Nordic asset management industry. A subscription ensures you stay on top of industry trends and in touch with industry peers. Read more at fbnw.se.

Nordic Night is a networking event for people interested in the Nordic asset management industry. Arranged exclusively outside the Nordic region, the first event was hosted to coincide with FundForum International 2014.

The Nordic Fund Selection Journal is a magazine dedicated to institutional investors and fund selectors in the Nordic region and we aim to publish insightful content that inspires them to excel in their work.

The Nordic Fund Selection Forum is a conference aimed at connecting fund companies and fund selectors/institutional investors, being a platform for exchanging ideas and challenges.

The Nordic Fund Selection Awards is an event aimed at promoting investment excellence. It is also a platform to facilitate feedback between fund companies and institutional investors and fund selectors.

Tell Media Group | **2017 events**

ROUNDTABLE
Helsinki, March 14
Topic: Equity risk factor strategies
Published in the Nordic Fund Selection Journal issue: 02

ROUNDTABLE
Stockholm, May 18
Topic: Real assets
Published in the Nordic Fund Selection Journal issue: 03

ROUNDTABLE
Reykjavik, June 16
Topic: Global equities
Published in the Nordic Fund Selection Journal issue: 04

ROUNDTABLE
Oslo, September 21
Topic: Fixed income
Published in the Nordic Fund Selection Journal issue: 05

ROUNDTABLE
Copenhagen, October 24
Topic: Emerging market equities
Published in the Nordic Fund Selection Journal issue: 06

ROUNDTABLE
Stockholm, December 12
Topic: Asset allocation 2018
Published in the Nordic Fund Selection Journal issue: 01, 2018

NORDIC FUND SELECTION FORUM 2017
Stockholm, May 12, 2017
Location: Grand Hôtel
Sponsors: AXA, BMO, BNY Mellon, GAM, Kames Capital, Lazard
Organiser: Tell Media Group

NORDIC FUND SELECTION AWARDS 2017
Stockholm, November 9-10, 2017
Location: TBC
Sponsors: Legg Mason, Robeco, Kames Capital, T. Rowe Price, BMO, Pictet, AXA, American Century Investments
Organiser: Tell Media Group

Publishing schedule 2017 – **Nordic Fund Selection Journal**

Issue	Ad due date	Print date	Publishing date
01	February 3	February 13	February 24
02	March 30	April 12	April 28
03	June 2	June 12	June 23
04	August 11	August 21	September 1
05	October 6	October 16	October 27
06	November 24	December 11	December 22

Tell Media Group AB
Västra Ågatan 16
753 09 Uppsala, Sweden
www.tellmediagroup.se
+46 18 69 22 22