ETF playbook

Drawing up a game plan for ETF success

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Introduction

Are you thinking about taking the plunge and entering the exchange traded funds (ETF) game? Have you already begun drawing up some plays and taken initial steps towards forming a fund, or are you on the verge of launching one?

Or maybe you've launched your ETF, but haven't scored the touchdown you were expecting?

You've seen the great potential for success. But you're also aware of some well-publicized, titanic failures that have taken place.

While the ETF space is growing by leaps and bounds, the playing field is replete with funds that were stopped in their tracks before they even made a first down. In fact, of the 204 ETFs that launched in 2014, 92 have gained less than $10 million each in assets—that's a 45 percent flop rate.[1] And it's getting harder for new launches to break through and put some points on the board.

So what can you do to bolster your chances of being one of the few to score a game-winning touchdown, and more importantly, keep the winning streak going?

To help you reach these goals, we're creating a series of articles—an ETF playbook, if you will—designed to enhance your game plan for success, and help you gain a thorough understanding of the ETF landscape, complete with both pitfalls and potential.

In this first article, we're going to explore the significant and growing "ETF opportunity" and then address some essential elements needed to launch and operate a successful ETF. These include the necessity of having the right:

- Product to market
- Distribution game plan
- Execution strategy

In upcoming playbook chapters, we will take a deeper dive into:

- Taxation of ETFs as compared to mutual funds
- Operations and technology
- Formation and launch
- Audit and regulatory requirements for ETFs as compared to mutual funds
- Sales and distribution

The playbook will feature case studies of ETFs that made it to the playoffs and those that were knocked out of contention early in the season, as well as practical, actionable lessons that can be gleaned from each.

[1]ETF Strategist: The 10 biggest fund flops of the year, CNBC.com, 12/30/14

The ETF opportunity

The ETF space is expected to represent a huge growth opportunity in the coming years. That's why so many potential sponsors, entities, and investors are interested in them.

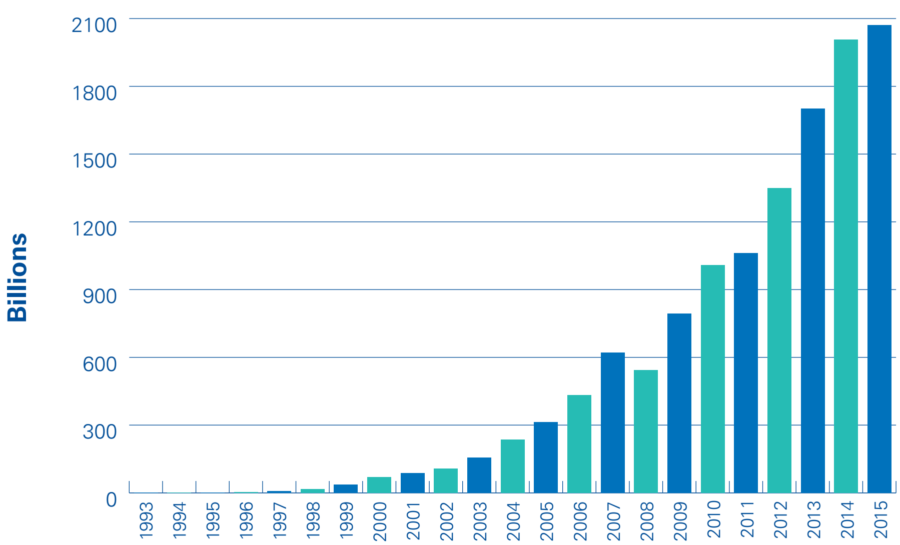
After starting out slowly in the late 1990s, assets under management (AUM) in ETFs and other exchange traded products (ETPs)[2] grew to more than $1 trillion in 2011 and jumped to more than $2 trillion in 2015.

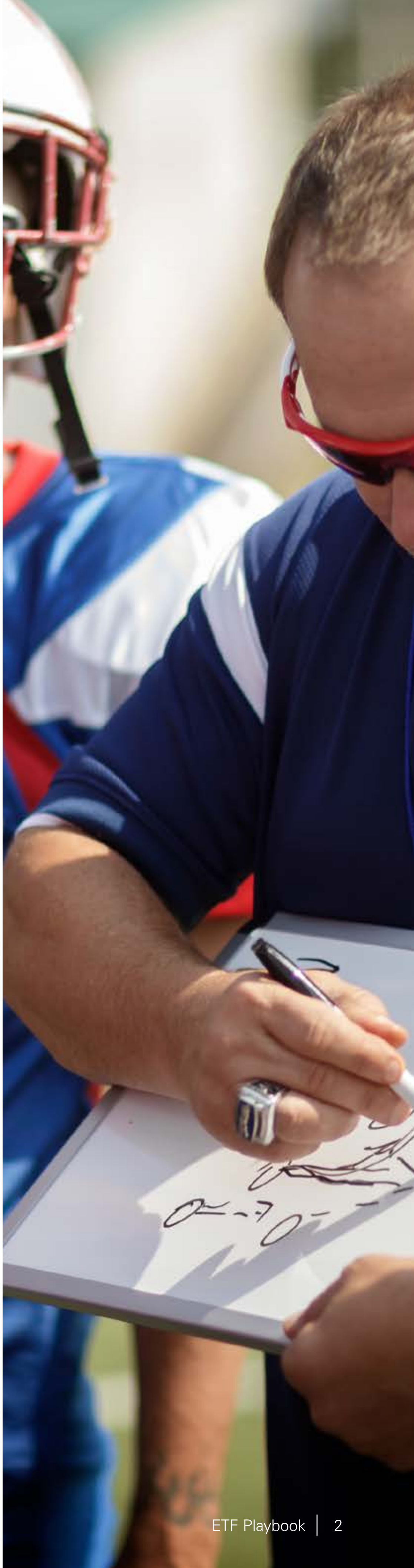
And that's just the tip of the iceberg. Global ETF/ETP AUM is projected to hit $15.5 trillion by 2024[3] and will likely be a key contender for marketplace supremacy alongside the reigning champ, mutual funds.

"ETFs are creating dynamic and innovative investment strategies," noted Sean McKee, KPMG's National Practice Leader for Public Investment Management. "And 'actively managed' ETFs represent the next generation of innovation."

With actively managed ETFs, rather than simply assembling a portfolio of indexes on which to base an ETF, managers of these types of ETFs may continually change the underlying index or portfolio allocations, like managers of mutual funds. What's more, investors have a wide variety of choices; they can purchase ETFs holding currencies, commodities, frontier markets, sectors, countries, leveraged vehicles, bank notes, and more.

ETP Asset Growth





[2] ETPs, or exchange traded products, include ETFs, exchange traded vehicles (ETVs), and exchange traded notes (ETNs).

[3] ETFs' Future: Huge Growth, ETF.com, 2/4/2014

Your ETF coaching staff

In this article, and throughout the upcoming articles in the ETF playbook, you'll be seeing quotes and guidance from KPMG's ETF specialists. Here's a brief rundown of what they bring to the table:

Deanna Flores
Deanna is KPMG's National Tax Leader for Public Investment Management and a principal in our National Tax Financial Institutions and Products group. She has more than 24 years of experience providing tax advice to investment management industry participants, including on matters related to investment alternatives and product structures, cross-border financial products transactions, and investor opportunities.

Jay Freedman
Jay is a principal in the Financial Services Tax practice, focusing on alternative investment and capital markets clients. For 20+ years, he's advised clients on a broad array of tax issues related to the alternative investment and banking industries, including financial products and derivatives, cross-border structuring and transactions, partnership tax, and corporate tax.

Robert McGraw
Bob is an Advisory principal with more than 20 years of management consulting and business experience with a focus on formulating and executing IT-enabled business strategies. His specialties include wealth and investment management, retirement services, new product development, and regulatory compliance.

Sean McKee
Sean is KPMG's National Practice Leader for Public Investment Management. He has 25 years of experience in the investment management industry, providing professional services to mutual funds, exchange traded funds, hedge funds, commodity pools, investment managers, private equity funds, fund administrators, transfer agents, family offices, public pension funds and institutional investors.

Jim Penman
Jim is an Advisory director with 25+ years' experience with financial services product development, design, and architecture. His main focus is on innovation, systems implementation, technology enablement and operational optimization in connection with ETFs, mutual funds, trust companies, banks, broker/dealers, custody and recordkeeping providers, and registered investment advisors. Jim has previously worked with ETF technology providers and DTCC on the launch of new ETFs.

Kim Zavislak
Kim is an Audit partner with extensive experience in providing financial reporting guidance and audit services to the complete spectrum of financial services clients, including investment advisors, banks, broker-dealers, ETFs, mutual funds, and private equity funds. She's also assisted clients with valuation issues, master-feeder fund structures, multi-class structures, derivatives, reorganizations, and common trust conversions.

More opportunity, more competition

But just because there will be more investable assets on the playing field doesn't mean there will be room for everyone to play. The so-called "Big Three"—BlackRock, Vanguard, and State Street Global Advisors—currently control around two-thirds of the ETF marketplace. What's more, in 2015, these three fund sponsors took in 55 percent of the new cash allocated to ETFs.[4]

A number of other heavy hitters have also entered, or are taking steps to enter, the ETF market.[5] So, the battle for the remaining portion of investable assets is likely to be difficult, albeit potentially lucrative.

"To be successful in this competitive market, it's going to come down to outthinking your competition, having a game plan in place, and staying two or three steps ahead of the rest of the pack," observed Robert McGraw, KPMG Advisory principal. "You'll have to be ready to seize an opportunity when it appears and be nimble enough to adapt quickly."

Let's take a look at some key factors that enhance the likelihood of ETF success.

The right product

Regardless of the size of the fund or the sponsor, "you need to offer a product that provides a better or new solution for investors," noted Deanna Flores, KPMG National Tax Leader, Public Investment Management. "This fundamental principle was behind some of the recent ETF success stories." (See sidebar on right.)

To increase the likelihood of creating an ETF product that connects with investors, you need to identify where there are existing or emerging market gaps that may call for an ETF to fill those needs.

"One great way to determine if there's a market for your ETF is to hold focus groups with potential investors to see if they understand your product and its investment strategy," suggested Flores. "If you're considering marketing to retail investors, for example, you should be able to explain the product in a short elevator speech. If you can't, you may hit a significant roadblock entering that market."

Another key point is that the ETF should have a broad appeal, even if it's in a niche market. "Creating an ETF that's only appropriate for one or a few of your larger clients can lead to problems down the road," cautioned Flores.

Case Studies: Two Paths to ETF Success

#1 - Sponsor finds an ETF niche: With no legacy mutual fund business as a base, one sponsor did its due diligence and found a niche by creating a line of equity, fixed income, currency and alternative ETFs. This allowed it to market to a broad range of investors. In addition, the sponsor pays close attention to customer suggestions, and has launched ETFs inspired by such suggestions.

Measure of success: The sponsor launched its first ETFs in 2006 and is currently the fifth largest ETF provider in the United States. It manages nearly $60 billion in its various ETFs, and inflows more than tripled in 2015 compared with the prior year.[6]

#2 – ETF sponsor nurtures relationships: One sponsor's ETF strategists attribute the firm's success not just to outperforming the market, but also to its coordinated efforts to cultivate and strengthen relationships with the financial advisor community. They noted that they take a very patient approach, explain their strategies simply, and base them on the fundamentals.

Measure of success: Although it took time to foster these relationships, the results speak for themselves. ETF AUM grew nearly five-fold in the past three years, and the fund had the biggest asset growth of all ETF issuers in 2014, up 35 percent. In 2015 alone, it was the fastest growing ETF firm outside of the Big Three.[7]

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[4] Dominance of 'Big Three' forces wave of innovation, FT.com, 1/30/16
[5] 3 ETF Predictions for Rest Of 2015, ETF.com, 8/7/15
[6] ETFs 2.0: The Next Wave of Growth and Opportunity in the U.S. ETF Market, BNY Mellon Asset Servicing, 6/2011
[7] Track Record Our Trump Card, ETF.com, 3/30/15

Repackaging a failed fund in an ETF wrapper? Don't bother

You'll likely be setting yourself up for failure if you're considering using an ETF as a way to repackage and sell another fund that wasn't successful previously.

Observed Jay Freedman, KPMG tax principal, "We've seen managers who ran hedge funds that never really got off the ground, and then decided to repackage the product in an ETF wrapper so it would get more attention and market share."

"Invariably, this turned out to be a terrible idea," he continued. "If you didn't have the track record or the proper sales and distribution setup for the hedge fund, your chances of getting any more traction by repackaging it as an ETF are slim to none."

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The right distribution

Another key to a successful ETF is making sure your distribution game plan is in place well before launch.

"I can't emphasize enough how important your distribution strategy is," stated McGraw. "No matter how good your product is and how compelling your investment theme, unless you can find a way to get it distributed, you're likely to find yourself and your ETF falling short of the goal line."

Here's what you need to know. The North American marketplace comprises four key sales segments:

- Direct-to-consumer
- Adviser sold
- Registered Investment Advisors (RIAs)
- Institutional

What do investors like about ETFs?

Below are some advantages that retail and institutional investors can get from ETFs as compared to corresponding mutual funds:

- **Fees:** ETFs typically have lower fees than comparable mutual funds. That's because the cost of shareholder servicing and recordkeeping is largely eliminated for ETF sponsors.
- **Investor objectives:** ETFs are well suited to meet investor objectives related to portfolio diversification, liquidity needs, or hedging.
- **Intraday trading:** ETFs are continuously valued throughout each trading day, and the price of an ETF share is market-derived.
- **Liquidity:** ETFs can be bought and sold at any time during the trading day, just like a stock. This liquidity factor is particularly important to institutional investors (e.g., pensions), as they can use it to "equitize cash," or park money for short periods of time.
- **Taxes:** Both ETFs and mutual funds distribute realized capital gains every year to minimize or eliminate entity level taxes. "But in practice, ETFs often distribute fewer capital gains than comparable mutual funds due to ETFs' ongoing redemptions of investors in-kind," observed Flores. "That's why retail investors may prefer ETFs." (The tax implications of ETFs versus mutual funds will be addressed in more detail in an upcoming ETF playbook article on taxes.)
- **Access:** ETFs offer cost-effective access to an array of investment options for any investor with a brokerage account, as well as the ability to short-sell for investors looking for the inverse exposure of an ETF.
- **Transparency:** ETFs generally must disclose their holdings on an intraday basis, while mutual funds generally have to do it quarterly. While this places an administrative burden on the ETF sponsors, it's a benefit for investors.

In addition, there are a number of sub-segments that can serve as distribution channels, including robo-advisors[8], platform providers, wirehouses[9], banks, trust companies, independent broker-dealers, and direct-to-consumer providers.

When it comes to developing a distribution strategy, the three primary ways to enter the ETF market are launching your ETF:

– Independently
– As a sub-adviser with an existing ETF sponsor
– As a sub-adviser to an ETF platform provider

Here are some key points to keep in mind when developing your distribution strategy. "Getting attention – and shelf space – at broker-dealers often depends on a product's size, liquidity and track record," observed McGraw. "Smaller ETF sponsors will likely have distribution challenges until they gain some credibility and market share through the performance of their funds."

On the other hand, fund providers that already have strong distribution channels in certain segments can often leverage those channels to market their ETFs.

"But just because you distribute a mutual fund through one channel doesn't necessarily mean that the same channel has the appropriate technology platform and expertise to distribute your ETF," noted Jim Penman, KPMG advisory director.

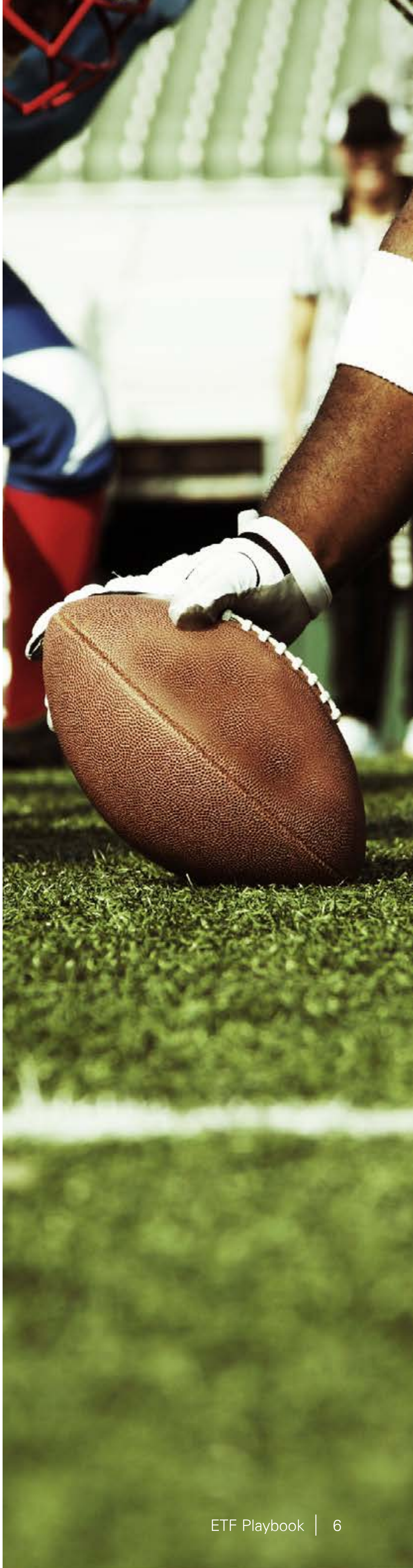
The right execution strategy

It's essential that you have all phases of your ETF game plan locked down tightly before launch—from investment strategy to operations to sales and distribution. According to McGraw, "You generally have about **18 months** after launch to get to the next level, where sales become self-sustaining."

If you don't hit that mark within that time frame, your chances of being successful dwindle markedly. "Generally speaking, you may as well shut it down," he observed. "Otherwise, you may be one of those stragglers who'll be out there for a long time stuck at the same level. And the cost and effort of keeping the ETF going is probably not worth the time and expense."

How do you gauge whether you're on the right track? McGraw noted that "A good indicator of ETF success is reaching at least $100 million in assets within the first year, and then continuing to build momentum from there. But only a small percentage of new fund launches get to that level."

McGraw also noted that the bigger players in the ETF space have strong product portfolio management and a good feel for knowing when to go for it or punt. But smaller ETF sponsors who are determined to keep their fund alive may have to partner with someone, or hope that they get enough shelf space from some platform providers to drive sales. "But those tend to be 'Hail Mary' passes that don't typically work out," he added.



[8] A robo-advisor is an online wealth management service that provides automated, algorithm-based portfolio management advice without the use human financial planners. It typically offers only portfolio management services, and not tax, retirement or estate planning.

[9] Wirehouses range from small regional brokerage firms to giant full service firms with offices around the world that share financial information, research and prices. For more information, see Wirehouses still attracting adviser talent, Investment News, 4/8/2015.

The ETF playbook

Our ETF playbook is designed to provide practical insights to help firms of all sizes compete and enhance their game plans for success in the growing and highly competitive ETF market.

Stay tuned for articles that focus on:

- Taxation of ETFs as compared to mutual funds
- Formation and launch
- Audit and regulatory requirements for ETFs as compared to mutual funds
- Operations and technology
- Sales and distribution

So, how do you make sure that you're prepared to execute quickly and effectively against your game plan? Our ETF coaching staff's blueprint to increase your chances of success calls for:

- Understanding the ETF landscape thoroughly, including your competitors' strengths, weaknesses, and tactics
- Offering a product that connects with investors, and developing a compelling "elevator speech" to explain the product to appropriate audiences
- Realistically assessing the fixed costs and run rate it will take to launch and maintain the ETF for at least 18 months (or until it gains traction). In addition, consider the amount and timing of seed capital to show activity in the fund, versus seeding the entire amount at launch
- Making sure that you have the right talent, experience, and track record to execute on the investment strategy you've selected
- Locking in your operations, technology, and sales platforms, and your custodian and distribution contracts
- Creating a competitive and predictable fee structure
- Building in options that allow you to be more nimble and agile than your competitors

"If an ETF sponsor executes its game plan successfully, it can create a niche and potentially lock out the competition in that area," stated Flores. "A key component of successful execution is closely tracking the ETF's index, while also developing and evolving a strategy to mitigate investor tax exposure."

Final thoughts

Due to their overall efficiency, which growth and competition will continue to drive, ETFs are expected to command increasing market share in the investment community among both institutional players as well as the consumer market. This article sets out some of the reasons why this is so, and also offers suggestions on how fund managers and ETF sponsors can bolster their likelihood of success.

The ETF landscape is not without some potential storm clouds on the horizon, however. The so-called "flash crash" that occurred in August 2015 has raised the eyebrows of regulators at the U.S. Securities and Exchange Commission.[10] The crash saw the market price of many ETFs fall below their underlying value, in some cases substantially. This resulted in significant losses for investors who sold their ETF shares at the market price.

We will be covering these and many more issues in future articles of KPMG's ETF playbook.

[10] Should You Fear the ETF?, MarketWatch, 12/27/15

How KPMG can help

KPMG is a leading provider to the financial services industry, serving more than more than 25% of Fortune 1000 companies in the United States. And through our global network of member firms, we serve clients worldwide with more than 2,700 partners and almost 39,000 professionals.

Our firm provides professional services to:

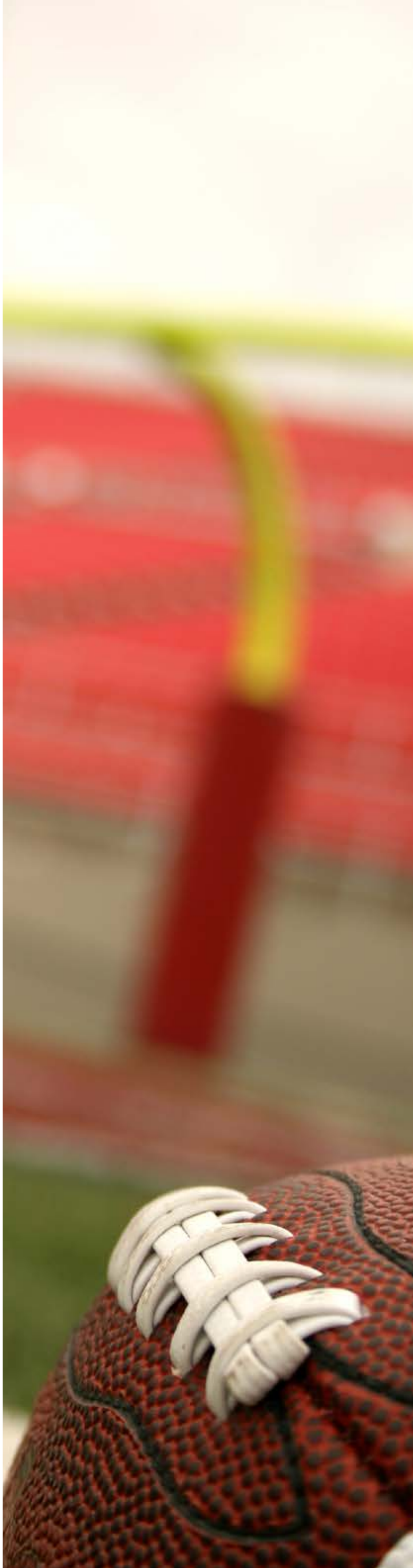
- Nearly 80 percent of the top 50 U.S. stock-based mutual funds
- 70 percent of the 50 leading asset management firms in the United States
- 95 percent of the top 20 public money managers and their funds.[11]

We provide audit, tax and advisory services to a broad range of industry players—from start-ups to FORTUNE 50 diversified financial service firms—enhancing financial and operational structures, and helping our clients proactively take advantage of change rather than merely reacting to it.

We offer:

- Deep industry experience: Regardless of where your firm is in its evolution—from launch to globalization to exit—our professionals have the passion and experience to help you deal with the issues and challenges that impact you today, as well as prepare you for what lies ahead.
- Global strength and capabilities: Our global network of member firms includes professionals located in all of the world's commercial hubs, enabling us to serve our clients wherever they do business.
- Outstanding team leadership by senior professionals: Our engagement teams, led by senior partners and professionals, work shoulder-to-shoulder with you to offer practical, customized and appropriate insight and guidance, and deliver tangible results.
- Advanced technology and innovation: We supplement our hands-on approach with industry-leading technology and innovation capabilities that enable you to operate and leverage your resources—people, vendors, legacy platforms and equipment—more efficiently.

[11] KPMG Analytics



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