ETFs and the retail investor

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Despite their advantages, European retail investors have yet to significantly embrace ETFs, but the tide could be about to turn. Matthew Craig investigates

To a highly intelligent visitor to Earth from a distant planet, the low sales of ETFs to retail investors in the UK and Europe would seem most illogical, as a certain Vulcan might say.

After all, ETFs are a cheap, flexible and increasingly ubiquitous investment tool, so the fact that around 90% of their users are institutions and professional investors would seem odd, especially when in the US, retail investors account for around 50% of the ETF market.

The low cost of ETFs is a compelling argument for their use by retail investors, according to ETF supporters. Caroline Shaw, a fund manager at wealth management company Courtier Investment Services, said that many ETFs have a total expense ratio (TER) around 50 basis points, compared to a typical annual management charge (AMC) for an actively managed mutual fund of 150 basis points. Both types of fund will have a bid-offer spread, but this is likely to be narrower on an ETF than for a mutual fund, which may also have an initial charge and other costs outside the AMC, raising its TER above 150 basis points.

Against this, ETF use may involve a transaction cost for a retail investor, as a dealing fee of £10 or so may apply on each ETF transaction. However, some brokers have been waiving this fee in order to drum up ETF business, so by shopping around an ETF investor may be able to keep trading costs to a minimum.

Passive management

One reason why ETFs are low-cost products is that they are passively managed. This means comparing their costs to that of actively managed mutual funds can be misleading, as the two types of fund do different things. And not everyone is convinced that ETFs have a significant advantage on price. Martin Bamford, a chartered financial planner and joint managing director at independent financial adviser (IFA) firm Informed Choice, commented: “Whilst the running cost of an ETF appears quite low, it is important to consider the overall cost and factor in trading expenses and any additional platform costs to gain access to the ETF market. When looking at the total cost of ETF investing, it is not significantly lower than investing through a competitively charged portfolio of retail funds.”

Nevertheless, most experts see ETFs as cheaper than traditional mutual funds, even if some mutual fees are coming down. For example, Vanguard, an index-tracking US fund manager, has just launched a series of index funds in the UK with TERs of between 15 and 55 basis points and initial charges between zero and 150 basis points, but these fees are for a minimum investment of £100,000, so it is expected that a retail investor would have to go through a fee-based adviser or a platform to invest at these levels.

While ETFs are competitively priced, most retail distribution of investment funds is controlled by IFAs, who, to date, have placed clients in mutual funds, rather than ETFs. On the reasons for this there is another difference of opinion between ETF supporters and others. To ETF supporters, the failure of IFAs to recommend ETFs is a clear-cut example of the commission bias that the Financial Services Authority (FSA) is looking to eradicate with the Retail Distribution Review (RDR). As BNP Paribas managing director Matthew Carr commented: “The main reason for the low penetration of ETFs in the retail market in the UK and Europe is that ETFs are low-margin products and do not pay a retrocession of fees to intermediaries. Consequently, intermediaries do not recommend ETFs because there is no kickback to them.”

A certain point of view

But not everyone accepts this view. Bamford acknowledged that moving to fees will make the use of ETFs easier for advisers, but commented: “There has been a long-held argument in the press that IFAs do not recommend investment trusts because they do not pay commission, where the reality is that other factors prevent fee-charging IFAs from recommending these funds. I suspect that ETFs will fall into a similar line of argument.” Bamford added that fee-charging IFAs might have other reasons not to recommend ETFs, such as a lack of access on platforms and a preference for active fund management.

However, Towry Law is a fee-based advisory firm and its head of wealth advice, Andy Cowan, said it is genuinely ambivalent about using active or passive management. He commented: “Where we think it is appropriate, we will use ETFs in order to minimise costs as much as we possibly can.” Cowan added that the greater use of ETFs in the US retail market was a result of moves there to fee-based advice. “There is a direct correlation between the usage of ETFs and fee-based advice. IFAs have 70% of the retail market here and the fact that ETFs are so rarely used is entirely related to IFA remuneration.”

While the RDR seeks to reform the advisory landscape so that remuneration is not a factor in an adviser’s recommendations, the emergence of wrap platforms could also increase the distribution of ETFs.

Barclays Global Investors global head of ETF research and implementation strategy Deborah Fuhr said that, like some IFAs, some platforms do not have a direct interest in offering ETFs. “Some platforms expect a fund to pay the platform 25 to 30 bps to be on that platform. If the average TER for an ETF is 31 bps, there is no way it is going to pay that,” she said. “Many platforms admit that although the end clients are asking for ETFs to be on the platform, they are still saying to ETF managers, ‘can you find a way to pay us?’”

David Ferguson, chief executive of the Nucleus platform, added: “ETFs are a growing part of the market and true wrap platforms will facilitate their use because they charge clients for administration, rather than charging fund managers for distribution. It is another reason why fund supermarkets are not very good.”

So the low cost of ETFs, which should make them attractive to retail investors, is perversely a hindrance to their take-up, as it currently means that many advisers and platforms are not incentivised to recommend or distribute them.

Low profile

The other major reason why ETFs do not have greater market share among retail investors is a lack of awareness of them, although ETF providers feel that this is changing and they are receiving more enquiries from investors and advisers. Manooj Mistry, head of db-x trackers UK, said that the minority of retail investors currently using ETFs are typically self-directed ‘hobbyist’ investors who are used to buying shares and funds online and running their own portfolios.

These individuals are not representative of the mass market and Mistry said for ETFs to reach this market, raising awareness is important, as well as reforms to the distribution system. “We have mostly focused on the institutional market, but the next step is to raise awareness among IFAs and financial planners,” he said. “As their understanding increases, they can pass on information to clients in the retail market.”

Claus Hein, a director at Lxyor Asset Management, the ETF arm of Société Générale, agreed that the main way to increasing the presence of ETFs in the retail market is through raising ETF awareness among the financial advisers who dominate retail distribution. But he added: “There has been a significant increase in the number of ETF enquiries from IFAs and individuals and we will continue to expand our coverage of this growing segment through investor education and dedicated client resources.”

Retail investors may also be unaware than passively run ETFs can still play a part in active investment strategies. Noland Carter, chief investment officer at Heartwood Wealth Management, said that ETFs can be invaluable for short-term tactical moves, giving broad exposure at a low cost. “At the moment, we are overweight in Asia and emerging markets, as we have a conviction there and we have a thematic bias to income. The iShares Dow Jones Asia/Pacific select dividend ETF matches that perfectly. Very few, if any, active managers can do the same thing.” This example illustrates how ETFs can be used for an active play by fund managers, despite being a passive vehicle.

Carter feels this is where investor education is vital. “Active management should be at the asset allocation level. Active management in individual markets is appropriate if there is evidence that active managers can outperform. So in major developed markets, where very few active managers outperform, looking at ETFs is a sensible thing to do,” Carter said.

So if our mythical visitor from another planet reviewed this sort of evidence, they might come to the conclusion that, while retail use of ETFs is currently low in the UK and Europe, it looks set to rise. Regulatory changes and a move to fee-based advice, a trend towards ETF use in discretionary fund management and a growing customer awareness of ETFs are all forces which, over the next three to five years, should see much greater use of ETFs in retail investor portfolios.