CLEARBROOK

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ETFs: Harnessing the Power of Disruptive Innovation

Institutional investors should take a new look at Exchange Traded Funds

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When they first began to appear on the investment industry's radar, institutional investors largely dismissed ETFs. They were seen as index-tracking, 'set-it-and-forget-it' products for individual investors, not as viable investments for alpha-seeking institutions.

The landscape has changed. ETFs have emerged as a textbook case of disruptive innovation – a new concept originating in low-end or new-market niches, then spreading into larger mainstream segments, often before more established market participants even realize what's happening to them. In this case, ETFs are moving into the institutional mainstream.

ETFs and the Institutional Portfolio

ETFs were a response to deeper disruptive forces enabled by Big Data, ever more sophisticated financial technologies, and globalization. This new investment environment is characterized by intensifying pressures to reduce performance-deadening costs, accelerating growth in the complexity of markets and asset classes, and increasing uncertainty, volatility and risk.

A few years ago, the *Harvard Business Review* counseled readers faced with disruption to "develop a disruption of your own before it's too late…." For many institutional investors, ETFs have the potential to play that role, helping them deal effectively with the disruptive forces reshaping the global investment environment.

Begin with the basics. Even traditional broad market-based ETFs have a place in the institutional portfolio, particularly for smaller and mid-size investors. Much has been made of studies showing that most actively managed portfolios have underperformed their benchmarks in recent years, but the potential benefits of ETFs go beyond avoiding below-benchmark returns. ETFs' lower fees have the potential to enhance performance, their diversification and liquidity can help manage risk, and their transparency supports compliance with increasingly stringent fiduciary standards. Some institutional investors have even adopted broad market index-based ETFs as core portfolio holdings, to achieve market returns by the most cost-effective means possible.

It's time to think outside the index. While Big Data and new financial technologies have helped create a more complex and competitive investment environment, they have also enabled the development of a much broader range of ETFs, many of which are focused on specific factors, asset classes, styles, themes, regions or sectors (some bill themselves as "smart beta" ETFs). These specialized ETFs offer institutional investors opportunities to gain exposure outside their traditional comfort zones.

For example, well-diversified portfolios increasingly include exposure to alternative investments such as real estate, commodities, hedge funds, private equity, and emerging markets. However, these non-traditional investments demand a degree of asset class-specific expertise that many institutional investors lack. Hiring that expertise or outsourcing on an advisory or discretionary basis is an increasingly expensive investment solution, with fees levels that can quickly negate the "solution" part of the equation.

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Specialized ETFs have the potential to provide that access on a cost-effective basis. By thinking beyond traditional perceptions of ETFs, institutional investors can add new dimensions to their portfolio allocations without scaling up internal staff or adding new advisory or discretionary management fees. While ETF fees vary, with passive, broad market index-based funds on the low end and actively managed EFTs somewhat higher, the costs to the institutional investor are still likely to be lower than their counterparts.

ETF Next

One of the latest innovations in exchange traded funds is the ETF-of-ETFs structure. While some dismiss the concept as fees-on-top-of-fees, fund-of-funds ETFs can be a simpler, more cost effective way of accessing multiple investment strategies than investing in multiple single ETFs.

A single trade provides access to all of the indexes, asset classes, styles, themes and markets covered by the ETFs owned by the fund. The ETF-of-ETFs structure can also simplify rebalancing, minimizing the number of trades needed to maintain a target allocation. ETFs-of-ETFs have the potential to be practical, cost-effective core and sleeve portfolio solutions for all institutional investors.

A new ETF-of-ETFs innovation is already emerging in the form of a more broadly diversified, multi-asset class fund-of-funds ETF. This innovation has the potential to be a total portfolio solution for institutional investors, particularly those that are small and mid-size.

Cost effective, transparent, liquid, professionally managed – it can check all the boxes for the institutional investor facing the new investment environment.