The Evolving ETF:

Using Exchange-Traded Funds in Client Portfolios

Contents

Mutual funds have the assets, but exchange-traded funds (ETFs) have the growth. In fact, investors are pouring record amounts into these low-cost, flexible investment vehicles. Their relative benefits are well-documented, but advisors are now specifically looking to ETFs to address recent market and regulatory conditions. The following whitepaper examines the why and how around the explosive growth of ETFs and where they may be headed next.

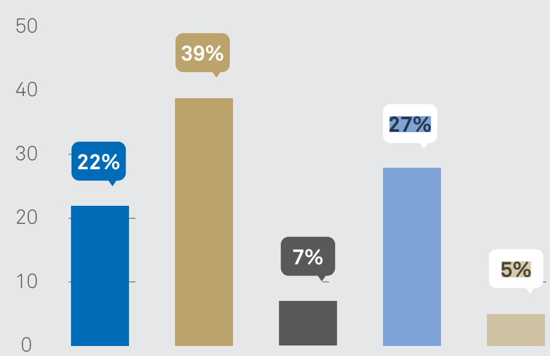
ETF growth may be old news to some, but why it's happening certainly isn't. New research offers a number of surprises about who is using ETFs, their place in the portfolio, how they're perceived by advisors and their rate of adoption in light of the release of the Department of Labor's Conflict of Interest Rule.

ETFs experienced a massive $53 billion net inflow in the month of July 2016 alone, despite investor concerns over Brexit fallout.[1] This came after ETFs took in a grand total of $238 billion for all of 2015, just shy of their record of $243 billion set the previous year. In 2015, no other investment vehicle came even close to this number. It's more than the flows into mutual funds and hedge funds *combined*.[2]

Growth

68% of advisors who use ETFs said they will increase their use over the next 12 months

- Increase by 1-10% (22%)
- Increase by 11-25% (39%)
- Increase by more than 26% (7%)
- Stay the same (27%)
- Decrease (5%)



[1] "July ETF Flows Total Massive $53B." etf.com. August 1, 2016.

[2] "Five Key Takeaways from 2015 ETF Flows." Bloomberg.com. January 4, 2016.

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The drivers of demand are well-documented. Mutual funds continue to serve as effective investment vehicles for the general public and the advisors with whom they work. However, the low-cost, transparency, diversification and tax-efficiency frequently attributed to ETFs are features that many investors are looking for from their financial and insurance solutions.[3] They increasingly offer something for everyone regardless of age, investment goal or risk tolerance.

For financial advisors, wealth managers, broker-dealers and registered investment advisors (RIAs) in particular, ETFs offer customizable solutions and lower-cost access to markets, countries and sectors than many comparable investment vehicles can provide.

According to Matthew Forester, chief investment officer for Lockwood Advisors,[4] "ETFs have captured a large share of new investment flows. They are a technological and legal evolution in packaging investment returns. With growth, what once was an evolution has led to innovation. Traditional ETFs competed on cost efficiency. Newer, quasi-active ETFs, sometimes called smart beta ETFs, challenge active managers to compete on performance, return to risk ratios or both."

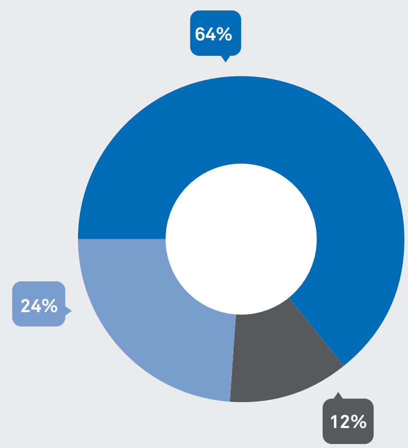
Indeed, it's clear that ETFs occupy a prominent place in the advisory toolkit, with expanding use across all advisor channels.[5]

It's little wonder then that PricewaterhouseCoopers conservatively forecasts global ETF assets to reach $5 trillion by 2020,[6] up significantly from $3.07 trillion at the end of March 2016.[7]

Prominence

The majority of advisors using ETFs said they are core to their clients' portfolios

- Core to the portfolio (64%)
- Used for diversification (24%)
- Satellites to the core (12%)



So how, specifically, are advisors using ETFs? How and to what extent are they expected to use ETFs in the future, and what specific issues will drive adoption in the near term?

Through original research and interviews with various industry stakeholders—including advisors, RIA executives, global wealth managers, ETF managers and providers—this whitepaper will answer these questions while providing an overview of the ETF market's future.

[3] "Weighing the Advantages of an all-ETF portfolio." CNBC.com. February 18, 2015.

[4] Lockwood Advisors, Inc. (Lockwood) is an SEC Registered Investment Adviser and an affiliate of Pershing LLC, each subsidiaries of The Bank of New York Mellon Corporation (BNY Mellon).

[5] "What's New for ETFs?" Wealthmanagement.com. August 9, 2016.

[6] "Exchange-Traded Fund (ETF) Assets Under Management to Exceed $5 Trillion by 2020, Says PwC." PwC.com. January 26, 2015.

[7] "Global ETF Assets Top $3 Trillion." Etf.com. April 12, 2016.

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Uncovering Clues

An increasingly hyper-connected and always-on world means market events, both positive and negative, occur with ever-increasing speed. ETFs allow for intraday trading, something that's frequently cited as an advantage. But how, specifically, are they being used by advisors?

A survey by Beacon Strategies LLC in conjunction with Pershing LLC, a BNY Mellon company, of more than 1,500 advisors and wealth managers (U.S. and international), including RIAs working with Pershing Advisor Solutions, was conducted to determine current perception and use of ETFs. The results of the survey revealed the following:

- Of advisors who use ETFs, 64 percent said ETFs are core to their clients' portfolios
- 68 percent of advisors who use ETFs said they will increase their use over the next 12 months
- Baby Boomers working with advisors are currently the largest users of ETFs by generation
- When choosing a specific ETF, performance is most important (43 percent) and the provider's brand recognition is least important (2 percent)
- "Concerns around ETF structure" was the biggest barrier to advisor use of ETFs, signaling a need for further education and potential market structure improvements

Survey Surprise

RIAs were early ETF adopters. As fiduciaries operating in a fee-based model, many incorporated ETFs in portfolios when they were first brought to market.[8] Today, RIAs still dominate in ETF use, leading all other distribution channels in 2015, followed by wirehouses and independent broker-dealers.[9]

However, Boston-based research and consulting firm Cerulli Associates adds that, despite ranking after RIAs in terms of percentage of advisors' portfolio allocation to ETFs, wirehouse firms hold the largest percentage of ETF assets compared to any other intermediary channel. Cerulli further anticipates advisor allocation to ETFs to increase, on average, another three percent over the next two years.

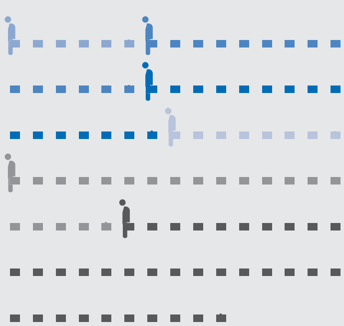
The percentage of ETFs currently included in client portfolios varies greatly depending on individual investor characteristics and needs. However, 55 percent of advisors indicated that more than half of their clients have ETFs in their portfolios.

68 percent of advisors who use ETFs said they will increase their use over the next 12 months.

Usage

55% of advisors surveyed said more than half of their clients have ETFs in their portfolios

- 6% said 0%
- 15% said 1-10%
- 16% said 11-25%
- 8% said 26-50%
- 20% said 51-75%
- 35% said 76-100%



[8] Ibid. Wealthmanagement.com

[9] "How Did RIAs Fare In Recent ETF Growth?" 401kspecialistmag.com. January 6, 2016.

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"Our process is highly customized to meet the goals and objectives of each client. Therefore our allocation of ETFs in a client portfolio is specific to the clients' needs," said Sean Clark, chief investment officer with Clark Capital Management. "For our larger accounts, we may allocate between 10 percent and 25 percent of the portfolio to ETFs. Smaller accounts, depending upon the objective, may be up to 100 percent."

One widespread industry assumption is that ETFs particularly resonate with younger investor demographics. The survey of advisors, however, contradicts this claim. Younger clients seem no more or less open to ETF inclusion in the portfolio than other demographics. Not only are older clients not resistant to the use of ETFs, but Baby Boomers (age 51-70) are the most receptive at 48 percent. They are followed by the Greatest Generation (age 71 and older) at 29 percent, Generation X (age 36-50) at 17 percent and Millennials (under age 36) at 6 percent.

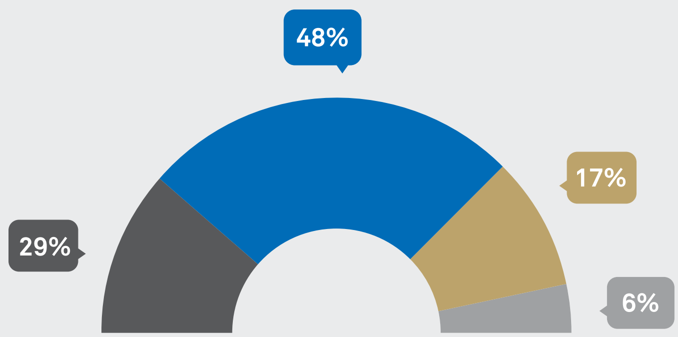
"We treat all ages the same, so we do not segment in that way," Craig Birk, executive vice president of portfolio management with Personal Capital, explained. Online (or robo) advisors have favored ETFs and typically do attract a younger clientele. Whether they're independent or proprietary, that's the direction they're going.

"Older generations, however, are more fee-aware," he added. "In general, investors have more access to information and are more questioning of the investments they have. We tend to skew younger with clients in their 30s, 40s and 50s, but also some that are a lot older."

Demographics

Baby Boomers are currently the largest users of ETFs by generation

- Greatest Generation (age 71+) (29%)
- Baby Boomers (age 51-70) (48%)
- Generation X (age 36-50) (17%)
- Millennials (under age 36) (6%)



Rather than age, Clark sees it as a high-net-worth versus lower-net-worth, size of the account, and asset allocation issue. "In our opinion, high-net-worth individuals still like individual stocks and bonds for the majority of their portfolio, even with interest rates moving higher," he claimed.

Interestingly, the survey found that a solid majority of advisors (64 percent) use ETFs as a core strategy in their clients' portfolios, signaling a greater acceptance overall.

Personal Capital's Birk uses a blend of ETFs from different sectors for tax-efficient and cost-efficient market exposure that is highly diversified and granular.

Aside from their own internal research and direct contact with providers, advisors overwhelmingly pointed to Morningstar as their primary source of ETF research, with "underlying costs" mentioned as an area in need of more information.

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“There is not enough of a focus on certain fund fees,” said one advisor. “The focus is on the overall fees charged by the advisor, but not enough on the embedded fees.”

Despite this, the ETF structure received high marks overall, with advisors pointing to the high ETF inflows as evidence.

“Institutional use is on the rise,” said one advisor. “We would not have ventured into certain asset classes without them; commodities for instance. The structure works.”

Independence Day

While the RIA channel continues to dominate, ETF managers and providers report seeing a significant increase in ETF adoption across all channels.

“While there is growth in every channel, some channels are further along the adoption curve than others,” said Jason Stoneberg, director of ETF research with Invesco Powershares. “RIAs are ahead as they already largely have a fiduciary role. Independent broker-dealers are also opening up as they become more fee-based.”

“RIAs seem to have less required ‘guidance’ from a home office and therefore have the ability to go anywhere,” Ryan Issakainen, ETF strategist and senior vice president with First Trust Advisors, added. “They are adopting a number of innovative strategies like smart beta and actively managed ETFs, among others.[10] Wirehouses and regional broker-dealers are also seeing an increase, but provide more guidance about what their advisors can and can’t use.”

BlackRock’s Joe Craven agreed. The firm’s managing director and head of iShares US Wealth Advisory sees strong ETF adoption in the double digits regardless of channel.

“Independent broker-dealers are coming on strong,” he said. “ETFs are being integrated within their individual stock allocations and mutual funds at an accelerated pace. Overall, investments in ETFs are still small relative to other products and strategies, but they’ve also experienced tremendous growth, which gives investors unprecedented choice of asset classes, styles, regions and outcomes. Typically, investors are introduced to ETFs through an equity allocation. However, we’ve seen record flows in fixed income ETFs as investors continue to look for ways to navigate today’s more complex markets.”

Barriers

“Concerns around ETF structure” is the biggest barrier to advisor use of ETFs

[10] Investors should be made aware that smart beta and actively managed ETFs may involve additional fees or charges associated with these types of ETF strategies.

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> "Risk events in the market used to happen every five years, now they happen much more frequently."

Issakainen used this analogy when describing sources of ETF asset growth, noting that newer investors will "dip their toes in the water and eventually feel more comfortable."

"A lot of it comes from existing users increasing their allocations," Issakainen said. Some are also now looking at the replacement or replication of a certain mutual fund strategy.

"A large part of product growth is an increase in investor education and awareness," he added.

And while core equity and core fixed income are attractive to investors at the moment, Issakainen explained that other categories, such as actively-managed fixed income, are experiencing a greater percentage growth.

"We've also seen increased interest in minimum volitatility investing products," Craven emphasized. "Risk events in the market used to happen every five years, now they happen much more frequently. An ETF of this type can help lower overall portfolio risk and is a good complement to a core allocation to help smooth market peaks and valleys."

As for the relative attractiveness of ETFs to certain groups and demographics, both agreed ETFs seem to be age-agnostic.

Focus

Advisors are most often leveraging ETFs to invest in broad market indexes

Going Global

A number of advisors noted that ETFs are a unique and egalitarian solution with the same minimum investment size and cost structure, whether it's an institutional investor, financial advisor or direct investor. It is, therefore, increasingly popular in international markets, in addition to the U.S.

Deborah Fuhr, co-founder and managing partner with London-based ETF research and consultancy firm ETFGI LLC, pointed out that in 1997, there were 21 ETFs and $8 billion in assets. ETFs were typically part of a "large tool box of products with low fees for institutional investors, and part of a smaller tool box of products with higher fees for advisors and direct investors."

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In 2016, ETFs globally feature:

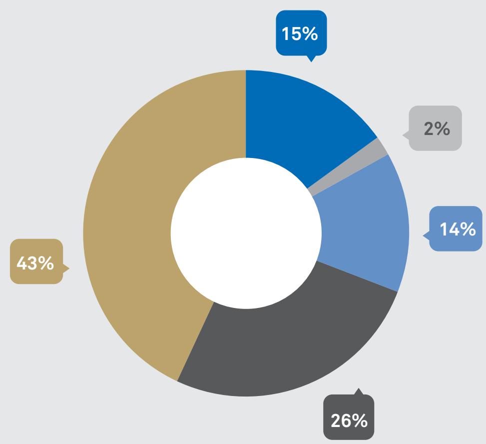
- A record $3.07 trillion of assets
- 6,240 products
- 12,042 listings
- 277 separate firms now offering ETFs
- Availability on 64 exchanges in 51 countries

“Most allow for index exposures, as it is hard to find consistent, active, alpha managers,” she said. “It’s hard to find active managers anywhere in the world that consistently outperform [their benchmarks].”

Direct investors are realizing that paying less in overall fees could potentially lead to better long-term performance, and ETF wrappers have made it easier for them to access emerging and frontier markets, different sectors and even physical assets such as gold.

Selection

Performance and expense are the most important factors for advisors when choosing specific ETFs



- Performance (43%)
- Expense ratio (26%)
- The bid-ask spread (15%)
- Strategy or sector (14%)
- Provider brand recognition (2%)

“Adoption among financial advisors is high in the United States, but we haven’t seen significant adoption in other markets because of how investment products are sold, and specifically with commission issues,” Fuhr said. Innovation among providers is occurring around index funds and smart beta ETF strategies, even though market cap strategies still have by far the largest amount of assets.

“So-called *smart* beta has $400 billion in assets and has a five-year compounded growth rate of 35 percent,” she emphasized, “versus a five-year compounded growth rate of 14 percent for market cap, which is driven by a market cap that is largely locked up by the ‘Big Three:’ BlackRock’s iShares, Vanguard and State Street’s SPDR brand.”

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Fuhr concluded by noting that, “In 1997, 154 institutions reported using one or more ETF. In 2014, 4,000 institutions in 53 countries reported using one or more ETF. Sophisticated investors are using them just as much, if not more, than their less sophisticated counterparts.”

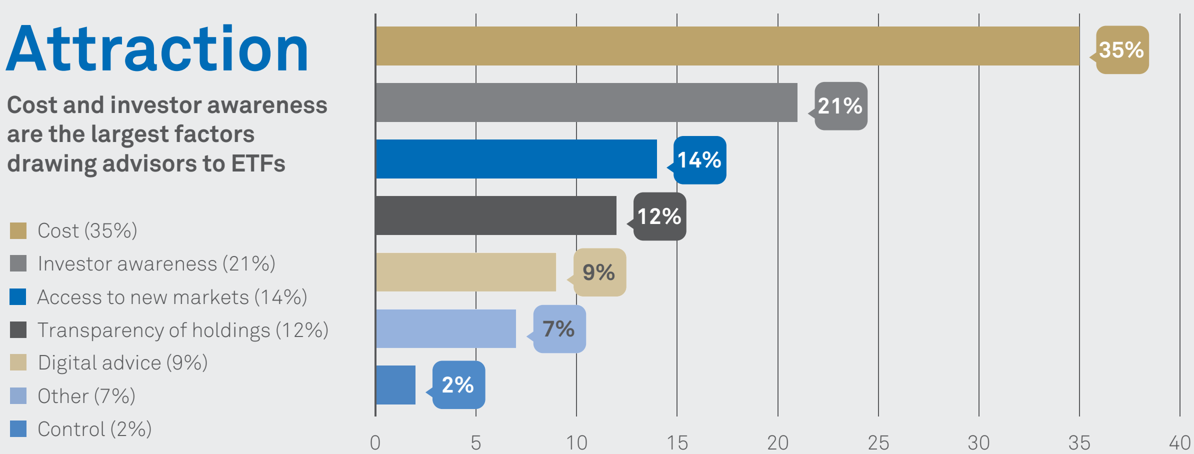
Fiduciary Opportunity

A final point involves the recently passed Conflict of Interest Rule from the Department of Labor and its effect on the financial services industry, ETFs included.

According to Robert Cirrotti, managing director of Retirement and Investment Solutions for Pershing, “Further scrutiny of investment expenses will be one of the outcomes as the industry seeks to comply with the Department of Labor’s best interest standard of care. Greater utilization of ETFs is expected as a result consistent with the trends we’ve seen among fiduciary advisors today.”

Attraction

Cost and investor awareness are the largest factors drawing advisors to ETFs



Powershares’ Stoneberg concluded, “Specifically how advisory firms and independent broker-dealers implement ETFs in light of the rule is still to be determined, so it’s a little bit of a holding pattern.”

What’s Next?

Although ETFs are undoubtedly a popular solution, and one that’s rapidly growing across all distribution channels, industry misconceptions about who is using them and how remain. Survey participants and interview subjects reported greater adoption among older clients than previously believed, and market segmentation by age demographics is minimal or non-existent among advisors and ETF providers. No longer considered ancillary to the portfolio, ETFs are increasingly considered a core investment strategy, especially as education and use increase.

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So where do they go from here?

Their flexibility, transparency and lower costs effectively address increasing demands from investors and advisors, indicating continued ETF asset inflows. However, concerns surrounding the ETF structure, identified as the largest barrier to ETF use among survey respondents, signify a need, and indeed opportunity, for further education efforts as well as potential market structure improvements.

Survey Methodology

Beacon Strategies, in conjunction with Pershing, surveyed more than 1,500 financial advisors, RIAs and global wealth managers. Simultaneously, expansive interviews were conducted with individual advisors and RIAs, as well as with ETF product representatives, to address both quantitative and qualitative aspects of the underlying research.

Beacon Strategies LLC is a premier research and consulting firm that specializes in technology developments for the financial services industry. Founded in 2006, the firm focuses on strategic and tactical decisions that banks, broker-dealers and advisors face in an increasingly fast-paced and hyper-connected business environment. Beacon Strategies delivers critical thought-leadership insight in print, in person and on-line through publications, website content, consulting assignments and industry-leading conferences and events.

ETFs are subject to market fluctuation and the risks of their underlying investments. ETFs are subject to management fees and other expenses. Unlike mutual funds, ETF shares are bought and sold at market price, which may be higher or lower than their NAV, and are not individually redeemed from the fund.

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