INTERVIEW

Breaking traditions with ETFs

FTSE RUSSELL CONVENES

Kingsley Ford

Global Head of Index Investments Group, FTSE Russell

Interviewed by

Jamie McDonald, ex-portfolio manager, Point 72

Jamie: Kingsley, thank you so much for stopping by and having a chat with us.

Kingsley: Well, it's a pleasure to be here, thank you.

Jamie: Please tell us what your role is at FTSE Russell.

Kingsley: I'm the global head of our Index Investments Group at FTSE Russell and we focus on every bit of the client's market participant area where there's an index, or an investment linked to an index. It could be anything from ETFs to passive mandates, structured products, derivatives, and how do we grow that business, how do we raise AUM and launch interesting new products.

Jamie: If I could start by talking about ETFs. Back when I was a portfolio manager in 2008 to 2012, there were several hundred ETFs but now we are talking like almost 10,000. Do you think this rise in ETFs is going to continue? What areas are most people interested in? I was thinking that because rates are where they are, there could be more interest in bond ETFs and I'm just interested in a bit of colour around the world of ETFs today.

Kingsley: Okay, there's a few things in there we can unpack. So, it's a phenomenon of this generation of finance. The absolute explosion of ETFs and indices, or people might call it passive investing. It's grown huge, it's grown exponentially, and I think, the systemic trends are going to continue, probably not in the volume of ETFs. So not just more and more ETFs but really growing the size. So, we see big ETFs dominating the inflows because they build up a whole ecosystem around them, more AUM makes them more liquid. They become more easy trading instruments. They become trading tools in their own right. I mean, I think one of the interesting things we've seen is from the old days of people using index and ETFs, it tended to be this sort of long term buy and hold that's your choice stake there. They've grown to such size and become such trading tools in their own right. A lot of active managers, hedge funds, really different market participants, have been huge users of ETFs because they can then express a view, and there's been a lot of different views and macro events going on in the last few years to quickly express a view on the market rather than trying to pick individual stocks. They may say they want to go long or short, a country or a sector or a style or a size, and it's very easy, it's cheap for them to do that through ETFs. I think having started as a sort of long term buy and hold tool, they've evolved into a trading tool in their own right, which all of the market participants are now using. I think that facilitates that growth and that ecosystem around them. To answer the first part of the question, yes, we see the growth continue but in more new and interesting areas.

Jamie: Of the more nuanced ETFs, do they have quite high expense ratios because obviously that would be a sort of deterrent from trading ETFs, I know, particularly for hedge funds who want to keep their costs down.

Kingsley: Absolutely, so price compression in index investing has been a huge theme. It's driven so much change in asset management. You can now buy large cap equity for pretty much free, three basis points that hold a big-

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Jamie: And what would it have been like five, 10 years ago? I mean, it's always been coming down.

Kingsley: It's been coming down consistently. But people have just got increasingly comfortable with just the fixed income can work in the ETF form. And I'll talk about what happened through COVID in a second. Secondly, obviously now, the rate environment, people actually get a yield. So, they can get in some return there. That's driven a lot of more recent interest in fixed income. But there has always been a question that on the equity side, it's a tradable, it's a liquid underlying on a stock exchange, you can see the price. But the question with fixed income ETFs, because it's OTC, how would that work when an ETF is trying to hold all these bonds underlying it? And a lot of those don't trade very often. How do you have the price? How would that work in a difficult environment? So, when it came to COVID. Sort of March 2020, fixed income markets froze up, there was no trading and it was a real testing moment for fixed income ETFs. And actually what they did is they came through so strongly that they've now passed that test and seen a lot more investment. And what we saw was, even when the underlying bonds weren't trading, the fixed income ETFs above them were trading and passing hands. It became a sort of price discovery tool for the underlying.

Jamie: So, the ETF started leading the price of the bonds rather than the other way round.

Kingsley: Well, it's a way to indicate what the price of the bond is because the underlying, if it's never trading. But people were then thinking what's the appropriate price for the ETF and it came through that. The trading continued in the ETFs because of the distinction that then you didn't have to trade the underlying. I mean, one point, I'll point out sort of linked to this, this sort of trading the actual ETF as opposed the underlying investments is that recently, in fact, last year, we saw in the US trading of ETFs was 30% of the market of total stock market turnover.

Jamie: Wow.

Kingsley: A huge amount. And it has been growing slightly but over the last five years, it's only come up from sort of 25 to 30%. So not huge growth, it's not certainly proportional to the way we've seen the AUM go up. But then when you unpack it a bit further, of that 30%, it's nearly all in the, what we'd say the secondary markets. So, the ETF units themselves changing hands not the underlying. So 85% of the turnover comes from people just trading the ETF and only 15%, the underlying. You'll see in the press a lot about people asking does ETFs and the trading and index investing increase volatility? But a lot of it, they're only trading ETF units themselves, not the underlying components.

Jamie: So just sticking with fixed income ETFs for a second, as you say, short rates up around 5%, is that where you're getting a lot of attention in terms of volume into those products and what products can get in there? I mean, you could go out and you could buy three-month treasuries at whatever they are, five, 5.1%. But what will you be getting in money market ETFs right now? I mean, is it comparable to that?

Kingsley: Yes, taking a step back. What we've seen with the flows into fixed income ETFs, it's really at the early stage of this sort of, innovation evolution. It's very basic vanilla US, govies, investment grade, that's huge volume of flows, mostly into the US, mostly into sort of stable, what we would consider vanilla investments. What we've not seen yet but it's starting to come is the innovation and people thinking, what else can we get, where can we go? I mean, of course you have emerging markets and so on, but beyond that, on the equity side, we've had years and years of ESG type of investing, factor investing, thematic. And that's a really early stage, both on the sort of the research side but also the sort of implementation side in fixed income. So, we're beginning to see a huge amount of interest there. In fact, last year in Europe, of all the flows into fixed income ETFs, 50% of them were into sustainable or ESG ETFs.

Jamie: Wow.

Kingsley: Tiny fraction in the US. But Europe is really leading the way. And that that's both the equity and fixed income. And actually, this year, inflows into fixed income ETFs have overtaken equity for the first time ever. It's sort of been catching up last year and the year before sort of getting from 20%, 30% but this year it's over 50% of the flows have gone into fixed income. It's a whole new world of things for people to explore because it's been a long-held view that the best way to access fixed income is through active. And it's definitely still a place for that. And you can still find out performance, but people have just got comfortable with the index and the ETF approach.

Jamie: You mentioned you oversee quite a few different areas in terms of the products that FTSE Russell offer. How about structured products? What falls into that bucket?

Kingsley: Structured notes has been a huge area for us and a huge growth for index. So typically aimed at the kind of the wealth advisor, high net worth kind of market. And this is an area where we've seen huge innovation because unlike a big passive or pension fund or ETF who has to take a really long-term view and these things, billions of dollars take time to set up. For structured products, they can turn around these products in a week, couple of weeks, get them out and really capture themes in the market. So, this is ripe for innovation. I mean the recent topics people have been talking about is biodiversity which really come to the fore in the media. So that's gained interest. Is there even the data to approach getting an exposure to these types of companies? But what we really think about is this whole ecosystem of the users of index products. So, in the old days we might build an index, give it to a client, they launch a fund or an ETF, and that's kind of it, we walk away. But now, the success really for an index is not about a single product and the methodology behind it, it's about the ecosystem around it. Say for example, having liquid futures derivatives on an ETF means investors can then hedge their exposure.

Jamie: Yes.

Kingsley: If the asset owners and the wealth advisors understand the index and the methodology, they can become more comfortable investing in it. And it builds up the big popularity indices around the world. You see a big liquidity ecosystem around them. And interestingly, we're starting to see that from the old traditional benchmarks. We are starting to see these ecosystems evolve around sustainable and in ESG benchmarks, which is something brand new.

Jamie: Going onto to a slightly different topic of AI, either personally or professionally, I've asked others this as well. Are you excited about it or are you nervous about it? Where do you stand?

Kingsley: Personally, I'm definitely on the positive side. I think, there's always potential pitfalls and people using it the wrong way. But look over history, you can't hold back innovation and technology, it's going to be here. It's really how we handle it and how we put it to the best use. Like I guess all industries we are looking at how this potentially could impact investment in indices and so on and trying to think through the different applications. I mean one interesting thing is people say, can you build an AI index? So firstly, what does that mean?

Jamie: Let me ask about that. Because if somebody did come to you and say, I want to build an index where I just have as much exposure to AI as possible, would you go out there and say, okay, how many companies should be in this index? First, call it a hundred. Are there a hundred companies with 20% of their revenues directly coming from AI innovation? Are those the kind of conversations you have? I'm just interested how you go about constructing these.

Kingsley: These days people don't buy an index off the shelf anymore; those days are gone. which makes it very interesting for us. But also, it's a challenge in terms of, getting the data and doing this. So very much everything is customised and so for that, yes, we would look at a lot of, back and forth with the client to see what's the best approach and the size of the benchmark they might want, the volatility they'd be comfortable with. And then what sort of data is available to try and do this. And I've seen some commentary and analysis recently that the more often a CEO mentions AI in their quarterly earnings report, the better the proportional returns.

Jamie: Yes, I'm sure.

Kingsley: So, you have to be careful like, is this data true? Is this company really exposed to AI? But there are obviously, companies who are and we've seen that in the video, in obvious example. So yes, that's exactly the type of thing you could do. So that's in building an index, if someone said, I want to be exposed to the AI revolution, for example. And then I suppose the question we're also asked is could you build an index, or could you have AI build an index itself? Now I think certainly you could. Always with AI is I think the way that you set it up and the way you ask the question, which is done by a human, heavily influences the outcome. But another point to make about entities is a key part as well as the ecosystem, the evolution, it's really the kind of the governance, the transparency. People don't want to be surprised by what happens with their index. They want to understand the rules which companies can go in or out because they don't want to be surprised by their benchmark. And so, it raises the question, people can look at all of the index rules for any benchmark provider which are published and they can predict what's going to happen and they can think, if this country gets promoted from emerging to developed or this company goes from a small cap to a large cap, I can predict what's going to happen and I can trade around that. If you had an index built by AI, the question is why did that company go in? Why did that country change classification? So definitely see what happens. Undoubtedly people will build indices made out of AI, I'm sure.

Jamie: Kingsley, it's been so much fun chatting with you. Thanks for stopping by.

Kingsley: Absolute pleasure, thank you.

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