INTERVIEW

The continuous rise of ETFs

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Interviewed by

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Jamie: Ravi, thank you so much for joining us today. It's great to have you here.

Ravi: Thanks for having me here.

Jamie: Ravi, back when I was a portfolio manager many moons ago, there were only I think about a few hundred ETFs out there in the world. And now we're looking at, I think almost 10,000 ETFs worldwide, something like that. Their growth in popularity doesn't seem to be stopping so I wondered if you could give us a little bit of an update about what's driving the popularity in ETFs, what kind of product innovation you are looking at, clients are looking at, and really just give us an update of where we are in that world today.

Ravi: In our world, we talk to institutional clients and we also talk to wealth clients. So let me focus on the institutional clients a little bit more since that's my role. And within institutional clients, the single biggest driver for growth of ETFs has been liquidity. ETFs in many, many cases have become more liquid than the underlying securities. So for example, if I use Russell 2000, the Russell 2000 ETF trades at a tighter bid-ask spread and a lower transaction cost than many of the underlying securities.

If I was an institutional investor and I want to quickly access the small-cap market using Russell 2000, I could very quickly do that using the ETF that's based on Russell 2000, than the underlying stocks themselves. That's a simple example of why institutions are driving ETF adoption.

Jamie: What about cost of ETFs? How's that changed over the years?

Ravi: That's a great point. So as liquidity has gone up, happily for investors, the management fees have come down. And so if you look at the total cost of ownership which is a sum of the cost to get in, the cost to get out and the management fee, that's been steadily declining, and that's been a huge reason for the increased adoption as well.

> A recent study with a Norwegian pension plan found that more than 90% of its alpha came from asset allocation. If you're doing asset allocation, then if you can find the right low cost building blocks, then you can get to alpha very, very efficiently.

Jamie: Now I used to work at a hedge fund, so our job is really stock picking. But have you seen an increase in liquidity? Have you seen different types of clients even hedge funds moving into the ETF world?

Ravi: Our largest client base are asset managers. The biggest asset managers in the world use our ETFs. And the reason is a couple of reasons. One, we talked about liquidity to get it in and get out. And the second bigger reason is a huge source of alpha is asset allocation. Somebody did a recent study with a Norwegian pension plan and they found that more than 90% of their alpha came from asset allocation. If you're doing asset allocation, then if you can find the right low cost building blocks, then you can get to alpha very, very efficiently. And so that's the second reason, especially a lot of the multi-asset strategies that have a combination of equities and fixed income, they use different low-cost building blocks to get to the right alpha. And so a combination of liquid and low-cost building blocks allow you to arrange the Lego pieces in a way that you can find your own alpha. So the world has moved on from active and passive. These sort of index building blocks are a source of alpha for active managers. That make sense?

Jamie: It does. Yeah. People have perhaps got more into thematic trading because these ETFs can be so granular in terms of what they're getting your exposure to. Does that sound right?

Ravi: Totally right. So I feel like if you look at the example, if you were like an active manager and the value you're going to get between picking a Verizon bond versus an AT&T bond, is this much. But choosing the right asset class is going to have this much in alpha compared to the little sort of alpha you get in security selection between, you know, Ford and GM or Verizon or AT&T. So if you get the asset allocation right, there's a lot you have a lot going for you. And to do that, you need sort of liquid, easy to access building blocks and ETFs are serving a tremendous purpose in that selection.

Jamie: You talked about liquidity and I was an equities guy so I'm afraid I'm not an expert in the world of fixed income. But I can understand in inequities how liquidity can be readily available. But how does it work with fixed income products? A lot of these trade over the counter, you know, some of them are buyer and seller being matched, brokered, so how do bond ETFs work with underlying liquidity?

Ravi: Great question. If you like ETFs for additional liquidity, you will love ETFs for trading and fixed income, and here's how that works. Let's say you look at the high yield market. In the high yield market, the bonds in the high yield market have a typical transaction cost of something like 100 basis points. If you look at our liquid ETF, the transaction cost for that is about two basis points.

Jamie: So, it's a 100 basis points.

Ravi: 100 points of just transaction costs bid-ask spread if you're trading the underlying high yield bonds. So a typical basket of high yield bonds has a bid-ask spread of 50 to 100 basis points. The ETF has a bid-ask spread of two basis points. And the reason for that is the ETF is an equity instrument that trades not over the counter but on an exchange.

That's the big difference. The ETF almost serves on top of a liquidity layer that's traded between two people on the exchange and not through the over-the-counter market. So that's what the ETF have done is liquified a difficult to access and less liquid asset class, and that's made it sort of more attractive for a lot of adopters to use it because they're paying far lower in transaction costs.

Jamie: Ravi, what about periods of high volatility? I mean, during the pandemic, for example, a recent period of very high volatility. Was it difficult to find the true price of some of these fixed income ETFs because, you know, the bid-ask spreads, there must have been big dislocation. So how do you know what the sort of true underlying price was?

Ravi: Another great question. So, every time there's a dislocation in the market, what actually trades is what are the securities that trade on an exchange. So, fixed income is over the counter. It's harder to find the true price of something that trades over the counter. But on an exchange, if you look at our big ETFs, they trade 10, 20,000 times a day. Even the most liquid bonds we're trading 20, 30 times a day. So where is the true market price on something that trades 20,000 times a day or something that trades 20 times a day?

And what trades 20,000 times a trade is the ETF, and that becomes the leader in liquidity. That is actually telling you where the true market is. And then the underlying bonds tend to catch up a day later. It actually leads the way in price discovery compared to the underlying bonds.

Jamie: So actually fixed income ETFs, they're a huge enhancement to trading bonds because they've increased price.

Ravi: Totally. Price transparency, price discovery and liquidity. T-costs are lower, you actually find a true market price for exchanging risk, and you're able to do it at a very low bid-ask spread.

Jamie: Sticking with fixed income if we can, for a second. rates were very, very low for such a long time. I can't imagine there was huge appetite for that asset class. But as rates now seemingly are in the mid-single digits, are you seeing a lot more appetite from institutions for bond ETFs?

Ravi: I see two things have changed. There was a reasonably good appetite for bond ETFs, for liquidity reasons, for tactical reasons because people would say, "Listen, I want to increase my exposure to say, corporate bonds." You look at a pension plans, they're always going to have a significant allocation to fixed income regardless of where rates are, right? That's just the balance in the portfolio. And for them, for example, they're like, "Hey, I'm going to get a new active manager, but it's going to take me six months to onboard the active manager. I'm going to have something as a placeholder." And that placeholder used to be the ETF because it is very low cost to get in and get out. So those use cases have been going on for a long time and they've been increasing constantly. So even in a low rate environment, those use cases were very useful to our clients. Now let's switch over to your question which is in the high rate environment. Those use cases are still valid but what you also have is a lot of people parking money in the short end. And at the short end, there's a whole bunch of ETFs where you can park your money at the short end of the curve very quickly and very efficiently to pick up the 4 to 5% sort of yields that you want. So both in the low rate cycle and the high rate cycle, we are finding ETFs to have like enormous application.

Jamie: Ravi, if you don't mind talking a little bit at BlackRock, how do the conversations go in terms of product innovation? Who comes up with the new ideas? Is it more client-driven or is it more you guys sitting in an office thinking "What do we think our client's going to want next?"

Ravi: So for most time, we don't operate a lab. It's not like we have five people with lab coats figuring out like this is the next ETF and then we bring it out and say, "Voila." That's not how it is, right? That's maybe the Apple model because they're geniuses at stuff like that. In our world, we try to interact with clients with index providers, lots of partners in the street, to figure out where, one, what our clients want. And it's rare for clients to come in and say, "I want X, Y, Z, ETF with this benchmark." Like that's long gone, right? It's more like what are the issues you're trying to face and trying to read those themes out. Like you know, if inflation's an issue, like do we have the right product set for it? Work with index providers, you know, like Footsie to say, "Hey, can we sort that problem out?" That's the way product development sort of works. And oftentimes, clients call us and say, "You guys are the leaders in the ETF space. I'm thinking of doing X, Y, Z. Would you be able to help me?" And then we talk to more clients and say, "Can we build a little bit of a coalition of clients to see if we have the same thing?" We've done something very similar in this case many, many times in the past, and that's how we sort of operate.

Jamie: The period from about 2013, 2014 to about 2020 is what, in my head, I've got this period of huge liquidity, quantitative easing, whatever you would like to call it. And it became a very difficult market for stock picking in particular, more thematic trading was working better. Do you think now that we're returning to quantitative tightening or higher rates or less liquidity in the market, is it now going to become a market where it's better for stock pickers and maybe less likely the ETS will be used as much?

Ravi: Yeah, I think there's always a space for both. There's some incredible stock pickers who have an incredible knack and process for security selection. We think that's very complimentary to still using low cost liquid index building blocks to generate alpha. It's still complimentary for people having liquidity sleeves because they still need to take money in and out seamlessly and at the lowest part of possible transaction costs. So we think there's a nice sort of coexistence between high conviction alpha stock picking versus finding alpha through, you know, index allocation or through pure sort of index investing. All three coexist right now in a lot of our client portfolios and they'll continue to do that. So I feel like these things all are sort of very well jigsaw together.

Jamie: Let's look at into the future. I guess by just what you're saying is this growth in ETFs is going to keep going. You don't see any slowdown in the near future?

Ravi: Not even close. I think one of the biggest trends we're seeing, especially in the wealth space, is the use of model portfolios. And what's happening here is that a lot of money is moving into sort of index products because clients, asset managers, and advisory platforms are able to talk to clients and use different low-cost building blocks especially across different ETF providers across different asset managers. If I was an advisor and I want to tell my client that I've got the best products of BlackRock and two or three other competitors, that's a powerful story. That's a powerful story to take to an end client and say, "I've got the best of worlds of all these different people," and these are called model portfolios. A lot of money is moving into model portfolios, and this is a trend that is going to continue and we will see in the trillions of dollars moving to it. If I would say there is one big trend, this is the single biggest trend we're going to see in the next few years with trillions of dollars moving into model portfolios to be used by sort of end investors and that's the space we think there's enormous innovation that's happening, that's the space we are very committed to and working with sort of index providers like Footsie, working with lots of our partners to see how we can collectively grow that space.

Jamie: How about the interactions with retail? Are retail becoming a growing part of your customer base or are they staying roughly the same?

Ravi: A growing part again, for exactly this trend because a lot of investors are finding that if I can use the best products, the best ideas for multiple different asset managers, and if there's someone who can put all this together and so I don't have to pick between the two of them, that'll be great. If I was retail investor, I don't want to have to find which is the next biggest mega trend. Is it robotics? Is it, you know, something in biotech like, I don't know. But if I had someone else doing that for me, that would take the brain damage off of me. And that's where again ETFs become the building blocks to put these little you know, portfolios together, and become an important part of the client's, you know, overall portfolio. So, this trend is here for the future. And if we offer liquidity and convenience. Convenience is a very powerful factor, this becomes so convenient for them to say, "Yeah, I've got the best of all this and I don't have to worry about it." That becomes great for advisors and their clients.

Jamie: Ravi, that seems like a great place to finish. I want to say thank you so much. This has been a great conversation.

Ravi: I appreciate it. Thanks for having me.

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