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Price war begins as investors focus on cost

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Cost remains the most important motivation for investors to use exchange-traded funds above other investment tools, according to Financial News' ETF Snapshot Survey 2012.

Price war begins

Asked why they use ETFs, survey respondents scored cost-effectiveness highest (2.31 out of a possible three points) on average, followed by exposure to markets that would otherwise be hard to access, long-term strategic exposure and greater liquidity than other investments. Laurent Kssis, partner at marketmaker Bluefin Trading, said: "First and foremost, people invest in ETFs because of costs. Only after that will they discuss other reasons."

It's a lesson the US market has been taking to heart, with price wars erupting this year. Most recently, in September, Charles Schwab cut fees on its range of 15 ETFs to as low as four basis points. BlackRock said it would reduce costs across a range of its products and Vanguard has already cut its fees this year.
Lower returns and regulations, such as the Retail Distribution Review in the UK, are increasing investors' focus on cost generally. Ben Seager-Scott, senior research analyst at wealth managers Bestinvest, said: "You are already starting to see a price war across the passive products range."

That is filtering through to ETFs, and already low-cost providers entering the UK market in the last couple of years have focused on price. Amundi launched in the UK in 2011, highlighting expenses close to 25% lower than the average in the market. Vanguard has been no less explicit about its intentions.

Tim Huver, ETF product manager at Vanguard, said: "We are very focused on competing on cost. It will be one of the key differentiators going forward."

Mistry: Liquidity is as important as costs for some investors

However, while providers might be eyeing the retail market in the UK, elsewhere in Europe it’s still not on the agenda.

Jose Garcia-Zarate, senior ETF analyst at Morningstar Europe, said: “Europe is not really a single market. It’s a collection of very different markets with different strategies, so you have to distinguish between them.”

Liquidity essential

Even in the UK, institutional sales will dominate for the foreseeable future, and some argue such investors are focused less exclusively on cost. Manooj Mistry, head of Deutsche Bank’s db x-trackers ETF team in London, said liquidity is almost as vital for many.

His belief is borne out by the survey results, where liquidity ranked equal second alongside total expense ratio with an average score of 2.12 out of three when respondents were asked the most important factors they consider when choosing between ETFs. The most important factor for respondents was underlying index, which scored 2.34 out of three.

Stephen Doran, a senior fund manager in the private client fund management department at HSBC Global Asset Management, said: “We have a reasonably well-defined universe of providers we are comfortable with, so if a new, relatively unheard-of provider came to market with something that undercut by 10 basis points that wouldn’t be a prime driver for switching.”

Even if investors do decide to shop on price, the complexity can make it difficult – requiring investors to look beyond the TER. Morningstar’s report into the cost of ETF ownership earlier this year highlighted the importance of issues such as tracking error and bid-ask spreads, for example.

Valérie Baudson, managing director of Amundi ETF, said: “Cost is not just the management fee.”

Nevertheless, costs are likely to trend downwards, partly due to the maturity of the market. Price cuts in the US at the start of the year by Vanguard, for instance, were put down to economies of scale. As the European market grows and matures, the same should be possible.

Dan Draper, global head of ETFs at Credit Suisse, said: “The ETF business is a scale business and as it gets bigger arguably it gets cheaper for the customer.”

Added to that, low returns are putting a focus on investment costs generally. David Norman, co-founder of TCF Investment which runs funds and portfolios mainly for the retail market, said costs have risen steadily up his agenda. High TERs and trading costs are no longer simply a drag on performance; they can eradicate investment returns. Norman said: “When you have got returns slumping from 20% a year to 3%, the impact of costs is rocketing up.”

There are two further reasons to expect further declines in cost. First, the European market still has a large number of players: 40 providers in a $309bn market, according to ETFGI, compared with 33 providers in the US market with $1.158 trillion in assets. Even allowing for the fragmentation of Europe (with those ETFs spread across 22 stock exchanges, compared with three in the US), that suggests a competitive market.

Mistry said: “To a certain extent, over the years, the European market has probably been more competitive than the US market.”

Competing investments

Second, it’s not just competition from other ETFs that providers, particularly in Europe, have to be concerned with. Guy Simpkin, head of business development at Bats Chi-X Europe, the largest pan-European equities trading market, said: “Individuals can obviously trade the underlying shares but they are also more active in Europe than in the US in warrants, stock options, spreads trades and CFDs [contracts for difference]. They have many alternatives to trading in ETFs, many of which IFAs are incentivised to promote.”

That’s arguably even more significant for larger long-term investors, for whom ETFs will not necessarily prove the most competitive compared with the fees on offer with other index-tracking products.

While cost was the most attractive characteristic for investors to choose ETFs, it was also the top reason for not choosing them, scoring 1.19 out of three. Costs will have some way to fall before everyone is persuaded by the case for ETFs.

But cost pressure and price wars could lead to less choice for investors.

There are 1,318 ETFs in Europe according to ETFGI’s latest data, and Seager-Scott said: “For these funds to be profitable, low costs must be coupled with very large volumes.”

That, he added, favours the big player that can put money into marketing and keep nascent funds going long enough to reach critical mass.

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