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While ETFs Will Continue to Grab a Bigger Slice of the Mutual Fund Pie

by: Index Universe

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By Matt Hougan

I've just returned from the 2010 Inside ETFs conference, and the momentum in the ETF industry is palpable.

For starters, [the conference](#) was a huge success. We had more than 800 people attending, up 60 percent from last year, and CNBC broadcast live from the event for two consecutive days. The rooms were packed during the sessions and advisers came armed with excellent questions about how to best use ETFs in their portfolios.

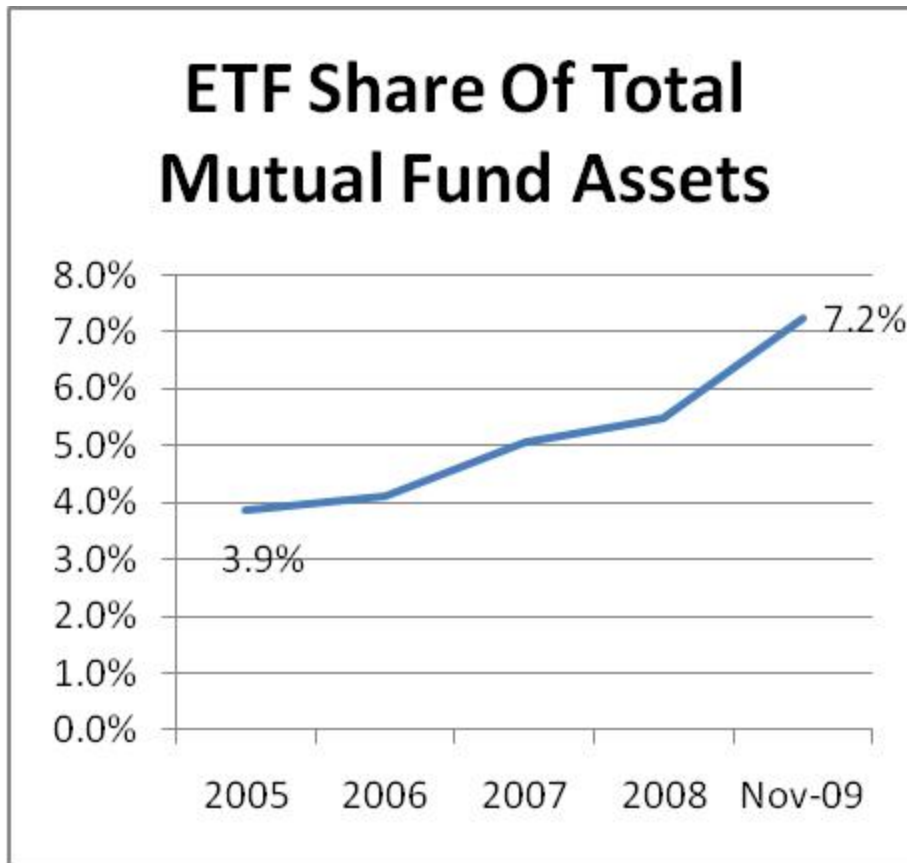
But the momentum is broader than one single event. Time and time again, I was asked in the hallways, "What's changed since last year?" My answer was simple, and everything I see supports it: "ETFs have *arrived*." Just think about what's happened over the past 12 months:

- BlackRock ([BLK](#)) paid more than \$15 billion to acquire Barclays ([BCS](#)) Global Investors, in large part so it could get its hands on the iShares ETF division.
- Schwab ([SCHW](#)) and PIMCO entered the ETF market in a major way.
- T. Rowe Price ([TROW](#)), Goldman Sachs ([GS](#)), John Hancock and others laid the groundwork to enter the market in 2010.

In a year in which investors pulled money out of equity mutual funds, investors poured more than \$100 billion into ETFs, including significant assets into equity-based products. ETF assets rose 46 percent over year-ago levels, and now make up more than 7 percent of all mutual fund assets. That percentage has nearly doubled over the last four years.

On a trading basis, the story's even bigger: ETFs now account for 30 percent of all trading on the NYSE.

The question on everyone's mind is, will ETF assets plateau, will they continue to grow or will their growth actually accelerate?



I line up on the “accelerate” side of the equation, for three reasons.

First, the wave of new companies entering the ETF space will significantly expand the public’s familiarity and comfort with the products. While those of us in the industry live and breathe ETFs all day long, Main Street still barely knows what they are. That’s already changing, and the arrival of companies like Schwab and T. Rowe Price will accelerate that change. As that happens, expect a new wave of growth among financial advisers and self-directed retail investors.

The second reason I expect things to accelerate is that we’re really just now starting to have a fully diversified, fully liquid lineup of ETFs. The major thrust of ETF investing is that you can use ETFs to access any asset class in the world. In that environment, the whole is worth more than the sum of its parts. Until this year, there were major areas of the fixed-income market that were not available in ETF format. Until a week ago, there wasn’t a good way to access platinum. Even today, there are a few holes, and some of the more recent products will need to gain assets and traction before investors are truly comfortable with them. As the number of liquid, well-constructed ETFs grows, it will make the entire process of ETF investing more attractive.

But perhaps the biggest reason I expect ETF asset growth to accelerate is that ETFs are rapidly chipping away at the only advantages mutual funds have.

Mutual Fund Advantages Disappearing

ETF Advantage	Mutual Fund Advantage
Lower cost	Dollar-cost averaging
More tax efficient	Actively managed funds
Tradable in real time	401(k)s
Available in every asset class	
Can use with options, margin, etc.	
Fairer tax and expense treatment	

Since the very first ETF launched, ETFs have had a number of core advantages over traditional mutual funds. They are inherently lower cost and more tax efficient, and they do a fairer job assigning trading costs and tax payouts than mutual funds. You can also trade ETFs like stocks, write options against them or use margin. And as mentioned, they cover everything from stocks to bonds, commodities, currencies and more.

But mutual funds had other advantages that at times seemed unassailable. For one, the fact that you pay commissions every time you buy and sell an ETF means that they are not appropriate for retail investors who dollar-cost-average. If you're buying \$500 or \$1,000 of an ETF every month, the commissions will eat you alive.

With Schwab offering free trading on its family of well-diversified ETFs, that's no longer the case. Today, retail investors who want to dollar-cost-average into ETFs can do so in any Schwab account.

Mutual funds historically have also been the only way to access active strategies. Say what you will about the value of active management, the vast majority of invested assets are still actively managed, so investors clearly demand it in some areas.

But over the past year, ETFs have broken down parts of the active management wall. I am still skeptical of actively managed equity ETFs, but actively managed fixed-income and commodity products are increasingly available in ETF wrappers and are attracting real assets.

As far as I can tell, all that's left is 401(k)s. We already have the software to put ETFs into a 401(k) plan, and there are firms out there doing so today. But they are bit-players in a massive industry, and there is a huge wall of money that has zero incentive to allow ETFs to penetrate the 401(k) market. If it happens in a major way—and that remains a legitimate "If"—it will take many, many years.

So let's grant mutual funds the 401(k) space. That still leaves a lot of room for ETFs to steal market share from the mutual fund industry.

I'm not pie-in-the-sky enough to say that ETF assets will soon top mutual fund assets, or that mutual funds are going away. But let's be clear: We're not going to be 7 percent of the mutual fund industry for long. I'd put the over/under for year-end at 10 percent of assets, doubling from there with a few years.

I think most of the people who attended our Inside ETFs conference would agree.