State of the ETF Business (and more!)

March 2022
Dave Nadig (@DaveNadig)
State of the ETF Business (and more) 2022
Feb Flows Signal

Despite the shorter month, U.S.-listed ETFs took in nearly 2x January’s inflows, ending February with $70B of new cash.

Overwhelmingly, flows went to U.S. equities ETFs, which added $41B despite inflation, rate uncertainty, and geopolitical upheaval — the last of which will likely show up more in March’s flows.

Vanguard, which dominated 2021 inflows, continues its reign. One out of every four dollars entering an ETF went toward VOO, which alone took in $16.3B — nearly twice the flows of rival IVV.

Meanwhile, SPY saw the month’s biggest outflows, at $2.2B.

Ascendant sectors included energy, tech, and consumer staples.
ETFs Set to Pass Mutual Funds ~ 2028

Ex-ETF MF Assets  ETF Assets ($,MM)

Source: ETF Trends, Bloomberg, ICI, Factset. 2022 and further are estimates.
Vanguard Dominant

Issuer % Flows

Source: Bloomberg, Obviously, as of Year end 2021
The ETF Landscape

2,888 Funds

482 Launches (4.57 Open/Close Ratio)

>$7 Trillion in Assets

44% Revenue from “Smart”

11% Revenue from “Active”
Money in motion

Source: Bloomberg, year end 2022
The 2 Big Reg Issues of the Now

Consider the Children!

Who’s paying who what now?

Regulatory Notice 22-08
FINRA Reminds Members of Their Sales Practice Obligations for Complex Products and Options and Solicits Comment on Effective Practices and Rule Enhancements
Comment Period: May 9, 2022

Pensions & Investments
Revenue sharing declines among DC plan sponsors
By ROBERT STEYER
The Bad One

“Ah, the ol’ ‘rulemaking in comment-clothing’ ruse!”

“Classification”

“a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks (including the payout structure and how the product may perform in different market and economic conditions).”

Examples:
- All geared funds
- All funds using options
- All funds mixing asset classes
- All funds with timing characteristics

“Gating”

Proposed ideas include:
- Account level approval (ala Options)
- Periodic or per-trade attestations
- Knowledge testing with remedial education

Comment Here! -> https://www.finra.org/rules-guidance/requests-for-comments/submission?notice_ref=215666
What Advisors Are Thinking
Key Advisor Themes for 2022

- Inflation & Labor
- Income & Risk Management
- ESG
- Active & Smart Beta
- International and Global Macro
Although the balance has undoubtedly shifted of late due to current events, for most of Q1, advisors’ chief concern was inflation. (Unsurprisingly, in March volatility has become top of mind.

Commodities-related topics dominated traffic, while advisors reported making a variety of new commodities allocations, including broad commodities funds, oil & gas equities, gold, mining equities, and MLPs.
Advisor Insights: Cost & Strategy

- The “Anything But Beta” trend peaked in early 2021. Throughout the rest of the year, both research and flows migrated back towards sub-25bps products, with flows collapsing for more expensive products by mid-summer.

- Despite this, advisors expressed a desire to allocate into smart beta and active strategies in the future.
Sourcing income for clients remains a challenge. In order to find it, advisors consistently report needing to take on more portfolio risk (credit, duration, or some balance of the two). Approaches differ from advisor to advisor, but most advisors aren’t just taking what a traditional stock/bond portfolio hands them and calling it a day.
Inflation!

My current view on inflation is...

- It will continue to be above 4% for the foreseeable future (66.7%)
- It will return to a baseline below 4% by the end of the year (31%)
- Inflation? We're headed for deflation before year end (2.4%)

Source: ETF Database

$40B into TIPS!
“ESG” as a buzzword is slowly fading in favor of “energy transition,” “net zero economy,” “carbon readiness,” and other environmental-specific keywords. Recent polling suggests that advisors’ understanding of the energy transition isn’t yet sophisticated enough to appreciate a theme-by-theme breakdown, however. Right now, they want more of a high-level overview and outlook.
# ESG: Struggling with Classifications

**ESG**  
(Environmental, Social, Governance)

**SRI**  
(Socially Responsible Investing)

**Impact**

<table>
<thead>
<tr>
<th>Portfolio Rubric</th>
<th>Example</th>
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<tbody>
<tr>
<td>Data Driven</td>
<td>ESG</td>
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<tr>
<td>Values Overlay</td>
<td>LGBT</td>
</tr>
<tr>
<td>Future Action</td>
<td>EQUL</td>
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</tbody>
</table>

So What Are You Futuring, Futurist?

**Big Topics:**
- Fixed Income
- ESG
- Portfolio Construction, Automation and Models
- DeFi & Tokenization
- The Ethics & Impact of Passive

**Key Influences:**
- TDFs, QDIA and the Relentless Bid
- Corporate Statehood
- Externalized social structures & Regulatory capture
- QE, MMT and Global Liquidity
- The Ethics & Impact of Passive
- The Ergodicity Assumption
- Citizens United
- Technological Tribalism and Theory of Mind
- Flow Driven Markets, Derivatives and Convexity
- “Nanny State” Investor Regulation
- Right-braining of Finance
- Financial Literacy
Building a Crystal Ball

Understand The **Past**
(This is a Buttonwood tree)

Take Apart the **Present**
(This is a Knolled typewriter)

Grok the Zeitgeist
(**People** Confound Everything)
Building a Crystal Ball

**Understand The Past**

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**Grok the Zeitgeist**

People Confound Everything

what are other words for maybe?

perchance, perhaps, mayhap, possibly, conceivably, peradventure, it could be, probably, feasible

Thesaurus.plus
## TDFs and Market Structure

<table>
<thead>
<tr>
<th>Problem</th>
<th>Solution</th>
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<tbody>
<tr>
<td>Baby Boomers can’t retire. Social Security won’t help without unacceptable politics!</td>
<td>Outsource retirement to corporations!</td>
</tr>
<tr>
<td>Pension liabilities can destroy balance sheets!</td>
<td>No more defined benefits for you! Here’s your 401k!</td>
</tr>
<tr>
<td>We can’t convince employees to participate, and those that do barbell!</td>
<td>Target Date Funds!</td>
</tr>
</tbody>
</table>
TDFs and Market Structure

2022 Target-Date Strategy Landscape

Exhibit 1  Total Target-Date Assets

**Market stability**  By putting downward pressure on prices after market increases and upward pressure after market drops, TDBFs can dampen market fluctuations. However, any impact on volatility would require a substantial dollar amount of rebalancing trades in order to be statistically detectable. Suppose $R_e - R_b = 10\%$ in a period, at the current holdings of 4% of the U.S. equity market, TDBFs trade -0.12% of the market ($=-.7 \times .3 \times 10\% \times 4%/7$), assuming the equity share of the aggregate TDBF is 70%. Even if we aggressively assume that all rebalancing is implemented within the same period and the aggregate “price multiplier” is 5 (Gabaix and Koijen (2020)),

TDBFs can reduce the excess equity return by 0.6%, or from 10% to 9.4%, which is statistically undetectable (given the sample size to date). However, if stocks held by rebalancing investors were to grow to 20% of the market, the return would be reduced by 30% (from 10% to 7%).
Outsource the Social Safety Net

Lower Entitlement Burden, Personal Sovereignty, Etc.

Good DC plans become National Security issue

Middle class becomes investor class

Investor education gap leads to barbelling

Massive increase in CITs, TDFs

Better DC outcomes

Corporate Regulatory Capture

Money is Speech for ESG too…

Market Structure Perturbed

The Market has to provide all patterns of return (at all risk levels)

Better DC outcomes

The Economy becomes the Market

Easy Money Makes Income Impossible

Easy Money Props Assets

“Hunt For Income” leads to derivatives Explosion.

Citizens United

TDFs & Indexing Create Relentless Bid

Derivs Perturb Market Structure
Moubison on Ant Trails: as perception of environment becomes less certain, exploration increases.

Ergodicity Economics: Starting conditions matter. An individual’s path cannot be predicted meaningfully by averaging the cohort.

Anil Seth: We hallucinate reality. We process a tiny amount of incoming information. We process all information as a change in our prediction model, not our reality.

Iain McGilchrist: Wholes vs Parts (the left/right brain issues)