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As ETF Market Grows, Dealmakers Follow

Although exchange traded funds enjoyed rapid growth after their introduction around 1990, they accounted for only $66 billion in assets in the U.S. market by 2000. In comparison to the U.S. mutual fund industry, which at that time had $7 trillion in assets, the new investment products barely caused a ripple.

What a difference another decade can make. Since that time, the uneven performance of actively managed equity funds and the concurrent search by investors for low-cost and liquid alternatives has fueled extraordinary gains for ETFs. Driven by 26% growth last year, the ETF industry in the U.S. reached $891 billion in AUM, according to **BlackRock**. Worldwide, ETF assets grew 27% to top $1.3 trillion, with No. 2 market Europe increasing 25% to $284 billion in assets. BlackRock, the leading ETF provider worldwide since its 2009 acquisition of **Barclays' iShares** business, figures growth will remain torrid in the foreseeable future, projecting a $2 trillion market worldwide by 2012.

The growth of ETFs has mirrored the longer-term tilt toward passive investment products in the mutual fund industry. In 2009, traditional equity index funds in the U.S. accounted for nearly 14% of equity mutual funds as a whole, according to the Investment Company Institute — nearly a five-point gain from 2000 and more than triple the share in 1995. But proponents of ETFs cite added benefits over traditional index funds, most notably the ability to trade the instruments like stocks, along with even lower fees. ETFs can also be more tax efficient for investors, enjoying the advantage of tax deferrals on capital gains until the investment is sold by an individual or institution.

Equity-based investments represent some 80% of ETF assets in the U.S., followed by fixed income (16%) and commodities (3.5%). But the industry has both responded to and spiked demand by expanding beyond broad-based stock indices to encompass instruments ranging from futures products to indices linked to corporate earnings. As the number of funds has grown, asset managers have continued stretching the boundaries of their product lines. In 2006, for example, the **Claymore/Oceana Tomo Patent** ETF was introduced built on an index of companies owning the "the most valuable patents relative to their book value." In total, the number of products exploded in the 10 years between 2001 and 2010, from 202 to 2,460.

Indeed, critics say that as the products have grown more specialized, they have parted ways with the logic of broad-based indexing, in many cases adding significant elements of complexity and speculation that retail investors in particular may not appreciate. Some observers attribute part of the run-up in the prices of selected commodities to the aggressive actions of ETF managers, for example. Skeptics add that one of the selling points of ETFs — liquidity — could also work against smaller investors tempted to trade the vehicles like stocks, adding transaction costs that ultimately counteract lower management fees.

The growth within the industry has been largely driven and enjoyed by three major players: BlackRock (iShares), **State Street Global Advisors** and **Vanguard**, which account for a combined 70% of assets, with the iShares platform holding a commanding 44% share. That isn't scaring away competitors: The number of ETF providers rose by 31 last year to reach 136 worldwide, with BlackRock projecting the addition of another three dozen "in the future." Recent entrants include such major players as **Charles Schwab, Fidelity Investments, Pimco** and **TD Ameritrade**. Notable specialist firms include Van Eck Global, which manages a range of commodity funds, **ProFunds**, with a focus on alternatives such as leveraged and inverse ETFs, and **Wisdom Tree** with a suite of dividend weighted and currency ETFs.

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Although acquisitions are circumscribed by industry concentration and the limited number of players, there has been a steady flow of deals over the last five years, with at least four recorded in 2010 and two more early this year. Not surprisingly, targets tend to be fast-growing and deliver a marketplace niche. To date, buyers have been major asset managers seeking entry to the industry or expansion of existing ETF businesses. The superior growth profile of the industry and the companies generally being targeted has added up to premium pricing in transactions.

The first deal of note took place in 2006 and involved **Amvescap**'s acquisition of PowerShares Capital Management, at the time a three-year-old firm headquartered in a former bed-and-breakfast in suburban Chicago. PowerShares made a name early on for the rapid-fire introduction of new and narrowly focused products, including nanotechnology and clean energy ETFs. Between the deal announcement in January 2006 and year-end, PowerShares' AUM more than doubled to $8.5 billion. By 2010, **Invesco PowerShares** had a portfolio of 130 products and was the fourth-largest ETF provider in the U.S. with nearly $56 billion in AUM, including $27 billion in aggregate net inflows since the acquisition.

The initial $60 million price paid by Amvescap was just a small part of a deal that backloaded a series of performance-related contingent payments worth as much as $670 million over five years. One major beneficiary of the deal: **FTVentures**, a private equity firm based in San Francisco and New York that made a $10 million investment in PowerShares just one year before the sale.

Guggenheim Partners has been the most prominent privately held asset manager to make acquisitions, securing two deals for ETFs in the last two years to build a portfolio with more than 50 such products and $10.5 billion in AUM in aggregate. In 2009, the New York- and Chicago-based investment bank and alternative asset manager gained entry to the market with the purchase of a top-10 ETF provider, **Claymore Group**. Founded in 2001 and based in Illinois, Claymore began building a line of innovative ETFs in 2006 in areas such as natural resources and emerging markets, including several focused on China. Within 10 months, Claymore was managing more than $1 billion in ETF assets, a number that jumped to approximately $3 billion by the time of the Guggenheim deal. In 2010, AUM climbed another $2.5 billion, with the funds having been rebranded under the Guggenheim name.

Last year, Guggenheim added $5 billion more in ETF assets (as well as separate account and mutual fund assets) through its purchase of **Security Benefit Corp.** of Kansas. Security Benefit had itself gained entry to the ETF market through its 2007 acquisition of Rydex Investments, whose portfolio has been gravitating toward equal-weight index products, which manage risk by underweighting the largest-cap shares. Rydex was an early entrant in the leveraged and inverse-leveraged ETF market, but the products never caught fire and were largely shelved last year. Guggenheim, which took a majority interest in Security Benefit, was joined by other investors, including Guggenheim shareholders, and committed to a $400 million investment in the company as part of the deal.

In March, *Investment News* reported that Guggenheim was mulling a merger of its two ETF firms that would create the No. 7 provider in the U.S.

America's broker for everyman, Charles Schwab, expanded its participation in the ETF marketplace last year when it paid $150 million for Windward Investment Management, with $4 billion in AUM and a five-year track record of 56% compound annual growth. Windward, which prior to the deal sourced a third of its assets through Schwab's retail advisor network, established its niche managing assets via three separate account-style global portfolios of ETFs, with each one providing a different risk profile.

"Among independent advisors and retail investors there is a growing interest in the kind of value Windward can provide — portfolio construction which puts risk management at its core, an ideal approach for today's world," said Walt Bettinger, Schwab president and CEO. Stephen Cucchiaro, president and chief investment officer of Windward, told *Financial Advisor* the link to Schwab provides the benefits of distribution while allowing him to "focus my time on the investment methodology, which is where my passion is."

Schwab followed up in the first quarter of 2011 by introducing a rebranded **Windhaven Portfolios** line providing "institutional-quality" investments to retail investors seeking "broad diversification." (Following the deal, the Windward name was changed to Windhaven due to a trademark issue.) In 2009, Schwab introduced its own line of ETFs, amassing $1.4 billion in AUM prior to the Windward announcement in August 2010.

Deutsche Bank accounted for a third ETF transaction last year, but focused on a different niche in acquiring New York's **XShares Advisors** — target-date ETFs. The transaction was unique for another reason: XShares had stagnated as an increasingly marginalized business. Started in 2006 by parent **XShares Group** and with backing from New York merchant bank **Grail Partners**, XShares Advisors attempted to build its business with a specialized line of health industry ETFs. The funds never garnered much interest from investors, however, and were ultimately liquidated, leaving a handful of target-date ETFs with just $140 million in AUM in their wake. Following the deal, Deutsche rebranded the products under the **DBX Strategic Advisors** name.

The final significant transaction last year — and the second by a major European financial services firm —saw **Natixis Global Asset Management** take a majority stake in a new Paris-based firm, **Ossiam**. Natixis said Ossiam intends to be the first European ETF startup to focus on providing a range of specialty ETFs "based on quantitative and fundamental data." Pierre Servant, CEO of NGAM, said his company wants to position itself in the growing European ETF market "not on the plain-vanilla market — an already very concentrated one — but in the specialty ETF market." Ossiam plans to launch its first ETFs this year.

The deal momentum from 2010 continued into the early part of this year, with two transactions announced in April, including **Columbia Management Investments Advisers**' acquisition of **Grail Advisors**, an active ETF provider that uses traditional asset managers as subadvisors (among

them **McDonnell Investment Management** and **Western Asset Management**). Boston-based Columbia said the deal "jumpstarts our entrance into active ETFs," enhances its product lineup, and allows it "to reach even more investors with our broad investment management capabilities." The company, part of **Ameriprise Financial**, reportedly plans to replace the subadvisors managing Grail's equity and fixed income funds with its own in-house teams. Grail, based in San Francisco, introduced its first active ETFs two years ago, but has amassed just $20 million in AUM. The second deal saw New York private equity firm **Millennium** lead a $70 million secondary share purchase in the equity of London-based **ETF Securities**, a specialist in commodity investments with more than $27 billion in over 200 exchanged traded products. Millenium said the investment "stands to benefit" from the shift of institutional and retail assets into ETPs and the "emergence of commodities as an asset class of growing importance within diversified portfolios."

The blockbuster deal in the ETF industry involved BlackRock's $15.2 billion acquisition of **Barclays Global Investors** in 2009, a transaction that included the iShares ETF business, with some $300 billion in AUM in the U.S. Driven by Barclays' pressing need to raise capital following the financial crisis, the deal provided a once-in-a-lifetime opportunity for a buyer to become the dominant industry player overnight. The bidding process was triggered by private equity player **CVC Capital Partners**, which made a $4.4 billion bid for iShares. That bid was ultimately trumped by BlackRock's offer to buy the entire BGI asset management business.

In the first full year under BlackRock, AUM at iShares jumped $96 billion to $590 billion, with 46% of the increase due to net inflows. In Europe, the iShares business passed the $100 billion mark — twice the level of its nearest competitor, **Lyxor Asset Management** a subsidiary of **Societe Generale**. Overall, the iShares business accounted for one-third of net inflows at BlackRock last year. Those solid results aside, iShares is facing stiffer competition from the likes of Schwab and Vanguard, which have been seeking to grab share with the industry's lowest fees. Last year, iShares lost share to competitors. But during BlackRock's third-quarter 2010 earnings conference call, chairman and CEO Larry Fink emphasized that fees "are not always a prime mover of ETFs." Other critical drivers, he said, include service, customer and advisor education, and liquidity, along with performance. In assessing the future, Fink added: "I think [during] the next two years it's going to be all about innovation." ▲