ETFs

INTRODUCTION

For more than a decade, the AdvisorBenchmarking RIA Trend Study has provided the financial advisory community with analyses of advisor performance and attitudes across a variety of areas critical to their business practices—and offered a current assessment of how the top performing practices differ from their peers across these areas.

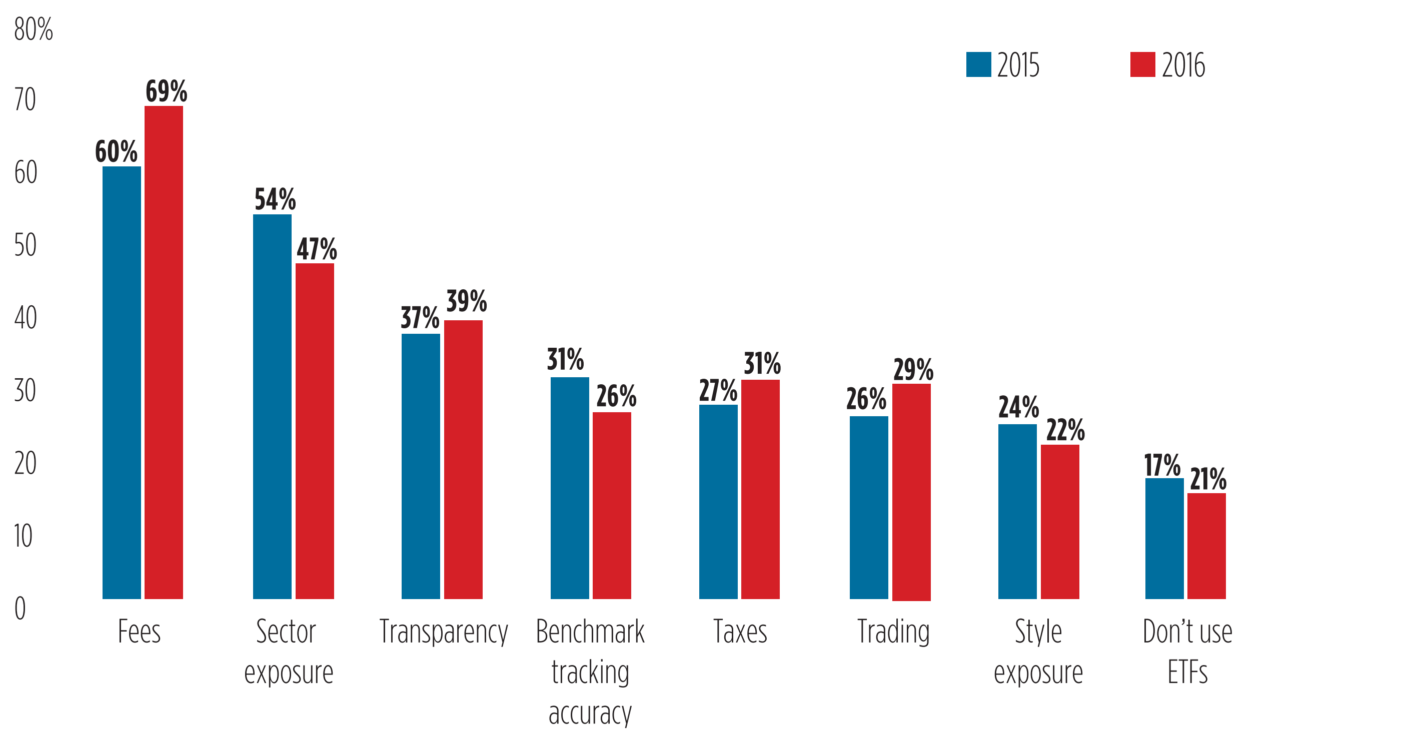
Like last year, the study results are being published on WealthManagement.com in nine individual chapters providing a comprehensive look at the survey's most relevant measures: practice management and operations; ETFs; alternative investments; marketing and client relations; financial performance; investment management; best practices; robo-advisory, and economic and advisory business outlook.

In this chapter we present key findings and insights from our 2016 survey questions on exchange traded funds, including how and why ETFs are used, which research resources are most popular, and how advisors describe their own knowledge and understanding of the key aspects of the ETF market.

THE MAIN REASONS ADVISORS USE ETFs

Overall, our survey indicates that exchange traded funds remain popular investment vehicles, with only 15% of advisors indicating that they do not use ETFs for their clients, a level slightly below last year. The cost advantage of ETFs continues to resonate with RIAs and appears to be an increasingly important factor in their usage. Indeed, 69% of respondents indicate fees as the main reason to use ETFs, which is both the highest response rate to this question and the largest year-to-year increase among all answer options. Sector exposure, at 47% of respondents, is the second most common reason advisors use ETFs, but is down year-over-year. This may reflect equity markets that seem to be driven more by central bank policies than sector and industry fundamentals. Transparency, tracking error, taxes, and trading are also important to RIAs; each garnering the attention of between 26% and 39% of respondents. In total, the responses illustrate a wide variety of ETF characteristics that increasingly allow RIAs to customize the exposure that fits with their clients' risk profiles and time horizons.

FIGURE 1: **Main Reasons Advisors Use ETFs**



EXPECTED CHANGE IN THE USE OF ETFs IN THE NEXT THREE YEARS

The percentage of advisors who expect to increase the use of ETFs over the next three years tallies 50% this year, up slightly from last year's 47% response rate. Just under half of RIAs expect to maintain their allocation to ETFs, a percentage nearly identical to last year. Finally, the percentage of advisors aiming to decrease their ETF usage in the next three years is essentially unchanged as well, at 2% compared to 3% in 2015.

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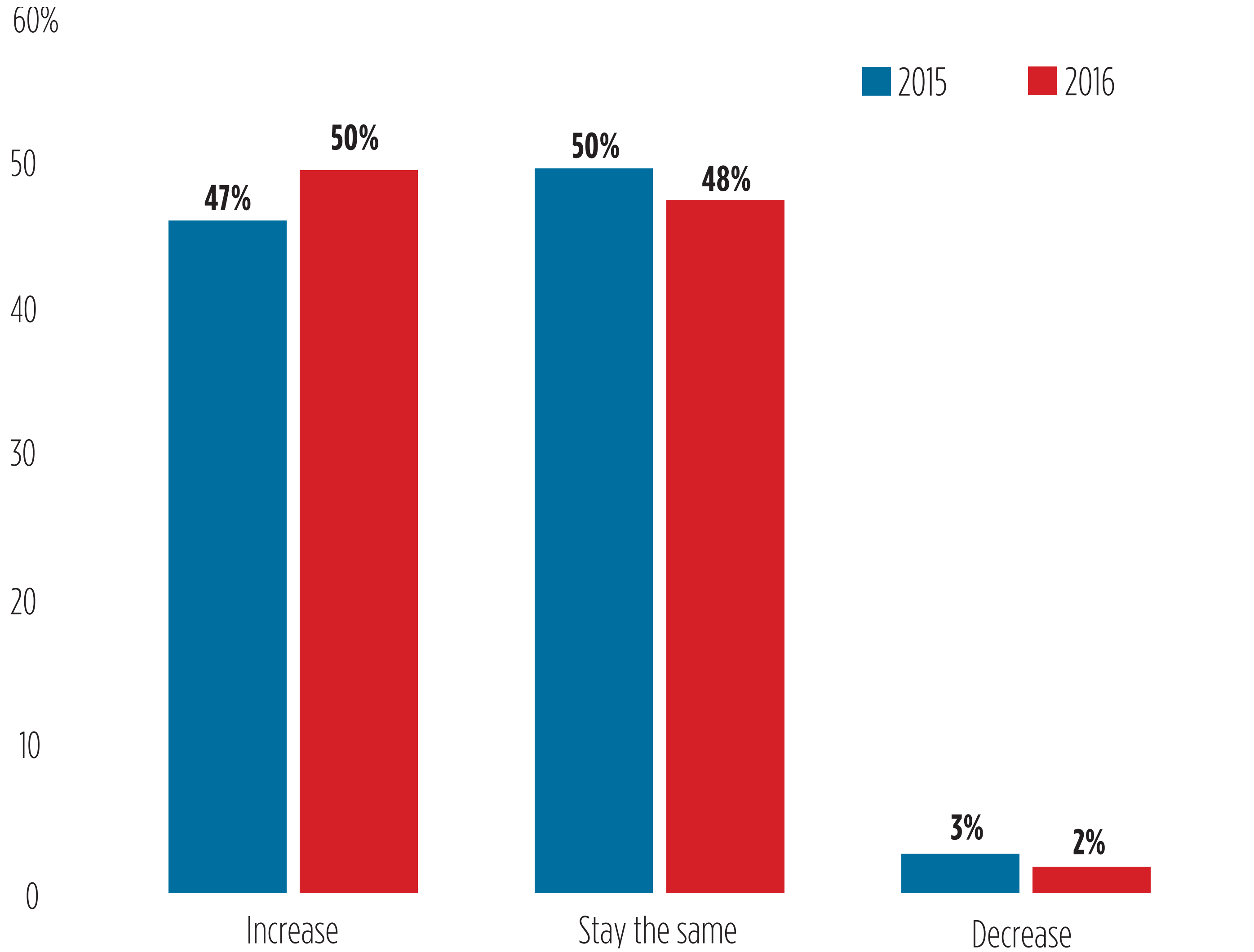
Overall, these responses paint a picture of exchange traded funds continuing to gain share at the expense of other types of investment vehicles, but given the significant usage of ETFs already the rate of increase should be expected to slow going forward.

FIGURE 2: **Expected Change in the Use of ETFs in the Next Three Years**



RESOURCES USED WHILE RESEARCHING ETFs

Results for this question are presented in descending order of the 2016 responses. Consistent with last year, Morningstar.com garners the top spot for ETF research among providers, with over one-half of respondents indicating use of their online platform. And, just over 40% of RIAs indicate they use Morningstar's ETF-specific research offering, notably higher than last year's response rate of 33%. The ETF issuer websites continue to gain popularity as sources of information, with a 35% response rate in 2016, up 3 points year-over-year. Lipper, the primary competitor to Morningstar in mutual fund research, appears to have lost its momentum in the ETF research space. We had noted in prior years' survey increased usage of Lipper's service, but in 2016 it is utilized by only 9% of RIAs surveyed compared to 13% in 2015. ETF Trends shows greater usage year-to-year, at 12% vs 9% last year, but competitors ETF.com and ETF Guide are used by fewer RIAs this year. While Morningstar is the most comprehensive service, more than likely advisors access a combination of many of these sites as each have different strengths and weaknesses.

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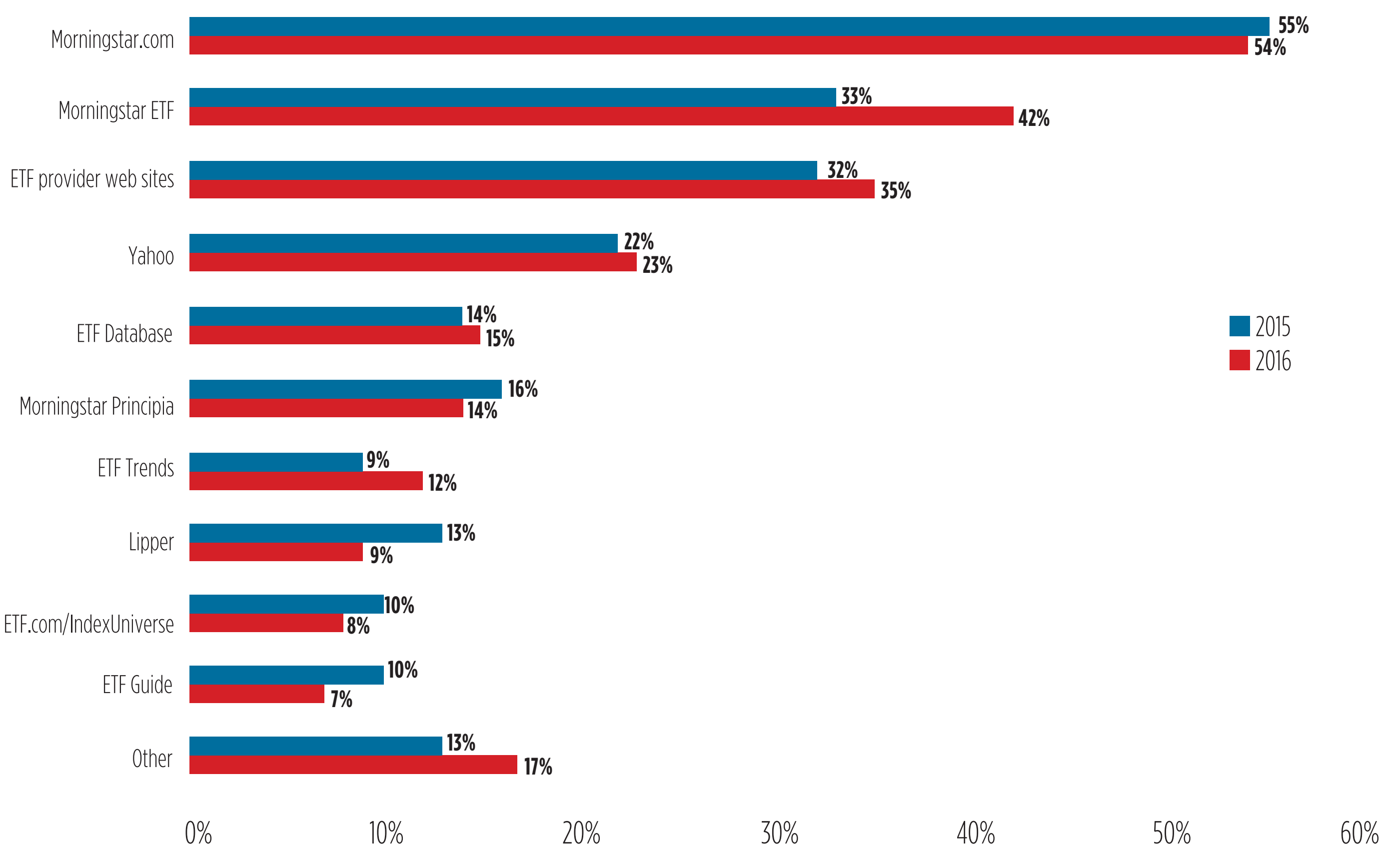
FIGURE 3: **Resources Used While Researching ETFs**



STRATEGIC ROLE OF ETFs IN THE PORTFOLIO

While the overall usage numbers demonstrate a trend towards moderation in the rate of increase in utilization of ETFs, it is important to assess how these products are being deployed within client portfolios. While using ETFs for core portfolio positions and for sector exposure remain dominant roles cited by RIAs, we note some interesting changes in this year's responses that parallel the observations in Figure 1. Specifically, while we observe a small increase in ETF usage for factor or asset class exposure, we note decreases across the other specific use cases. For example, ETF usage for directional market positions declined to 30% from 35% last year. We note even larger declines for country/region exposure and alternative exposure. Given the wide variety of ETFs that are available to achieve specific portfolio objectives, it cannot be a lack of viable options that explains these changes. Rather, these findings are consistent with equity markets driven by extremely loose monetary policy that seems to overwhelm fundamentals and valuation considerations.

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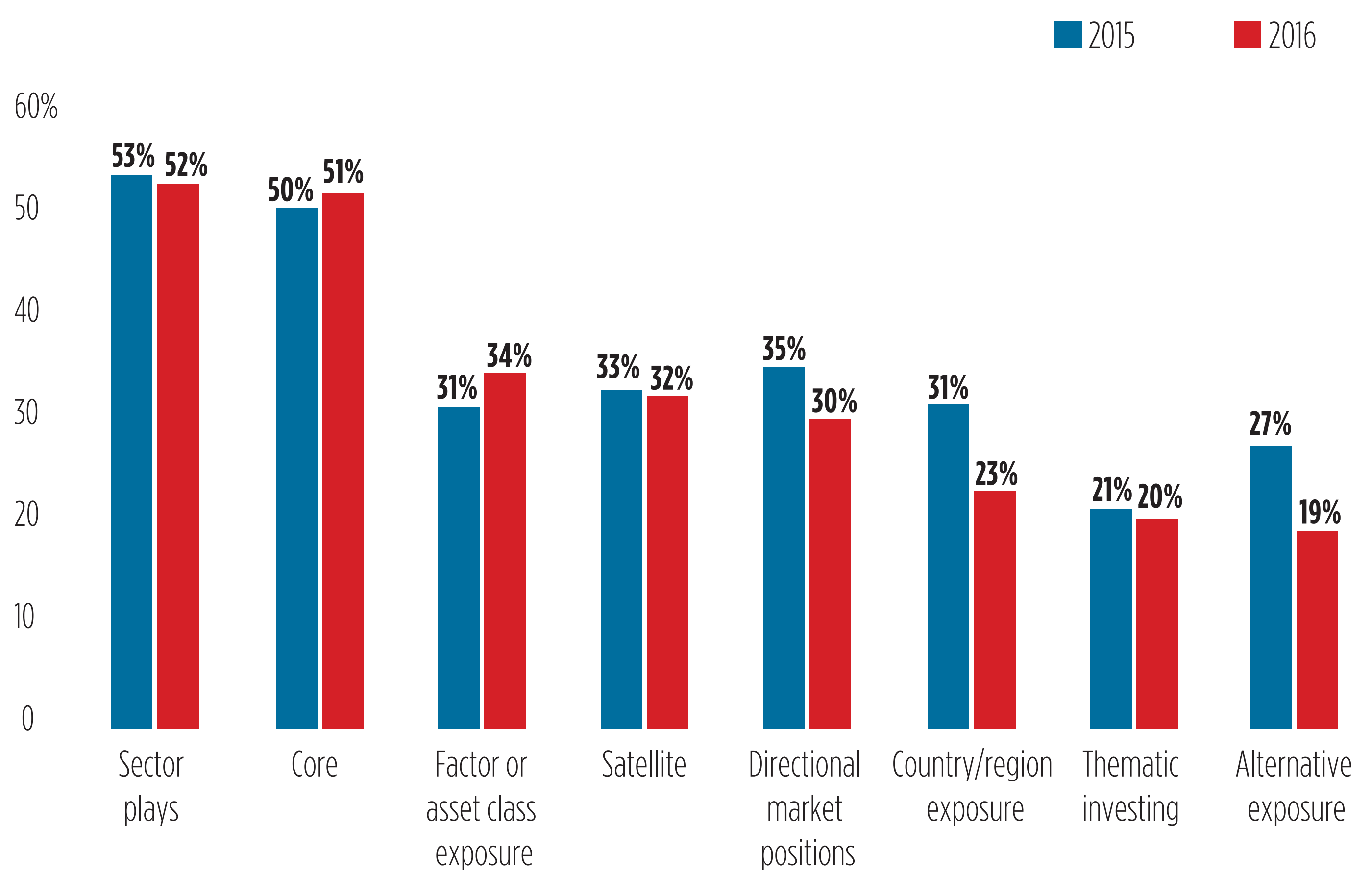
FIGURE 4: **Strategic Role of ETFs in the Portfolio**



ADVISORS' SELF-RATED KNOWLEDGE

Given the broad adoption of exchange traded funds and the financial media attention to their potential risks and pitfalls, we review advisors' self-rated knowledge of the most important aspects of ETFs. Survey results portray clear differences between knowledge areas and indicate details in which practitioners feel they could use education. Notable subjects for improvement in advisor knowledge are the intraday value calculation, distribution schedules, and character of distributions. All of these details are relatively technical aspects of ETFs and advisors can arguably be forgiven for not being experts in such matters, but as more creative and alternative ETFs are launched, advisors would be wise to better understand the underlying details. Aspects such as liquidity, trading, and investment methodology, which receive a lot of attention in the financial media, are relatively well-understood by advisors, with response rates ranging from 17% to 21% of advisors stating they have below average knowledge across these three aspects.

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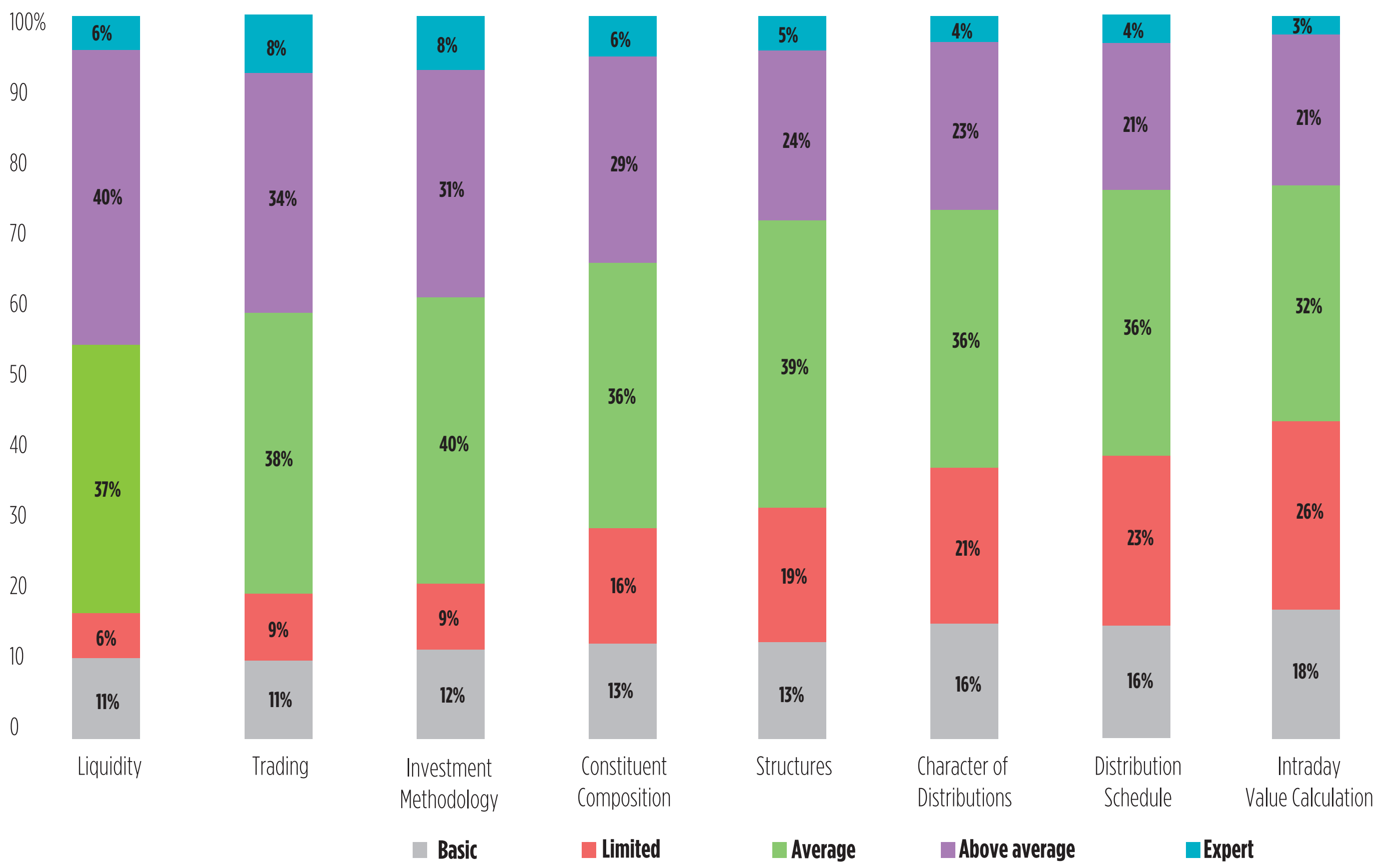
FIGURE 5: **Advisors' Self-Rated Knowledge of ETF Details**



KEY TAKEAWAYS

- Sixty-nine percent of respondents indicate fees as the main reason to use ETFs, which is both the highest response rate and largest year-to-year increase among all answer options.
- Fifty percent of RIAs expect higher usage of ETFs over the next three years, a level consistent with the past few surveys.
- Morningstar continues to be the dominant resource for researching ETFs, with Morningstar.com and Morningstar ETF usage at 54% and 42%, respectively.
- Sector plays and core positions play the most important strategic role within client portfolios but more specific roles are seeing lower utilization rates.
- Only 17% and 20% of advisors stated they have below average knowledge of ETF liquidity and ETF trading, respectively, while intraday indicative value calculation and distribution schedules were both notable areas for improvement in advisor knowledge.