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Domestic ETF market's rapid growth driven by short-term traders

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Executive Summary



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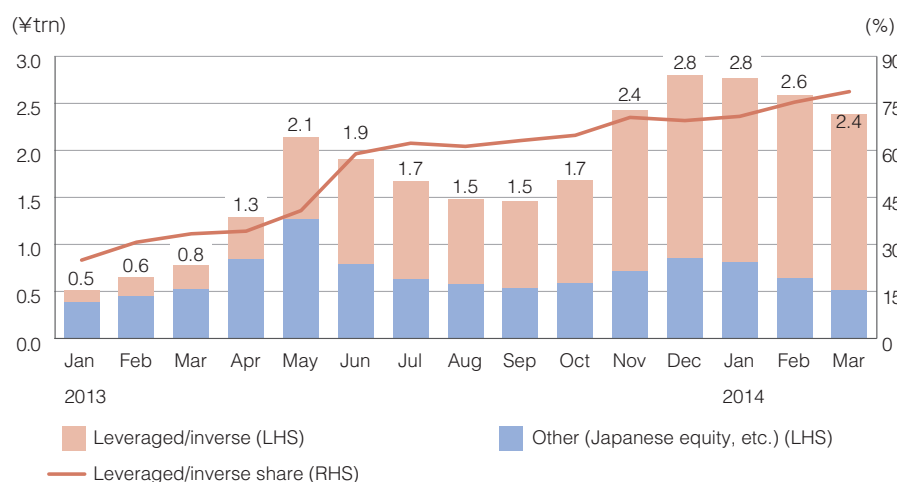
Domestic ETF/ETN trading volumes were buoyant in fiscal 2013 by virtue of a sharp increase in trading of leveraged and inverse ETFs. Japanese ETF providers should develop new products to better meet long-term investment needs, particularly individual investors'.

Brisk trading in ETFs

In fiscal 2013, trading in ETFs and ETNs (collectively referred to below as ETFs) was robust in Japan. ETFs' on-market trading volume peaked at around ¥2.8 trillion in December and totaled roughly ¥25 trillion for the fiscal year as a whole (Exhibit 1). In comparison to previous fiscal years, when monthly ETF order flow never exceeded ¥1 trillion, ETF trading underwent a sea change in fiscal 2013.

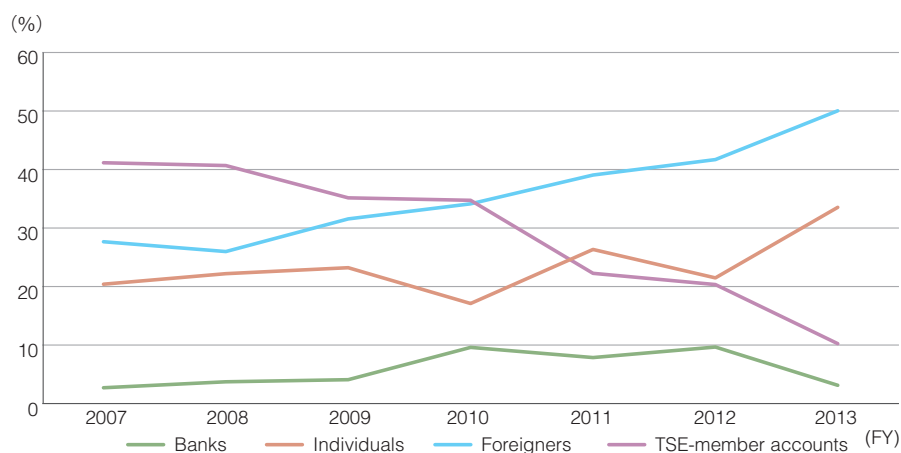
ETFs remain a vehicle utilized mainly by institutional investors. Financial institutions and other institutional investors still account for the lion's share of ETF trading inclusive of off-market and OTC trading. In fiscal 2013, however, individual investors' share of ETF trading rose sharply (Exhibit 2).

Exhibit 1. Tokyo Stock Exchange ETF/ETN trading value (on-market trading)



Source: NRI, based on Tokyo Stock Exchange data (including NRI estimates)

Exhibit 2. ETF trading value shares by investor category



Note: The above data series are shares of on-market trading volume in value terms.

Source: NRI, based on Tokyo Stock Exchange data

Rapid growth driven chiefly by leveraged and inverse ETFs

The rapid growth in ETF trading in fiscal 2013 was driven predominantly by leveraged and inverse ETFs, although trading in conventional (e.g., domestic equity) ETFs also increased. Leveraged and inverse ETFs' share of ETF trading value skyrocketed, exceeding 75% in March. Leveraged ETFs are designed to deliver double the daily return of the index that they track (e.g., TOPIX, Nikkei 225). Inverse ETFs are designed to deliver a negative multiple (usually -1x) of the tracked index's daily return. Leveraged and inverse ETFs first became available in the Japanese market in fiscal 2012. Both have gained popularity because they enable investors with strong confidence in their market views to take short positions or index positions without borrowing shares or trading futures¹⁾.

However, these ETFs are geared toward expression of short-term trading ideas. They are not necessarily suited for long-term, buy-and-hold investing. Leveraged and inverse ETFs suffer NAV depreciation to the extent that their underlying index fluctuates up and down during their holding period, even if the index ends up unchanged from its initial level (compounding of cumulative excess returns relative to the underlying index detract from leveraged and inverse ETFs' returns²⁾). Additionally, leveraged and inverse ETFs charge trust fees of around 0.8% per annum, several times more than conventional index-tracking ETFs.

While leveraged and inverse ETFs were the main factor behind buoyant ETF trading

NOTE

1) Such leveraged and inverse ETFs reportedly account for a large share of ETFs owned in NISAs (Nippon Individual Savings Accounts) held at online brokers and other financial institutions.

2) The magnitude of this NAV depreciation is a function of the underlying index's volatility and the ETF's leverage multiple. Because the geometric average return is approximately equivalent to the arithmetic average return minus one-half of the returns' variance, 2x-leveraged ETFs' NAV would depreciate at a rate equivalent to the underlying index's variance, even if the underlying index ends up unchanged over the ETF holding period. For example, 2013 TOPIX daily returns' volatility of roughly 1.5% equates to a daily-average NAV depreciation rate of around 0.023%.

volumes in fiscal 2013, their popularity was attributable to high-turnover, short-term traders. If the ETF industry broadens its investor base, net assets could grow even if the incoming investors are short-term traders, but there are inherent limits to such growth. In fiscal 2013, ETFs' aggregate net assets increased from ¥5.2 trillion to ¥8.1 trillion, a modest 56% increase relative to ETF trading value's torrid growth. From a net asset standpoint, leveraged and inverse ETFs are unlikely to contribute much to ETF market growth.

Meeting long-term, buy-and-hold investors' needs

3) Tokyo Stock Exchange, "ETF Beneficiary Survey" (January 2014).

4) Conversely, the fund vehicle that meets financial institutions' long-term investment needs at the lowest cost is not necessarily ETFs but private investment trusts with degressive fee schedules.

With financial institutions owning over 70% of domestic ETFs by NAV³⁾, individual investors are underrepresented in terms of ETF ownership also. However, meeting individual investors' long-term investment needs is important for the domestic ETF market's future growth. ETFs have many advantages for individual investors, including lower trust fees than public investment trusts, generally lower trading commissions than investment trusts' sales loads, and availability through any broker⁴⁾. For individual investors that do their own asset allocation without actively managing their portfolios, there is little reason not to use ETFs from a rational standpoint.

Exhibit 3. ETF availability by major asset class

Asset class	Domestic ETF/ETN availability	Public investment trust fee rates*1
Domestic bonds	×	25
Domestic equity	○	
Foreign developed-market government bonds	○	
Foreign developed-market government bonds (currency-hedged)	×	50
Developed market bonds (including credit)	×	(105)
Emerging market bonds (USD-denominated)	×	(146)
Emerging market bonds (USD-denominated, currency-hedged)	×	60
Emerging market bonds (local currency)	○	
Foreign developed-market equities	○	
Emerging market equities	○	
Frontier market equities	○	
High-yield bonds	×	(135)
Bank loans	×	(58)
J-REITs	○	
Global REITs*2	△	(55)
Commodities	○	
VIX	○	

*1. Examples of low trust fees, mainly for passively managed funds that track the most common benchmark index in the asset class, excluding funds exclusively for DC pension plans and funds for wrap accounts. Figures in parentheses are examples of fees for actively managed funds because no passively managed funds are available in those asset classes. Fees do not include advisory fees paid from trust assets.

*2. Global REITs are available for only US and Australian REITs and therefore have a triangle symbol in the availability column.

Source: NRI

However, the ETF market has a number of shortcomings, the biggest of which is product lineup. Although the ETF lineup has expanded dramatically in recent years, domestic ETFs still offer relatively limited access to asset classes popular among long-term investors such as pension funds. While individual investors can pursue broader diversification by utilizing public investment trusts to supplement available ETFs, even passively managed investment trusts are not yet available in certain asset classes (Exhibit 3). To invest in such asset classes, individual investors must pay the higher fees charged by actively managed funds. Additionally, they would most likely end up managing portfolios comprising multiple distributors' funds. This situation forces individual investors to turn to the much more diverse universe of foreign ETFs listed overseas and incur additional costs such as foreign exchange fees and foreign countries' withholding taxes. Another disadvantage of ETFs in comparison to public investment trusts is that cash dividends cannot be automatically reinvested in ETFs. In the US and Canada, by contrast, automatic dividend reinvestment programs are available for listed equities, including qualifying ETFs.

ETFs are capable of meeting both short-term trading and long-term investment needs by virtue of their low cost, high liquidity and high transparency. Creating an environment in which many individual investors can build long-term wealth by utilizing domestic ETFs should be conducive to balanced growth in Japanese markets.

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