Small but Strong

ETF investors do not look at size but other factors. What investors should pay attention to.

ETFs are one of the most significant recent financial innovations. It is not without reason that more than €4 trillion are invested in these funds worldwide. But are all ETFs successful? Definitely not - every year, issuers close hundreds of funds. Some ETFs may fail because of quality issues or because they track an unquoted index. However, sometimes ETFs fail that provide innovative access to a new market, or portray interesting risk/reward profiles or new diversification possibilities.

Difficult start. Why can't every innovative ETF succeed in the market? Similar to many other products, the marketing process also plays an important role in ETFs. Established ETF providers are at an advantage. When a large ETF issuer issues a new ETF, sales and marketing teams and media contacts already exist. There are also relationships with gatekeepers of investment advisors and asset managers. These play an important role. Gatekeepers are experts who use banks, asset managers and trading platforms to ensure that their clients have access to appropriate funds.

New ETF providers are finding it hard to get past the gatekeepers - even if they present a great fund concept. Many gatekeepers only include ETFs in their network for distribution beyond a certain minimum size. New funds with assets of less than €25 million are often taken with reluctance. Not infrequently, significantly higher amounts are required.

However, I think it is worth taking a closer look at smaller funds and making these ETFs available to investors. Private and institutional investors benefit from innovations and product diversity. New issuers must therefore have a chance to place their products. The fear of funds with small assets under management seems exaggerated.

There are mutliple reasons for this. First, almost all European ETFs are UCITS funds. Every UCITS ETF needs a license. The supervisor will examine the internal processes of the issuer, the ETF, its index, etc. The issuer must operate transparently and carefully, and the index must be sufficiently diversified, replicable and liquid for the ETF to obtain authorization.

Secondly, each issuer must find a stock exchange to list its ETF after admission. For this purpose, the issuer must pass numerous tests. He must also find the right market maker, who keeps the gap between buying and selling prices within certain limits. The work of market makers ensures that liquidity is usually not a problem for smaller investors. Professional investors generally buy and sell ETFs on the NAV or market opening or closing price. Therefore, liquidity is no problem for them too.

Third, we should remember that the liquidity of an ETF comes from the index that it replicates. This means, for example, that a new Dax 30 ETF with just a €1 million initial investment should trade with the same liquidity as an existing Dax 30 ETF with a volume of €1 billion or more. This is because the liquidity or price movement does not come from the ETF itself, but from the individual components of the tracked index.

Necessary innovations. ETFs give private and professional investors the ability to quickly, easily and affordably manage their portfolio or that of their clients. In many markets, the barriers to entry are waning. The internet gives investors access to very timely information. So why should size be decisive for an officially approved ETF, quoted on a European exchange, and offering guaranteed market-making and liquidity?

What investors and gatekeepers should pay more attention to are the profitability and business models of the issuers. Many small ETFs have exciting concepts or are from promising markets. The issuers of these funds are also often sound institutions, but are less well known in Germany. For example, the Market Access iSTOXX MUTB Japan Quality 150 ETF or the CSOP FTSE China A50 ETF only have fund assets of less than €20 million each. But they offer a superior risk-return profile and better performance than comparable beta-tracking ETFs. The issuers of these two ETFs are market leaders in the Chinese asset management market and not risky startups. The same applies to the providers of many other ETFs, which (still today) have small assets under management.

Why do you want to exclude such funds from your considerations? If you look closely at an ETF in detail, you should not be confused by small fund volume. Instead, ask who issued the ETF, what distinguishes the ETF concept, and how the underlying Index is constructed.

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Few big ones

In the ETF market, the weights are unevenly distributed. The bulk of investor assets are in a few large funds. There are also a large number of small funds with low volumes. 53% of all equity funds listed on Xetra and 48% of all pension funds have assets of less than €100 million. Respectively, only 18% and 16% of the funds have a volume of more than €500 million. At the end of January, 1340 ETFs were listed on Xetra with total assets of more than €550 billion. Three-quarters of the money was in the largest 200 ETFs.