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How institutional investors in Asia can make the most of a surging ETP market

As more opportunities emerge in Asia's growing ETP market, selecting the optimal products involves navigating issues beyond expense ratios. Institutional investors must consider an array of factors such as thematic exposure, taxation, and market liquidity to make fully informed choices.

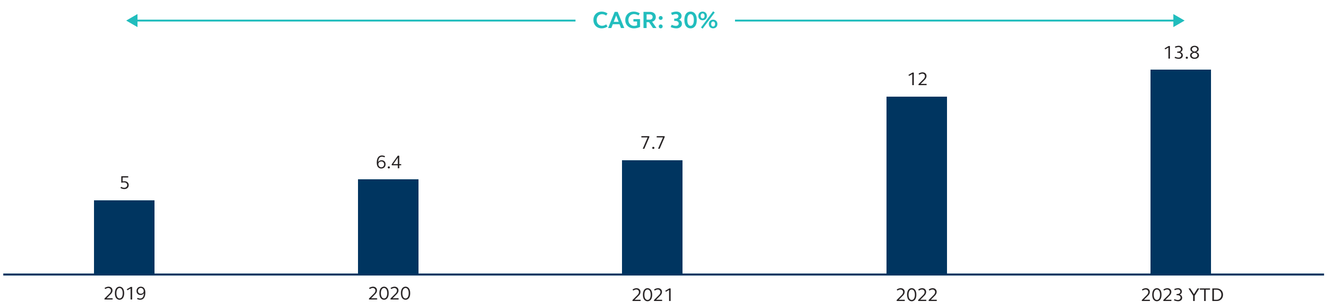
Exchange traded products (ETPs), which include exchange traded funds (ETFs) and leveraged and inverse products, have become an integral part of the mainstream financial system.

In 2023, the global year-to-date (YTD) fund flow has reached more than US$570 billion, spreading across 10,237 ETPs[1]. Although ETPs were initially popular primarily in Western economies throughout their three-decade-long history, Asia, including the thriving ETP market in Hong Kong, has been rapidly catching up and experiencing significant growth in recent years.

Hong Kong's ETP market grows at an impressive clip

As of October 2023, YTD average daily turnover (ADT) for ETPs listed on the Stock Exchange of Hong Kong stands at HK$13.8 billion (approximately US$ 1.8 billion) — more than 20% increase over the same period in 2022. Since 2019, ADT has been growing at an impressive clip — a CAGR of 30% — driven by market enhancements including a deepened liquidity pool, protection against extreme price volatility, improved market quality, and lower trading costs.

Average daily turnover (HK$ billion)



Source: HKEX. Data as of 31 October 2023.

Brian Roberts, head of equities product development at HKEX said, "ETFs are increasingly popular as a low-cost and flexible investment vehicle for both retail and institutional investors."

[1] Source: Bloomberg, data as at end of September 2023.

Hong Kong's ETP market grows at an impressive clip (Cont.)

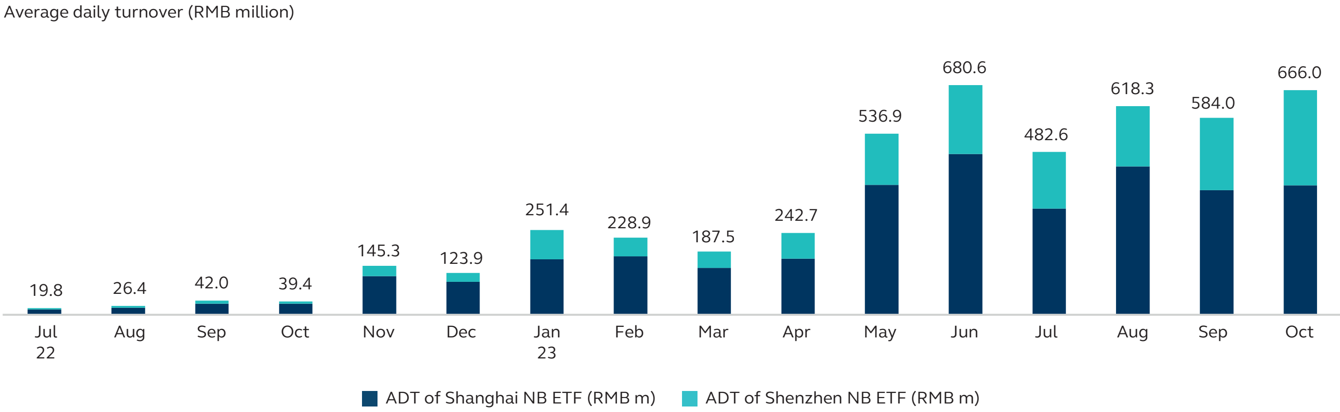
In July 2022, ETFs were for the first time included in Stock Connect, a mutual market access programme connecting China and the world that allows investors in the Mainland China and Hong Kong to trade and settle shares listed on the other market via stock exchanges and clearing houses in their home market. There has been a rapid uptick in both Northbound (Hong Kong and overseas investors accessing Mainland China markets) and Southbound (Mainland China investors accessing Hong Kong markets) ETF trading ever since.

ETF trading in Stock Connect is gaining momentum

Northbound Trading Trend (Jul 2022 – Oct 2023)

RMB 300 million
NB ETF ADT

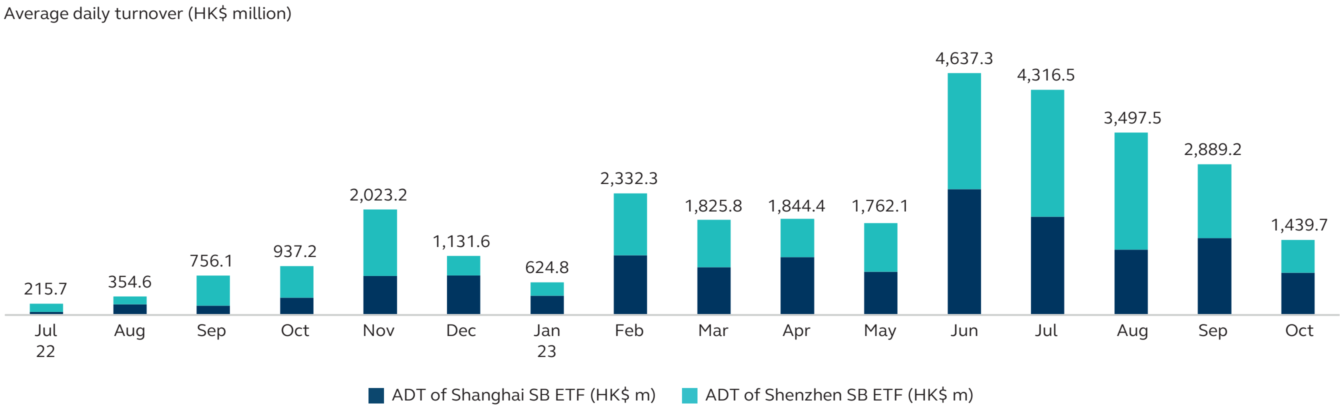
0.3%
Of overall NB Stock Connect ADT



Southbound Trading Trend (Jul 2022 – Oct 2023)

HK$ 1,954 million
SB ETF ADT

6.3%
Of overall SB Stock Connect ADT



Source: HKEX. Data as of 31 October 2023. Turnover is calculated as buy value + sell value.

One year since its launch, ETF Connect has shown strong trading momentum. In its first year of trading (July 2022 to June 2023), the ADT for Northbound and Southbound stood at RMB 207 million and HK$1.6 billion, respectively.

As of October 2023, Southbound ETF ADT surpassed HK$2.6 billion (US$333 million) while YTD Northbound ETF ADT stood at RMB 448.4 million (US$57.5 million), demonstrating the program's success in facilitating investor access to the well-established ETF liquidity pools across the border.

Investing in tomorrow with megatrend ETFs

ETFs have also gained traction because they reflect the wider interests of investors in megatrends, such as ESG, disruptive technologies, healthcare, and aging populations. Jean-François Mesnard-Sense, head of exchange traded products at HKEX, said, “ETFs have evolved beyond traditional strategic asset allocation.”

For instance, while platforms such as ChatGPT have recently commanded a lot of attention, from an ETF perspective, AI and other potentially disruptive technologies have been a priority for years. ETF issuers focus on innovation and providing investors with exposures to what they believe are the industries of the future.

Mesnard-Sense explained, “Some industries, such as technology and automotive, have achieved strong returns in recent years. ETF issuers have looked at biotech, AI, semiconductors and even crypto, offering targeted access to forward-looking trends. While there are some risks inherent in investments in megatrends, ETFs provide a valuable tool for managing these through diversification.”

The growing demand for ESG investments, both in Hong Kong and worldwide, has led ETF issuers to incorporate ESG into their offerings.

Mesnard-Sense said, “Many pension funds invest in stocks as well as ETFs and have started providing exposure to ESG, based on public demand. If they lack in-house capabilities for ESG filtering, ETFs are used as a first step to enter the space.”

Another reason that ETFs have caught on is being able to make markets all over the world accessible. Roberts said, “You can gain exposures to Mainland China and Hong Kong, and also to the developed US capital markets, fixed income, and even virtual asset ETFs.”

Use cases for ETFs in institutional portfolios

The versatility of ETFs makes it easy for investors to pick the ‘best’ option, or one most suited to their requirements, whether strategic or tactical.

Strategic asset allocations:

For investors who have a long-term view on a market, and expect it to grow despite current volatility, ETFs are an ideal option. They can be used for strategic tilts within asset classes, such as towards small-cap stocks, emerging market debt, specific types of commodities or a host of other categories. Mesnard-Sense said, “They can provide easy access to emerging markets like Mainland China, whether it's in the equity or the fixed income space.”

Tactical asset allocations:

Being traded on exchanges makes ETFs a great tool to react rapidly to changes in the market. Mesnard-Sense said, “We see investors using ETFs to express short-term views around macro data. For instance – economic data released by the US can be quickly acted on by markets in Asia.”

Access to restricted markets:

Institutional investors typically have the requisite licences and are well equipped to trade in most markets. This is however not always the case for retail investors, depending on their scale and background. For retail investors and intermediaries who wish to access fixed income securities or government bonds, ETFs can help democratise investments.

Use cases for ETFs in institutional portfolios (Cont.)

A hedge against volatility:

Critics of ETFs have argued that they could contribute to the next market crash because of their growing popularity and their inability to sustain extreme volatility. However, Mesnard-Sense pointed out that when the markets collapsed in March 2020, on examining the trading volumes of single stocks and ETFs across markets in Asia Pacific, the latter were found to represent more than 8% of the overall trading volumes compared to only 5% in 2019. It meant that during volatile times, ETFs emerged as a more preferred option to either get in or out of the market.

Transition management:

When investors like pension funds bring in a new contributor, or when they wish to switch active managers, ETFs have emerged as an effective tool in transition management, allowing for the parking of finances, trading and easy access to liquidity.

Selecting the most appropriate ETFs

Given the abundance of choices in the ETF market, Asian investors frequently face the task of choosing between multiple ETFs. A common tendency is to assume that products offer the same sort of exposure irrespective of geography, and to make a choice using headline information expense ratio and spreads. However, Roberts believed this was not the best way to select ETFs and, while these components are important, they don't tell the whole story.

To select the most appropriate ETFs across jurisdictions, he recommended keeping the total cost of ownership framework in mind. This framework can be broken down into two major components: trading costs and holding costs. The former includes bid-ask spreads, broker commissions, as well as costs associated with implementation shortfall. Holding costs can be split into the tracking difference — the NAV performance over time versus the benchmark performance — and taxation at a fund and investor level.

Roberts said, "While all other costs – tracking difference, expense ratios, trading spreads – are explicit and can be found on websites, taxation is implicit. It can have a very significant impact on your overall returns."

In collaboration with Ernst & Young, HKEX has created a tax calculator on its website which considers index data based on an investor's location and the jurisdictions that the investments are situated in.

For instance, an Asian investor in an overseas jurisdiction can accurately estimate the after-tax return using the calculator — an objective measure that relies on current and updated information based on different tax treaties and domiciles. This helps provide a greater degree of transparency.

Initiatives from HKEX like the tax calculator go a long way in helping investors in the region make an informed choice when it comes to specific ETFs and jurisdictions, enabling them to make the most of the surge in the ETF market.

For more information, please visit **HKEX ETP website**.

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