Capturing alpha in Asia's ETF market

Trends to watch in 2019

As the inclusion of China A-shares into major indexes could potentially lead to record inflows into China, 2019 is set to be an exceptional year for the Asian exchange-traded funds (ETFs) market. Meanwhile, investors in the region are increasingly eyeing bond ETFs as a portfolio diversifier, and new technologies are revolutionising the ETF space. Hong Kong Exchanges and Clearing (HKEX) takes an in-depth look at these key trends

A year of inclusion draws record inflows

China makes a grand entrance into major international indexes this year. Following the debut of China A-shares on MSCI's benchmark indexes last year, the index provider will quadruple the weighting of A-shares in its flagship emerging markets index by November 2019. On completion, A-shares will represent 3.3% of the pro forma MSCI Emerging Markets Index, which is tracked by $1.8 trillion in assets worldwide. Meanwhile, FTSE Russell and S&P Dow Jones Indices will both include A-shares in their global benchmark indexes for the first time within this calendar year, signalling significant inflows into the asset class in the coming months.

Inclusion of Chinese assets in global indexes bodes well for the growth of exchange-traded funds (ETFs), which allow investors easy access to unfamiliar markets. In the A-share inclusion story, Hong Kong stands as an important platform for investors to enter China, given its expanding A-share ETF offerings, friendly tax rules and a globally connected marketplace. A deep pool of offshore renminbi liquidity, coupled with an expanding array of tools to access China, including Stock Connect, the direct investment channel, and the potential launch of the city's first A-share index future, also provides Hong Kong a competitive advantage in becoming the A-share transaction hub.

The growing interest in China ETFs is evident in the period leading up to MSCI's inclusion decision. In the week of February 25, 2019 – the week the inclusion announcement was made – the average daily turnover (ADT) of A-share ETFs surged 90% from a week earlier to HK$5.5 billion, accounting for 72% of the total ADT in Hong Kong's ETF market.

Market volatility fuels appetite for fixed income ETFs

Besides China A-share inclusions, volatility is another key investment theme for 2019. Heightened levels of volatility in equity markets at the end of last year, coupled with rising global interest rates, have prompted a sentiment shift from equities to fixed income. According to a survey conducted by global investment management corporation BlackRock, more than half of the 230 institutions planned to decrease allocation to equities this year, while 38% of respondents said they would increase allocations to fixed income in 2019, up from 29% in 2018.[1]

Fixed income ETFs – with their liquidity and flexibility to adjust bond portfolio duration according to rate hike expectations – stand to benefit from this trend. According to research and consultancy firm ETFGI, globally listed fixed income ETFs and exchange-traded products saw net inflows of $23.7 billion in January 2019, compared with net inflows of $11.07 billion over the same period last year.

Bond funds that adopt a rules-based investment approach – or smart beta bond ETFs – are also gaining popularity as they can be useful tools for weathering volatility. Such funds can be tailored to a rising rates environment, with solutions such as duration management and capped allocations to rate-sensitive bonds.

Beyond protecting their respective portfolios, investors are using fixed income ETFs, in particular money market fund (MMF) ETFs, to take advantage of the rate hike cycle. While being out of favour in the past few years because of prolonged low interest rates, MMF ETFs are staging a comeback as rate hikes are giving a boost to their yields, and ETF issuers are grasping the opportunity to issue more MMF ETFs.

ETF innovations take centre stage

ETFs are proving the market to be especially prime for incorporating some of the latest technologies, such as robo-advisers. Not only do ETFs keep costs low, which serves the goal of robo-advisory, but their diversified, easy-to-trade features also make them ideal for robo-advisers to construct portfolios that cater to their clients' risk appetites.

The growing popularity of robo-advisory services can inject fresh impetus into the ETF market. According to the Chartered Financial Analyst Institute, in the five years following the birth of robo-advisory, almost 100% of assets managed by robo-advisers had become ETF-based. An EY report predicts robo-advised assets could reach $8 trillion by 2020, which will provide a significant boost to retail ETF adoption and encourages ETF promoters to partner with or acquire robo-advisers.[2]

Meanwhile, asset managers of active ETFs are increasingly looking to supplement their investment decisions with artificial intelligence (AI). The EY report revealed that investor interest for alternative, AI-related ETFs is on the rise. Such ETFs use AI to develop and execute stock selection strategies and, given the budding interest in active ETFs in Asia, the potential of AI is likely to take an even firmer hold.

[1] *BlackRock,* Global institutional investors shifting risks from public to private markets, *January 2019, https://bit.ly/2QK6h12*
[2] *EY,* Reshaping around the investor, *Global ETF research 2017, https://go.ey.com/2QXbfJ5*