Episode 1: Use of ETFs in managed account portfolios and transaction implementation considerations

IMAP in conjunction with BetaShares and Lonsec present the first Podcast in the IMAP Independent Thought series.

In this Podcast **Lukasz de Pourbaix (Lonsec)** and **Peter Harper (BetaShares)** discuss

- What use is made of ETFs in managed account portfolios and is this changing as FUM in managed accounts grows?
- What issues can this give rise to?
- How are these issues addressed?
- What are the roles of the various participants in particular the issuer and market makers?
- What are the particular challenges of fixed interest ETFs?
- How can a portfolio manager efficiently switch between similar ETFs

Toby Potter- IMAP Chair (00:04):

Welcome to the first of the IMAP independent thought podcast series. The Independent Thought program is about giving portfolio managers involved with managed accounts, an opportunity to raise, discuss, talk about issues that are important in the management of managed account portfolios and Independent Thought has got three components. This podcast series, the "round tables", which we run about six times a year and leading into an annual conference where portfolio managers from licensees asset consultants, and the people involved in managing managed account portfolios have an opportunity to meet and talk. So today we're going to be talking about the implementation of ETFs. They are a critical part of managed account development, ETFs and managed accounts have grown in lockstep really, and are now coincidentally each accounts for about 14% of the F In the other today, we are lucky enough to be joined by **Lukasz de Pourbaix. Lukasz is Executive Director, and CIO of Lonsec Investment Solutions**. And by **Peter Harper, Executive Director Capital Markets for Betashares**, we're going be talking about the use of ETFs implementation issues, and the problems that can rise as managed account portfolio's grow large. So Lukasz and Peter, welcome to today's podcast. Lukasz, let's start with you. What use has made of ETFs in managed accounts, and is this changing as the FUM grows?

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Lukasz de Pourbaix - Lonsec (01:58):

Yes. In terms of the use, there's probably three main uses, right? So one is to reflect an asset allocation, whether it's a strategic asset allocation of view, and secondly could be reflected to reflect a dynamic allocation or a tactical allocation view. So for example, at the moment, we do have a positive view on emerging markets and, we have reflected that via an ETF exposure and it's a quite efficient way to do it in that way. And then thirdly, we will also use ETFs to reflect in a way, a bottom-up view. So for example, we've had some exposure to sector specific ETFs, whether it's the NASDAQ or, some healthcare ETFs. So there's a range of ways you can use ETFs to reflect on overarching asset allocation, but then also a view from a more a bottom-up perspective as well, and how you want to tilt your portfolio.

Lukasz de Pourbaix - Lonsec (02:59):

The interesting second part of your question there is as you know, the universe of managed accounts has grown, and ETFs have grown, and implementation becomes a bigger consideration. Particularly with ETFs as you've had this proliferation of ETFs, they vary in terms of the volume, how big they are, the liquidity profile, and so forth. So, you know, as, as you know, S has grown, for example, in, in size, when we are making decisions around ETFs, there are more decisions to be made. It's not just around the investment itself, but then it is going into those things like how big is the ETF? What's the impact of the spread. If we do a bigger trade on that ETF and how do we manage that so that we ultimately get the best outcome for the client. And I think as we see that continued growth, in manage accounts and ETFs as well, these implementation considerations are going to become more and more important.

Toby Potter- IMAP Chair (04:02):

And so Peter as an ETF issuer, how do you respond to these types of issues that has just talked about?

Peter Harper - BetaShare (04:13):

Yes, first of all, I very much agree with Lucas's view and at their core ETFs are portfolio building blocks, whether that's at a strategic or dynamic or tactical level. In terms of the growth of ETFs, and managed accounts together. one thing that's worth remembering at all times is obviously that ETFs are just managed funds, like any other un-listed fund. And so when you look at the liquidity of an ETF versus a managed fund on a "like for like" basis, the ETF liquidity is always going to be equally as good as the unlisted managed fund. And it may actually at times be better by virtue of additional on-screen trading between natural buyers and sellers. And so we think on that basis that ETFs really are an optimal sort of vehicle for use within managed accounts.

Toby Potter- IMAP Chair (05:07):

But as the total FUM in managed accounts grows, what are the issues that can arise then when there are block trades, for example, to be executed that don't arise when you've got a hundred advisors, each making their own independent transaction.

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Peter Harper - BetaShare (05:26):

Yes. And that's also a good one Toby. So look in a nutshell, if you're talking about something like ASX 200 or S&P 500, there's very little, if any liquidity issues in transacting, large lines and block trades in those sorts of exposures. You know, as with any exposure, when you get down to more niche areas of exposure, e.g. Emerging markets is a fairly standard part of many portfolios, but there's no doubt that with emerging markets, liquidity isn't as strong as S&P 500 liquidity, for example. So when you get into those areas.... When executing ETFs or any other sort of fund vehicle, you know, you need to think about the liquidity profile, and that would involve thinking about which markets are involved in that underlying exposure, are those markets open during our time zone for all, or part of the day, and potentially thinking about which time of day you want to execute to maximize your exposure to open markets at any point in time. So you know, the more niche an exposure gets, the more you need to be cognizant of your execution, and the more detail you need to look into in that regard. And that's something we help buyers with a lot as part of the capital markets function.

Toby Potter- IMAP Chair (06:42):

So Lucas, how much are these sorts of considerations important to you in the management of portfolios?

Lukasz de Pourbaix - Lonsec (06:51):

Look, they are increasingly important. And as you know managed accounts are continually evolving and I do think the area of implementation is one piece of that puzzle, which is going to continue to evolve as we grow to where it becomes a consideration is to Peter's point. There are some exposures where if you are trading a larger block, that are potentially less liquid, they need to be managed more. So, one of the views of managed accounts implementation is you just send a spreadsheet or you just go onto a portal, and you're done. The reality is like where we had this example where we worked very closely with the Betashares team with the relevant platforms where we were allocating to the emerging market exposure, and because of the size of our portfolio, we wanted to ensure that that the client is not disadvantaged, the spread doesn't blow out and so forth.

Lukasz de Pourbaix - Lonsec (07:56):

So it was a great exercise in terms of being able to work closely with Betashares and in this example, also work closely with the platform providers, obviously there's stuff at our end, we had to, ensure that we were able to coordinate that in a fashion and that the trade would be able to be executed where there was very little friction, , for the end client. And these are things which I think as managed accounts mature, they get larger. They're going to become an increasing consideration when managing a portfolio.

Toby Potter- IMAP Chair (08:33):

So Peter, from, from your side as the issuer, what what's involved in that coordination.

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Peter Harper - BetaShare (08:38):

From our side as the issuer, we were expecting an inflow into the fund. And so for us, it was very important to make sure that that inflow came in on tight spreads and that sufficient liquidity was available. So the capital markets function that I'm part of really revolves around accessing best spreads and liquidity for large trades in ETFs. So, you know, we were making sure that the underlying platforms had received the order from the managed account provider. In this case with Lonsec we were making sure that the platforms had liaised with their executing brokers. We'd made sure that those executing brokers had liaised with the market makers who were going to provide the liquidity in the units in our fund, and so we worked to make sure that all of those groups were on the same page, and ready to transact, and to make sure that that happened within a time period of the day where best liquidity was available based on the underlying constituents that needed to be bought in several markets around the world.

Peter Harper - BetaShare (09:41):

And so at a high level, it's quite a simple process, but at the same time, it requires diligence, and so on through the process to make sure that it all goes smoothly. I mean, at the end of the day, we're able to achieve an excellent result.

Lukasz de Pourbaix - Lonsec (09:56):

Just to give some context around that. The interesting thing about with that trade was that we had a very finite, time period. I think Peter (correct me if I'm wrong), it was from 1.00 to 2:00 PM on the day. So everyone had to align their ducks, basically to ensure that that trade went in time in that sort of time period, which was a good exercise in having those strong relationships across all parties and ensuring we could do that within that window.

Peter Harper - BetaShare (10:29):

That's right. And to run with that for just a moment, you know, between 1.00 and 2:00 PM was when the maximum number of markets were open that needed the maximum volume of underlying shares needed to be purchased in. And we were successful in meeting that timeframe... You know had that not been met, the order still could have been executed, but for a market maker, then they would have to take on additional risk because perhaps some of the markets might start closing after 2:00 PM. If those markets close, they can't execute the underlying purchase until the next day that creates additional risk for their book, and that results in wider spreads that they charge for that exposure. So by making sure that we had our ducks aligned and that we all worked collaboratively, we knew what time we had to get the order executed in order to achieve the best liquidity, the best spreads and the best execution for everyone involved. And we were able to do that.

Toby Potter- IMAP Chair (11:22):

So this sounds like a sort of a same day completion. How would that compare from Lukasz, for example, to trying to do the same sort of transaction through unlisted managed funds?

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Lukasz de Pourbaix - Lonsec (11:36):

Well for unlisted managed funds, we would obviously go through the same process from our side, but in terms of managing spreads and so forth, there's little control over that. In terms of from our side in terms of how we would do this, the implementation would be similar. However, in terms of that, that would be on done more so on the manager side themselves, rather than relying on our direct involvement, but with the ETF structure, you look at the overall farming the ETF, we were able to manage that more closely than we probably would with a fund.

Toby Potter- IMAP Chair (12:20):

One of the areas that interests me is fixed interest investing, and the use of ETFs to access fixed interest markets. Peter, how do you think ETFs are placed for reaching into the various components of the fixed interest markets where you don't simply have fungible shares listed on an exchange?

Peter Harper - BetaShare (12:43):

Yeah, it's a great question, Toby, because I mean, as most listeners would be aware, the majority of fixed income is traded around the world in OTC markets, and it tends to be traded with large sort of minimum sizes. And so, that create some potential liquidity concerns, relative to a share trade. And so some of those things can be dealt with at the index level. So for example, we always think about trying to make sure all of our fixed income indices, hold the most liquid and largest fixed income securities in the market that they are "repo eligible securities" with the RBA, for example, so that in crisis events which is when you really want the defensive part of your portfolio to be liquid, that the liquidity is there and available to the greatest extent possible.

Peter Harper - BetaShare (13:40):

So, there are things to consider in terms of index construction, but just in terms of ETFs themselves, , you know, one of the other things we saw during crisis periods like COVID was that the liquidity in the underlying bonds actually dried up quite a lot, and the major buyers of bonds, (which are often in Australia, the big four banks), just weren't bidding. So if you wanted to sell a bond exposure, it was very, very challenging regardless of the implementation vehicle, but with ETFs being a listed security, we were able to still see some volume traded between natural buyers and sellers, and that was even more so the case in the US market where the underlying junk bond market failed to trade at all. But the ETF became the go-to source of liquidity as natural buyers and sellers look to exchange units in junk bond, ETFs, and source liquidity from each other. ,And so I think that's that's one way that ETFs have certainly boosted the liquidity of fixed income as an asset class in aggregate,

Toby Potter- IMAP Chair (14:46):

Because in the fixed interest part of your portfolios, how do these sorts of considerations play into your thinking about appropriate vehicles?

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Lukasz de Pourbaix - Lonsec (14:58):

Yeah. Fixed interest and if we look at the list of space or the broader ETF market, I think fixed income is more difficult in terms of constructing a holistic portfolio. So in terms of your more vanilla exposures, whether it's government bonds and so forth, you know, that's no issue there. I guess it's more, if you're looking at some sectors, whether it's R&BS or some of the more relative value type strategies, those sort of strategies are much more difficult package as an ETF, or they're not available as ETFs in some instances. So the universe is fairly small, and you've got less to choose from. Then with some of the exchanges themselves, there are some products out there that are listed on ChiX, for example, but not on the ASX and so forth. So, I think those things will resolve themselves and we will see more choice, but it's probably fair to say that today you can construct a portfolio, but in terms of the choice and the building blocks that you get to choose from, it's more limited compared to the unlisted fund space at the moment.

Toby Potter- IMAP Chair (16:12):

Thanks, let's wrap up this podcast by talking about one of the final issues around implementation, which we discussed a little earlier, whcih occurs when a portfolio manager, like Lonsec wants to switch from one ETF to anotherin a similar market and the way in which the issuers of those ETFs can facilitate the way in which ETFs can become a more efficient part of portfolio rebalancing, Peter...what you are thinking about that.

Peter Harper - BetaShare (16:48):

I think that's something that can be utilized more by the market to achieve more efficient outcomes. First of all, I'll give an example of a switch between two exposures that aren't similar, and don't have efficiency benefits, and then I'll show one that does, and I hopefully that'll explain to listeners how they can best achieve good outcomes. You know, if you were going to move from US equities into Aussie equities and were selling a US equity ETF, the market maker would buy that ETF back and they would sell all of the underlying shares into the market. You would then buy from them... the Aussie ETF, and they would have to buy all the underlying shares in the market. So they have to go in and transact a sale of the underlying shares on one side and a purchase of the underlying shares on another.

Peter Harper - BetaShare (17:40):

But if a manager is looking to switch between two similar ETFs, for example, two broad market Australian ETFs, then the market makers sitting in the middle of that transaction can buy one ETF back from the investor and redeem that ETF with the issuer for the underlying share basket. And then they take that share basket that they receive, and they use that basket to create units in the new ETF and as such it means that the market maker is not required to actually go in and transact the underlying share basket on the ASX. And that creates a really big spread efficiency for the market maker. And therefore those sorts of switches can be priced at incredibly tight spreads to the benefit of the underlying investor, and so that's something that we do see people using, but something that for large scale transactions between similar ETFs, I think there's a lot more scope for that to grow in the Aussie market from where it stands currently.

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Toby Potter- IMAP Chair (18:47):

And how does the how does the investor experience that benefit from the tighter spreads

Peter Harper - BetaShare (18:55):

Look in those sorts of trades, normally they would be priced against the closing Net Asset Value of each of the funds. And so they would tend to be transacted at close on the Aussie market, and so if they were in a normal circumstance going to receive Net Asset Value minus three basis points, for the sale and pay Net Asset Value plus three basis points for the purchase, you may be able to cut that spread in half or by a third of what it might otherwise have been, because that manager is simply making more efficient utilization of the underlying basket of shares, and so that can create some really good efficiencies for investors making switches between similar ETFs subject to them being of sufficient size.

Toby Potter- IMAP Chair (19:54):

Well, this is really in a completely different league from the buy sell spreads on unlisted funds at 25 to 50 points each way. Isn't it?

Lukasz and Peter, thanks very much for your time today. I've certainly learned a lot about the mechanics and the intricacies of ETF trading and to those of you, who've listened. Thanks very much for listening to us today. And we look forward to you joining further Independent Thought podcasts with IMAP.

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