Insights
ETFs

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European ETF Industry Evolution:
2 Crises Survived and 10 Years of Growth

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ETFs have seen strong growth and, in Europe, total assets now exceed $1 trillion. In this paper we look at the trends across asset classes from the past 10 years and what the industry could see going forward.

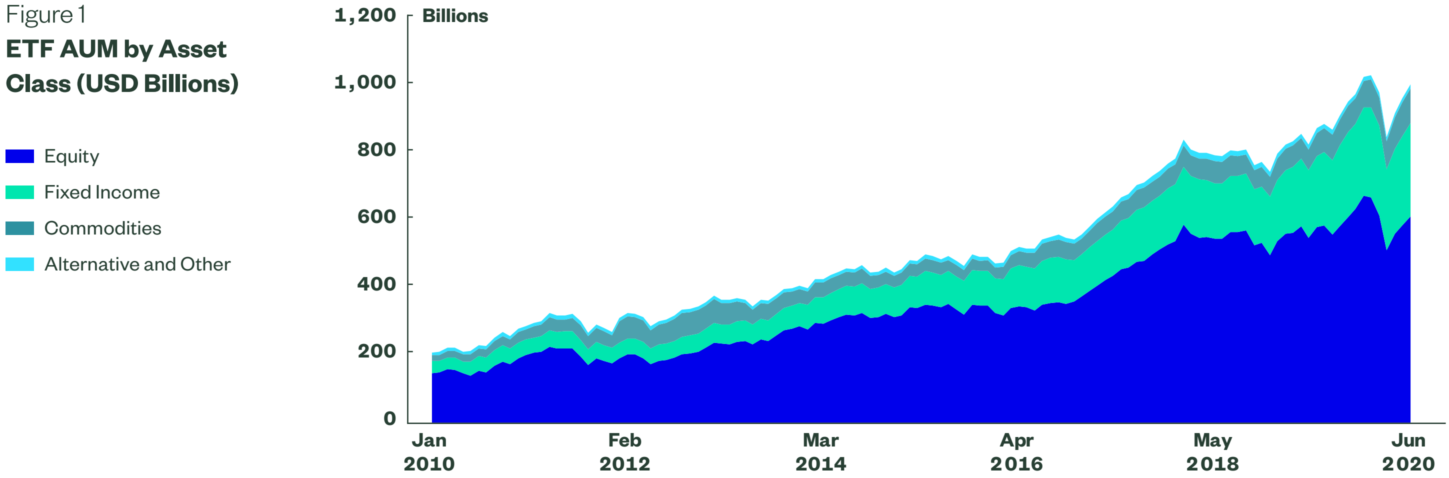
Introduction

While ETFs have been available in Europe since 2000, in the 10 years following the Global Financial Crisis we have seen a boom in ETF asset growth.

Over this period, ETFs in Europe have seen a compounded annual growth rate (CAGR) of more than 16%. Starting 2010 with just $228 billion of assets, ETFs entered the new decade with more than $1 trillion in total assets.

Although the onset of the COVID-19 crisis caused a significant dip, as markets plummeted and investors pulled money out of funds, the subsequent recovery and market rally has seen assets jump back above the $1 trillion mark.

Figure 1
ETF AUM by Asset Class (USD Billions)



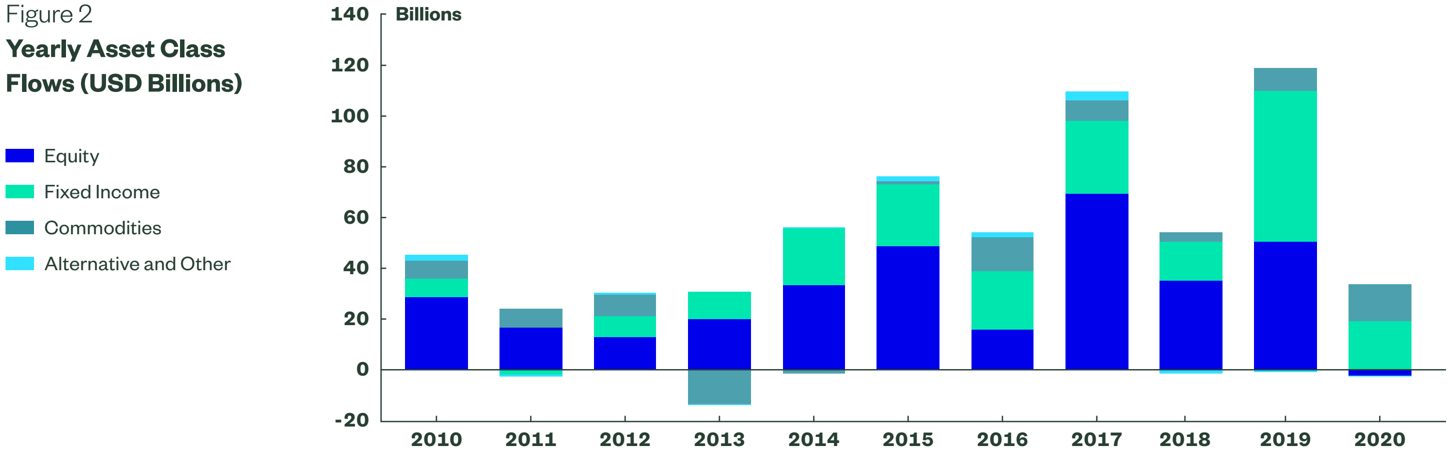
Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

So what have been the main products driving this phenomenal growth in the industry? For most of the decade, equity products drove the majority of flows, first through broad market beta products then later on also through smart beta and sector products. However, more recently, fixed income ETF asset growth has started to accelerate. In 2019, these products saw $60 billion of new assets — more than double the previous record set in 2017.

While equity ETF flows have outpaced other asset classes in most years, it is worth noting that the intra-year volatility in equity flows is far higher. Equities have often seen very sudden shifts in flows month by month, whereas fixed income flows tend to be more stable.

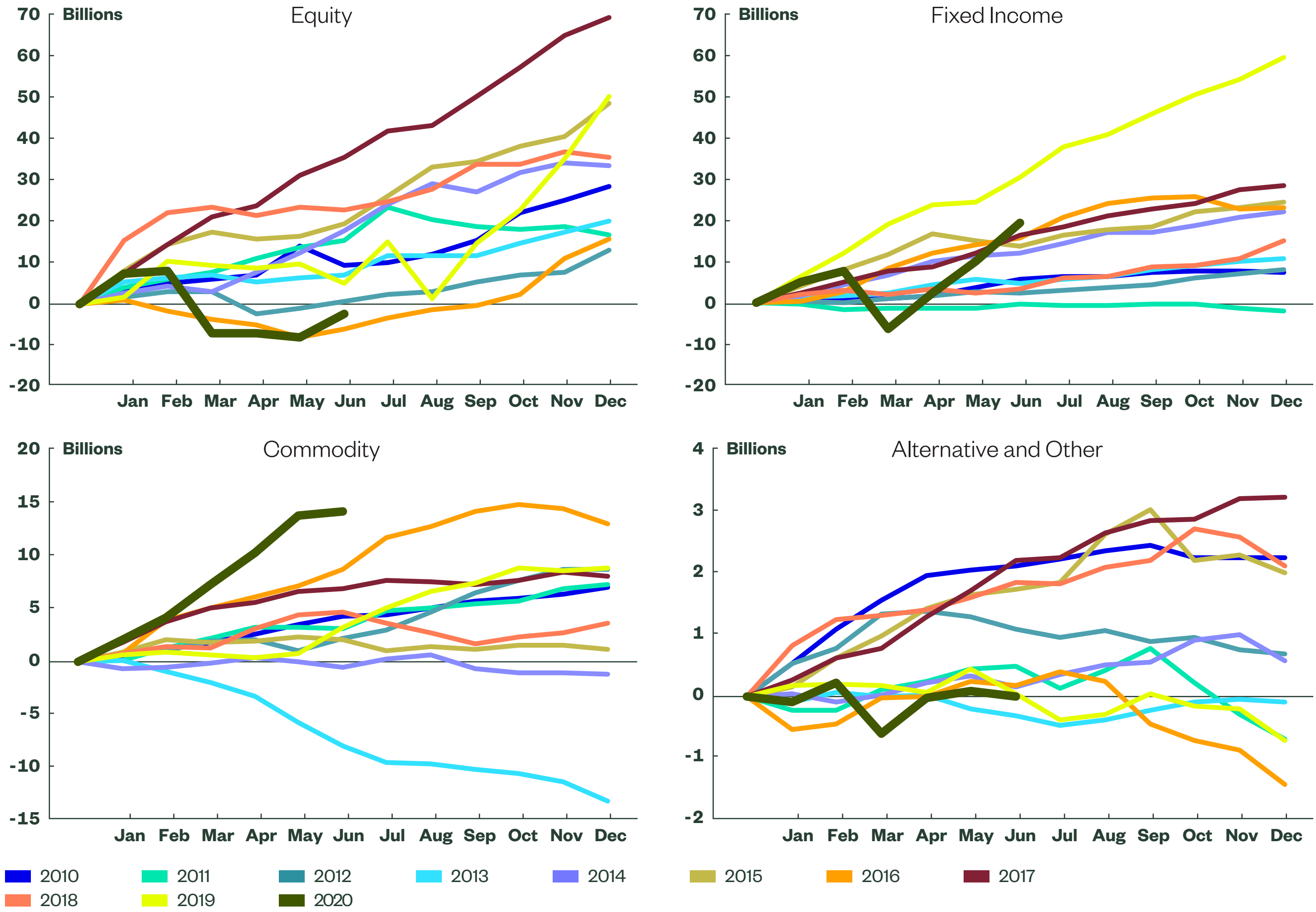
It looks like 2020 is set to be a record year for commodity inflows, with the first six months of the year already pulling in more than the previous record in 2016.

Figure 2
Yearly Asset Class Flows (USD Billions)



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Figure 3
Annual Cumulative Asset Class Flows (USD Billions)



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Equity

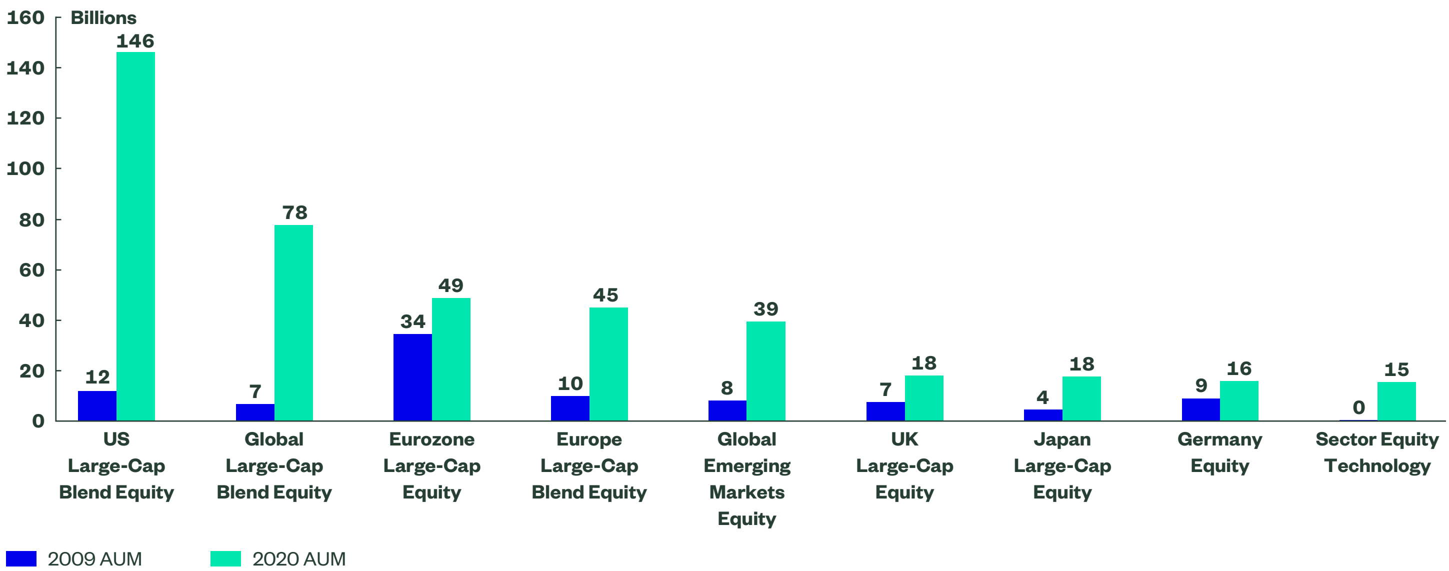
US large-cap products dominate the equity space, with many of the largest ETFs in Europe benchmarked to the S&P 500 index. In addition to attracting consistent and sizable inflows, these ETFs have also been helped by a roaring bull market, which has driven the AUM of these products up organically.

This trend was not always the case. Ten years ago, Europe and eurozone-focused equity products held a much greater proportion of total assets, and were by far the most popular exposure. Even Europe single-country products, such as UK, German and Swiss equities, held relatively large proportions of assets compared to the rest of the market.

Although these products still account for a large percentage of total AUM, they have seen their market share eroded by growth in more diversified exposures, such as globally focused products, as well as emerging markets and Japanese equities.

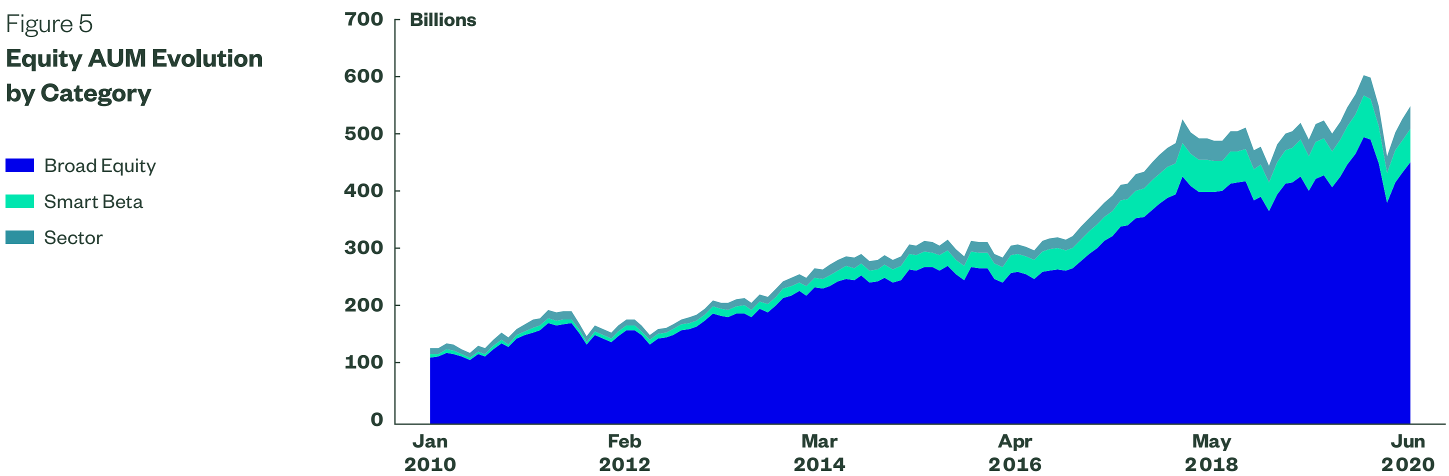
In more recent years, smart beta and sector ETFs have enjoyed significant expansion of assets, as investors have begun using ETFs as a way to implement investment strategies and gain exposure to individual sectors or factors through an ETF wrapper. Technology-focused ETFs in particular have become popular among investors, partly helped by surging market capitalisations of the underlying companies within this sector.

Figure 4
10 Largest Categories in Equity by AUM



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Figure 5
Equity AUM Evolution by Category



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Fixed Income

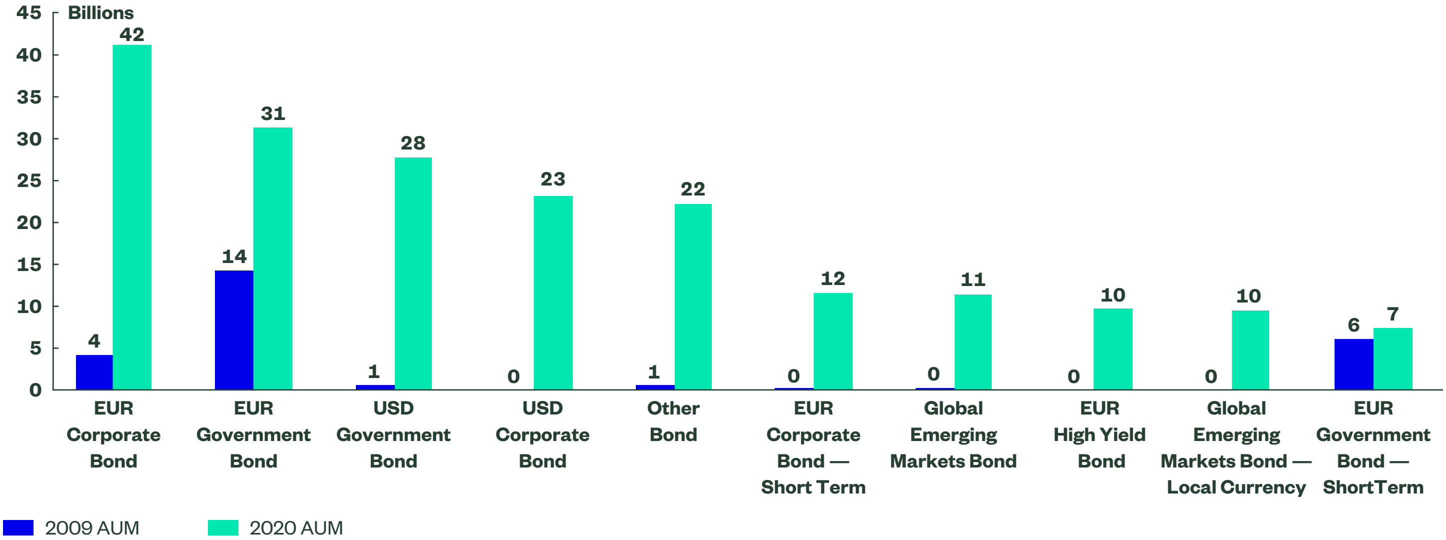
Fixed income started the last decade in a fairly similar position to equity, with European exposures being by far the most popular, both in the government and corporate space. However, as time has passed, European exposures have kept their dominant position, albeit in a much more diversified way, with no single exposure taking a particularly dominant position.

Unlike equity, many of the exposures that are now most popular were not being used by ETF investors 10 years ago. The largest beneficiaries of this effect have been USD-denominated exposures, as well as emerging market debt local currency, which has grown to more than $16 billion in assets from nothing a decade ago.

Another great beneficiary of the expansion in fixed income ETF coverage is high yield, both in the EUR and USD space. These exposures were also unaccounted for in ETFs at the start of the period, but have swelled to a combined $19 billion, as investors have looked to take advantage of the added liquidity that ETFs can offer when accessing this notoriously difficult-to-access asset class.

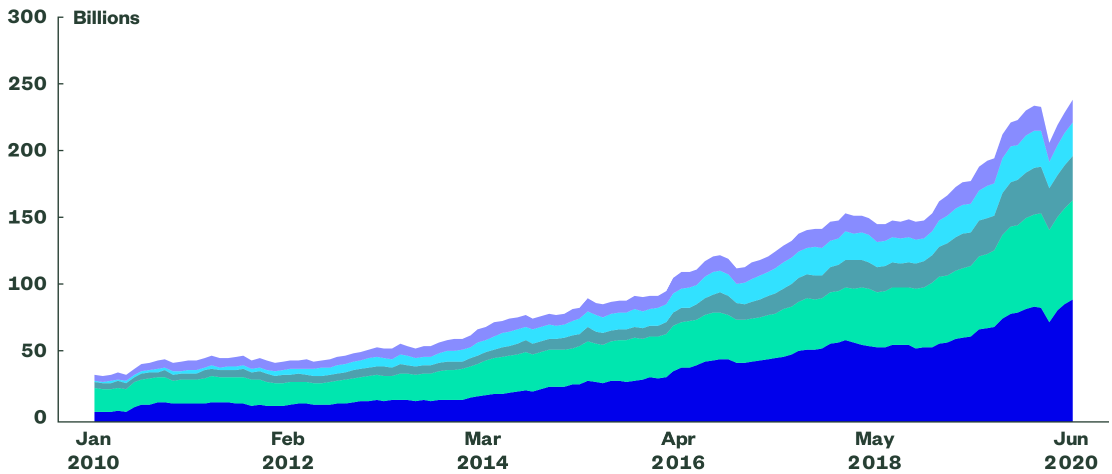
Targeted maturity products have also seen significant growth. Fixed income investors can use these products to easily adjust the duration of their portfolios. This is demonstrated by the adoption and expansion of the short and ultra short duration products below, which have seen increased popularity more recently as investors look to shield their portfolios from bouts of volatility.

Figure 6
10 Largest Categories in Fixed Income by AUM



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Figure 7
Fixed Income AUM Evolution by Category



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

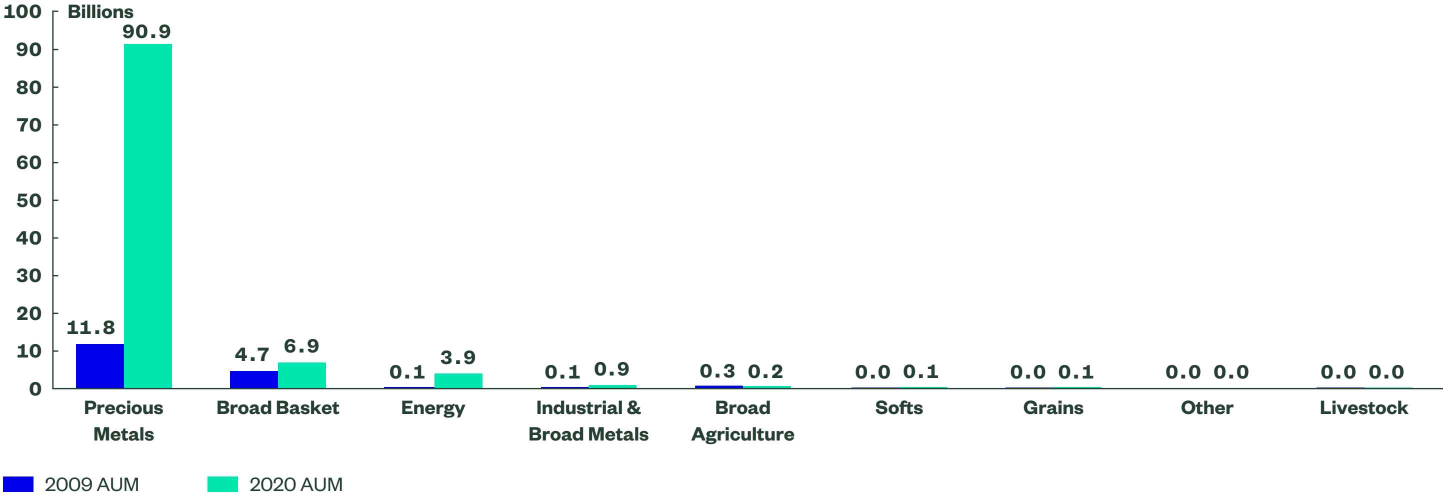
Commodities

In 2010, commodity ETFs were dwarfed by other asset classes, as investors mostly used ETFs for their equity and fixed income asset allocations. However, more recently, investors have begun to use commodity ETFs as a way of gaining exposure to the various segments of this asset class.

This is particularly the case for precious metals, which have ballooned to over $90 billion of assets. Gold ETFs have been major contributors to this growth, as investors have sought exposure to the yellow metal as the price has surged, especially during the COVID-19 crisis and the subsequent global drop in bond yields.

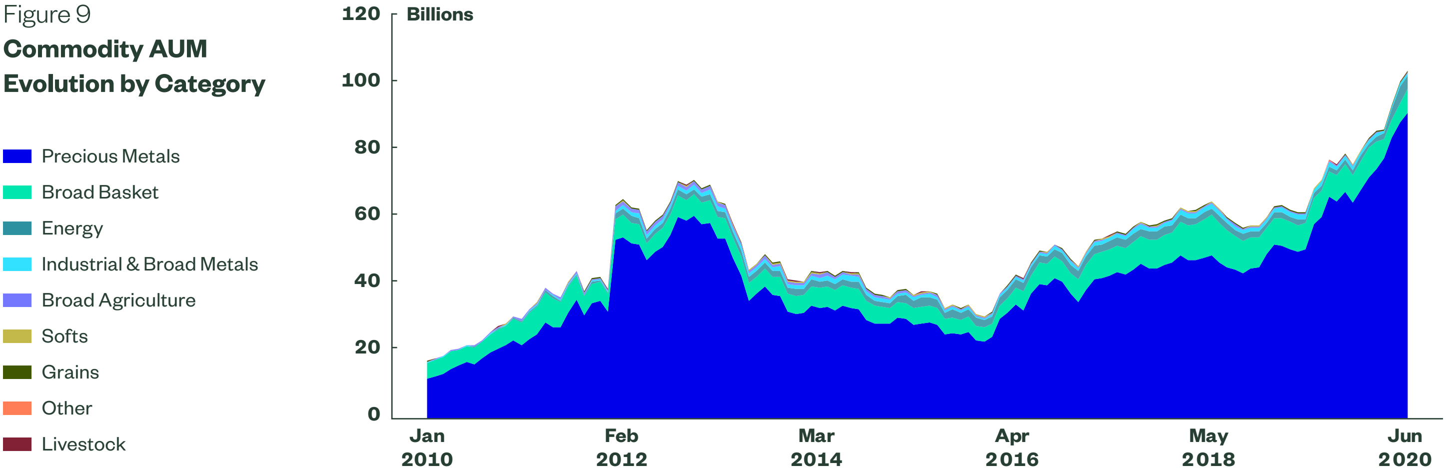
Energy has also seen significant expansion in assets, mainly from investors using oil ETFs as a way to express a view on oil prices.

Figure 8
Commodity AUM by Category



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Figure 9
Commodity AUM Evolution by Category



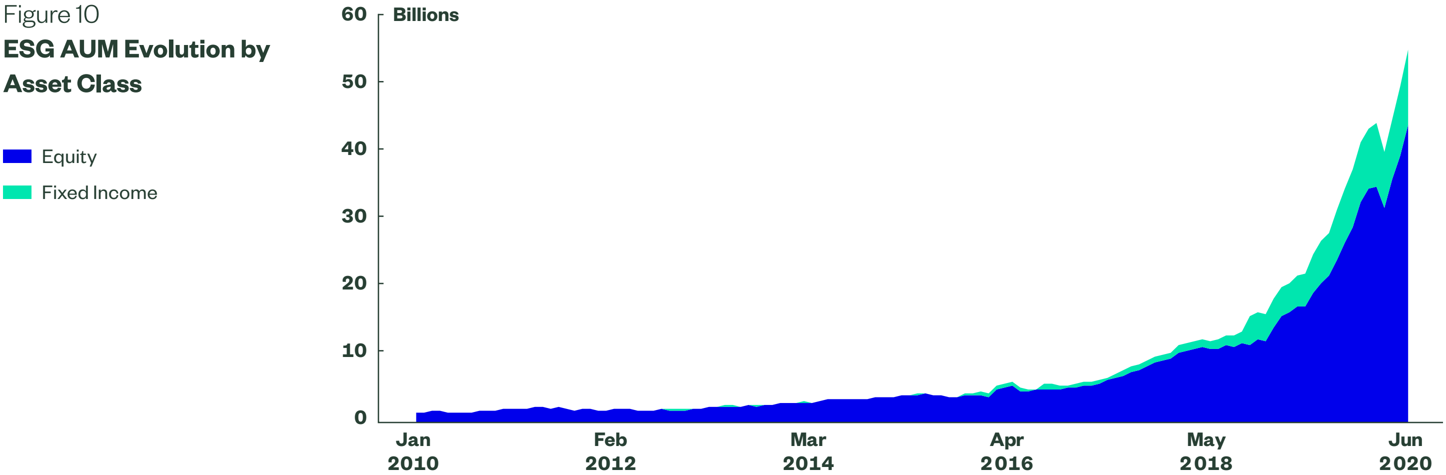
Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

ESG ETFs

ESG ETFs were not initially popular, with less than $5 billion of AUM until the beginning of 2017. Since then, the popularity of these products has exploded, and in the last three years assets invested in ESG ETFs have swollen more than 10-fold to nearly $55 billion.

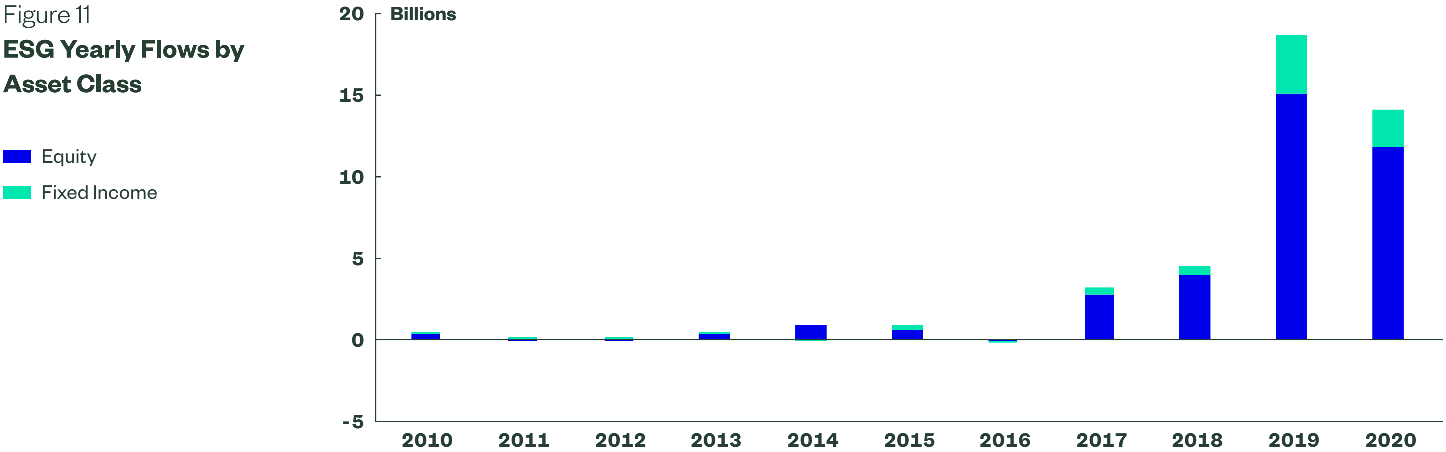
Initially, equity made up almost the entirety of the ESG ETF AUM. However, in the last few years fixed income has begun to grow in popularity as well, and assets in these products recently broke through the $10 billion mark. Despite that bounce, equity inflows have still far outpaced fixed income so far in 2020.

Figure 10
ESG AUM Evolution by Asset Class



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

Figure 11
ESG Yearly Flows by Asset Class



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

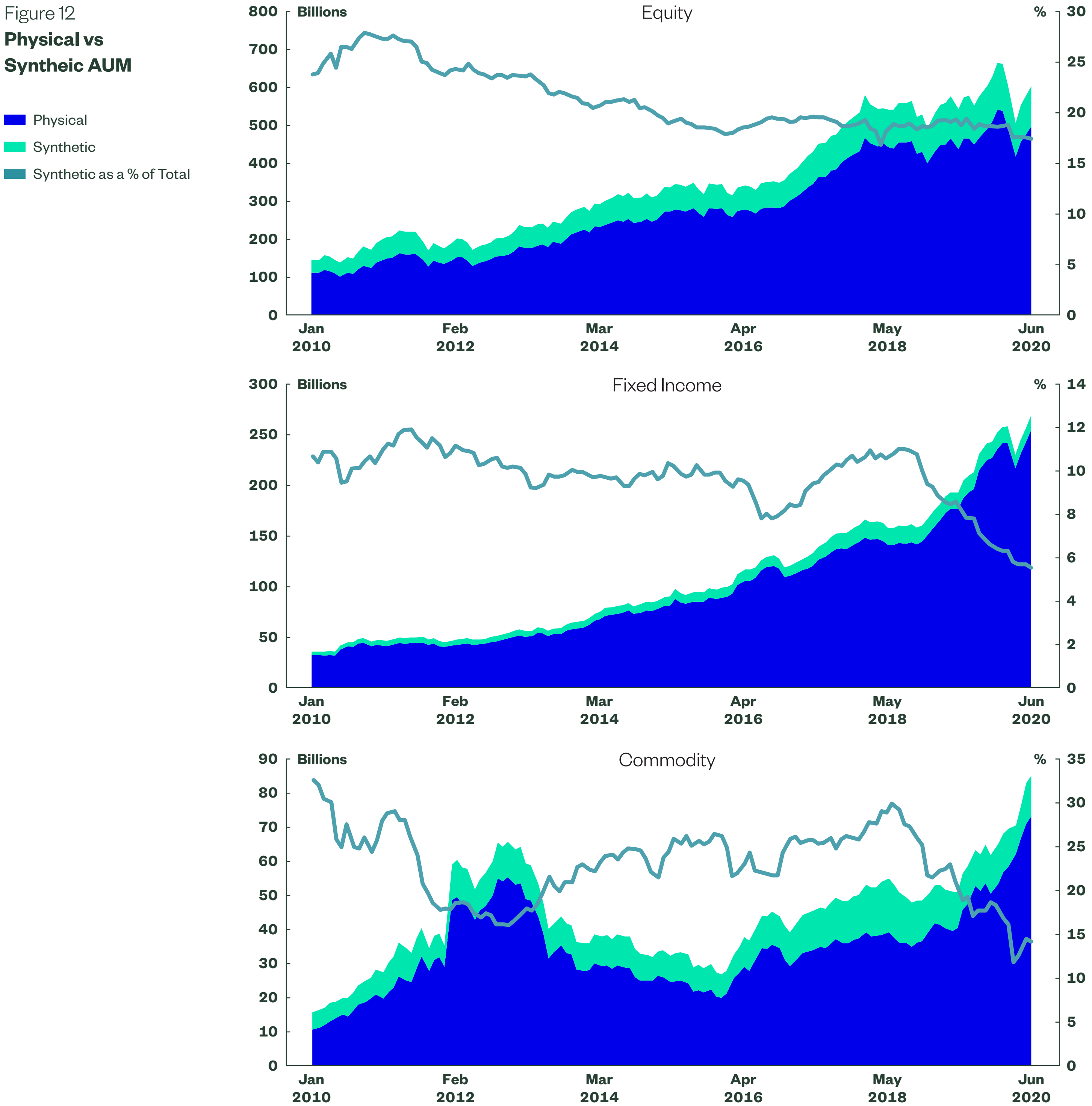
Physical vs. Synthetic ETFs

In Europe, investors can choose whether they want to invest in physically backed ETFs (which hold the underlying securities and either directly replicate the index or replicate it through a process of optimisation or sampling) or synthetic ETFs (which replicate the index through use of a total return swap or other derivatives).

Across asset classes, investors have shown a strong preference for physical. Physically replicated ETFs have taken more of the share as time goes on, particularly in fixed income where synthetic ETFs now account for only 6% of the total market.

Commodity has also seen a dramatic fall in the proportion of synthetic assets, largely driven by the swell of inflows into precious metals ETFs in the last five years, where investors clearly favour physically backed products over synthetic.

Figure 12
Physical vs Synthetic AUM



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions.

What Could the Future Hold for the European ETF Industry?

The growth in assets held by European ETFs has been widely reported, as has the potential for continued room to grow going forward. New industry players have entered the European ETF market regularly, hoping to capitalise on this growth.

But what can we expect from the European ETF market in the future? Figure 13 shows projected future AUM levels under three different scenarios.

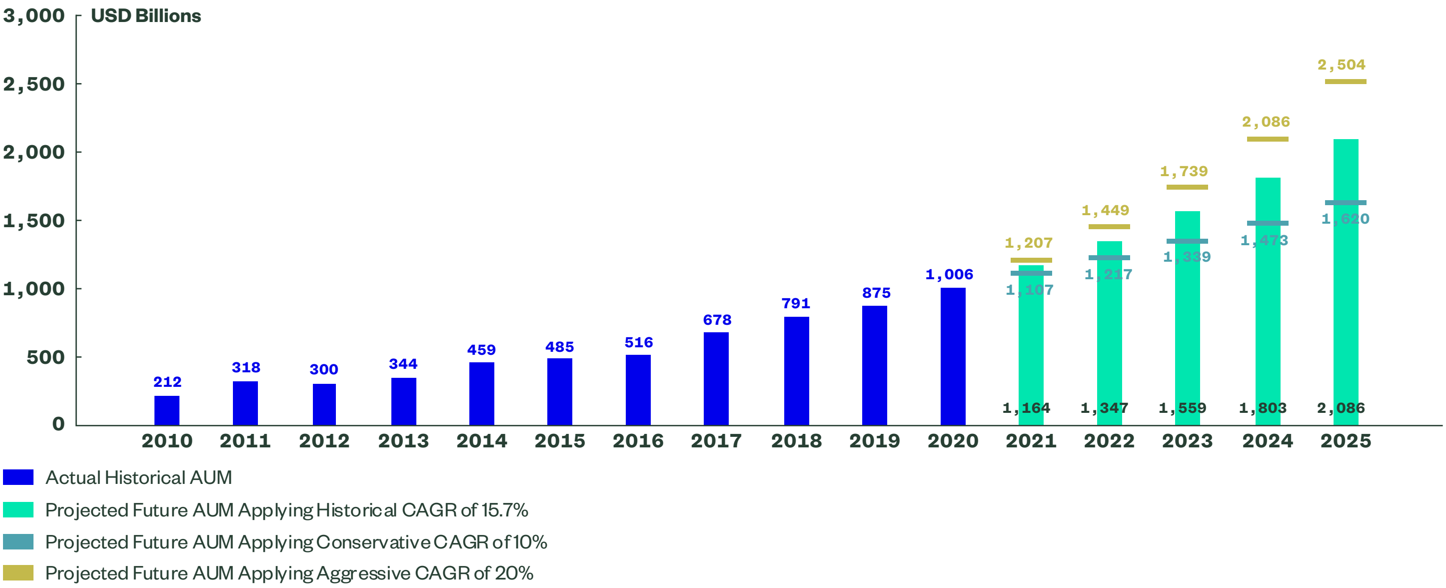
The first projection assumes the industry continues to grow at the same CAGR that it has for the last five years (15.7%). Under this assumption, we can see that by 2025 ETFs in Europe might well surpass the $2 trillion mark, doubling the current asset levels.

We have also taken two other projections: a more conservative assumption that growth will slow to just 10% annually (due to the initial surge in popularity waning), or a more aggressive annual growth rate of 20% (as investors get more comfortable with the vehicle and therefore invest in ETFs at an exponential rate).

Under the more cautious expected growth rate, the industry would still get up to $1.6 trillion, while under the more aggressive scenario, assets could swell to over $2.5 trillion.

Although some may query whether the industry could really double in size again so quickly, and whether this level of growth can realistically be sustained for a further five years, it is worth noting that the US ETF industry, which had reached $1 trillion of assets by the end of December 2010, managed to break through the $2 trillion mark before the end of 2014. Of course, this coincided with the start of one of the greatest bull markets in history, which helped propel the asset base higher. Time will tell whether the European ETF industry will be helped or hindered by market moves.

Figure 13
Annual European ETF AUM and Projected Future AUM



Source: Morningstar Direct, as of 30 June 2020. All figures expressed in USD billions. The above estimates are based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

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