



SEI RESEARCH BRIEF

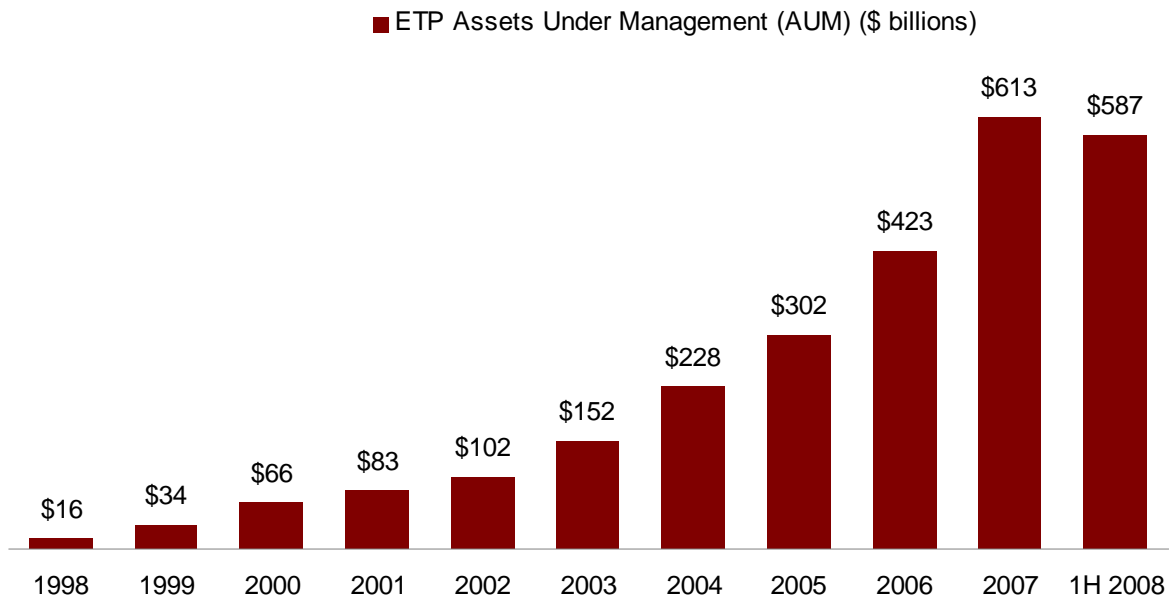
Exchange Traded Products: A Look Ahead

The SEI Knowledge Partnership recently surveyed asset management executives to get their views on Exchange Traded Products (ETPs), such as Exchange Traded Funds (ETFs) and Exchange Traded Notes (ETNs). The poll was completed by executives at firms ranging in size from less than US\$250 million to more than US\$10 billion in assets under management. Survey questions were formulated in an effort to better understand managers' perceptions of the market for ETPs, including whether they planned to introduce their own ETPs, factors critical to a successful launch, and asset classes and investment styles that show the most opportunity.

Market Snapshot

As an investment product package, ETPs have experienced phenomenal growth by almost every measure. Although suffering slightly at the hands of the current market downturn, ETP assets have grown over the past ten years from \$16 billion to \$587 billion as of June 30, 2008, a compound annual growth rate in excess of 43%.

Figure 1: Historical growth of ETP assets



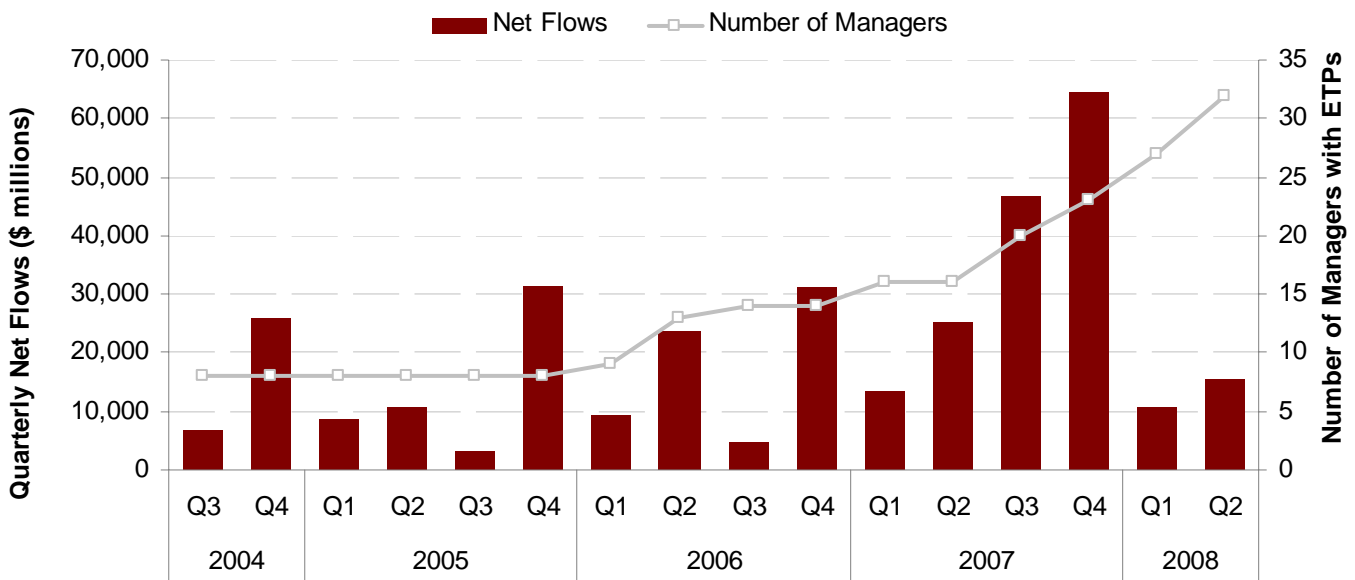
Source: SEI, Strategic Insight

ETPs have traditionally been dominated by a handful of managers. State Street alone represented 35% of all flows in the first half of 2008, while Barclays represented 52% of total assets.

New entrants are now storming the gates, and there are changes afoot. As an example, at the start of 2008 Barclays accounted for the seven largest ETPs (all ETFs); however, currently they only account for five of the largest as other firms are quickly gaining ground on the industry leader. In this same time frame another nine managers have jumped into the fray, bringing the total number of managers sponsoring ETPs to 32.

In addition to the growing number of managers, there has been a veritable explosion in the types of ETPs available to investors. Ten years ago, there were 30 ETFs representing 14 Morningstar categories. By mid-2008, investors could choose from 796 ETPs in 53 of the 68 total categories used by Morningstar to classify long-term funds (most of the remaining are single state municipal bond categories). Among the fund categories penetrated most recently by ETPs are various international asset classes, municipal bonds, and various asset allocation strategies, including target date products.

Figure 2: ETP Flows and Managers with ETPs



Source: SEI, Strategic Insight

Are there still opportunities for newcomers in this increasingly crowded playing field? What are the concerns of potential ETP managers? Why are some firms choosing to sit on the sidelines? And what can be learned from those that already manage ETPs? All of these questions and more were addressed by this survey.

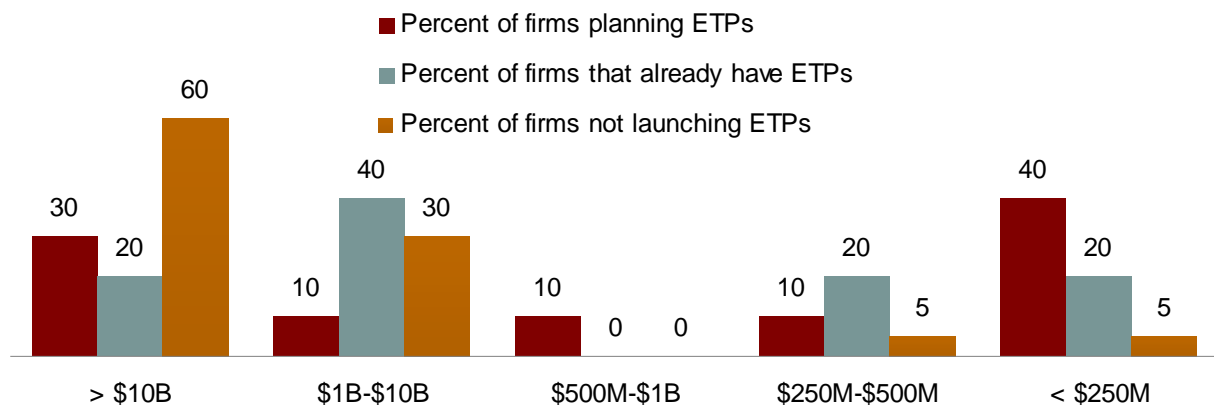
Survey Results

Among the firms surveyed, 28% of firms indicated they would be launching ETPs in the next 18 months, 58% said they had no plans to launch ETPs, and 14% already sponsor ETPs.

Firm Size

The size of organizations participating in the survey that already sponsor ETPs varies widely, with both the largest (>\$10B AUM) and the smallest (<\$250M AUM) firms represented. Those reporting that they plan to launch these products are similarly diverse, although the center of gravity appears to be shifting slightly toward smaller firms: 60% of firms planning to launch ETPs have less than \$1 billion AUM, versus 40% of those that currently offer ETPs. Larger firms participating in the survey are more content to remain on the sidelines. More than half of the firms saying they did not plan to launch ETPs have more than \$10 billion in overall assets.

Figure 3: Current AUM

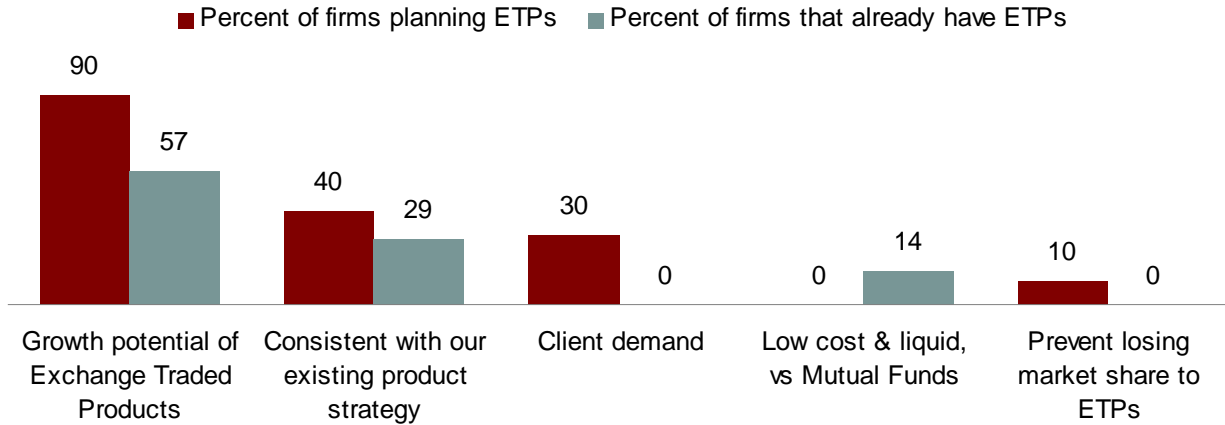


Why launch ETPs?

There is broad agreement among both aspiring entrants and existing competitors over the environmental factors that led to their decision to offer ETPs, with growth potential within the product category most commonly cited as a leading reason. It is worth noting that those yet to launch are decidedly more optimistic about the product category potential, with 90% listing it as a reason, versus 57% of those with existing ETPs. Some managers clearly see ETPs as a logical extension of their existing business. Consistency with the firm's existing product strategy was the second most prevalent reason given.

There were some differences of opinion on the margins. Firms planning to launch ETPs are more likely to quote client demand as a reason. No current ETP managers gave this as a reason, possibly because there was very little measurable demand when they launched their products as early movers in the market. A small minority of those planning to launch ETPs are taking an explicitly defensive stance, stating that offering their own ETPs will protect them from losing market share to those managed by other firms.

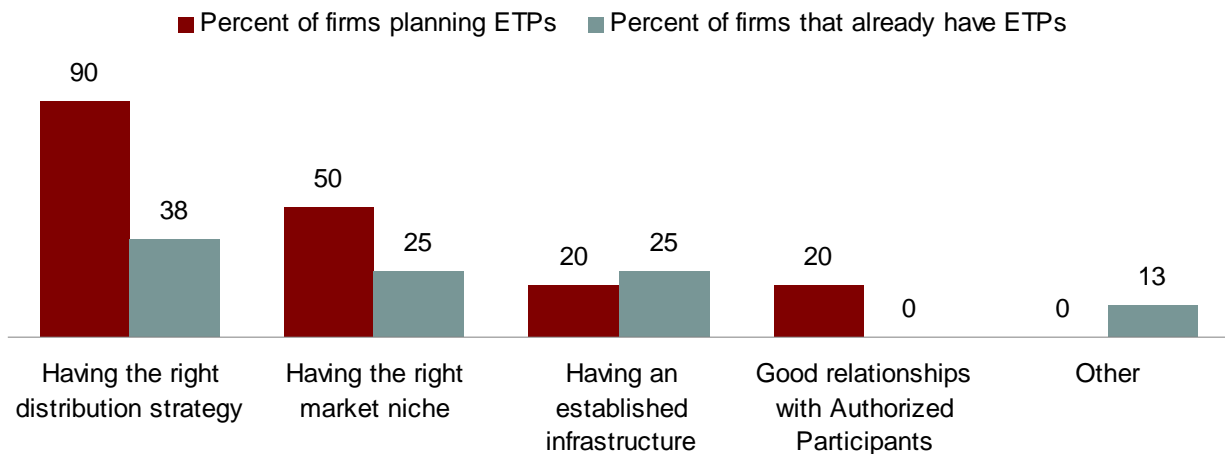
Figure 4: Most important marketplace conditions leading to launch decision



Success factors

Distribution is weighing heavily on the minds of those planning to launch: 90% say having the right distribution strategy is one of the most important factors in a successful launch. Reflecting the growing flood of products into increasingly focused asset categories, a full half of those participating in the survey said that finding the right market niche is a critical factor. Interestingly, existing managers of ETPs more often acknowledge the importance of having an established infrastructure, including order taking, administration, accounting, custody, and transfer agent functions, as critical success factors.

Figure 5: Most important factors in a successful launch (current or planned)

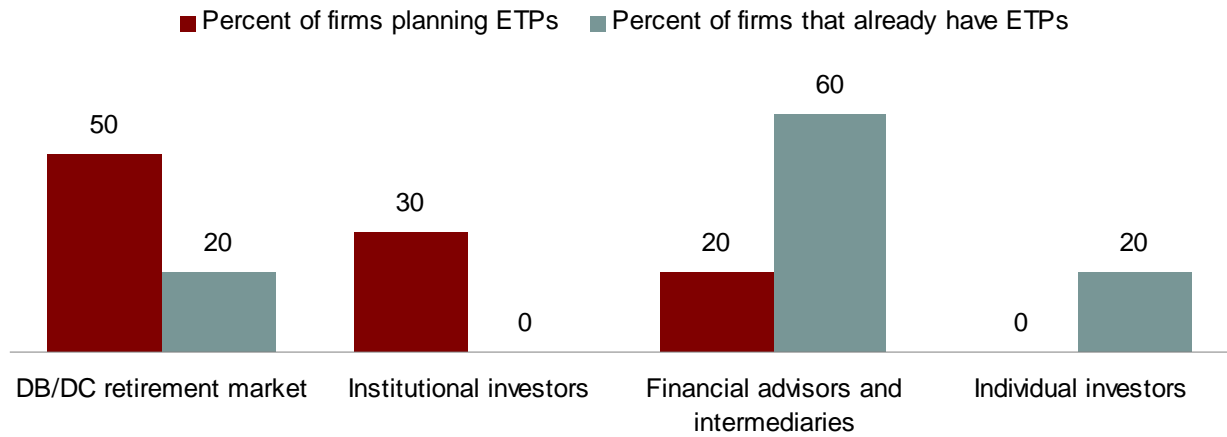




Promising segments

There is disagreement over which customer segment offers the most significant near-term opportunity. Firms with existing ETPs are more likely to see financial advisors as the most promising segment, while those planning to launch see the retirement markets as a better prospect.

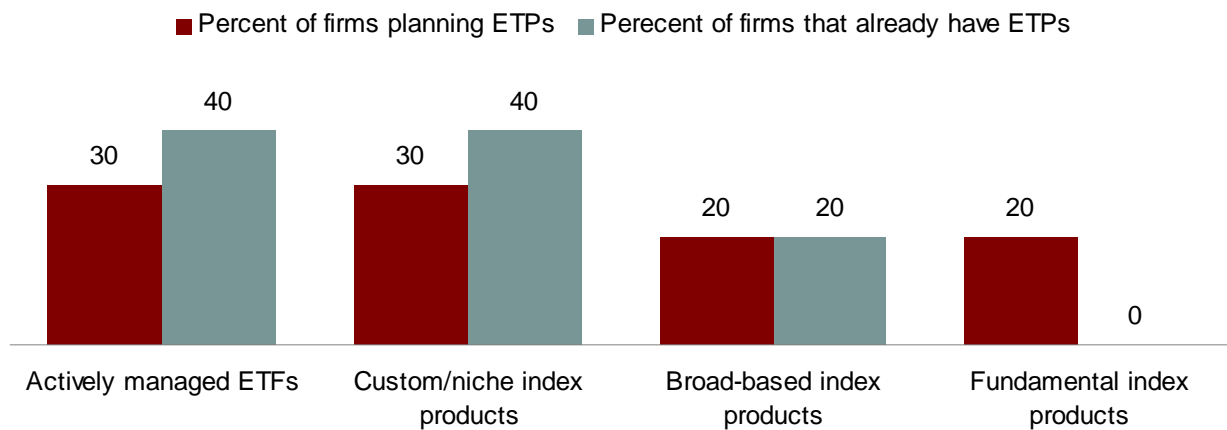
Figure 6: Segment presenting the biggest opportunity for ETPs over the next 3 years



Investment styles with potential

Amid the quest for differentiated investment styles, it should come as no surprise that actively managed and custom products are seen as the most promising by both firms with existing ETPs as well as those that plan to launch them. Some new entrants are apparently not convinced that the market for index products is played out, with 40% saying either broad-based (e.g. large cap domestic equity) or fundamental (e.g. dividend, earnings weighted) index products held the most promise over the medium term.

Figure 7: Investment style offering biggest opportunity for ETPs over the next 3 years

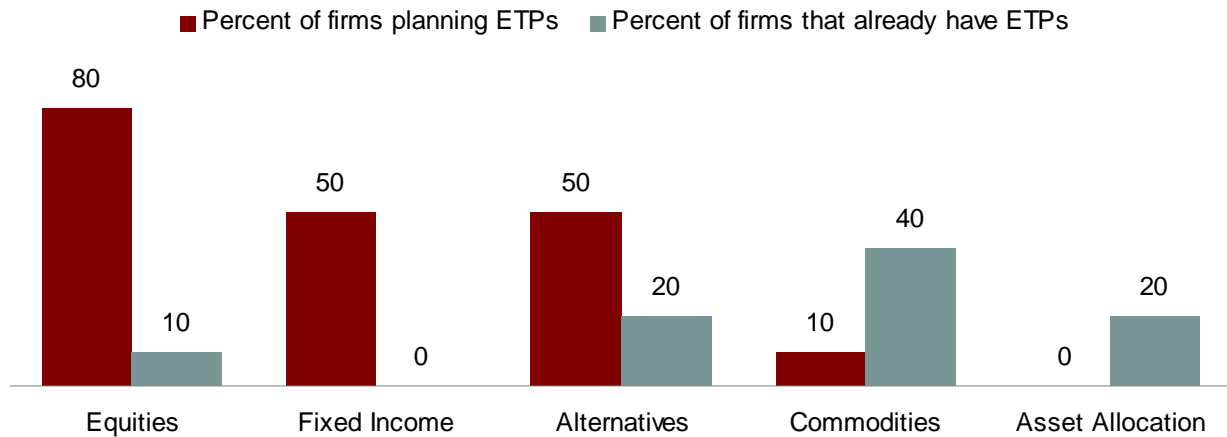




Which asset classes?

There is a prominent shift underway in which asset classes are viewed as desirable. Survey respondents that already have ETPs are most likely to have entered the market with products focused on commodities. They are least likely to have launched with equity focused products. Firms planning to launch, on the other hand, are most likely to offer equity products. Only 10% say they will launch ETPs based on commodities.

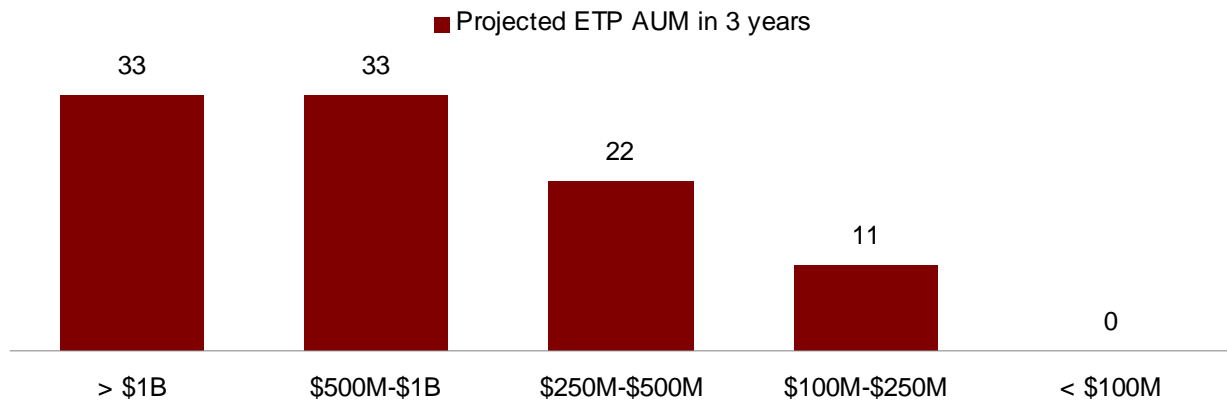
Figure 8: ETP Asset Classes – Planned / Current



Growth expectations

Survey participants that already have ETPs do not yet have significant assets under management in those products. All of them reported less than \$100M in ETP assets. Those planning to launch ETPs have their sights set somewhat higher, with a full two thirds expecting ETP assets to top \$500M within three years, and half of those projecting ETP assets in excess of \$1 billion.

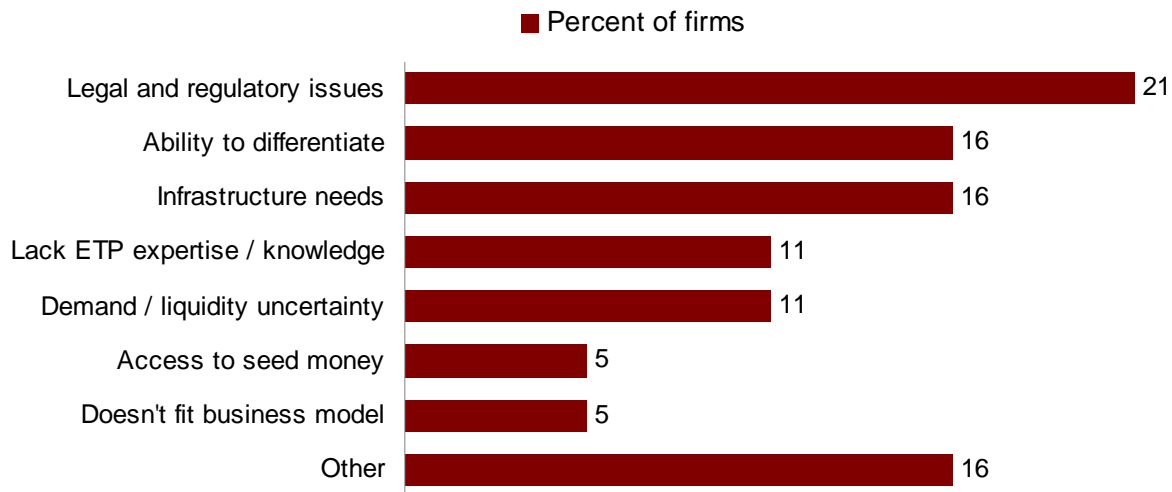
Figure 9: Projected ETP AUM in 3 years



Barriers to entry

Interestingly, there are widely divergent opinions on what constitutes the highest barriers to entering the ETP market. A quarter of respondents, representing the largest single group, said legal and regulatory issues were the primary barrier. A significant number noted the challenges of differentiating products or meeting infrastructure needs (e.g. order taking, administration, accounting, custody & transfer agency).

Figure 10: Highest barrier to entry into the ETP market

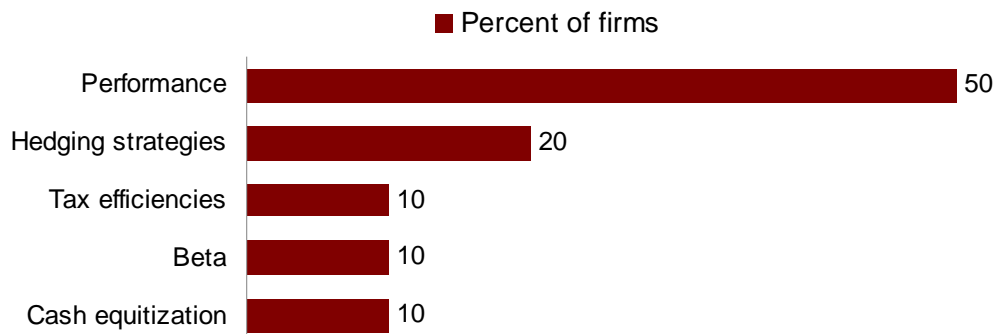


Using ETPs

Even firms that have no plans to launch their own ETPs are not immune to their charms: 55% said they invest in ETPs managed by other firms. Among these, half do it primarily for performance reasons. The rest are split, citing reasons including hedging strategies, tax efficiencies, beta, and cash equitization.

For firms that neither invest in ETPs nor plan to launch their own, their decision usually comes down to philosophical differences: 78% stated that ETPs were at odds with their company's investment philosophy. Half of those remaining claimed a lack of relevant experience or knowledge. The remainder indicated that they were considering investing in ETPs over the longer term.

Figure 11: Most important reason your firm invests in ETPs



Conclusions

The results of this survey show continued interest among asset managers in ETPs. Some of this interest is manifested in firms planning to launch their own ETPs. Another group of managers prefers to leverage ETPs by investing in those managed by others. Only one in four firms surveyed do not have ETPs, do not intend to introduce them, and do not invest in them.

When it comes to gauging market potential, the biggest cheerleaders are those that have decided to launch their own ETPs. Rather than being starry-eyed optimists however, they are determined to enter the market with their eyes wide open and their strategy buttoned down. Areas of focus include:

- Pursuing a sound distribution strategy
- Finding a differentiated and defensible niche
- Lining up the right infrastructure partners

Which distribution segments and asset classes will prove the most rewarding? These remain open questions that will only be answered with time. In the meantime, expect more niche products, including actively managed ETPs. And expect them to be used more and more in retirement plans.

Exchange traded products are here to stay. They already play an important role in the portfolios of all investor types. Being careful not to stray from their existing investment philosophy, many firms are treating ETPs as another opportunity to package up their expertise in a way that will provide them with access to new markets, a differentiated position in a competitive marketplace, and long-term asset growth.

To learn more about Exchange Traded Products and the services SEI can provide, please contact us at:

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Survey methodology: SEI surveyed 36 executives at firms ranging in size from less than US\$250 million to more than US\$10 billion in assets under management. Participants were asked to select their top two answers for certain questions. Therefore, not all totals will equal 100%.

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