Exchange trading: More important than you think

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One of the most common reasons that critics use to dismiss Exchange Traded Funds (ETFs) is lack of need for intra-day trading by long term investors. The thinking is that, the 1-day change in price of a fund is inconsequential compared to the returns expected over a multi-year holding period; why care about trading intra-day if it means changing my operating model? Whilst I agree that most investors aren't looking to start day-trading, there are three major reasons investors could benefit from the ability to trade on exchange:

1) It's there when you need it:

For example, when you realise that you're positioned unfavourably an hour before an economic announcement and you need to buy exposure; or on the day the market is dropping and you need to take risk off now. It is in these moments that the ability to transact quickly comes to the forefront; better to have it and not need it, than need it and not have it.

2) Transaction cost reduction:

There are well documented reductions in transaction costs for ETFs with an active secondary market when compared to their underlying securities. This is driven by investors looking to buy and sell on a given day, essentially trading with each other and avoiding the need for an Authorised Participant to interact with the underlying securities. Trading multiple times per day appeals to a certain type of investor, not a long-term holder, however having many different investors active at any given ETF helps it achieve scale. The transaction cost benefit will then be available to all investors regardless of how frequently (or infrequently) they choose to use it.

3) Single point of access:

Being listed on an exchange means all ETFs are accessed through the equities market ecosystem and as such have a common operational set-up. Once you're set up to trade securities on a given exchange you'll have access to every ETF that has ever been listed or ever will be listed.

Although it might seem minor, the last point is arguably the element of ETFs that has added the most value to investors. Not because of the operational simplicity it brings, but rather the levelled playing field created and competitive market dynamics that have resulted.

Along came the competition

If we think about the headline benefits that ETFs have delivered such as increased transparency, lower costs, product innovation; there's absolutely no reason that mutual funds couldn't have brought these to investors, so the question is why didn't they?

With no common infrastructure in place, investors would typically access a fund via a fund platform or big advisory firm, essentially creating gate keepers that sat between the fund provider and the ultimate beneficiary of an investment. This also meant that moving from one provider to another was very difficult if they weren't offered via an investor's current set up. As a result, the mutual fund industry focused on these gate-keepers, as the key to success was to be onboarded in as many places as possible, leading to the rebate culture regulators across Europe are now trying to end.

Then along came the first ETF providers, who offered cheap passive building blocks for the masses with initial success coming from an increasing focus on asset allocation within the investment community. Success brings competition and additional providers entered the space. Given the common platform on which ETFs are accessed (the equities market) the only way to get the attention of investors was by catering directly to what they wanted: increased transparency, lower costs and product innovation.

Mutual fund providers had an oligopoly on the platforms on which they were offered. With limited competition there was no reason to deliver client focused innovation. Every ETF needs to compete with every other ETF and the only way to do that is to be better in the eyes of investors.

While the intention of the first ETF was probably not to create such an ecosystem, this unintended consequence is a primary driver of the investor focus the industry has which, in turn, is a primary driver of the growth and investor confidence that we have seen over the last 10 years. You might not anticipate using exchange trading on a daily basis, but I'd argue that you're immeasurably better off as a result of its availability.

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