ETFs Lessons from a Twenty-year Success Story
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Introduction

Good morning ladies and gentlemen.

I would like to first thank the organiser for inviting me here to give the opening remarks.

I am very pleased to have the opportunity to speak to you today. As some of you may know, a key part of my job at the Hong Kong Securities and Futures Commission is the regulation of publicly-offered investment products. ETFs are an important part of the investment product universe. In fact, my team and I have been working on the regulation and development of the ETF market since this product category first appeared in Hong Kong in 1999. The development of the ETF industry is something I follow closely.

ETF is a big success story. It has a relatively short history. The first ETF was launched in Toronto just over twenty years ago. Then in 1993, the SPDR S&P 500 ETF was listed. It played an important role in popularising ETFs among the international investment community. The SPDR S&P 500 is now the world's largest ETF, with about USD120 billion under management. It was followed by many other successful ETFs. Today, asset under management by the industry totalled USD2 trillion worldwide. This is comparable to the total amount of money that hedge funds manage.

I would like to share with you my thoughts on what underlies this spectacular growth and what could prevent it from continuing. I would like to offer some advice on how the industry and the regulator could work together to keep up the momentum. At the SFC, I also oversee the Commission's Mainland policy. I believe that the interaction between the Mainland and Hong Kong markets could have some major implications on the ETF industry in the region. I will spend some time elaborating on this.

Factors of success of ETFs

ETFs embody many characteristics that investors and regulators find desirable. Many ETFs are straightforward. They track the performance of generally well-known indices. ETF prices simply reflect the performance of the underlying indices. In many cases, the pricing of ETFs is also very competitive. Some ETFs can have an expense ratio of less than 0.1%, against more than 1% for some actively managed funds. And it is not just about cost. In terms of return, research has shown that many benchmark indices, and by implication for the ETFs that trac

In addition, ETFs are convenient. They can be bought and sold just like any other listed stocks. The proliferation of ETFs on the back of their success also means that there are now ETFs to meet many different investment strategies. All these factors combine to make ETFs an important building block in the portfolios of many investors.

Just like many other financial products, as ETFs became more popular and their population grew, the market became more crowded and started to commoditise. To build an edge for themselves, issuers began to innovate. Many of the innovations, such as improving tracking accuracy and offering products that are more tailored to specific investor needs, should be welcomed.

But there are instances where innovation has taken some ETFs off the original value propositions as a transparent and convenient investment product. Such deviations are not inherently undesirable or risky. Yet it is important that the industry and the regulators keep a close eye on them, so that we do not sleepwalk into a time bomb. I will share with you examples of some recent innovations that could create new risks. And I would like to demonstrate how the industry and the regulators have worked towards balancing risk and innovation. I think they carry some useful lessons for many of you that are at the forefront of ETF product development.

Opacity and mis-selling

The first such risk is opacity and mis-selling. Many investors see ETFs as passive, almost boring products. ETFs replicate indices. Subject to tracking errors and expenses, the price of an ETF and the underlying index should move in lockstep.

In the past few years, we have seen ETFs that are very different from this simple formula. Some ETFs, known as inverse ETFs, seek to deliver the opposite of the performance of the index that they track. Investors make a gain when the indices go down, vice versa. Effectively, an inverse ETF offers a way for investors to short an index.

Lessons learnt

I would like to use the above examples to elucidate a few lessons that I believe are important to the continued success of the ETF industry.

First, innovation does have to come at the expense of more complexity and risks. ETFs offer investors a cost effective way to access a particular market. Over the past two decades, the industry has continued to improve and has found more creative ways to do this job better. It strove to drive down costs, improve tracking accuracy, and expand the types of underlying exposure that it offers. For many ETFs, the proposition remains the same, and remains simple. In fact, many of the most popular ETFs today are the forerunners of the industry. They have been around since almost the industry's inception and have been offering the same products. Rather than adding more complicated features, they chose to focus on improving their existing offerings, and many have gained a large following.

Second, if innovation does sometimes result in added complexity and risks, the industry needs to work with the regulators to reach a balanced outcome, always putting investors' interest first. Sometimes the balanced outcome is enhanced disclosure. But disclosure is not always enough. This is a lesson that we learnt, most recently and with agony, from the financial crisis. So there are instances where certain structural require o70.944 465.715us055004E000348

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particularly when Mainla

momentum to cross-border cooperation between the two markets and would open up major opportunities for the ETF industry in the Mainland and Hong Kong.

Clearly, this is an exciting development, and I encourage you to seize upon the opportunities this creates. You must remember, however, the success did not come easy. RQFII, for example, came after three years hard work by us and our Mainland counterparts. We were able to finally convince Mainland authorities to approve the scheme because Hong Kong has over the years accumulated a wealth of experience in the ETF space, that we have a robust regulatory regime, and that our industry has a stellar track record, not least in having weathered the financial crisis largely unscathed. Any misstep, however, could set us back in years. As you consider the next products that you wish to bring to the market, I hope you will pay special attention to the risks involved and how you plan to manage them.

Conclusion

The global ETF industry has enjoyed an excellent run since its birth just over twenty years ago. The industry offers a transparent, easy-to-understand product that gives investors access to a wide range of underlying exposure in a cost effective manner. Over the years, the industry has been innovating and improving tirelessly. Such innovations and improvements enhance the value proposition of the industry. There are a few instances where innovation has raised alarm. In most cases, the industry has been able to work with