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The Rise Of The Small Index Provider

By Heather Bell
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The spectacular growth of the ETF industry has been a much-commented-upon phenomenon in the financial media, among financial professionals, and even among laypeople. Nowhere near as much notice, however, has been given to an equally interesting development associated with the proliferation of ETFs: the growing footprint of small, entrepreneurial index providers that are creating many of the nouveau indexes underlying ETFs.

It makes sense when you consider it, but the truth is, most people don't. Investors in general are at best only subconsciously aware of the most well-known index brand names—S&P and Dow Jones, and maybe MSCI. Indeed, the lineups of the three largest ETF providers—BlackRock, State Street Global Advisors and Vanguard—are dominated by funds based on indexes from the best-known index providers. Only a handful of their funds use
indexes from upstart providers.

But as you move down the list of ETF issuers, the story changes dramatically. PowerShares, the fourth-largest ETF provider in the U.S., bases much of its business on ETFs with indexes from lesser-known providers, such as the $1.3 billion PowerShares Water Resources ETF (NYSEArca: PHO), which tracks an index developed by a firm called Palisades. Van Eck, the sixth-largest ETF firm, similarly has a lineup that features only a few products based on indexes from top-tier U.S. providers: Its largest funds track indexes developed by the (now-defunct) American Stock Exchange and the (relatively unknown in the U.S.) Deutsche Boerse. The smaller the ETF provider, the more likely you are to see small index providers playing a role. And the outlook for those index companies could be quite rosy.

“Everyone talks about the explosion of ETFs, but it’s really the explosion of indexing. We have to have an index before we can have an ETF,” said Ben Fulton, head of Invesco PowerShares’ global ETF business.

Symbiotic Relationship = Perfect Storm

It wasn’t really until 2005 that ETFs based on anything but major brand name indexes were launched with regularity. By then the bulk of the most obvious asset classes had been covered or were in the process of being covered—not a lot of smaller firms really wanted to launch another broad-based large-cap domestic fund in an industry where “first to market” is the winner’s mantra. Everyone at the time recognized that “blockbuster” funds were becoming harder and harder to create.

And perhaps that’s where a whole different set of opportunities was born. Large ETF providers like the iShares family and the SPDRs were after blockbuster funds, and large index providers like S&P and MSCI were interested in partnering with the producers of blockbuster funds who had proven their ability to attract assets under management. New or small ETF providers would be unlikely to afford the fees of a top-tier brand name index, and new or small index providers would have a harder time making a case for their specialized benchmarks versus the comprehensive lineup of an established index business.

So with the big ETF providers preoccupied with rolling out traditional regions and sectors, along came a firm like PowerShares, which in 2005 ramped up launches of unique subsector ETFs covering nanotechnology, water and clean energy, among others—most of which were based on indexes created by research houses. And don’t forget the further expansion of its lineup of “Dynamic” ETFs that were based on quantitative indexes that carried no recognizable brand name.

2006—one of the banner years in the development of the ETF industry—saw many more small firms building out their lineups aggressively, usually with less well-known index providers. Roughly half of the nearly 150 ETFs launched that year were equities funds tied to indexes offered by firms other than Dow Jones, FTSE, MSCI, S&P or Russell. WisdomTree, for instance, debuted the first of its lineup of dividend-based ETFs that tracked its own in-house indexes. Claymore also burst onto the scene with five ETFs in its initial launch based on indexes from Zacks Research, Sabrient Systems and Bank of New York’s ADR division. And that’s really just the tip of the iceberg …

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