ETF and Securities Lending: The New *It* Couple

With revenues from securities lending by exchange-traded funds (ETFs) reaching a record $399 million in 2020, a growing number of asset managers are turning to a securities lending program as a way to help increase revenue, mitigate costs, and counteract downward pressure on fees. While many funds have been utilizing securities lending to boost returns for a number of years, new ETF issuers also are increasingly seeing the benefits.

The growth reflects the convergence of two important trends: assets continue to flow into ETFs at a blistering pace – global ETF AUM reached $8.3 trillion AUM as of February 2021, a 37% YoY increase[1] – while recent market volatility has ratcheted up demand for securities lending. Moreover, with increased competition in the ETF market, securities lending has emerged as a key tool for managers to reduce tracking error, which is a factor for many investors when selecting ETFs.

A Growing Market

ETFs are playing a pivotal role in the securities lending market, growing revenue by 34 percent in 2020, according to data firm IHS Markit. What's more, 19 of 20 U.S. ETF sponsors, representing 99% of the $5 trillion ETF market, participate in securities lending. These firms have traditionally played the biggest role in securities lending because they have a broad portfolio of securities to lend. With the mounting competitive fee pressures on index funds, the additional returns that securities lending can generate help defray the low cost of these products.

More than **50%** of asset managers plan to reduce expense ratios on their products in the next twelve months, according to BBH's 2020 C-Suite Asset Manager Survey

Demand for ETFs continue to attract investor interest, according to the Brown Brothers Harriman 2021 Global ETF Investor Survey, with 72 percent of investors saying they plan to increase their allocation in the next 12 months. In addition, 80 percent of respondents to the BBH survey said they planned to increase their exposure to thematic ETFs, with internet and technology ETFs receiving the most investor interest.

1 ETFGI, February 2021

With AUM in thematic ETFs surging, managers could have an opportunity to earn significant revenue through lending their underlying securities. Many newer funds are now reaching the informal $100 million AUM threshold at which many managers believe securities lending becomes practicable. For technology ETFs in particular, the recent demand from short sellers for certain stocks including GameStop and Tesla illustrate opportunities for generating l securities lending revenue streams.

No Better Time Than Now

For many ETF managers, consideration of securities lending has traditionally been put off until after the fund was well established in the market, a process that could take several years. Due to its increased relevance in the market, however, managers are being advised to embed securities lending, prior to launch and as part of the investment strategy, to obtain the potential additional returns, better performance, and enhancement to sales and distribution efforts. As recent market swings have shown, a fund can become "hot" almost overnight, prompting managers to ensure they can leverage the potential added returns of securities lending as quickly as possible.

There are some questions that asset managers may want to evaluate before engaging in securities lending.

- **Doesn't securities lending facilitate shorts?** A common objection from managers is the belief that securities lending will facilitate short selling, which will undermine their objectives. This argument has been largely discounted by many asset managers while intrinsic value lending, which prioritizes higher risk-adjusted rates of return by selectively lending securities with a scarcity premium, further addresses some of those concerns. With intrinsic value lending, our research indicates that 99% of open term revenue is generated by stocks with less than 15% short interest. In other words, shorting is relatively low in these stocks and lending would not "fuel the shorts."
- **Is it worth the effort?** Another frequently heard question from managers is whether securities lending is worth the added time and effort to secure board approval, implement a program, and put in place the necessary oversight. A better question might be: why not lend? According to our 2020 C-Suite Asset Manager Survey, more than 50% of respondents plan to reduce expense ratios on their products in the next twelve months. Many managers, understandably, are looking even harder at costs, operational resiliency and efficiencies, and new product opportunities to respond to changing market dynamics. The revenue from securities lending can help improve a fund's performance ranking relative to its peers, which are often tightly bunched together. Where many funds in a peer group already engage in securities lending, there is a strong commercial argument for also engaging in the practice.

Securities Lending Agent Due Diligence

Managers are usually advised to take advantage of due diligence to screen their lending agents carefully and make sure they are comfortable with the agent's program and overall approach to securities lending. Questions managers may want to ask include:

- If you're currently lending, what sort of transparency and customization does your lending agent provide?
- How do you benchmark the success of your securities lending program?
- Is your lending agent strategically focused on asset managers?
- For those not lending, when did you last evaluate the opportunity to engage your funds in securities lending?

Transparency in the securities lending industry has significantly advanced in recent years and lending agents such as Brown Brothers Harriman may be able to provide fund managers with portfolio analysis combining capital markets and securities lending data to provide a view into the demand for their portfolios and potential revenue opportunities.

Bottom Line

With AUM growing so quickly, especially in thematic ETFs that specialize in sectors like e-mobility, e-commerce, and artificial intelligence, it's harder than ever for fund managers to know what the hot stock might be and how to take advantage of lending those shares. Because managers need to set up a program's parameters and make arrangements with a lending agent, it is essential to have a securities lending program already in place so that they can take advantage when the next opportunity emerges.

If you would like to learn more about how ETF managers are considering Securities Lending to potentially generate additional returns, please let us know.

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