

Creating an Exchange Traded Funds Market in Portugal

A Case Study

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Abstract

This paper reviews the opportunities to create the Exchange Traded Funds (ETF) market in a country with no existing ETFs, as well as the operational and technical challenges that need to be overcome in order to do so. It uses SPA ETF's joint venture with Caixa Bank (Caixa) to create the first ETF in Portugal as a case study. In particular, this paper outlines how the market for ETFs has grown in Europe, the potential challenges of bringing a new ETF to market and provides an analysis of the partnership benefits between SPA ETFs and Caixa.

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What is an ETF?

An Exchange Traded Fund (ETF) is a collective investment vehicle that trades like a single stock. This means that it provides the benefits of an index tracking fund and the benefits of owning an individual share. ETFs generally track the performance of a stock, bond, or commodity index.

The Opportunity for Country Based ETFs in Europe

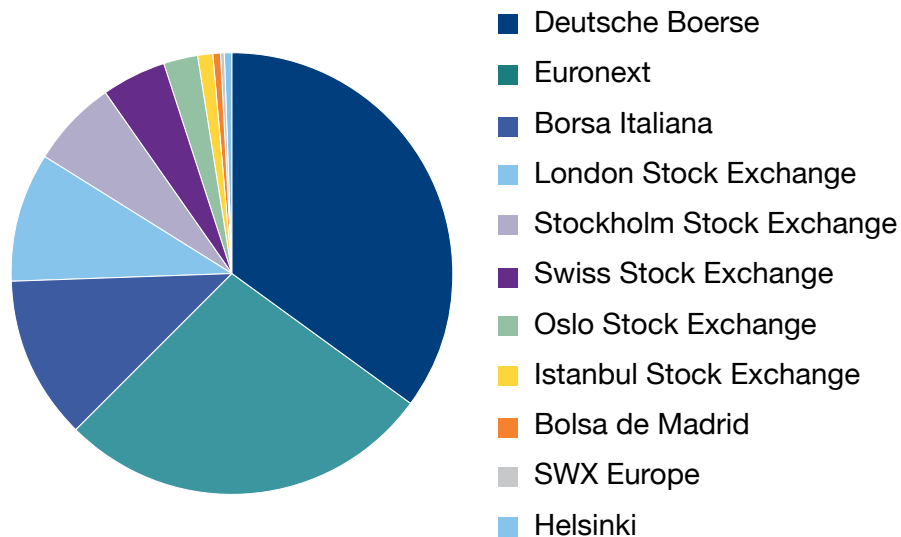
A fast growing market

The ETF market is one of the fastest-growing segments of the European asset management industry - at the end of Q3 2008 there were 570 ETFs with US\$145.17 billion in assets in Europe. Despite the recent correction in the stock markets, the ETF market in Europe has continued to grow. During the first 3 quarters of 2008 ETF AUM in Europe has increased by 13.0%, despite the 29.77% fall in the MSCI Europe index in USD terms.

Smaller European exchanges growing ETF market share

As Figure 1 demonstrates, the ETF market in Europe is dominated by the major exchanges. However, a number of the smaller exchanges, such as Stockholm, Oslo and Istanbul have begun to take market share as niche players have listed ETFs in their local markets, indicating that there is demand for Exchange Traded Products for asset managers with strong local distribution networks to exploit. Trading volume tends to stay within local borders, and most ETF providers offer cross listings of their funds on multiple exchanges within Europe.

Figure 1: ETF Market Share in Europe: Stock Exchange



Source: Barclays Global Investors, 2008

Country Based ETFs have largest share of market in Europe

Figure 2 shows that Equities are the most popular asset class by Assets Under Management (AUM), followed by Fixed Income and then commodities.

Figure 2: ETF Market Share in Europe: Asset Class

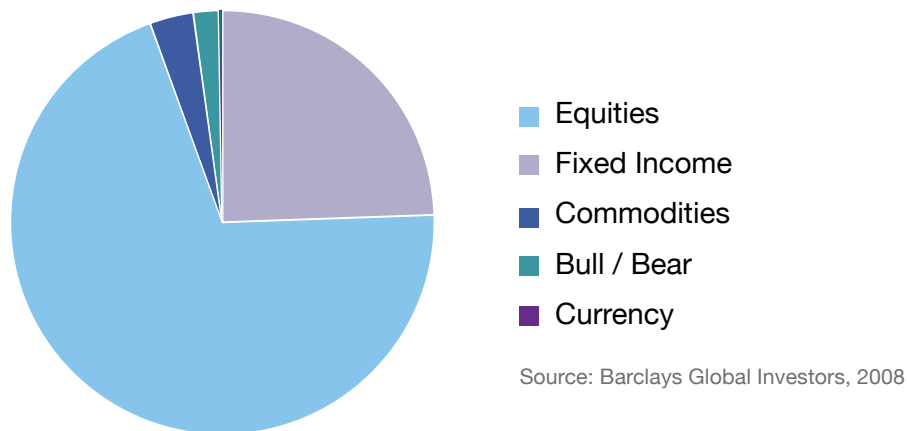
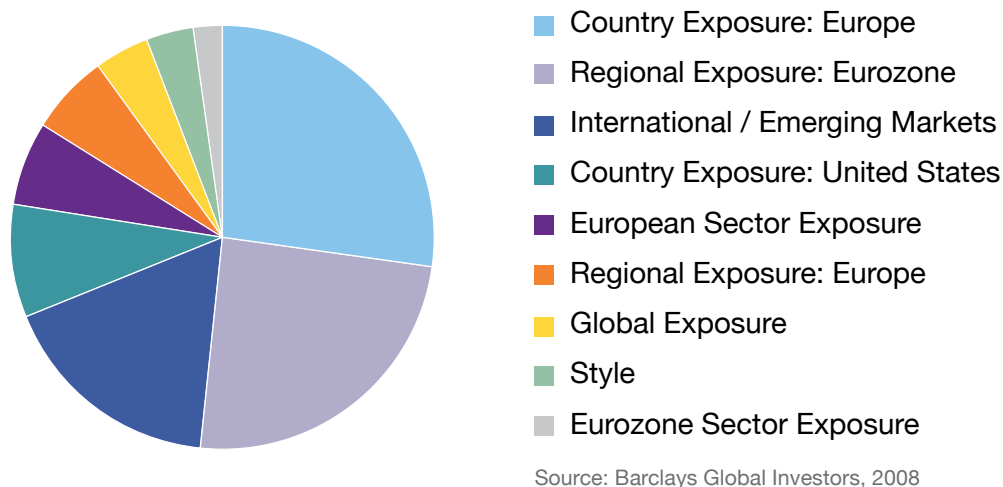


Figure 3 looks at the popularity of specific types of equity exposure more closely. Country exposure is by far the largest segment of the market, accounting for 27.5% of the Equity ETF market and around 19% of the total AUM.

Figure 3: Equity ETF Market Share



These statistics all indicate that an opportunity exists to create a successful and fast growing ETF market locally in these markets. The major players in the ETF market are generally focused on developing their market share in markets where ETFs already prosper (Germany, France, Italy, Switzerland and the UK). This allows a new entrant the opportunity to develop the ETF market from a dominant position.

The Portuguese Asset Management Market

The PSI 20 Index

The PSI 20 Index has a market capitalisation of approximately €50bn and represents around 0.8% of the MSCI World Index (October 2008). In Portugal alone, around €7bn is invested in Funds holding stocks within the PSI 20. For many fund managers, the PSI 20 ETF represents a more efficient way to gain exposure to Portugal than having individual custodian arrangements for 20 individual stocks. By listing on Euronext Lisbon, the opportunity it is possible to attract investment from across Europe via the NYSE Euronext trading platform.

Alternative ways to invest in Portuguese Equities

In Portugal, most of the major asset managers manage Portuguese equity funds which use the PSI-20 as a benchmark. These funds tend to charge a subscription and redemption fee, as well as a relatively high annual management charge.

Certificates that attempt to replicate the PSI 20 are available. However, with Certificates no dividends are accrued, making an Exchange Traded Fund a more attractive way to invest in the Portuguese equities market. There is a Futures market based on the PSI-20 but it is illiquid and therefore not heavily used. For investors looking for a low cost, passive exposure to the Portuguese stock market, an ETF based on the PSI 20 would fill an obvious gap in the investment market.

Structure of Portuguese asset management market

For a new ETF to succeed, the Fund Distributor would require strong local distribution network into both retail & institutional channels.

Figure 4: Structure of Portuguese Asset Management Market

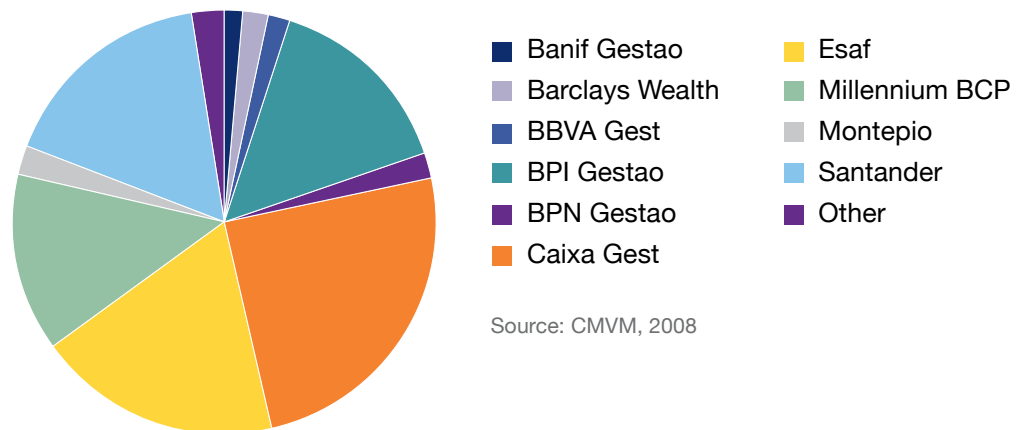


Figure 4 show that Caixa has a 24% share of the Portuguese funds market, making them the largest player in the asset management market. They are followed by ESAF, Santander Asset Management, BPI and Millennium BCP.

Demand for ETFs

In 2007, many Portuguese institutions and brokers began executing numerous ETF trades on foreign exchanges. The ETF market was therefore an interesting proposition for many of the domestic banks in Portugal but they did not have the in-house expertise in ETFs.

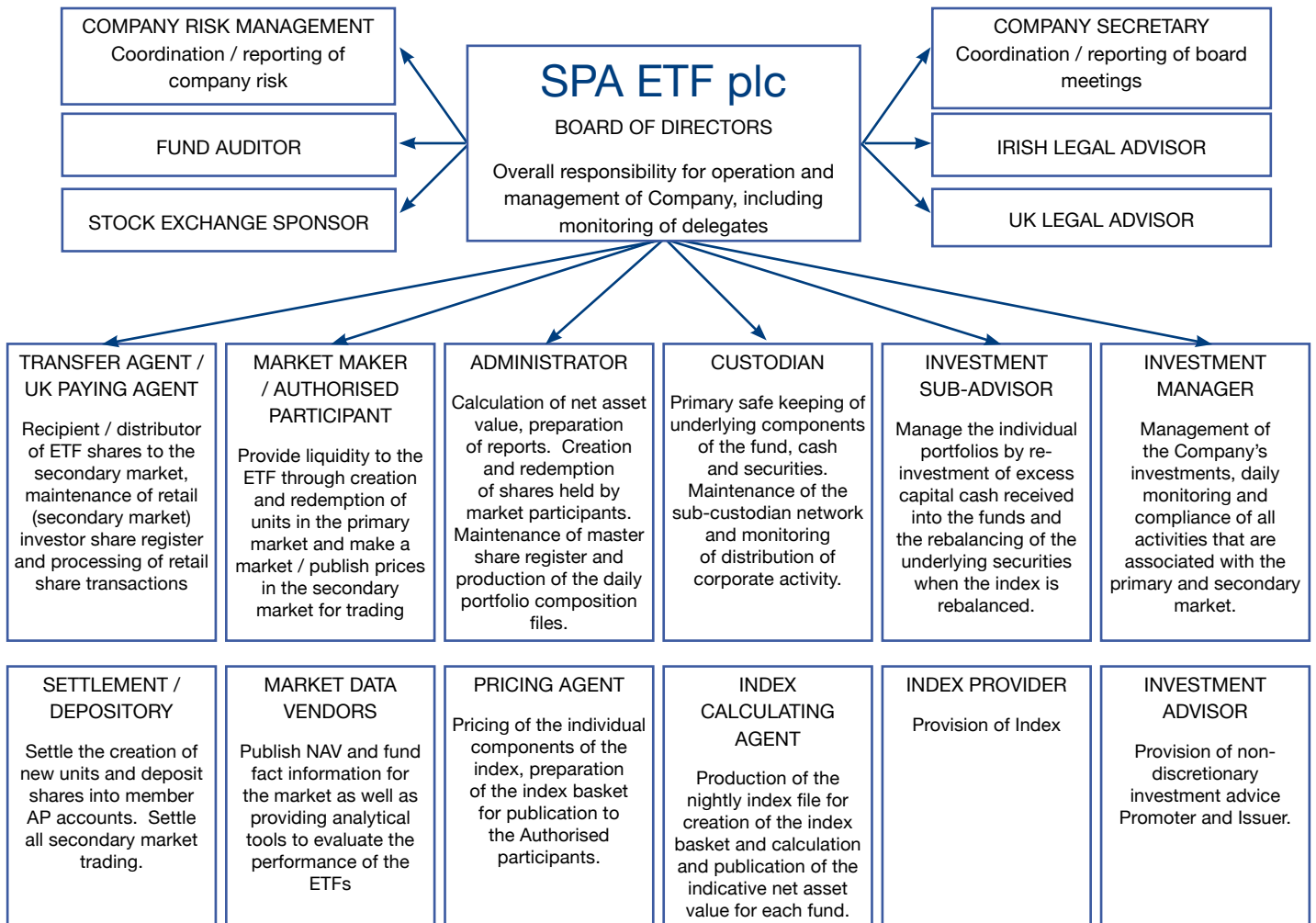
Challenges of Bringing a New ETF to Market

Bringing ETFs to a new market is a challenging process for the uninitiated. For any Financial Institution, maintaining reputation is key and the launch of a new product is a high risk endeavour. Conversely, if the Institution falls behind in new product development they risk losing their reputation as leaders in their industry. Clients may begin to migrate assets to other institutions with more innovative, interesting products. So Financial Institutions need to offer new products, but in a way that minimizes their reputational risk.

1. Operational Challenges

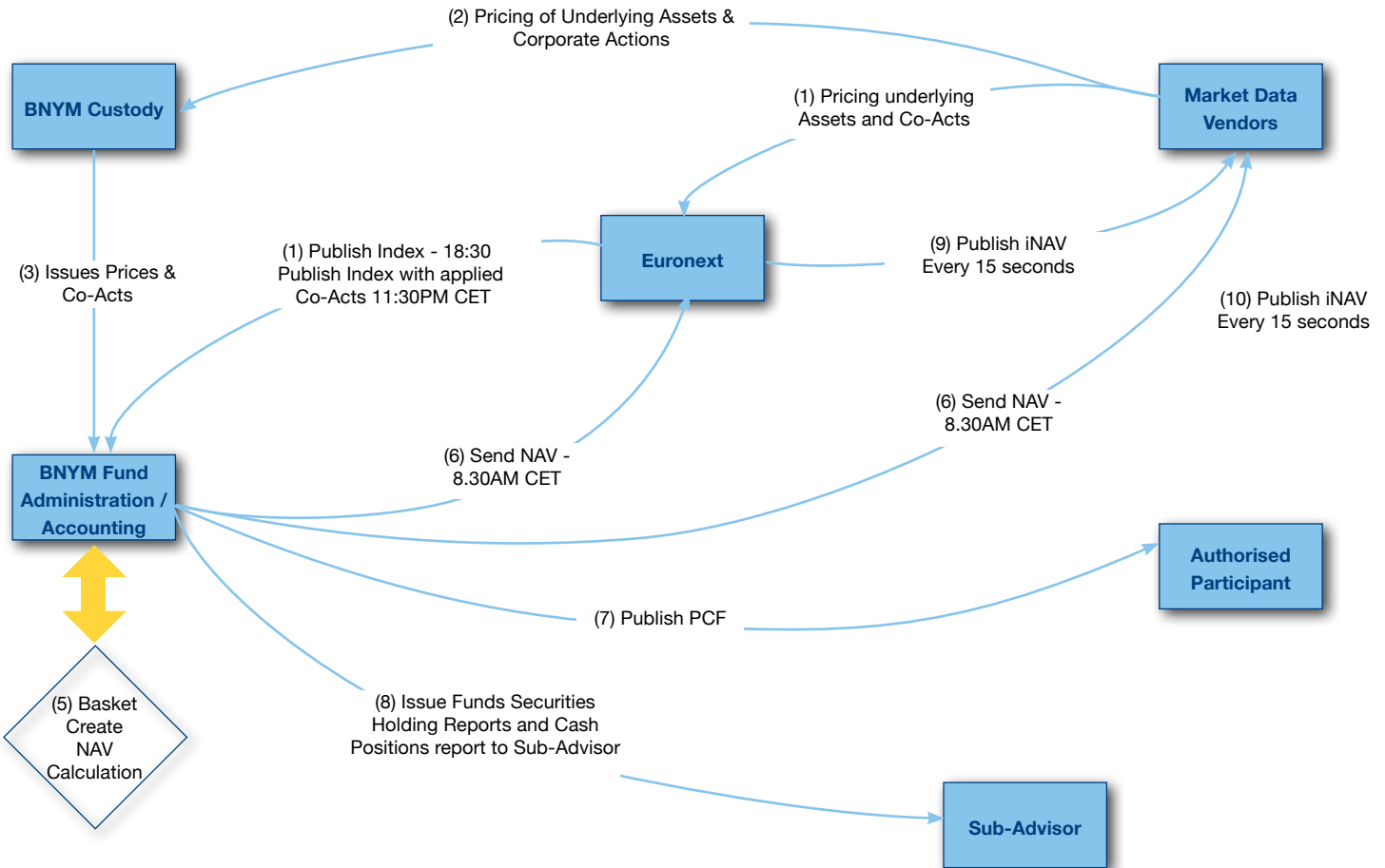
Figure 5 outlines the roles and responsibilities for each of the counterparties in the management of a UCITS 3 fund.

Figure 5: UCITS 3 ETF Fund Structure - example roles and responsibilities



Given the number of counterparties outlined in Figure 5, design and management of efficient processes is key to the successful operation of an ETF. Figure 6 below illustrates one of the daily processes involved in the running of an ETF, looking specifically at the processes for the calculation and publication of the Index, NAV and iNAV prices.

Figure 6: Index, NAV and iNAV Calculation Process



2. Distribution

Sales force development

Adding ETFs to a financial institution’s product range would open a new revenue stream through their existing distribution network. In order to effectively market the product across both Institutional and Retail channels, training would need to be delivered to a wide range of people.

Across the business, the sales force needs to understand the benefits of ETFs versus other products and how to use them in trading strategies and asset allocation exercises, requiring a deep understanding of ETFs and how they will solve different client’s needs.

The SPA Solution: Creating the first ETF in Portugal

In March 2008, SPA ETF approached NYSE Euronext to create an ETF based on the PSI-20, the benchmark of Portugal. It would be the first ETF to list on Euronext Lisbon.

To successfully create an ETF requires partnerships between the Exchange, Index Provider, Distributor and Operational manager of the ETF. NYSE Euronext are the Index Provider and calculation agent for the PSI 20 index. SPA ETF signed a license agreement to create ETFs on the PSI 20 Index family on an exclusive basis with NYSE Euronext.

A Partner with a strong local distribution channel was required to distribute the product effectively. Caixa are the largest bank in Portugal. They have 24% of the asset management market in Portugal and an 856 strong branch network , providing an excellent base for both institutional and retail distribution.

A proposal was put together focusing on each company's strengths; SPA ETF would develop, launch and manage the ETF and Caixa would be responsible for marketing and distribution of the product.

1. Set up and launch of PSI-20 ETF

Regulatory approval

As no ETFs had been listed previously in Portugal, the regulator CMVM would have to establish the regulatory environment for the first time. Setting up a fund structure in Portugal and gaining regulatory approval would be a lengthy process.

SPA ETF investigated a number of alternative routes on Caixa's behalf and concluded that the SPA ETF UCITS 3 fund structure, which permits the "passporting" of funds from one approved domicile to another, was the most appropriate. This pre-approved structure was simpler for CMVM to deal with and therefore the product was approved quickly and smoothly. Caixa could have set up a UCITS 3 ETF structure in a tax efficient domicile like Ireland, but this requires a permanent presence in that region.

The submission of the required documentation was presented to CMVM in late July 2008 and the fund was approved for listing 6 weeks later. The fund successfully launched on 17 September 2008.

Infrastructure

One of the challenges in listing an ETF for the first time is that the appropriate framework will not exist to allow ETFs to function properly. For example, rules on local settlement of shares needed to be adjusted in Portugal to take into account the wider UCITS rules. SPA ETF used its experience in other markets working with the regulator CMVM and NYSE Euronext to ensure that the correct framework was developed.

Structure of services offered

In developing the PSI-20 ETF, SPA brought its “best of breed” partnerships to bear. For example, the market maker on the PSI-20 ETF is FlowTrader. FlowTrader deal in all the major ETFs across all the major exchanges in Europe and are experts in ETF market making. SPA ETF’s fund administrator and custodian is Bank of New York Mellon, one of the world’s leading securities servicers, with more than \$23 trillion in assets under custody and administration.

Knowledge transfer

Importantly for Caixa, SPA ETF has worked with Caixa to ensure they build their understanding and knowledge of ETF operations, allowing Caixa to be able to provide additional services to ETFs in the future. For example, Caixa may look to become authorised participants/market makers, custodian or sub-advisor to ETF funds in the future.

2. Distribution

Sales force support & training

Caixa’s retail & institutional sales network is extensive – for example Caixa has some 856 branches. SPA ETF’s industry experts trained Caixa staff through a multi-city roadshow. Training was carried out in 5 city centres across Portugal – Porto, Lisbon, Aveiro, Faro and Coimbra, carrying out 14 training sessions in all. More than 700 of Caixa’s key sales staff were briefed on the new product in less than two weeks - 75% of Caixa’s client management group.

Market development

SPA ETF also helped to create the local ETF market. For example, we provided educational seminars for Banco Best – one of the largest online brokers in the country. Because Banco Best is a competitor, Caixa would not be able to do this themselves, but we as an independent fund provider could. This provides the benefit to Caixa of increasing potential avenues for trading and investment in the ETF.

Marketing advice

SPA ETF assembled a team that understands the dynamics of ETFs, to work with Caixa and a local marketing agency that understood Portuguese culture, to tailor messaging and communications to their local market. Working in the local language we then created:

- 1. Educational materials:** SPA used its knowledge of the ETF market to prepare an ETF guide for Caixa’s use with retail investors, in Portuguese.
- 2. Sales materials:** SPA ETF created a fund factsheet for the PSI-20 ETF launch. This factsheet was designed to be educational, including information on the benefits of ETFs as well as trading codes and related fund information.
- 3. Website:** A dedicated website was created, to include daily pricing, factsheets and links through to Caixa.
- 4. Press launch:** SPA ETF worked with NYSE Euronext and Caixa to ensure the fund launch was covered by the national media in Portugal.

Outline of distribution agreement with Caixa

The distribution agreement between Caixa and SPA ETF covers a number of different areas of cooperation, setting out how we work together in marketing and sales to achieve the minimum asset targets, the responsibilities of each party to the other in terms of management reporting and minimum service standards.

Caixa, as exclusive distributor, took on responsibility for marketing and selling the product in Portugal. As well as responsibility for the operational management of the ETF, SPA committed to support Caixa's sales efforts through country wide roadshows and follow up seminars for Caixa's sales staff.

SPA and Caixa have set out to achieve the minimum asset targets set out in the table below.

Projection for accumulated AUM

The distributor receives an annual payment on the basis of achieving these minimum asset targets, which increases as assets under management increase, aligning the interests of both parties.

Time	0-6 months	6 to 12 months	2 years	3 years
Accumulated AUM	€25,000,000	€100,000,000	€250,000,000	€500,000,000

Conclusion

Creating an ETF market in Portugal has had benefits for all parties concerned. The obvious benefit is to develop a new revenue stream in a fast growing market but the first ETF launch in a new market is high profile affair and all parties have also benefitted from increased brand recognition and local media attention.

NYSE Euronext have, aside from fees accrued in licensing the PSI 20 Index family, made investing in Portuguese equities easier and developed a new way of gaining exposure to Portuguese stocks. NYSE Euronext will hope to draw additional liquidity from investors across Europe and develop their local market with further local ETF listings in the future.

Caixa has been able to cement its position as Portugal's leading banking institution, ensuring it is at the forefront of the development of a modern, innovative financial instrument and "owning" the national index. It has allowed them to be able to create a first mover advantage in the domestic asset management market, whilst protecting their market share from competitors. By partnering with SPA, Caixa were able to build an ETF capability whilst minimizing their risk and capital expenditure.

As an independent company, SPA ETF plans to set up further partnerships with distributors who stand to benefit from SPA ETF's platform and knowledge in creating and listing exchange traded funds tailored to the specific needs of its partners.

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