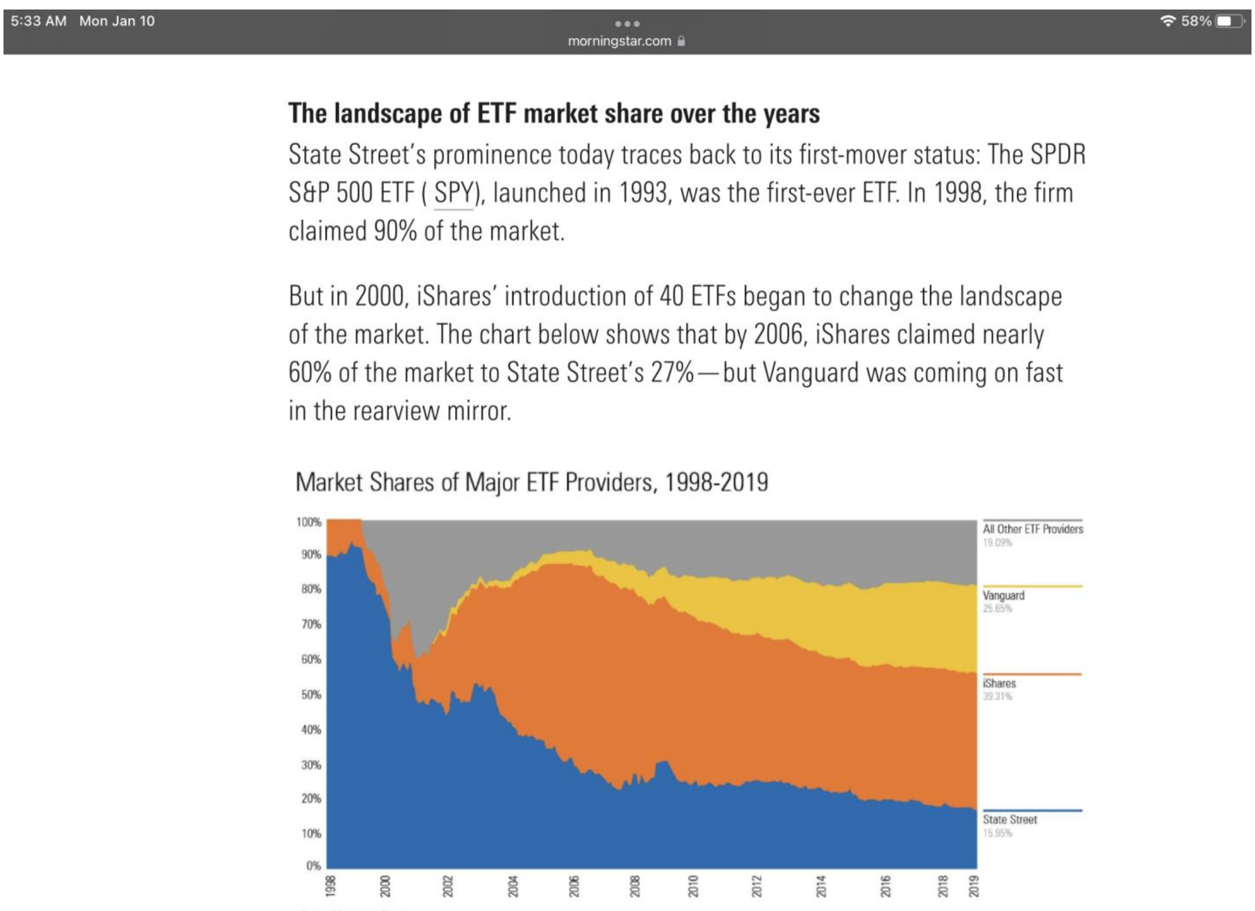
iShares: A Case Study in Disruption

By Mark Chamberlain, Founder, The Open Architecture 2020 Group

My career path has tracked evolution in the financial services industry. At the expense of personal humility, to me the history of "LDI for Individual Retirement Planning" feels a lot like the startup period for the iShares Exchange Traded Funds (ETFs). Both are disruptive ideas that lack broad industry support at their inception, but are destined for success because they benefit the financial consumer. This story is a first person account of my own journey inside the board rooms and conference rooms of some of the largest firms in the financial services industry. I do not intend to get the credit for the successes – they were and always are a team effort.

According to one industry analyst quoted in a 2021 interview in The Wall Street Journal, ETFs are *"…the greatest success story in financial services in the last two decades."* *

The chart below shows Barclays Global Investors' iShares transitioning from a small percentage of the ETF market (less than 10% before 2000), to a dominant market share by 2006. I was fortunate to be on the front lines of that business from 2000 through 2009, from just before iShares were launched until their parent company Barclays Global Investors (BGI) was sold to Blackrock.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morningstar.com

58%

The landscape of ETF market share over the years

State Street's prominence today traces back to its first-mover status: The SPDR S&P 500 ETF (SPY), launched in 1993, was the first-ever ETF. In 1998, the firm claimed 90% of the market.

But in 2000, iShares' introduction of 40 ETFs began to change the landscape of the market. The chart below shows that by 2006, iShares claimed nearly 60% of the market to State Street's 27%—but Vanguard was coming on fast in the rearview mirror.

Market Shares of Major ETF Providers, 1998-2019

Source: Morningstar Direct

Where the chart starts in 1998, retail financial services had not yet embraced ETFs in general. Except for some hedge funds using SPY and QQQ, most of the trading volume between 1998 and 2000 (reflected above) represented an industry seeking relevance.

The idea of indexing itself has always been disruptive. Beginning in the pension arena, the first institutional index portfolio was created by some investment thought leaders at Wells Fargo Trust Company in 1970. These pioneers later formed the nucleus of what became Barclays Global Investors. At the time, most industry consultants advising pension plans had little interest in promoting passive investing to clients.

Our team had to convince the gatekeepers for the broker dealers' advisory platforms that if they truly wanted to deliver unbiased, objective advice they were going to have to include low cost indexing. The LDI project is similar in that each reconciles major disconnects in the evolution of best practice standards. Both represent disruptions to the status quo. As with ETFs back in 2000, today the retail financial industry doesn't want to talk about LDI (yet). That's not because they're bad ideas but because they're good ones.

When BGI developed the business plan for iShares in 1999 they knew they had to build their ETF sales team from scratch. This was because the firm was still exclusively an institutional asset manager at that point. Even though they had created country-specific ETFs years earlier, they'd never developed an internal team to market them. This meant BGI's business model up until that time was unique in that there was no existing internal active mutual fund business at the company to cannibalize (the active side was institutional). This fact was critical to iShares' success. At any other mutual fund company in the industry iShares would have been seen as a threat to the much higher management fees from active funds. This may explain why State Street started out strong in terms of ETF market share but then faded after iShares launched (illustrated in the chart). State Street was certainly early to ETFs, but chose not to focus on it relative to the active side of their business (at least not in the individual investor advisor arena).

In terms of indexing as a whole, because BGI was focused almost exclusively on large institutional clients until 1998, passive investing for retail investors was primarily the domain of Vanguard (and also of a smaller niche firm called Dimensional Fund Advisors who marketed primarily through independent Registered Investment Advisors). Neither of those firms had selling agreements with the major broker-dealers.

Meanwhile, indexing had evolved into a standard practice for institutional pensions. But in the intermediated broker-dealers' private client divisions, index mutual funds were still outside the status quo. ETFs as sub-category of index funds were viewed as a kind of strange little cottage industry. They weren't even on the radar screen of most Broker-Dealer Registered Reps or independent Registered Investment Advisors (RIAs), weren't included in any asset allocation software, were excluded from supposedly open architecture flat fee advice platforms, and didn't even appear much in the news. At sales meetings with advisors, the first question asked was often "how do we get paid"?

This placed the academically acclaimed benefits of passive investing into a confrontational position with ideas that paid the mortgages of people on Wall Street. In fact, for many at the broker-dealers and the active money management shops index funds were viewed as a kind of threat to be defended against.

The broker-dealer home office managements at the time focused almost exclusively on building annual advisory revenue on top of active money managers actively trying to beat benchmarks, which they implemented with mutual funds, separate accounts and variable annuities. This business model generated ongoing fees for monitoring active managers (and replacing them occasionally); both advisor compensation and home office bonus pools were based on the annualized revenue streams. For the most part, ETFs and index funds were excluded. iShares could initially only be bought with a stock commission, or used in a non-discretionary fee-based account that was intended to be transactional, not advisory.

Recruiting people to join the iShares sales team wasn't easy. The available talent pool had worked exclusively for active managers their entire careers until then. Like most of the advisors they marketed to, they too had always sold *against* indexing. At the iShares launch, we were so shorthanded that I was travelling much of the Western U.S., holding ETF meetings in major money center branch offices during the day, interviewing sales team candidates in the evenings, and working on creating educational content and web tools while sitting in airplanes. Startups can be like that. Looking at how popular the ETF industry is now as an employer, it's hard to imagine that recruiters had trouble convincing qualified candidates to talk to us back then.

Hiring was just one of many obstacles we faced. In the beginning, we had no sales presentations to emulate, no web-based advisor portfolio construction tools to refer advisors to, and very little academic research on where ETFs fit into prudent portfolio construction. Our essay "*ETF 101*" was one of the first pieces of educational content ever written to support the product category.

What we did have in spades was the truth; the truth was that retail advice was ten years behind institutional best practice standards for integrating passive investing into prudent portfolio process. Many advisors prided themselves on following institutional best practices. So one way we set out to disrupt the disconnect was to talk about this white elephant through the lens of academic thought leadership on indexing, such as Bill Sharpe's "*The Arithmetic of Active Management*".

We also benefitted from the thought leadership of BGI's institutional Client Advisory Group, led by Barton Waring (his book *Pension Finance* is a key building block for our current essays). One of my self-appointed roles in 2000 was translating Barton's paper *"Optimizing Manager Structure and Budgeting Manager Risk"* to make it understandable to retail. The paper discussed ways of blending index portfolios with active managers, and even though it received acclaim from the CFA Journal it was ignored by the retail side of the industry. We decided to write an simpler essay, called "*Core Satellite Portfolio Construction*", which became our speak-the-truth paper about the ways active managers add risk to a portfolio through tracking error (instead of reducing risk, as was the philosophy of the day in the retail arena).

Our journey as truth tellers also led us to become advocates of Don Trone's work at the Center for Fiduciary Studies. Don suggested we interview the lead architect of the Uniform Prudent Investor Act (UPIA), John Langbein. When we published our essay called "*Inside the UPIA*", we were pleased to be able to quote Mr. Langbein's very favorable opinion of ETFs as "dream" investments for fiduciaries.

The UPIA suggests placing cost control and asset class diversification above the need for picking active managers. I saw a way to highlight this by writing a new paper in collaboration with our Business Development Officer Lara Roman, called "*On Prudent Standards and Optimal Portfolios*". Unfortunately, this was at a time in the company's development cycle when growing pains for the business had begun to surface. As we grew successful in attracting assets to iShares, other companies -- including Vanguard -- entered the marketplace with their own ETFs. When inconsistencies in our "low cost" value proposition began to surface -- depending on which ETF you considered -- the much higher expense ratios in some of our products became a point of contention (both externally and internally).

The truth was that some of the iShares management fees were considerably higher versus similar products then available in the marketplace (emerging markets and industry sector funds were prime examples). Pretending we were worth two to three times the price for the same basic investment exposure was disingenuous. This conflicted with our stated internal core values like "*speak truth"* and "*client focus".* As a result, our paper *"On Prudent Standards and Optimal Portfolios"* was viewed negatively by some of the iShares Managing Directors (who used a subtle turn of phrase with the words "*it doesn't represent us well*").

Harvard professor Clayton Christiansen's book *The Innovator's Dilemma* discusses how once-successful companies fail because middle managers stop taking risks. My own experience with speaking truth to power as a middle manager in the iShares business was that it can indeed be risky when it comes to profit margins. Most of our middle managers seeking promotions wouldn't challenge the much higher expense ratios of some of our ETFs, even though they jeopardized our credibility and threatened the hard-won trusted relationships with our clients.

When I was asked to head a task force to form an aligned opinion about our pricing policy, the leader of one of our sales teams refused to accept our recommendations for bringing down the ones that were out of sync with our "low cost" branding. He said he wouldn't support our conclusions that disconnects in our pricing policy would lead to diminished brand loyalty. He was promoted, and I was removed from the pricing task force. Startups can be like that.

On another occasion, I brought up our inconsistent pricing policy as a fiduciary problem in an Executive Committee meeting. I proposed the concept that long-term brand loyalty enhances profitability at companies who put their customers first. A deafening silence ensued, followed by the CEO moving on. So I summoned the courage to interrupt him, and repeated myself. This time, a senior manager in our marketing group objected quite emotionally, shouting in my direction "*Some of us care more about the bonus pool!*" This was followed by an even more deafening silence. When once again no one rose to support my position, the meeting simply moved on. The marketing manager was promoted.

We published the *"On Prudent Standards"* paper anyway. When my manager told me I could never become a Managing Director unless I became *"more pragmatic and less idealistic",* my response was *"I guess I'm not going to be a Managing Director."* The Executive Committee said my approach to succeeding in a corporate environment was misguided. One of our business heads said the executive committee wished I was *"a little less obsessed"* with ethics. From that point forward, my biggest challenge became how to survive without selling out.

Reconciling the white elephant of inconsistent fees in the iShares boardroom didn't happen until after the company was sold to Blackrock. But by then the damage to integrity was already done. While iShares is still an extremely successful business, they have lost their once-dominant ETF market position (Vanguard now holds that position). To me, this represents a lost opportunity to differentiate the brand.

Hopefully this helps explain the pro bono nature of the *LDI for Individuals* project. As with the iShares challenge, the question about success isn't whether we have the truth on our side; it's how long it will take for the industry to listen. It was slow going in the first several years for iShares, and I can appreciate how stressful it was for our senior management. But in the long run, in my book what's best for consumers must come first.

My iShares story has a happy ending even though I was eliminated during the post-acquisition period by the same middle managers mentioned above (who not only survived but were promoted *again*). I remind myself*:* startups can be like that….

Consumers have benefitted, to say the least, and I'm grateful to have been able to make even a small contribution to progress in the financial services industry. For the past twelve years, *LDI for Individuals* has also been a "speak the truth" project. We're similarly challenging some of the industry's sacred cows, calling out closed-mindedness where we see it, including conflicts of interest that drive profit margins but prevent true open architecture advice. We hope our work can one day benefit consumers as much as ETFs have.

For anyone interested to learn more about the history of ETFs, a few links are pasted below.

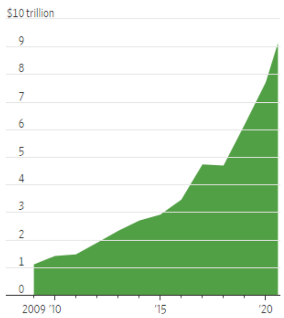
1)"ETF.com": https://www.etf.com/publications/journalofindexes/joi-articles/2044.html?nopaging=1
2)"Institutional Investor": https://www.institutionalinvestor.com/article/b150nn2x5fhmgd/for-whom-the-barbell-tolls
3)"Trillions: How a Band of Wall Street Renegades Invented the Index Fund and Changed Finance Forever", by Robbin Wigglesworth
4)"ETFs are probably the greatest success story in financial services over the past two decades."
- Anaelle Ubaldino, TrackInsight, *The Wall Street Journal*

THE WALL STREET JOURNAL.

Trillions

ETFs world-wide hit more than $9 trillion in assets last month.

Total net assets for global ETFs, annually



Note: Data for 2021 through July
Source: Morningstar

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U.S. ETFs accounted for a record $519 billion of the total, sending assets in U.S. funds to about $6.6 trillion. ETFs now hold more money than index-tracking mutual funds, which had about $8.8 trillion in assets as of June, though mutual funds overall still command more money, with about $40.7 trillion in assets.

ETFs are baskets of securities that are as easy to trade as a stock. They lack the investment minimums found in many mutual funds, are generally more tax efficient and carry lower fees. The success of ETFs was far from guaranteed after the first one launched in 1993. But enthusiasm for low-cost investments has led to an explosion in ETF assets over the past 10 years.

“ETFs are probably the greatest success story in financial services over the last two decades,” said Anaelle Ubaldino, head of ETF research and investment advisory at data firm TrackInsight, which also tracked ETFs crossing the $9 trillion

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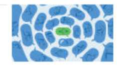

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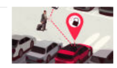

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