Emily McKinley

Episode 182: Deep dive into institutional ETFs with Invesco's Emily McKinley

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley. I'll be your host. Welcome back, Insurance Asset Management nation. We're so happy to have you. And today's topic is institutional use of ETFs by insurance companies, and we're joined by Emily McKinley, Head of Institutional ETFs and Models at Invesco. Emily, thanks for joining us. It looks beautiful out your window.

Emily: Thank you so much for having me. So excited to be here today.

Stewart: We're really happy to have you. And this is a big topic, right? Insurance companies are using ETFs. We've published some research that's been done on the topic, and I want to go through the things that we're scheduled to talk about today. But before we do, can you tell us a little bit about yourself? Where did you grow up? What was your first job, not the fancy one? And what makes insurance asset management so cool?

Emily: Well, thank you again for having me. I'm so excited to be here. I'm Emily McKinley. I grew up in a small town in Connecticut, and that is also where I had my first job. I was a waitress at a local seafood restaurant in my hometown, Old Saybrook.

Stewart: What was your hometown? Old Saybrook? Oh.

Emily: Yeah.

Stewart: That's a great spot.

Emily: I worked at the Dock and Dime every summer in college serving clam tenders and fish and chips to tourists. It was one of the hardest jobs I've ever had, this one included.

Stewart: Absolutely. What makes insurance asset management so cool?

Emily: I think insurance asset management is so cool because the managers are solving probably the most complex problems in the market, doing that on top of changing dynamics from a regulatory standpoint, and of course just market conditions. And so, I found that just some of the smartest investors out there are involved in insurance asset management. It's really a privilege to be able to offer something to help them.

Stewart: That's really, really kind of you. I wholeheartedly agree and have said numerous times insurance asset management is by far the most complex institutional asset management category in the world. The world of ETFs, I think periodically, I feel like I check in on it. It would be really helpful if you could give us an overview of ETF trends in the insurance space right now.

Emily: The ETF market itself is about 30 years old, so that's either old or young depending on where you're coming from, but it's certainly become quite seasoned, and especially with insurers. The growth in ETF usage has been really tremendous over the past 10-15 years or so for reasons that I'm sure we'll talk about. But today, insurers represent close to $40 billion in ETF assets. What I think is really interesting is that they are really quickly growing in their trading activity of ETFs and expanding in their usage of ETFs.

Today, we hear from our clients, from our insurer clients that they're using ETFs to solve an increasingly wider set of challenges in their portfolios. So, everything from efficiency and reducing the work of managing a core exposure, or providing liquidity during periods of friction, rebounds or transitions, that type of thing, to implementing tactical tilts. So using ETFs to immediately express a view at increasingly granular points to either put those exposures on or take them off really quickly, or they're using ETFs just to access harder-to-reach markets.

An ETF can provide clients that quick access to opaque markets that may be otherwise difficult to achieve. And so what I think is really exciting about insurers' usage of ETFs in particular is the way they're thinking about ETFs as really vehicles to solve a problem, and those problems are increasingly wider.

Stewart: Is it fair to say that the ETF is typically more liquid than the underlying?

Emily: Yes, it is absolutely fair to say that, and that is by design. There are certainly different ways to assess liquidity. Of course, the amount that it can be more liquid than the underlying will vary based on a number of different factors.

Stewart: Of course.

Emily: The whole concept of an ETF is to put this exposure, the underlying exposure, on an equity exchange. And so you essentially come up with an additive amount of liquidity between the underlying exchange and that secondary market list exchange.

Stewart: And so, can you tell us a little bit about how ETF usage has evolved? I mean, when you said 30 years, it's like I remember when ETFs were created, back when the earth was cooling and I was mid-career. It's interesting that there's an evolution that's happened with the NAIC giving look-through to certain ETFs, and so forth. But there's still this sticking point that some state regulations don't allow for look through. It involves the revamp of state insurance regulation, which is bigger than a bread box and hard to accomplish. But with all that said, how have you seen it evolve over time?

Emily: Well, I think what you just mentioned, the regulatory advancements is such a big component to the evolution of ETF usage within insurance portfolios. Absolutely. But what's also happening in conjunction, which arguably is contributing to or a result of what we've just talked about, is the growing and the seasoning of the ETF market.

I joked earlier that 30 years is old or young, but really in the grand scheme of the markets, it is still a fairly new innovation, a fairly new technology. The ETF market is approaching $10 trillion in assets and on average represents somewhere close to 30% of all trading volume on any given day, so it's quite significant. But I think that what has been important, and especially relevant, to insurers and other institutions is that as the ETF market has grown in size and liquidity, importantly, it's seasoned through every market condition that you can imagine. Every market condition, every market crisis that we've seen over the past 30 years, has actually proven to add to the vehicle's institutional viability.

And so today, institutions, whether it's pension funds, endowments, and foundation sovereign wealth funds, and of course insurers, are starting to view ETFs alongside other securities, funds, derivatives as really effective tools in the toolkit. And so I would say that is happening in the ETF market overall in conjunction with the industry, the NAIC, and of course the state regulatory support that's come along, and perhaps is in response to this client adoption. We have just seen such advancements and evolution in how clients can use ETFs, and really specifically around insurers. That speaks to bond ETF usage, whereas 5-10 years ago, the majority of insurer ETF AUM was in equity ETFs, much for the reason that you alluded to earlier. Fixed income ETFs are becoming much more in scope for insurers with really material acceleration since we saw the New York State legislation about two years ago.

Stewart: It makes a ton of sense. Invesco's obviously very well-known for your ETF capabilities, particularly in equities, but you also manage fixed income ETFs. I want to make sure that we get that out there. One question that comes up about fixed income ETFs is, do they ultimately behave like bonds or does the ETF wrapper introduced other considerations that if I'm an insurance CIO I need to be aware of? Could you walk me through that, please?

Emily: Yeah. That's such a good question. So, of course, as we alluded to earlier, structurally, an ETF is just a basket of securities, whether it's equities, bonds, commodities, currencies, and even more these days, but it's just a basket of securities that trades as a single unit on an exchange. That unit is of course an equity security, but it may track any asset class underlying. And so you do have components of both an underlying market as well as the equity market.

If we really narrow down into bonds, as you asked, in the case of bond underlying specifically, the ETF wrapper serves to add equity market transparency and continuous pricing to an opaque or over-the-counter bond market. And so, what comes with that is you get an intraday, real-time price for any bond exposure in an ETF. That's obviously, I think, tremendously valuable to portfolio managers who wish to express those exposures, but it can also bring to light the volatility inherent in the underlying market that might be otherwise masked by the opacity of the bond market.

So, sometimes you'll hear that bond ETFs are more volatile than the underlying. But for us, what that truly is, is an expression or an example of price discovery or the fact that the ETF vehicle itself, the equity market exchange nature of the ETF, is just shining a light on an otherwise opaque market. So it is something to consider. I think it's obviously incredibly important, but from our perspective, we believe that this is truly additive to the experience and can help bond portfolio managers with that transparency and access.

I would actually even say interestingly, it's actually during times of market crisis, or reduced liquidity in those primary markets, that you tend to see volumes in ETFs spike. Investors will in fact flock to ETFs to express their views with immediacy and transparency during those times and really take advantage of that equity market component of, say, a bond ETF.

Stewart: It's a great point. I have heard insurers express concerns around fixed income ETFs that have less liquid underlying exposures like, to some extent, IG bonds, but really loans and potentially EMD. What are your thoughts about that?

Emily: That's right. ETFs, by design, are meant to add liquidity to some of those less liquid underlying exposures. I would argue that that can actually be one of the greatest benefits to using an ETF or an institution, especially an insurer.

Maybe just taking a quick step back and just talking about how it all works and how it all comes together. The ETF itself links the underlying market, in this case the bond market, to the exchange through the creation-redemption process. It facilitates the open-ended nature of the fund. It allows shares to be created and destroyed. However, the reality is that the vast majority of ETF trading occurs on the exchange between transacting investors. They meet on the exchange. They trade shares at the ETF without even ever touching the underlying. From our calculations at an aggregate, the secondary to primary market volume of ETFs is somewhere around 9:1, so that means for every $9 traded on the exchange, $1 is traded on the underlying market.

Stewart: Wow! That's an interesting stat.

Emily: Exactly. The vast majority of this is occurring on that secondary market exchanges is that additive liquidity that we talked about earlier and, of course, note it increases during times of stress. But you're bringing this equity like liquidity and transparency and access to these markets, and it's obviously the most powerful and impactful in the less liquid underlying markets, so loans, high yield emerging market debt.

I'll give you an example. I've already briefly mentioned, but our Invesco Senior Loan ETF, which is pretty well-known in the market, it's Ticker: BKLN. It's a difficult and relatively manually intensive asset class. Bank loans, tend to settle. They still settle at anywhere from T+10 to T+12, T+15. So the T+2 settlement, the ease and exchange transparency of using this ETF, really is an important part of the loan ecosystem. This ETF, BKLN, was first to market back in 2011 when the size of the loan market itself was roughly half a trillion dollars, about $500 billion at that time. It has since roughly tripled in size close to $1.4 trillion, and ETFs are just a growing part of that.

In 2023 year-to-date alone, the loan market itself was stagnant, but we've seen massive growth in BKLN, which really just indicates that more and more clients and institutions really are using BKLN, the ETF expression, to access that underlying market. It takes on, I'd say, increasing importance as that access vehicle and we just continue to see that trend, I think, particularly in these harder to reach markets.

Stewart: The number that sticks in my head is 9:1. I'm astonished at that. That's a very clear indicator of the magnitude of the increased liquidity in this market. So, I don't want to get stuck there, but that does surprise me.

Emily: I was going to underscore that is the value of the ETF. If it can't provide some type of liquidity improvement, then how is it making our clients' lives easier? It's probably not. So that's why we're always really focused on that secondary market liquidity and growing the total liquidity of the ETF because that, in effect, can help with operational efficiency and can ultimately drive down costs for clients.

Stewart: Let's spend a little bit of time on trading. If I'm a CIO to take a position in a $10 or a $5 or a $1 billion ETF, how do I build that position? Are there resources that can help me get execution? It seems that this is where I think sometimes investment professionals get stuck when you go, "I really don't know how that part works." And so, as a result, maybe they don't go into the asset class. If you can unpack the trading aspect of it for us, that would be really helpful.

Emily: Absolutely. So I know... I mean, I've thrown around just the term "ETFs are liquid" already a ton, but it's what you hear a lot about ETFs in general. They're touted to be liquid and able to accommodate very large flows with efficiency. But I think, "What does that actually mean?"

It all originates from the basic structure of the ETF which is, again, just a basket of securities trading on the exchange. That unique creation redemption mechanism through which authorized participants are able to exchange portfolios of securities for shares of the ETF, it's incredibly important in terms of maintaining the liquidity because it allows for this multiple levels of liquidity of an ETF for the investor. Firstly, you have that on exchange liquidity, what we're talking about, that 9:1 component there, the on-exchange liquidity. But importantly then, it's linked really seamlessly to the underlying market through the creation-redemption process.

So what that means is for the very, very highly liquid ETFs, the headline ones, the ones you hear about all the time. I'll throw the QQQs out there. It's $200 billion in AUM. It trades $20 billion on exchange. An investor just can simply trade that on on-screen liquidity. That's not a problem. It's really, really straightforward and really, really obvious. But for a smaller, a newer, or less liquid ETF, it might require tapping into that underlying market to fulfill a similarly large trade. And so tapping into that underlying market is done through the creation-redemption process as facilitated by an authorized participant. The trade is executed efficiently by sourcing both the secondary and the primary market liquidity, but I think what I would point out is that, importantly, this is just part of the way an ETF runs. It's part of the operations of the ETF. It's not something that clients have to instruct or source themselves. It's part of the way the ETF maintains itself and part of just the basic structure of an ETF.

And then, I'd say probably the most important point, the one that I'd want your listeners to take away if nothing else, is that ETF investors also have at their disposal an important resource. It's the providers or, in our case, The Invesco ETF Capital Markets trading desk. This is a team that is tasked entirely with maintaining relationships with the market participants and the authorized participants who trade our funds. They, therefore, can act as a consultative resource for our institutional clients, for our insurance clients, when they're in fact considering a trade.

So, the Capital Markets team is just so plugged into the way the ETFs trade and the market around the ETFs, they can often or do often provide in-depth trading guidance, pre-trade analytics, so the clients know what to expect when they're trading ETFs. They can help source liquidity and definitely on an ex-post basis evaluate executions. It's a free and, I would say, incredibly valuable resource to our institutional investors, just really access to those experts who know how these ETFs are trading, who live and breathe that every single day, and one that really any client who's transacting in our ETFs or any ETFs really should take advantage of, in my opinion.

Stewart: That's really helpful. Insurance companies have externalities to deal with. There are impediments to perhaps why they aren't more fully utilizing ETFs. When we look around, what can you tell us about other large sophisticated institutional investors that maybe don't have those constraints? How are they using ETFs?

Emily: That's a great question. I would say that I work with institutions, insurance companies, pensions, sovereign wealth funds, endowments, some foundations and, as I alluded to earlier, none is quite as complex as insurance companies. But they all do have some level of externalities, whether it's state regulations for public pensions, whether it's counting requirements for corporate pensions, operating budget requirements for endowments. They all have something and I think that that is what makes ETFs and the usage of ETFs by institutions not a one-size-fits-all proposition. There are very clear benefits to the ETF wrapper that tend to be beneficial to institutions. It tends to be the access to hard-to-reach markets, the liquidity that we talked about, the operational efficiency, and just the ability to tactically tilt, but they don't all exist for everyone because there are so many of those different requirements.

When I think about how other institutional investors are using ETFs, I would say it does align similarly to insurance companies. They just tend to be a little less constrained, particularly by the regulatory component and, of course, the fixed income accounting component. But similar to insurance companies, other institutional users have evolved their usage over the past 30 years or so. In fact, it's a misnomer that I always like to point out when people say institutions are just discovering ETFs. I would actually say it's the opposite. In fact, large state pension plans in particular happened to be some of the first and most visible users of ETFs back 15-20 years ago. To them, ETFs were just a good way to get liquid and transparent access to broad indexes.

But what I think has been really exciting, and I see that reflected across all of institutional investors as well as insurers, is that just the way that they're able to use ETFs in their portfolio has just vastly increased. By our estimates, over the past 10 years, the number of institutions using ETFs has about doubled, but the number of funds and exposures that they're using has increased more than sixfold. So institutions don't just traffic in the same usual suspects, but they're actually starting to push into other types of exposures within the limits and within the externalities that you mentioned to push the boundary on what they can use ETFs for. So that's why I say institutions are certainly growing their usage of ETFs, but what's more exciting and more interesting to us is that they're really expanding their usage of ETFs.

Stewart: That's really cool. So I've gotten a great education on this topic today, and I certainly appreciate that. When we look forward, what is most exciting to you and what you want our audience to take away from today's discussion?

Emily: What I think has been incredibly exciting within the insurance space in particular is the regulatory advancements that we've seen over the past two, five years or so. I think in conjunction with what we're seeing broadly across the ETF market, increased innovation across the ETF market, it really is opening up a lot of opportunities.

So I would say that what's most exciting to me is the opportunity to bring ETFs to more parts of the portfolio, to bring different types of ETFs to insurers, and hopefully to continue to be supported by some of the regulatory advancements and changes that we've seen. I think that ultimately what we want is to be able to make our clients' lives easier, to ensure greater flexibility, better transparency, et cetera. So I think being supported by many of the advancements that we're seeing is really what's most exciting to me.

Stewart: That's fantastic. I really appreciate all of that education. I've got two fun ones for you out the door. You can actually take your pick, but lots of our guests take both, so no pressure. The first one goes like this, what's the best piece of advice you've gotten or given? The second one is, who would you most like to have lunch with alive or dead?

Emily: Those are great questions. No pressure, I'll take a stab at both of them.

Stewart: I like it. I like it.

Emily: So best piece of advice that I've gotten is really simple. It's to be yourself. Everyone else is taken. I try to keep that in mind quite a lot. And then who would I like to have lunch with? I'm going to throw out my favorite comedy duo, Tina Fey and Amy Poehler. So if you'll allow me two, I'll take-

Stewart: Of course.

Emily: Hopefully they're listening and hopefully we can get in touch.

Stewart: I like it. There you go. That's fantastic. We've been joined today by Emily McKinley, Head of Institutional ETFs and Models at Invesco. Emily, thanks for joining us. Thanks for taking the time.

Emily: Thank you.

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