Liquidity and Innovation – Nothing Else Matters

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1. Introduction

As little as five years ago, at best only a small group of experts in Europe knew what the abbreviation ETF stood for. In fact, anyone wanting to invest in ETFs – exchange-traded funds – had to do it in the United States; there was simply no such product in Europe. The situation has since changed dramatically, and over the past three years ETFs have become an established investment vehicle in Europe. And it is without doubt that Deutsche Börse AG was the pioneer and co-founder of the European ETF market.

As has often been the case in investment history, the idea for exchange-traded funds came from the United States, where they were invented about ten years ago. In a relatively short period of time ETFs have succeeded in establishing themselves as an indispensable investment category. It is with good cause that Deborah Fuhr of Morgan Stanley has termed them the "financial innovation of the last decade". Their unbeatable advantage is that, for the first time, two highly traditional, self-sufficient and completely separate branches of the investing world, namely fund investing and exchange trading, are combined in a single product. What is more, they are enticingly simple, for by means of ETFs investors can commit resources to exchange indices – and thus with one product cover entire markets, sectors and regions.

A glance at the figures soon reveals their significance in terms of worldwide asset allocation. At the end of the third quarter 2004, more than €200

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billion was entrusted to a total of 318 funds. By virtue of the fact that the product is cost-effective and easy to trade, the volume invested worldwide and the number of existing funds has increased exponentially in recent years.

In the 1993-2000 period, ETFs first became all the rage on the US market. The American Stock Exchange AMEX was the trailblazer in this regard. One of the very first funds was the Spider (SPDR), which tracks the S&P 500 Index. Today, this fund rates as one of the most heavily traded funds in the world, with some US$37.1 billion in assets under management. Other well-known funds soon followed, among them the Diamonds (Dow Jones Industrial Average Index) and the Cubes (Nasdaq 100 Index). In total, the number of exchange-listed funds in the United States surged from one in 1993 to 148 at the end of the third quarter 2004, and assets under management grew from €0.4 billion to €146 billion.

Trading segments for exchange-traded funds were first introduced in Europe in 2000. Deutsche Börse launched its XTF® segment in April 2000, and it has since emerged as the single most important trading platform for ETFs in Europe, significantly contributing to the success of this investment vehicle throughout Europe. Other ETF segments have emerged on Euronext, the London Stock Exchange, SWX Swiss Exchange and other exchanges. In Europe, the exchange operating companies do not act as issuers but simply supply the legal and organizational framework.

Specifically in Europe, the ETF market is booming. The number of ETFs in Europe has reached levels similar to those in the United States, with more than 100 funds listed in Europe at the end of Q3/2004. Assets under management increased by more than 60 percent over the last 12 month, reaching €21 billion in Europe at the end of Q3/2004 – yet still only a fraction of the US figure of €146 billion.

2. The XTF Platform: Europe's First ETF Segment

On 11 April 2000, Deutsche Börse launched its ETF segment XTF Exchange Traded Funds®. Right from the start, the vast majority of trading has taken place through the fully electronic Xetra® trading system. XTF started out with two index funds floated by European ETF Company plc, a subsidiary of Merrill Lynch. The indices tracked were the Dow Jones STOXX 50℠ and Dow Jones EURO STOXX 50℠. In the months that fol-