BMO Global Asset Management 2015 ETF Outlook

Q3 Update

The exchange-traded fund (ETF) industry has enjoyed strong momentum in 2015. Existing clients are becoming more comfortable with ETF products and their benefits, and the sector has seen an expanding client base. Asset allocators recognize that ETFs contribute to portfolios in two ways; as strategic buy-and-hold positions, and as short-term tactical tools to anticipate market events.

This update to our 2015 Outlook examines the trends in the ETF market, and reports on topical discussions as the industry moves forward.

Global Trends

In August 2015, the global ETF market was worth US$2.86 trillion. Exchange traded funds have shown an annual growth of 24.2% over the past ten years, adding a trillion dollars in the last two years alone. In the United States, the ETF market sits at almost US$2 trillion in assets, an increase of 1.4% year to date, even accounting for recent market turbulence. Equity ETFs in the United States have had inflows of more than US$83.9 billion, while U.S. fixed income ETFs added over US$30.1 billion.[1] The European market has grown to almost US$494 billion, gathering US$59.7 billion in new assets so far this year.[2]

The Canadian ETF industry is also off to a strong start in 2015. At over C$9.7 billion so far, inflows are approaching the total for 2014. Assets under management (AUM) have reached C$84 billion, an increase of more than 10% since year end 2014. Equity ETFs added $4.5 billion in inflows, as investors used equity ETFs to increase their U.S. and international exposures. Fixed-income ETFs continue to attract investor interest, with inflows of more than C$4.7 billion.[3] This illustrates the diversification and liquidity benefits of fixed-income ETFs, and the ability of segmented ETFs to target exposures. Canada continues to favour fixed-income ETFs, reflecting the more concentrated Canadian market and the expertise needed to trade bonds directly.

The Canadian ETF with the most net inflows so far this year is BMO MSCI EAFE Index ETF (ticker ZEA), reflecting that ETFs are highly efficient vehicles for making allocation decisions. For instance, with regard to monetary easing in Europe, investors are using ETFs to gain a broader exposure to international markets.

The next highest net inflows were in BMO Mid Federal Bond Index ETF (ZFM).[4] The interest in this fund illustrates the convenience of using ETFs for fixed income even with federal bonds – the most liquid and tradeable fixed income asset class.

Trading Efficiencies

Exchange traded funds have recently been in the news with questions about their liquidity. They have been called out as victims of their own success, growing rapidly and possibly outsizing less-liquid asset classes. The Volcker Rule, which restricts U.S. banks (and foreign banks operating in the United States) from engaging in certain types of speculative trading, may have caused fixed-income dealer trading inventory to drop. For asset classes like high yield bonds, this may mean less support from traditional sources like banks in the event of a liquidity crisis, leaving investors to wonder how an ETF will perform.

While we always caution that investors should only allocate a limited percentage of their portfolios to riskier asset classes, the old adage – don't invest in it if you don't understand it – still applies. The transparency of ETF holdings means investors can see exactly what their ETF holds, published daily on the provider's website. This scenario is very different from the sub-prime crisis, where investors did not understand what they had invested in. With ETFs, asset bubbles are much easier to avoid.

We believe all this attention is missing the point. Exchange traded funds are an access vehicle for an asset class – they provide additional benefits of liquidity, tradability, and diversification. This is particularly so for over-the-counter asset classes like bonds.

Investors looking for income, high returns, or portfolio benefits may decide high-yield bonds are appropriate. By trading an established ETF, the natural liquidity between buyers and sellers on the exchange may make the trade more efficient. If one investor is looking to buy and another is looking to sell, they can meet in the middle instead of each buying directly into the investment vehicle. Rather than sourcing bonds or buying into a fund with a daily opening, ETF investors can profit from intra-day liquidity on the exchange and full transparency of trading costs through the market bid and ask prices.

Importantly, ETFs are also backed by market makers who provide additional liquidity by holding and creating shares of the ETF. One-sided flows may affect the underlying asset classes in direct trading, but as market makers hedge their investment risk through the underlying holdings, the diversification across issues and issuers in ETFs reduces their impact.

Mature ETFs provide better liquidity than their underlying asset classes, but overall liquidity still depends on their portfolio holdings

As a test case of a market in crisis, we can look back to the high yield market in 2007. The liquidity crisis essentially froze trading in the underlying bonds. Meanwhile, as measured by SPDR Barclays High Yield Bond ETF (ticker JNK), ETFs continued to trade, acting as a price discovery vehicle for the asset class. The ETF did trade at a significant discount of up to 8.7%, and later at a premium of up to 9.9%, which means the market price moved away from the net asset value (NAV). However, since the NAV was not reflecting actual bond trades, the ETF reflected the true value in the marketplace. Importantly, while trading spreads may have widened as a reflection of market uncertainty, investors that needed to buy or sell high yield bonds were able to do so via the ETF, rather than through the underlying portfolio.

Concentration Concerns

Another concern is that ETFs are driving up the prices of securities within their benchmarks, while the rest of the market is being left behind. The simple answer for this observation is that a properly designed ETF diversifies across its asset class. Using the earlier example of JNK, this ETF has 793 holdings, which by index design are the largest three

issues by an issuer, with issuer weights capped at two percent. With so many holdings, JNK acts very much like the market. The remaining securities are typically small and illiquid, and therefore are difficult to build into a portfolio. This differs from an active investment product, where the manager invests in a concentrated portfolio in order to beat the market.

As we have mentioned earlier, ETFs are access vehicles for asset classes, allowing all types of investor to get exposure to an asset class more efficiently. An ETF lets a wider spectrum of investors build more effective portfolios.

ETFs trade more efficiently than their underlying holdings

We have heard similar concerns about smart beta ETFs, which are – unlike traditional market capitalization weighted ETFs – built to focus on an investment factor. Trade crowding may be an issue for strategies such as income investing and low volatility investing, where it is believed that the effectiveness of these strategies is diluted by investors piling into the trade. However, the limited ETF exposure of these strategies is unlikely to influence the market, considering there are already significant investments following these trends.

While single-factor ETFs are effective vehicles for focused exposure, we have seen smart beta ETFs evolve to a multi-factor approach. This provides diversification benefits by combining factors with low correlations. It is important to work with an established provider that focuses on portfolio construction, and not just factor exposure, to ensure the development of an effective portfolio-building block. As more of these products are launched, it is important for long-term holders to invest in factors that deliver strong performance across market cycles, including income, quality, and low volatility.

The Opportunities Ahead

The growth of the ETF market has meant that providers are able to offer more precise portfolios, providing more targeted exposures for asset allocation. By holding a cross-section of an asset class, ETFs deliver diversification benefits that enable the building of effective portfolios around narrower market bands. As the underlying assets become more complex, index rebalancing and inflows make it even more important to have an experienced manager.

As an example, investor interest and the global trading ecosystem – investors, dealing desks and market makers – has made term-segmented global corporate bonds possible. Five years ago, it is doubtful that such products would have been successful for either asset gathering or trading efficiency.

Across the globe, investors are warming up to the benefits of ETFs. In North American markets, we are seeing increased usage by larger institutional players and the rise of the ETF strategist. Low cost and simple fee structures are making them popular in markets like the U.K. and Australia that are undergoing structural reform. Success in these evolving markets will create a positive feedback loop, with deeper and more diverse investor groups making the trading of ETFs even more efficient and liquid as global ETF markets approach the maturity of the U.S. market.

BMO Global Asset Management

[1] Source: National Bank, as at August 31, 2015.

[2] Source: ETFGI, as at August 31, 2015.

[3] Source: Bloomberg, as at August 31, 2015.

[4] Source: Bloomberg, as at August 31, 2015.

09/15-1663