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Canadian ETF Outlook 2014

BMO Global Asset Management

Another banner year for the ETF industry, as ETFs are increasingly used in portfolio construction

The Canadian Exchange Traded Fund (ETF) industry had another strong year in 2013, with over $5.0 billion in inflows and climbing to $63.1 billion in assets under management (AUM), an increase of 11.9% over year end 2012. Equity ETFs led the way with $2.7 billion in inflows, as investors continued to see the benefits of using ETFs for both strategic and tactical positions. While fixed income inflows slowed after the tapering announcements that came out mid-year, investors still added $2.3 billion in inflows, which reflects the diversification and tradability benefits of fixed income ETFs. The flows for commodity based, leveraged, and inverse ETFs were muted as investors concentrated on traditional portfolios.

In Canada, the top selling individual ETF was the BMO S&P/TSX Laddered Preferred Share Index ETF (ticker ZPR) which appealed to investors looking to diversify yield sources and lower interest rate sensitivity relative to fixed income. Another popular theme in both Canada and internationally was broad market exposure, as investors looked to take advantage of global growth opportunities. In the U.S., the ETF with the highest inflows was the SPDR S&P 500 ETF (ticker SPY) which gathered over $16 billion USD. The success of these differing underlying portfolios illustrates the diverse use of ETFs, as both core building blocks and precise satellite exposures.

The Benefits of ETFs as Portfolio Tools

Investors have heightened sensitivity to the direction of markets, based on the impact from monetary policy announcements such as the magnitude of tapering and interest rate forward guidance. As economic growth has still not fully normalized to pre-recession levels, investors are aware of the fragility of global growth and impact of monetary policy on markets. As such, ETFs are a very effective tool to tactically reposition portfolios as they provide instant diversification within an asset class, and are very efficient to trade. Additionally, secondary market trading among individual buyers and sellers, instead of transacting directly with the fund, makes ETFs an efficient investment with less potential taxable events.

Fixed income ETFs, such as short term corporate bonds, can be used to lower portfolio duration without forcing investors to source bonds and while minimizing issuer concentration risks. By building their portfolios with ETFs, or by maintaining a liquidity sleeve of ETFs, clients can rapidly adjust exposures, reducing concerns of underlying investment liquidity and without potentially triggering a taxable gain if they are sitting on a basket of bonds that have risen in price since their purchase.

In the same way, equity ETFs can be used to provide exposure to regions of the world where investors do not have expertise to select individual securities or to conduct an active manager search. International ETFs can cover broad exposures such as emerging markets, or provide specific country exposures as diverse as China, Chile, or Columbia.

ETFs give investors a single ticket transaction to shift between asset classes, commodities, equity sectors, or reposition fixed income while minimizing security

ETFs provide a full spectrum of innovative investment solutions, enhancing opportunities for investors

specific risk. Unlike many other investment vehicles, ETFs trade on an exchange, allowing investors to quickly implement changes intraday.

Trends Moving Forward

ETFs remain an effective tool for strategic long term holdings, thanks to their low cost, diversified exposures. ETFs are excellent portfolio building blocks, allowing for investment by asset class and global region. Through 2013, we saw investors also use ETFs as satellite holdings to reposition portfolios.

Fixed Income Alternatives. Investors slowed down their fixed income purchases in the second half of 2013. Short term bonds were preferred, as investors avoided excess duration exposure. This has created a need for yield alternatives, to make up for income shortfalls. Clients have been attracted to preferred shares, as well as credit focused fixed income, including floating rate securities, high yield debt, and investment grade corporate bonds. ETF providers will continue to be focused on launching fixed income alternatives in 2014.

Recent product innovation has been to launch ETFs that combine fixed income asset classes using an active allocation model, thereby diversifying both asset class and issuer risk, and managing duration exposure. These ETFs represent a significant benefit to investors, by allowing for efficient exposure across different types of investments and the ability to rotate as asset classes move into favour. They also demonstrate the growing acceptance of active and rules based ETF strategies, as providers look to provide low cost innovative exposures, instead of launching duplicate broad market exposures.

Equity Income. As investors have become more defensive with their fixed income holdings, more income is required from their equity holdings. Dividend focused equity offers market growth, with lower volatility compared to pure growth exposures due to the downside protection of the dividend stream. We anticipate that equity exposures that combine both growth potential and income will remain heavily in demand in 2014.

A further development of the equity income strategy has been the increased demand for covered call ETFs, where the ETF sells excess potential upside return on the portfolio in exchange for up front call premiums. This adds to income from the portfolio and generally lowers volatility further while providing a similar long term total return. We have seen continued product launches in this area, which has given the benefit to investors of a full spectrum of underlying portfolio choices based both in Canada and the U.S.

Smart Beta. While market capitalization weighting remains a valuable weighting strategy to obtain market exposures and match benchmark returns, investor interest continues to grow in alternative weighting strategies. ETF providers have recognized this demand, launching new products that offer exposure based on factors. Smart

A growing trend has emerged: Mixing ETFs with active strategies

beta has diversified from fundamental weighting and dividend weighting, to factor weighting such as low volatility, momentum and quality. As an example, quality screening is based on high return on equity, stable year over year earnings growth, and low financial leverage, while still providing a diversified broad exposure to the geographic region.

This benefits investors by offering a low-cost, rules-based methodology, which maintains transparency as the index rules are published, and rebalances are announced in advance. The most recent forms of smart beta combine multiple factors, and are constructed to avoid unintended biases such as country or sector concentrations.

Currency Hedging. The Canadian dollar had generally appreciated since the introduction of ETFs, but has now declined to below par against the U.S. dollar. Traditional international ETFs based in Canada hedged the foreign currency exposure; however, we are seeing increased demand for unhedged products that allow investors to participate in foreign currency gains. Also, the increased volatility in currencies has led some investors to use technical trading signals, switching between hedged and unhedged ETFs based on short term currency movement.

In Canada, we have seen two new competitors enter the market in 2013, delivering further product innovation, including both portfolios based on active management and structures that can have tax benefits for investors. An increasing challenge for new products is to differentiate themselves enough to appeal to investors and gain assets.

We anticipate strong growth in 2014 in ETF based portfolios, where managers can add value with their asset allocation decisions. ETF portfolios have been targeted as a major growth area in the U.S., and we expect to see that develop as well here in Canada.

A number of existing providers have further committed themselves to the ETF industry by growing out a stronger product suite. This has included traditional active portfolio managers, by building out a complementary passive product suite, and using passive ETFs as building blocks for active mutual funds, they have recognized the benefits of mixing active and passive management, and provide a roadmap for the continued evolution of the Canadian investment manager industry.

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