BMO Global Asset Management ETF Outlook 2016

The exchange traded fund (ETF) industry had another record-breaking year in 2015. The availability of ETFs offering both diversified portfolios and precise exposures, along with the transparency and trading efficiencies of ETFs, make them effective portfolio construction tools for both institutional and retail investors.

This outlook report examines the year in review and then moves forward to discuss the impacts of industry development as 2016 unfolds.

Global Trends

The global ETF market grew to over US$2.9 trillion as of December 2015, with a record level of US$372 billion in new assets last year – a 10% increase over the previous year.[1] With shifting global market trends, 2015 proved to be an exceptional year for the ETF industry, signaling that investors are continuing to allocate ETFs to their portfolios when positioning around market news, while continuing to hold ETFs as core positions.

The U.S. ETF market ended the year with US$2.1 trillion in assets, an increase of 6% over 2014. In the United States, equity ETFs added US$173 billion in inflows, while fixed income ETFs added over US$50 billion. The European market has grown to US$506 billion and gathered US$82 billion in new assets in 2015, surpassing the previous year by 35%. The Asia Pacific market showed slower growth with the total ETF market reaching US$115 billion.[1]

The Canadian ETF industry had a historic year, setting a record with over C$16.3 billion in inflows. Assets under management reached just under C$90 billion, double that of five years ago. Equity ETFs added C$9.7 billion in inflows, as investors increased their U.S. and international exposures. Fixed income ETFs continued to attract investor interest, accumulating over C$6 billion in inflows.[2] Canada continues to have a higher allocation to fixed income ETFs than the U.S. market, as Canadian bonds are more difficult to trade directly than their American equivalents.

The Canadian equity ETF with the most inflows in 2015 was BMO MSCI EAFE Index ETF (Ticker: ZEA). This reflects that ETFs are highly efficient vehicles for making allocation decisions, and gaining broad regional exposures. The Canadian fixed income ETF with the most inflows was BMO Mid-Term US IG Corporate Bond Index ETF (Ticker: ZIC), showing investors' appetite for precise fixed income instruments that target a specific segment of the yield curve and credit.

Market Volatility and ETFs

Turbulent market events in 2015 captured the attention of investors, from China's "two steps forward, one step back" approach to deregulation of capital markets and large scale interventions, to the U.S. Federal Reserve's (the Fed) "will they – won't they" approach to raising interest rates. A few dates that highlight market uncertainty: on August 24th, anxiety around Chinese markets triggered sharp global market selloffs; on September 16th, the Fed surprised many by not raising interest rates; and on December 16th, the Fed finally met the market consensus by raising the target range of the federal funds rate from 0.25% to 0.50%, an increase of 25 basis points. For resource-dependent economies, the biggest story was the continued slide of oil, as it confounded experts by passing through support levels to end the year at 37.04 USD/bbl.[2]

ETFs are an effective trading tool for positioning portfolios and addressing these market concerns. Increasingly, investors and market commentators are using ETF flows as a leading indicator of investor interest and market confidence. Recognizing the trading efficiency of ETFs, particularly in more difficult-to-trade asset classes, institutional and retail investors are using ETFs as liquidity tools, rather than trading the underlying securities.

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As market volatility persists, both investors and regulators are looking at ETFs, as well as mutual funds to try to assess the risks within portfolios. ETFs have several significant benefits that help to mitigate the risks of the underlying holdings.

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As ETFs mature, more of the trading activity occurs on the secondary market; between buyers and sellers that meet on the exchange. This differs from many other products, where investors transact directly with the fund. As such, trading activity on the exchange that balances buyers and sellers does not affect the underlying portfolio. As an added benefit, mature ETFs develop better liquidity than their underlying asset classes.

In addition, ETF portfolio construction typically lowers risk relative to other products. By investing in a diversified portfolio of securities ETFs aim to provide exposure to an entire market, not just to a subset of securities. With more difficult-to-trade asset classes, ETFs further enhance liquidity by following indexes with higher liquidity thresholds, such as the Barclays Very Liquid Index (VLI) family.

ETFs can also reduce risk when market demand ebbs and flows, resulting in subscriptions and redemptions from the ETF. For redemptions in particular, large ETF flows create market anxiety for the underlying asset class. Another benefit of ETFs comes into play here – instead of paying or receiving cash, an ETF can settle portfolio securities against the capital transaction, so that trading costs are not incurred within the ETF. This allows for a slower impact to the asset class as market demand declines.

Advances in Smart Beta ETFs

The growing popularity of smart beta ETFs is helping investors to manage volatility. Smart beta ETFs provide factor based exposure to markets, by screening and weighting securities to adjust risk levels or enhance factor weighting. As demand for these products has increased, providers have been able to launch factor exposures

across markets. Initially, smart beta ETFs covered domestic markets and large markets like the U.S., but now ETFs covering smaller countries and other regions such as emerging markets are available, providing greater choice for investors.

Single-factor ETFs remain effective tools for increasing income, adjusting risk levels, or modifying growth characteristics. As a way to deal with fluctuating markets, low volatility ETFs help holders to remain invested in equity markets, with less exposure to market volatility. In particular, ETFs built around low-beta stocks are designed to cushion against broad market downturns.

Multi-factor smart beta ETFs are now available, giving more ways to access the market. For example, dividend and quality factor blends provide income and market growth, with the added benefit of lower portfolio volatility. Providers and index developers will continue to explore factor combinations that provide in demand market exposures and enhanced risk and return characteristics.

Fixed Income

Market volatility has similar impacts on fixed income portfolios. Economic news can have divergent impacts on short-term rates, based on current conditions, and long-term rates, based on future expectations. Market risk and economic data can have different impacts for sovereign and corporate bonds, particularly as governments and agencies have increased debt loads as a result of the 2008 financial crisis.

Interest rate curve and credit positioning has become more important in portfolio construction as a result of these factors. The ETF industry, while traditionally offering broad exposure bond ETFs, has evolved toward the delivery of precise positioning tools, slicing the credit spectrum and segmenting by maturity to create short-term, mid-term, and long-term exposures.

As well, fixed income ETFs have been developed to meet market demand for both global fixed income and country specific portfolios. With divergent economic growth expectations across countries, and yields remaining at low levels, investors are much more focused on identifying and investing in ETFs that provide the right exposure.

Impact of Currency

Another contributing factor to portfolio volatility in 2015 has been the impact of currency returns. Long term trends in currency pairs can significantly affect the domestic market return from global portfolios. In 2015, the U.S. dollar appreciated against most major trading currencies, on the back of relative economic strength and expectations of further rate increases. The greenback appreciated 10% against the Euro, 5% against the British Pound, and was relatively flat against the Yen (which had already moved 40% in the three previous years under the influence of Abenomics). With the steep decline in oil, the U.S. dollar moved even further against commodity led currencies, appreciating 16% against the Canadian dollar.[2]

Economic divergence also creates pressure on pegged currencies, where investors might not think to factor in currency returns. To maintain the Swiss Franc peg to the Euro, the Swiss government used currency reserves to offset persistent market demand. On January 15, 2015, the Swiss government capitulated to market forces by removing the peg, causing the Franc to appreciate by 20% and catching many investors by surprise.

Currency returns are having a greater impact on portfolio performance.

ETFs have historically been biased toward currency, with most developed markets offering unhedged ETFs. Canada is an exception to this rule. With significant exposure to the American market across their portfolios, cross-border businesses, and vacations and sometimes retirement homes, Canadian investors often prefer a hedged exposure. Now ETF providers are taking a more thoughtful approach to currency exposure, offering hedged, unhedged, and most recently, dynamic hedging strategies. This gives investors the ability to bet not just on markets, but on currency as well. We are seeing an increase in the use of institutional strategies that blend to create partial hedges, and tactical strategies that trade between hedged and unhedged ETFs based on short term currency movements.

The Opportunities Ahead

The growth of the ETF market, both in terms of product offerings through smart beta and currency options, and through growing investor interest and trading, is making ETFs into powerful tools for addressing market volatility and repositioning portfolios. While market participants remain focused on market and investment product risk, the unique benefits of ETF structures and exposures make them a popular choice for investors.

We expect the ETF industry to continue on its current growth trajectory, buoyed by the many benefits outlined in this report and by increased investor adoption in their portfolios. We project the global ETF industry to double to more than US$6 trillion over the next five years, and the Canadian industry to grow even faster to C$250 billion by 2021.

[1] ETFGI Global Industry Insights, December 31, 2015.

[2] Bloomberg, December 31, 2015.

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