ETF Outlook 2015

The Exchange Traded Fund (ETF) industry has continued to grow based on a wide spectrum of users, and the liquidity and trading efficiency benefits that ETFs deliver to a portfolio. ETFs are important tools for accessing growth in equity markets as well as properly diversifying portfolios in fixed income and other asset classes.

BMO Global Asset Management (BMO GAM) expects that over the next five years, the global ETF industry will double to US$ 6 trillion, and Canada will reach CA$ 200 billion, with Canada experiencing a faster growth rate than the global average.

This 2015 Outlook examines the growth opportunities for ETFs, as well as the challenges facing the industry going forward.

Global Trends

The global ETF industry has reached a new record level of US$ 2.7 trillion in assets under management (AUM) invested in over 5000 ETFs across 49 countries. The U.S. ETF market passed a significant milestone in 2014, ending the year with just over US$ 2 trillion in AUM, which was 17.8% higher than 2013. Equity ETFs added $185 billion in inflows while fixed income ETFs added $54 billion. This was much more balanced than 2013, where equity ETFs captured almost all of the inflows. As a percentage of AUM, the growth of fixed income ETFs exceeded equity ETFs in 2014. This reflected a pause in the expectation of significant interest rate hikes, where a slower rise is now anticipated in 2015 and beyond based on less positive economic indicators globally.[1]

The Canadian ETF industry had an excellent year in 2014, with over $10.3 billion in inflows which doubled from 2013. AUM reached $76.8 billion, an increase of 21.7% over year end 2013. Equity ETFs added $5.8 billion in inflows, as investors used ETFs for both strategic and tactical positions. Fixed income ETFs continued to exceed expectations, as investors added over $4.3 billion in inflows. This reflects the efficiency of offering fixed income on an exchange, as well as the liquidity benefits of bundling bonds in a one-ticket solution instead of holding individual positions and trying to find an offsetting buyer or seller. Canadian ETFs have a larger relative share of fixed income compared to the U.S., as the Canadian corporate market is more concentrated, both in investment grade bonds and high yield bonds, so the diversification benefit of ETFs adds even more value. In Canada, fixed income ETFs represent 34%, while in the U.S., they are only 15% of the ETF Market.[2]

In equities, for the U.S., large flows shifted to well-known S&P 500 tracking ETFs, including the SPDR S&P 500 ETF (ticker SPY). In Canada, the largest equity inflow has continued to be into the BMO S&P 500 Index ETF (ticker ZSP) as investors look for access to the relative strength of the U.S. market. There has also been a recent increase in flows to Canadian and energy ETFs as a contrarian trade looking for the floor in oil prices, which ended the year at $53.27 a barrel. The success of these ETFs reflects investor understanding of one of the key value propositions of ETFs, efficient market access, particularly in mature ETFs that have high trading volumes.

In fixed income, for the U.S., broad market exposures have had the largest inflows, including the Vanguard Total Bond Market ETF (ticker BND). In Canada, the largest fixed income inflows have been into credit products, including the BMO High Yield US Corporate Bond Hedged to CAD Index ETF (ticker ZHY), and the BMO Short-Term US IG Corporate Bond Hedged to CAD Index ETF (ticker ZSU). The flows into these products indicate two of the main uses of ETFs, as broad core solutions and as tactical tools to rapidly shift portfolio positioning.

The Growth Opportunities for ETFs

Looking forward to 2015, we expect a significant driver of growth to be further use by individuals who have traditionally traded individual stocks. Investors recognize that asset allocation is a significant source of outperformance, and with similar impacts across stocks from central bank announcements, it has been more difficult to capitalize on security selection in recent years. In addition, we view active and passive products as complementary approaches, not competing strategies, where core and satellite or blended approaches have become more heavily used. As a reflection of these strategies, we have not seen ETFs impact the growth of mutual funds, rather ETF growth is driven by acting as a replacement for individual positions.

ETF growth will be driven from replacing individual security positions.

Advisors and portfolio managers are also expected to rely further on ETFs as they build portfolios. ETFs offer global reach, to pair with the advisor's local market expertise, and to deliver alternative asset classes to enhance risk and return profiles. In addition, ETFs provide excellent broad market holdings for core positions, which provide efficiency through diversified baskets of holdings, and taxability benefits through local fund structures. With pressure on embedded trailers across the globe, including the elimination of advisor compensation in the U.K. and Australia, and the oncoming CRM2 fee disclosure rules in Canada, the move towards fee based services is well supported by low cost ETFs.

Additionally, with the continued emergence of smart beta ETFs, we see an excellent growth opportunity by combining

the transparency of ETFs with a rules based approach that sits closer to active management. These ETFs select and weight securities based on factors that have outperformed over the long term, instead of using traditional market capitalization, offering investors a wider spectrum of ETF exposures available across regions and countries.

For continued success, we anticipate that low volatility products, which offer better downside protection while still participating in rising markets, to resonate with investors. Even though markets are never expected to move in a straight line, over recent years they have consistently been moving upwards. With equity markets finally correcting sharply in October based on cumulative negative news, and investors looking to protect gains made over the six year bull market, risk reducing strategies are gaining traction. Beta based low volatility ETFs provide a benefit to portfolio construction techniques as they measure risk relative to the market, giving investors tools to mitigate large market events. We have seen these ETFs expand into other regions which gives investors greater control over the risk characteristics of their portfolios.

The Challenges Ahead

The growth of ETFs has attracted more competition, through new providers entering the market and existing providers adding to their product suites. In Canada, there are 360 ETFs, where five years ago there were just over 100. Globally and in the U.S., the numbers are much higher as there are now almost 700 ETFs with over US$ 1 billion in AUM.[3] The challenge is then to identify not just the right products to match investor goals, but also the right provider, as the two considerations are inter-related.

Experienced professional management is needed, even when tracking an index, in order to minimize tracking error and deliver the expected ETF performance. As the ETF industry expands, and moves into more esoteric asset classes, the importance of professional management is only enhanced as the underlying assets become more complex to manage across index rebalancing and inflows.

As ETFs have entered other asset classes, and as similar products are launched, we have seen a greater emphasis on liquidity. New investors want the assurance that selling an ETF will be as easy and efficient as buying an ETF. Institutional investors have long recognized the liquidity benefits of ETFs, as ETFs were first created in part as a liquidity vehicle for institutional trading, with advantages both by grouping stocks in a basket for a simple one ticket solution, and also as a way for buyers and sellers to meet on the exchange. An experienced manager will keep liquidity as a foremost consideration when designing ETFs, keeping mind that they have critical diversification benefits, that just like other pooled vehicles, they still subject to the liquidity of the underlying asset classes. As a bonus to popular ETFs, a more mature ETF will develop even better liquidity than its underlying portfolio as secondary trading between investors occurs.

An established provider will benefit from having mature ETFs in their line-up. The financial strength of the provider should be an indication of staying power, as we have seen more ETF closures as the playing field has become more competitive, particularly in the more mature U.S. market. Plus, an established provider will provide additional support, through education and training, as well as assisting investors with measuring the relative benefits of individual ETFs.

Globally, ETFs have come a long way since the first successful ETF was launched in Canada in 1990. They have become a mainstream investment vehicle for all investor types by providing transparency, liquidity, and access to new asset classes and strategies. Where initially ETFs were purchased mostly by institutional investors for complex trading strategies or cash management, advisors and individual investors now form a significant percentage of the market. As investors have gained a better understanding of the benefits of ETFs, their acceptance across platforms will continue to grow. Across regions, the ETF industry has experienced different growth trends, with the U.S. leading the way in developing a more mature industry. Opportunities exist to copy this success in other countries where ETF adoption has been slower to develop. In Canada, while the user base has been diversified, the overall adoption rate still lags the rate south of the border. Across Europe and the Asia Pacific, higher retail and advisor acceptance will spur industry growth. BMO GAM expects over the next five years, the combination of these trends will lead the global ETF market to grow to US$ 6 trillion and beyond.

BMO Global Asset Management

[1] Source: NBF ETF Research & Strategy, 2014

[2] Source: NBF ETF Research & Strategy, 2014

[3] Source: etfgi.com, 2014

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