# ETF Outlook 2018

February 2018

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The exchange traded fund (ETF) industry had another record-breaking year in 2017, reaching new milestones across the globe. Investors continue to recognise the efficiencies of ETFs as fundamental portfolio building blocks. As global news and events impact markets and performance expectations shift, ETFs have become effective investments to efficiently rebalance portfolios to reflect changing sentiments.

ETFs occupy a unique space as 'go to' investments for institutions, asset managers, advisers and retail investors. The growing acceptance of combining ETFs with traditional active solutions has accelerated the adoption of ETFs globally. This outlook report examines how the ETF industry evolved in 2017 and identifies key trends that are expected to shape the industry in 2018.

### Global trends

Global equity markets continued to advance in 2017, which led to record breaking flows into ETFs. The global ETF market exceeded US$4.6 trillion in assets by year-end, with over US$649 billion in new assets[1]. This tremendous industry growth has been matched by the emergence of new ETFs that transcend the traditional broad market capitalisation index structure, where there are now over 5,300 ETFs globally[1]. The diversity of ETFs and array of opportunities available to investors is now greater than ever. An investor today can access traditional equity and fixed income exposures, in addition to innovative market trends such as artificial intelligence or complex derivative strategies such as swaps or covered calls.

The U.S. ETF market crossed the US$3 trillion milestone this year and now stands at US$3.3 trillion in assets, showing significant growth from previous years with inflows of US$465 billion, a 67% increase from last year[1]. Equity ETFs saw inflows of US$336 billion while fixed income ETFs continued to gain significant inflows with over US$111 billion[1]. The European market had a strong year, with total assets reaching US$762 billion, a 40% increase from last year and inflows of just over US$102 billion. Japanese ETF assets increased by 60.7% to US$272.6 billion, with net inflows to ETFs of US$53 billion[1]. The Asia Pacific ex Japan market had an historic year with inflows of US$8.3 billion and the total ETF market surpassing US$165 billion.[1]

| | US ETF market | European ETFs | Japanese ETFs | Asia Pacific ex Japan ETFs |
|---|---|---|---|---|
| **Total assets** | US$3.3 trillion | US$762 billion | US$272.6 billion | US$165 billion |
| **2017 inflows** | US$465 billion | US$102 billion | US$53 billion | US$8.3 billion |

## Risk factors

Past performance should not be seen as an indication of future performance. The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested. Investing in ETFs involves risk, including risks associated with market volatility, currency rate fluctuations, replication strategies, and changes in composition of the underlying index and assets.

## Fixed income investing

There was an increased demand in 2017 for fixed income ETFs as institutional investors have had an increasing appetite for fixed income ETFs while contrarian investors have been looking to less risky assets to add to their portfolios. Investors sitting in idle cash have started to look at fixed income investments in 2018 for a way to generate additional income, without taking on a high amount of risk.

Investors have recognised that as much as the benefits of ETFs have helped with equity investing, the benefits are even more significant with over the counter asset classes such as fixed income. ETFs have provided liquidity, transparency and diversification to an otherwise hard to access and less liquid asset class. ETFs simplify fixed income investing by giving investors easy and efficient access to broad based fixed income exposures or more precise exposure to credit qualities, durations, sectors and maturities.

Going into 2018, fixed income investors are facing a macroeconomic environment where interest rates are rising, the yield curve is flattening and inflation might make a comeback. With ETFs investors have the ability to either build a portfolio, or tilt an existing portfolio to reflect their outlook for interest rate changes, inflation and credit spreads.

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Shortening portfolio duration and adding exposure to credit through higher-yielding ETFs has proven to be a popular strategy, while contrarian investors have benefitted from precise exposures in long-term treasuries or corporate bonds.

Our BMO Barclays 1-3 year Global Corporate Bond ETF is one option for conservative short-duration fixed income exposure. For long-term investors, looking for income and diversification, longer-dated bonds generally provide higher coupon rates and term premiums when yield curves are upward sloping. Our BMO Barclays Global Corporate Bond ETFs, segregated by maturity and credit, allow investors to effectively execute a precise duration management strategy and manage their credit exposure. In addition to being cost-effective, bond ETFs also provide an additional layer of liquidity allowing investors to quickly adapt to the changing environment.

## Valuation levels and market growth:

The bull run continued through 2017 where in the U.S., the S&P 500 was up 17.32%, the Dow Jones Industrial Average was up 24.44% and the NASDAQ Index was up 22.95%[2]. U.S. Tax Reform passed by the White House fuelled equity markets. President Donald Trump signed a tax bill that slashed corporate tax rates to 21%, hoping to increase capital expenditures among American companies, create jobs, and bolster U.S. corporations.

The extremely popular FAANG stocks (Facebook, Apple, Amazon, Netflix and Google), were a fundamental driver of market growth in 2017. These global technology and communication giants have been accelerating market growth and pushing indices to new heights. This impact on equity markets has encouraged index providers to consider sector classifications. MSCI and S&P Dow Jones Indices (SPDJI) have announced changes to the Global Industry Classification Standard (GICS) for 2018. The Telecommunication Services sector is set to expand and be renamed Communication Services. Some Consumer Discretionary and Technology stocks will relocate to this new sector. The impact on these future sectors will be most felt by the removal or addition of some of the heavy-weighted FAANG stocks, potentially impacting ETFs that track the Information Technology, Consumer Discretionary and Telecommunication sectors. While equity markets have been prosperous through 2017, it is important to highlight that valuations have been high. The S&P 500 closed out 2017 with a price-to-earnings ratio of 22.44 which is 67% higher than valuations in 2011[3]. Strategies incorporating an explicit quality screening while seeking high dividend-paying stocks, such as the BMO Income Leaders ETFs, have the benefit of reducing portfolio volatility and improving the risk-adjusted returns.

In the UK, the improving global economic momentum coupled with a weak sterling have been supportive for the FTSE 100 Index in 2017. 2018 may see a rebound in the pound as the Bank of England gradually increases interest rates and tensions around Brexit fade, which clouds the outlook for the FTSE 100 Index. We believe the defensive nature of our Enhanced Income strategy can outperform in a likely range-bound or down market. By selling call options on the index, the purpose of the strategy is to generate additional income in addition to the dividend yield and reduce the volatility associated to the stock ownership.

## Thematic investing:

A growing industry trend over the past year has been investing in thematic ETFs. Thematic ETFs allow an investor to access an industry trend. There have been several industry trends in 2017

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that ETF providers have pivoted to including; cryptocurrencies, artificial intelligence and ESG investing.

**Crypto-mania:** Cryptocurrencies have been making headlines in 2017 with the Bitcoin boom. These currencies are high risk and return, are difficult to buy and sell and have low liquidity. Therefore gaining exposure to cryptocurrencies via an ETF makes accessing this market trend easier and more efficient. Globally, multiple cryptocurrency ETFs have been filed with regulators.

**Artificial intelligence (AI):** AI is a sector of computer science, which focuses on the advancement of computer and machine learning. Its goal is to teach computers to learn and think with a level of intelligence that is similar to our own. Investing in AI using an ETF can be done in two ways: purchasing an ETF with exposure to companies which invest heavily in AI research and development or purchasing an ETF which uses AI methodology to make investing decisions. Markets have seen both styles of AI investing grow in popularity over the year, with more than 15 North American listings that align with AI investing.

> Thematic ETFs allow an investor to access an industry trend

**Socially Responsible Investing:** Being socially aware of your investments, also known as Environmental, Social and Governance (ESG) investing, has become very popular over the last year. Investors have become increasingly mindful of the types of companies their money is being directed to and are investing accordingly. With an ETF that has an ESG mandate, an investor can screen out stocks from a particular universe that do not support their values.

## The path ahead

ETFs deliver efficient access to equities and fixed income across all geographic exposures in addition to low-cost and liquid access to thematic and precise exposures. Investors are becoming increasingly confident in using ETFs and have become more knowledgeable of the advantages and efficiencies of ETF investing. The growth of the ETF market is expected to remain steady, in terms of both an increase in assets and an increase in options, further developing meaningful investment possibilities for investors in 2018.

We expect the ETF industry to increase its growth trajectory, backed by greater adoption across institutional, adviser and retail platforms. We project the global ETF industry to double to more than US$10 trillion over the next five years.

Sources: [1] ETFGI, Dec 2017 [2] Bloomberg, one year month-end total return 1 Jan 2017- 29 Dec 2017 [3] Bloomberg, Dec 2017

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