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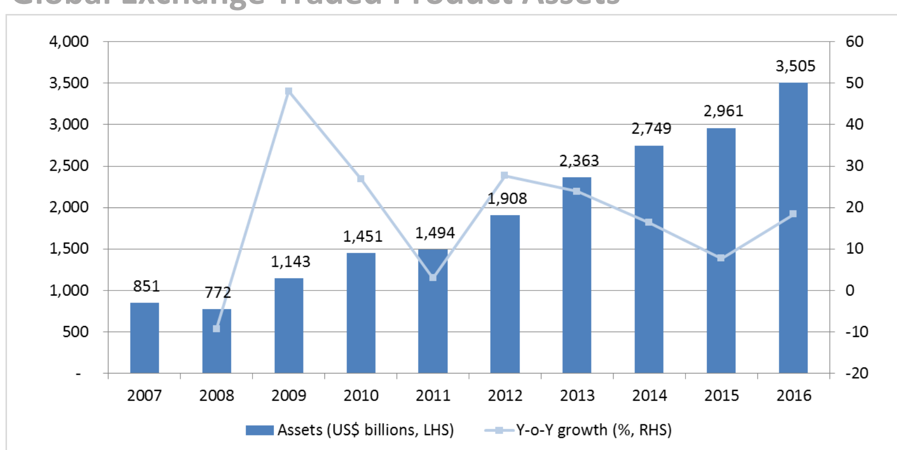
ETFs: STATE OF THE NATION

It's simple: we build client portfolios with only exchange-traded funds (ETFs). We like their diversification, tax efficiency, transparency and, most importantly, their low cost. We also know that the high-priced portfolio managers employed by mutual fund companies collectively underperform the market. For instance, S&P SPIVA research indicates that roughly 90% of US fund managers have underperformed their benchmarks, net of fees, over the past five years (you can access the research here). The high mutual fund fees are a significant factor in this underperformance.

The investing world is becoming more aware of this fact and the ETF industry continues to grow at an explosive pace with the global exchange traded product market in 2016 breaking through the US$3.5 trillion (with a "t") asset level for the first time ever, jumping 18% y-o-y.

Global Exchange Traded Product Assets



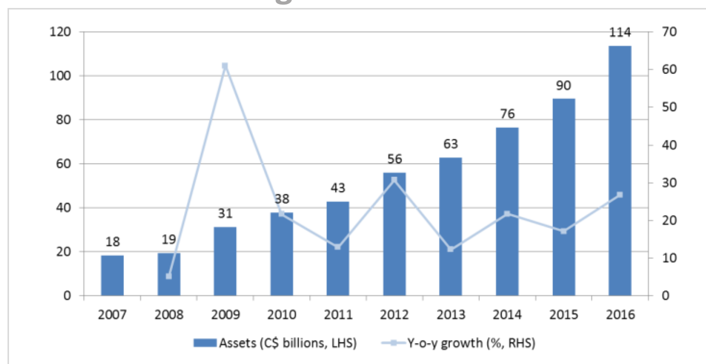
Source: Blackrock

CANADA: A CLOSER LOOK

As with the global market, the Canadian ETF space continues to experience incredible growth. The Canadian market currently sits at about C$114 billion in assets, up 27% y-o-y, according to Morningstar data. This growth rate is slightly inflated due to the sharp decline in the oil price in 2015 followed by its strong recovery in 2016; however, the long-term ETF asset growth rate continues to be impressive at close to 20% annually. Ten years ago there were less than 50 Canadian-listed ETFs on the market. Now there are more than 450.

The top choice for Canadian investors, naturally, is still mutual funds as total assets sit at more than C$925 billion; however, this industry's 10-year 5% compound annual growth rate pales in comparison to that of the ETF industry. The stark contrast in growth was highlighted during the credit crisis when Canadian mutual fund assets declined 25% y-o-y in 2008 while the ETF industry actually managed an *increase* of more than 5%.

Canadian Exchange-Traded Fund Assets



Source: Morningstar

The three dominant Canadian ETF providers continue to be iShares, BMO and Vanguard. However, iShares has lost significant market share recently, mostly to BMO and Vanguard, as pricing pressure and better competitive offerings have weighed on iShares' leading market position. Our clients have likely noticed this shift as well as we continue to move portfolios away from iShares products.

2017 TRENDS

More ETF Providers

The Canadian ETF market is rapidly becoming a crowded and more complicated space. It was much simpler only 15 years ago with less than 20 ETFs trading and iShares dominating the market. Now there are more than 15 different ETF providers with—you guessed it—more and more mutual fund companies jumping on the bandwagon. In just the past few months we've seen AGF Investments and Dynamic Funds launch suites of ETF products and Manulife Investments will have its own offering come April. Even prime minister of Canada–wannabe and *Shark Tank*–star Kevin O'Leary recently launched an ETF (branded appropriately O'Shares). The fact that so many mutual fund companies have now entered the ETF space confirms for us that the growth is unlikely to abate over the next few years and that more providers will emerge. We expect that the Canadian industry could see 20–25 providers by the end of 2018 with more issuance a certainty. With so much competition, buyouts and partnerships are inevitable and consolidation will likely be an ongoing feature of the ETF landscape over the coming decade (see 'Lower Fees' below).

Lower Fees

More competition, naturally, means lower fees. There are countless ETFs both in Canada and globally that charge less than 10 basis points (0.10%) per year. In fact, there are numerous ETFs that charge five basis points or less. To translate this into dollar terms, the BMO S&P/TSX Capped Composite Index ETF (ZCN), for example, which most of our clients own, charges five basis points, which amounts to 50 cents a year for every $1,000 invested. That's cheap! Not all ETFs can offer such low cost—emerging market ETFs, for example, have higher transaction costs as trading in foreign and overseas markets is usually more expensive relative to local markets. However, most of our client portfolios still have an aggregate ETF expense ratio of less than 30 basis points—a small fraction of the cost of a mutual fund.

Pricing pressure, of course, will mean that not all ETF providers will survive and the advantage will likely go to providers that have either built-in financial advisor distribution networks, and therefore can bolster revenue via commission charges, or larger salesforces. Bank of Montreal certainly falls into this category and it should be no surprise that BMO gained almost 3% market share in 2016 while iShares lost more than 5%. Vanguard has also grown market share partly as a result of its client-owned structure, which technically only obligates it to cover operating expenses and therefore allows it to price more competitively.

As fees decline, we expect ETF providers to either introduce more actively managed products (see below), which allow for higher pricing, or to partner with other firms to broaden their financial advisor and/or salesforce networks. We saw this at the start of 2017, for example, when Dynamic teamed with iShares to launch several Dynamic-branded ETFs.

More Smart Beta and Actively Managed ETFs

To be honest, it's not always entirely clear what the exact difference is between smart beta and actively managed ETFs. However, smart beta tends to be rules based (an algorithm pulling the strings rather than a manager) and straddles a middle ground between entirely passive index tracking and full-blown active management. But regardless, both smart beta and active management offer the possibility of outperforming a particular index. Therefore a 'strategy' must be applied that differentiates the ETF from the index. This could be something as simple as the ETF including only securities that have price momentum or exhibit low volatility; however, such strategies come at a cost and every strategy will, at times, underperform.

We are not averse to utilizing smart beta and actively managed ETFs (our client portfolios are already 5–10% weighted to them), but we must clearly understand the risks of the strategy, be certain that we are unable to replicate the approach ourselves at lower cost and refuse to pay more than a few basis points for the potentially better outcome. It's unlikely that these kinds of ETFs will ever occupy more than a small sliver of our clients' portfolios as there is still a lack of convincing academic research suggesting that they consistently outperform plain-vanilla ETFs or that the same results couldn't be achieved through other means such as adjusting asset allocation. For example, rather than adding a pricey 'low vol' ETF could portfolio volatility be reduced simply by increasing the bond weighting?

We'll also briefly mention leveraged ETFs, which we do not use in client portfolios. A leveraged ETF is designed to track a multiple of the return of a given index. However, they employ derivatives, which create significant volatility and can result in unexpected returns if held long term. During the credit crisis, for example, many investors discovered that their leveraged ‘bear’ ETFs had negative returns equal to or worse than leveraged ‘bull’ ETFs. Leveraged ETFs are expensive and are designed for short-term trading—a strategy we do not employ.

According to Bloomberg data, about one-third of Canadian-listed ETFs are currently classified as ‘actively managed’, but because such ETFs feature higher fees, this is an area of the market that will continue to see new issuance.

More Thematic ETFs

Thematic investing is popular and will likely become more so, supported by the increased complexity and specificity of global trends, particularly in the areas of technology and finance. Thematic investing is sector investing but with a narrow focus. This is more a global than Canadian ETF development, but examples would include cyber security, cloud computing or robotics ETFs. A Bitcoin ETF is currently under review by the Securities and Exchange Commission and may be released shortly. This would also fall into the thematic category. It’s possible that in the future we will employ sector-specific ETFs, but they will be established sectors (a US health care ETF, for example). Currently, theme-based ETFs are too granular, demanding a highly certain outlook on sometimes obscure areas of the market. We also highlight that 120 ETFs were closed last year in the US due to lack of interest, many of them being theme-based. A restaurant ETF, for example, with the ticker BITE, literally bit the dust last year. Before investing, we want to be sure that an ETF will be around long-term and is not simply the flavour of the month.

ETFs: BIGGER THAN MUTUAL FUNDS?

ETFs are here to stay, but drawing ahead of mutual funds in terms of overall asset size is unlikely over the next decade as the mutual fund industry is many multiples larger than the ETF industry, generates more revenue and has a larger and more established (and better paid) salesforce. However, a meaningful shift in the investment industry is occurring. The rise of ETFs is already forcing mutual fund companies to lower their own fees and, as we’ve highlighted, is prompting them to issue their own ETF products. Doubtless Canadian ETFs will be unable to sustain historical growth rates simply due to the laws of large numbers, but if we look ahead 20 years and assume that the ETF industry continues to grow at a slower, but still double-digit pace, and similarly assume that the mutual fund industry’s annual growth rate moderates from 5% to, say, 3%, ETFs could eventually draw even or even surpass mutual funds in terms of assets.

Naturally, such an industry shift is a long-shot, but to paraphrase Ernest Hemingway, isn’t it pretty to think so?

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