

October 2013

# Canadian ETF Outlook 2013

## October Update

BMO  Global Asset Management

This update to our 2013 Outlook examines tactical benefits, and provides some interesting statistics on the popularity – and future trends – of ETFs.

### Continued growth and relevance amid market uncertainty

**W**ith market uncertainty exacerbated by the roller coaster ride of U.S. Federal Reserve Bank (Fed) announcements, exchange traded funds (ETFs) have experienced significant inflows, as investors gravitate toward a vehicle that proves efficient and responsive to changing needs, and changing market environments.

This update to our 2013 Outlook examines tactical benefits, and provides some interesting statistics on the popularity – and future trends – of ETFs.

### As predicted, inflows continue

Through the first nine months of 2013, the Canadian ETF industry has continued to grow, with over \$4.1 billion in inflows. In the big picture, Canadian ETFs have approximately \$60 billion in assets under management (AUM) as of September 30, an increase of 6.0% over year-end 2012.

Over the summer, we saw a significant shift in market behaviour as the U.S. Fed indicated it might taper its bond-buying program. While equity demand has held steady, investors' preference for fixed income has declined, in response to sharply rising yields and greater uncertainty in the bond markets.

The surprise announcement on September 18th, that the Fed would hold tight on monetary stimulus, may reinvigorate emerging markets, and had an immediate positive impact on gold and fixed income prices.

Overall, fixed income ETFs have represented around 55 percent of year-to-date inflows in Canada, at \$2.3 billion, with the majority of flows received through the first six months of 2013. Even with the unforeseen reversal in the Fed's tapering plans, we can expect increased volatility in fixed income markets as a result of uncertainty and anticipation, which could further dampen investor demand.

Equity ETFs have received nearly 40 percent of year-to-date inflows at close to \$1.7 billion, with greater interest in U.S. ETFs, as a reflection of investor confidence in growth south of the border. Demand for commodity ETFs has been muted, particularly gold ETFs, as commodity ETFs have experienced outflows of almost \$100 million year-to-date. With equity flows representing a larger portion of market activity, the shift could indicate that the great rotation into equities has begun.

### The Trading Efficiency of ETFs

The seemingly inevitable result of instability and uncertainty is that investors have rapidly responded by adjusting their portfolios, with ETFs proving to be an important investment component to efficiently help them adapt. ETFs give investors a single ticket transaction to shift between asset classes, commodities,

ETFs allow investors to quickly and efficiently respond to changing market conditions.

equity sectors, or to reposition fixed income, while minimizing security-specific risk. Unlike many other vehicles, ETFs trade on an exchange, allowing investors to quickly implement changes intraday.

In Canada, ETFs, as a percentage of the total trading dollar volume, remained just below ten percent. However, in the U.S., which is often considered an indicator of future market trends for Canada, ETFs, which traditionally represent less than a quarter of total trading dollar volume, surged up to a third of total trading dollar volume after the Fed's initial June tapering announcement.<sup>1</sup>

Of that volume, the SPDR S&P 500 ETF (ticker SPY) was the most heavily traded ETF in June, with turnover that exceeded \$570 billion USD, more than four times the AUM of the ETF. As a significant benefit of the ETF trading structure, most of this trading occurred on the secondary market, without impacting the portfolio of the ETF, and potentially causing turnover and triggering taxable events. Only when supply imbalances occur as the ETF grows and shrinks, does the basket of investments receive creation or redemption orders.

Additionally, SPY market prices remained very close to the value of the underlying portfolio, demonstrating that when combined with a narrow bid/ask spread, investors are provided with a very efficient trading experience. The end-of-day market price premium or discount to the underlying portfolio was a high of 5.4 basis points and a low of 5.7 basis points, with an average very close to zero.<sup>2</sup>

Media coverage in June indicated that as market volatility increased, some of the more esoteric ETFs traded at a discount or premium to their underlying portfolio value. This is especially true when observing the iNAV – a published intraday value of an ETF's underlying portfolio, and a U.S. requirement, not yet mandated in Canada. However, little attention has been put on the accuracy of the iNAV, specifically its reflection of true market value, as it may become stale when underlying markets are closed or when underlying securities are infrequently traded. Its limitations need to be better understood.

We see real potential premiums and discounts for demand imbalances in thinly traded ETFs, or in ETFs with underlying portfolios that are too 'niche'. ETF providers need to recognize the importance of diversified, liquid and tradable underlying investments, and must work closely with underwriters to ensure sufficient liquidity exists to support demand fluctuations. An important benefit of ETFs is that with growth and maturity, they can become more liquid than the underlying portfolios.

Another ETF that's in the news consistently is the SPDR Gold Shares (Ticker GLD). This ETF has been a lightning rod in the marketplace, especially for those concerned that ETFs allow for too much speculative trading. GLD has lost 40 percent of its AUM this year, which is a result of both redemptions and price decline. We view this ETF, and the like, as efficient vehicles for average investors, because they level the playing field by 'democratizing' asset classes that are harder to access. GLD and

## The Opportunity:

- Alternative strategies
- Tactical allocation
- Diversified exposure
- Low cost

similar ETFs allow the true investment demand for gold to be expressed, and while an impact on volatility may be part of the result, they allow for more efficient exposure and trading.

### Trends Moving Forward

In Canada, we have seen stronger competition, as represented by the market share growth of smaller players, which increased from 26.1% at year end to 32.3% at the end of September, as well as the entry of two new providers, bringing the current total to nine.

**Product Innovation.** The barriers to entry from the entrenchment of existing products have led to new alternative beta strategies and rules-based strategies, as there is less opportunity in replicating existing, traditional exposures. Additionally, there is a growing ideology that supports these innovative approaches.

**Positioning for defensive growth.** Recent volatility has also been a reminder that Fed policies have a significant impact on market expectations, leading investors to continue to be cautious. Confidence in the U.S. and global markets to prosper, against a backdrop of tapering central bank intervention, will be a driving force for market returns. As well, income generation remains critical for investors, and innovative ETFs that deliver diversified exposures with an income focus, while mitigating some of the risks of rising rates, will remain popular.

**The convergence of the mutual fund and ETF industries.** In the mutual fund universe, ETFs offer a multitude of benefits. They are increasingly being used for tactical allocations, exposure to more difficult to access asset classes, as core portfolio building blocks, and for diversified exposure to satellite investments.

The ability of ETFs to cope with market volatility and swings in investor demand, through liquid, tradable underlying portfolios, continues to make these funds an increasingly popular tool for investors. Additionally, secondary market trading that does not impact the ETF portfolio makes these investments more efficient, and less susceptible to taxable events.

Finally, while we have focused on the tactical benefits of ETFs in this review, the low cost of ETFs remains critical to their appeal as buy and hold investments. This is especially evident in an environment of lower market return expectations.

<sup>1</sup> ETF Trading Spikes in Volatile Times, Index Universe

<sup>2</sup> Source: Bloomberg

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