

September 2012

Canadian ETF Outlook 2012

September Update

BMO  Global Asset Management

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This year, the exchange-traded fund (ETF) industry has continued its strong pace of growth. As of August 2012, the Canadian ETF industry stood at approximately \$50 billion in assets under management (AUM), up an estimated 15.9% year to date. In only eight months, the growth rate in 2012 far is already close to the Canadian ETF industry's compound annual growth rate (CAGR) of 18.5% over the last five years. We continue to see a growing number of users, including institutional investors, asset managers, investment advisors, and individuals, implementing ETFs as part of their portfolio construction process.

While ETF assets have shown significant growth so far in 2012, there have been a number of notable trends that have been driving this growth. The macro-economic backdrop and continued low interest rates in the developed world has certainly steered investors towards more defensive oriented ETFs. The Canadian ETF landscape also continues to evolve, both in terms of providers and also their respective product sets. Outside of a growing user base, we believe the key themes below have been instrumental to the growth in ETF assets in Canada so far in 2012:

Key themes in 2012:

- 1) ***Bond ETFs continue to dominate fund flows.*** Despite the 10-year Government of Canada bond yield remaining near record lows, fixed income ETFs have continued to attract significant assets. Year to date, bond ETFs have grown from \$12.9 billion to \$17.8 billion in AUM. There has been a trend of investors becoming more tactical in their fixed income investing, targeting various parts of the yield curve and/or credit spectrum in order to generate higher total returns from bonds or reduce interest rate sensitivity. In addition, we continue to see a significant growth in higher yielding, non-Canadian bond ETFs such as U.S. high yield corporate bonds and emerging market debt.
- 2) ***A preference for dividend based ETFs over growth oriented areas.*** A combination of low interest rates and aging demographics continue to make dividend based ETFs a popular theme with investors. Although the year has seen some brief rallies in Canadian equities, it is clear that the appetite for risk amongst Canadian investors continues to remain low. The year to date growth of AUM in dividend based ETFs, which tend to be more defensively oriented, has already grown 45.2% more than it did in the entire year of 2011.
- 3) ***Continued innovation from Canadian ETF manufacturers.*** While the Canadian ETF industry represents roughly only 3.0% of global ETF assets, it continues to be one of the leaders in innovation. Several ETF providers in Canada have gone beyond plain vanilla ETFs, developing innovative

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solutions that help investors reduce volatility, source yield and in some cases both.

- 4) ***A growing number of ETF based products.*** As stated in our Canadian ETF Outlook Report at the start of the year, we have seen an increasing number of mutual funds or fund-of-fund products holding ETFs. These products are particularly appealing to those investors that are looking for a well diversified portfolio, but also looking for the flexibility of a mutual fund structure that would allow users to dollar cost average through a single trade. It is also possible that we will see an increasing number of fund-of-fund programs combining active and passive mandates together, to bring the best-of-class investment solutions.

We believe the strong asset growth in ETFs that we have seen in the first eight months of the year will continue to close out the year, despite a number of uncertainties that remain on the macro-economic landscape. Furthermore, even though the Canadian ETF industry has seen a significant growth rate over the last decade, we believe a continued evolution within the industry will bring further asset growth in the coming years. Although we do not see them as substitutes, ETF assets still represent only 6-7% of mutual fund assets in Canada. While the ETF industry may never surpass the mutual fund industry in terms of size, we do see room for further asset growth as both mutual fund and single security investors continue to recognize that ETFs are very complementary in their investment strategies and portfolios. From our perspective, we believe the following factors to be the key drivers in asset growth in the ETF industry.

- 1) ***Growing number of distribution channels.*** In comparison to actively managed mandates such as pooled funds and mutual funds, ETFs still lack the same penetration in certain distribution channels. For example, the use of ETFs in defined contributions (DC) plans is currently very limited, but with a growing number of asset managers now offering both active and passive solutions, this may allow them greater access to DC platforms. On the brokerage side of the business, it is also possible we will see a greater use of ETFs on managed programs such as separately managed accounts (SMAs) and unified managed accounts (UMAs).
- 2) ***Potentially more entrants to the ETF space.*** Only a few years ago, the Canadian ETF landscape was made up of two providers. A few entrants and an acquisition later, the industry is now made of seven providers which benefits investors as they now have more choices. Over the next several years, we may potentially see more entrants and existing manufacturers ramp up their product offerings, which will continue to drive further innovation in the industry. The end result will be a greater

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number of solutions that appeal to a wider range of investors and thus more tools for their portfolio construction process.

- 3) **Growing number of implementation strategies:** With a growing number of ETFs based on varying styles, exposure types and niches, ETFs are being used in an increasing variety of ways by investors. From transition management to hedging to long/short strategies, there already are countless ETF based strategies, but it is likely new applications will continue to be uncovered. Furthermore, with increased segmentation and ETFs based on specific areas, even basic uses of ETFs such as cash equitization have become more efficient for investors.
- 4) **Cost savings crucial in current market.** As the investment landscape has become progressively more challenging and alpha generation less consistent, investors have become increasingly cost sensitive. As such, ETFs have become a popular solution for investors looking to reduce costs while also attaining market exposure. This is especially true given similar plain vanilla products are becoming less expensive due to pricing competition from various providers.
- 5) **Potential entrance of active ETFs.** Although the ETF structure may limit the effectiveness of actively managed mandates, a notable asset management firm has successfully launched actively managed ETFs in the U.S. this year. In addition, there have been rumours that other well known mutual fund providers are planning to make an entrance in the ETF space by providing actively managed products. Continued success of mutual fund providers in offering actively managed mandates in the ETF space may eventually lead some Canadian mutual fund companies to consider ETFs to complement their existing mutual fund offerings. Should this occur, it could potentially accelerate the growth rate of the ETF industry.

Given much of the success of the ETF industry has been its appeal to investors, such as low fees, transparency and product support, it is essential that ETF providers maintain these characteristics. Continued growth in the industry will not only be dependent on ongoing product innovation and creating viable solutions for investors, but also on a strong emphasis on client education. Although existing ETF users are becoming increasingly sophisticated, it is also important that newer users receive the same level of support as in the past to ensure newer investors have a good client experience. Local expertise and on the ground specialists will be key in ensuring both new and existing clients get the needed education and support.

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