BMO Global Asset Management ETF Outlook 2019

The exchange traded fund (ETF) industry continued its growth trajectory in 2018, and in Canada annual flows surpassed mutual fund flows for the first time in a decade. ETFs continue to be important investments for institutions, asset managers, advisors and retail investors alike. Investors look to ETFs as their product of choice for effective, low cost, asset allocation tools. The diversification and trading efficiency that ETFs offer has become more important than ever as volatility has returned to global markets.

This outlook report examines how the ETF industry developed in 2018 and identifies key trends that are expected to drive the industry in 2019.

Global Trends

Global equity markets had a strong start to 2018 with the S&P 500 hitting record highs early in the year, but by the third quarter, most gains had been erased, and volatility spiked. Geopolitical concerns such as trade war tensions and Brexit deal negotiations combined with monetary policy tightening on a global scale put pressure on equity markets. By the end of 2018 all the gains enjoyed in the first half were gone, the longest bull market in history was put to question and market volatility continued straight through to the new year.

The global ETF market continued to expand. There were 6,483 ETFs globally by the end of 2018, up almost 12% from the previous year accumulating a total of US$4.7 trillion in assets[1]. Assets under management remained close to 2017 levels, a result of the equity market sell-off in December. Entrenched providers continue to attract the majority of inflows; however industry growth has also come from new ETF providers who can no longer sit on the sidelines. The challenge for providers launching new ETFs is how to differentiate in the marketplace. The industry has seen new active, thematic and derivative-based strategies complementing an investor's known list of tickers. As well, a trending movement to create funds of ETFs is helping to address distribution channels that do not access ETFs directly.

The US ETF market added 163 new ETFs in 2018 and gathered net inflows of US$316 billion[1]. Equity ETFs saw the largest net inflows of US$208 billion while fixed income ETFs continued to gain noteworthy inflows of US$75.29 billion[1]. Despite a rough year for European equities, the European ETF market added 112 new ETFs in 2018 and enjoyed US$53.48 million in net flows[1]. The Japanese ETF industry grew by 12.5% with assets now at US$306 billion, driven mostly by the Bank of Japan who now own 69% of total Japanese ETF assets[1]. The Asia Pacific ex Japan market enjoyed inflows of US$56.18 million pushing its total assets to US$190 billion, up 14.5% year over year[1].

The Canadian ETF industry continued to expand at a rapid pace with C$20 billion of new inflows (only C$6 billion off of 2017's record-breaking year) to support a year-end tally of C$156 billion[2]. Despite assets dropping due to the market correction, the Canadian industry still grew by 6.5% at year-end; a significant number given it was not buttressed by a strong bull market as in previous years. What's more interesting, in Canada ETFs gathered more net assets than mutual funds did in 2018, something that has not happened since 2009[2]. This signals an important shift in investor behaviour to seek out low-cost and transparent products, and acknowledges an increasing investor awareness and comfort with ETFs.

The Canadian ETF with the most inflows in 2018 was BMO S&P/TSX Capped Composite Index ETF (Ticker: ZCN) which saw over C$1 billion in net flows in 2018[2]. Investors continued to show support to broad Canadian equity exposure, especially to financials and to the energy sector, seeing value here as Canada has underperformed leading global markets.

Asset Allocation Investing

2018 saw the advent of the Asset Allocation ETF: the ETF industry's answer to the risk based conservative, balanced and growth portfolios traditionally offered by mutual funds. The low cost, easy to use structure has attracted close to C$1 billion in new assets during the year. The simplicity

message has resonated with investors and media, where holding only broad ETFs with strategic, disciplined rebalancing makes these diversified products feel like an indexed ETF. Similar to the success of traditional ETFs, these asset allocation ETFs are showing signs of disrupting the industry by challenging fund construction and entrenched products.

> "Asset allocation ETFs are showing signs of disrupting the industry."

Canadian ETFs had higher net flows than mutual funds in 2018, for the first time since 2009. The arrival of asset allocation ETFs, alongside macro uncertainty and fourth quarter market volatility, contributed to this reversal of flows.

Volatility

After a strong 2017 for global markets, equity markets hit all-time highs in early 2018. There seemed to be no end in sight as the longest bull market in history pushed forward, immune to political and economic news. Eventually, global monetary tightening, combined with rocky geopolitics (trade tensions, Brexit, global debt levels) and below average earnings from some FAANG stocks led to indigestion for investors, and corrections began to ripple through equity markets. Due to their trading efficiency, where an investor can place a diversified exposure with a single ticket, investors have turned to ETFs in several ways to navigate the resurgence in market volatility.

Particularly in December, the ability to trade ETFs intra-day has been more impactful, where tactical traders have capitalized on quick shifts in the mood of the market. After a continuation of down days heading into Christmas, those who were still looking at markets saw a sharp rebound into New Year's Eve. On December 26th the Dow Jones Industrial Average (DJIA) added 1,080 points (4.9%) its biggest points gain in history[4]. An ETF trader could benefit by identifying the trend and trading into the recovery early instead of being forced into an end of day trade with non-exchange traded products.

Factor rotation has played into investors' portfolios, where a heightened allocation to defensive factors such as low volatility and dividend yield continue to outpace flows into growth oriented factors like value and momentum. From the MSCI Factor Index Reports, based on global exposures, low volatility outperformed momentum by almost 8% in the fourth quarter. Low volatility ETFs attracted C$643 million in Canada through 2018[2].

The challenge with factor investing is that the methodologies surrounding security selection, weighting, and portfolio construction can differ across ETF providers as each looks to create a niche in the market. Because of this, factor ETFs will have varying levels of factor concentration which can dictate if they are complimentary holdings or replacements for broad exposures. As an example, the BMO approach, such as BMO Low Volatility Canadian Equity ETF (ticker: ZLB), considers beta across five years with an emphasis on the most recent year, and then looks at interest rate sensitive sector concentration. This strikes an effective balance between factor concentration and broad market exposure.

Active ETFs

The success of the ETF industry has been built on the back of broad based index exposures that track market leading indexes. Of late, perhaps based on the growth rate of the ETF industry, providers and investors have recognized that an ETF is a vehicle that can include different mandates such as active strategies. In Canada, the hurdles of disclosure that greatly concerned active managers has proven to be less of a concern in equities and for bonds, the importance of curve and credit positioning outweigh the impacts of security trading. The active ETF segment has proven successful and is here to stay.

Going forward, just like a mutual fund, the active ETFs will need to prove value by delivering outperformance and differentiating exposures. Market volatility creates opportunity for active managers, both across asset classes and within equity security selection. ETFs have addressed one of the outstanding concerns with active management – the performance hurdle caused by higher fees. Typically, the fees for active ETFs fall between those of passive ETFs and other active investment products. One of the largest impacts of the rise of ETFs, and yet less discussed, has been the impact on fees across other investment products, as funds adjust to a new competitive structure.

A new area of growth has been concentrated equity ETFs. This again speaks to the mix of active and passive within ETFs, as these ETFs step away from the broad diversification message and instead focus on performance via a basket of high conviction investments. BMO SIA Focused North American Equity ETF (ticker: ZFN) and BMO SIA Focused Canadian Equity ETF (ticker: ZFC) are recent launches that have captured investor interest.

On the fixed income side, tactical management is just as important with the expertise of portfolio managers who can adjust curve exposures and move through global credit markets, high yield investments, and emerging market debt to find value. Active managers appreciate volatility across these investments – it provides them with more opportunity to find and capture returns for investors. The correction in markets in the fourth quartile meant that the performance of duration and credit strategies reversed and successful investors repositioned their portfolios. ETFs have provided a great tool for investors to access active strategies in a single trade and at low cost.

Active & Passive

The rise of active ETFs has not meant moving away from passive ETFs. Instead, it has been finding ways to use them together, depending on an investor's view of the efficiency of asset classes and markets, focus on fees, and combined exposures to enhance risk and return profiles. The traditional message of passive ETFs: diversification, low cost, trading efficiency and transparency is as relevant as ever, and these ETFs are the core of the industry, the addition of active ETFs can be seen as complementary.

ETFs are being used more and more with core and satellite investing, a disciplined approach to strategic weightings of broad markets, supported by tactical trading and rotation across non-traditional exposures. Within larger allocations, such as North American equities, a blended approach of a passive ETF and an active strategy has given investors a beneficial blend of low fees and potential outperformance.

2018 has also seen the growth of funds of ETFs, where asset allocation portfolio managers use ETFs to construct low cost solutions. The efficiency of using ETFs allows managers to quickly shift exposures and does not require operational support to trade the underlying asset classes. The growth of these funds is considered one of the primary proof points of the effectiveness of ETFs.

Passive ETFs are relevant as ever, the addition of active ETFs is complementary.

Fixed Income

Investors continue to look to ETFs to access hard-to-reach asset classes such as fixed income which trades over-the-counter. With ETFs, investors can rotate and shift their fixed income exposures easily, trading on the open market, to reflect market sentiment. In 2018, there was a rotation into shorter duration fixed income asset classes, in addition to interest in actively managed fixed income strategies.

A challenge for both ETFs and mutual funds has been as short term interest rates have climbed (including three increases by the Bank of Canada in 2018) and as central banks normalize balance sheets and reduce liquidity, buy and hold fixed income strategies do not have the same outcomes. Investors have become less complacent around fixed income markets, such that guaranteed investments (GICs) have been a cash alternative, providing higher yield than they have in the last few years, combined with investment safety. As an alternative, there has been a trend towards short dated fixed income ETFs, where the enhanced yield from higher corporate bond exposures in the portfolio compensates investors for a low level of price volatility compared to the security of cash. Tactical trading and repositioning within fixed income using ETFs has become a popular strategy.

Despite prevailing opinions, it might be a surprise to some to see that the broad fixed income market, represented by the BMO Aggregate Bond Index ETF (ticker: ZAG) returned positive 1.24% in 2018[4]. Particularly with equity volatility, the importance of fixed income exposure in a portfolio to provide protection, shouldn't be understated, and clearly has a different role than cash investing through a GIC. Fixed income ETFs provide value as asset allocation tools, where an investor can rotate towards specific duration and credit exposures, demonstrated by BMO Long Federal Bond Index ETF (ticker: ZFL) which returned positive 3.24% in 2018[4].

The Path Ahead

ETFs are now a mainstream option but at the same time, while ETFs have surpassed the hedge fund industry, they still lag behind other investment products at near 10% of the assets under management of the mutual fund industry in Canada[5]. The opportunity for growth remains significant as the efficiency, low cost and tradability of ETFs resonates with investors as they adopt ETFs into their portfolios.

The number of providers in Canada has climbed to 33 and the number of ETFs is now over 650[1]. The number of ETFs has become more difficult for investors to navigate, highlighting the increasing importance of working with an established provider that is focused on education and support. The need for investor tools is apparent and is a key theme for 2019 – the rise of ETF analysts and industry tools and databases are working together to help investors research and improve portfolios. As Canadian investors look to ETFs to provide value across global equity markets and segments of the fixed income universe, there is a greater need for clarity between ETFs.

The success of ETFs has caused some to raise capacity concerns, where the size of ETFs has become impactful in narrower asset classes. To counter that concern, while an investor should always have an understanding of the asset class where they are investing, as large trades and directional trading activity is dependent on the ETF's underlying portfolio, the direct trading between investors and capital markets participation enhances the liquidity of the ETF compared to its holdings. As well, ETF managers can choose to sample their indexes in order to best use more liquid holdings. The more difficult to trade asset classes, such as preferred shares and segments of the fixed income market, are areas that most benefit from the emergence of ETFs by improving their capacity relative to their underlying holdings.

> The need for investor tools and databases are helping investors improve portfolios.

The industry expects to increase its growth trajectory, backed by greater adoption by existing users including institutional, advisor and retail platforms. While 2018 did not add assets primarily due to the fourth quarter correction, the expectation is that the ETF industry assets will rebound. The global ETF industry is projected to double to more than US$10 trillion over the next five years, and the Canadian industry to grow even faster to C$400 billion by 2024.

BMO Global Asset Management

[1] ETFGI, December 2018. [2] National Bank, December 2018. [3] BMO Global Asset Management, December 2018 [4] Bloomberg, December 2018. [5] IFIC, December 2018