THE DECADE OF THE EXCHANGE-TRADED FUND

ONCE A PASSIVE, INDEX-TRACKING PRODUCT, ETFs NOW MAKE UP A DIVERSE ARRAY OF INVESTMENT STRATEGIES

BY JADE HEMEON

The burgeoning choices among exchange-traded funds (ETFs) are allowing clients, large and small, easy access to a multitude of financial assets, geographical locations and sophisticated investment strategies that once were the exclusive territory of high net-worth and institutional accounts.

"This decade is, and will be, the decade of the ETF," says Barry Gordon, president and CEO of First Asset Investment Management Inc. in Toronto. "Mutual funds are not going the way of the dodo bird, but the advantages of ETFs are becoming apparent to more investors, including their simplicity, transparency, low cost and liquidity."

Adds Pat Chiefalo, director of ETF research and strategy with National Bank Financial Ltd. in Toronto: "ETFs trade on the stock exchange — they are easy to buy, and they offer exposure to any asset class the investor could possibly want."

The latest innovations in ETFs have moved beyond the passive, index-based investing strategies that characterized the original ETF offerings to include products that offer exposure to varying degrees of active management, ranging from automated, rules-based portfolios to fully active individual securities selection executed by a portfolio manager or team based on specific criteria. The trend is toward increasingly active management packaged within an ETF wrapper.

Canada was a pioneer in the development of ETFs, with AUM now standing at $63 billion

The barrage of ETF products spells opportunity for financial advisors to help their clients assemble suitable portfolios by guiding clients through a marketplace that is rapidly becoming more complex. ETFs can access both developed and emerging markets, as well as a variety of geographical and industry sectors, such as agriculture, real estate, banks and utilities. These products also offer exposure to assets that are not correlated to traditional stock and bond indices, such as currencies and commodities. And some ETFs offer the potential for enhanced returns. In Canada, Horizons BetaPro Bull and Bear ETFs, for example, offer inverse and leveraged exposure to various stock, bond, commodity and volatility indices, allowing clients to capitalize on both upside and downside momentum by amplifying the returns of the underlying index by 200%.

Canada was a pioneer in the development of ETFs; the Toronto Stock Exchange (TSX) began listing Toronto 35 Index Participation units (TIPs) in March 1990, allowing investors to participate in the performance of the TSE 35 composite index without having to buy shares in each company on the index. And while total assets under management (AUM) of Canadian ETFs is still far less than the AUM of Canadian mutual funds, which recently hit $1 trillion, the pace of ETF growth has been impressive in a short time.

As of Jan. 31, 2014, Canadian ETF AUM stood at $63 billion, according to the Canadian ETF Association, 11.5% above the level reached a year earlier, with the growth rate based on a combination of market appreciation and new ETF creations. The number of Canadian ETFs now totals roughly 297, up from just 50 in 2007; 36 new ETFs were listed on the TSX last year.

On a global basis, ETF AUM has grown to US$2.4 trillion, spread among more than 5,000 ETFs — roughly double the asset base of four years ago. The lion's share of ETFs are based in the U.S. These ETFs account for AUM of about $1.7 trillion, while Europe and Asia are the second and third largest markets, respectively.

Canadians can easily access ETFs in other regions, in the same way as they would trade a stock on a foreign stock exchange — and many are doing so, says Chiefalo: "A lot of investors are looking for international exposure, and many want U.S. ETF assets denominated in U.S. dollars. Canada has been out of favour since the interest in commodities trade faded in 2013, and many investors are going south of the border as opposed to buying in Canada."

Although ETFs have captured an impressive share of the Canadian market, last year saw the pace of growth slow compared with the previous year. The value of net new ETF creations was $5.1 billion in 2013, less than half the $11.8 billion created in 2012, according to figures supplied by Toronto-based Investor Economics Inc.

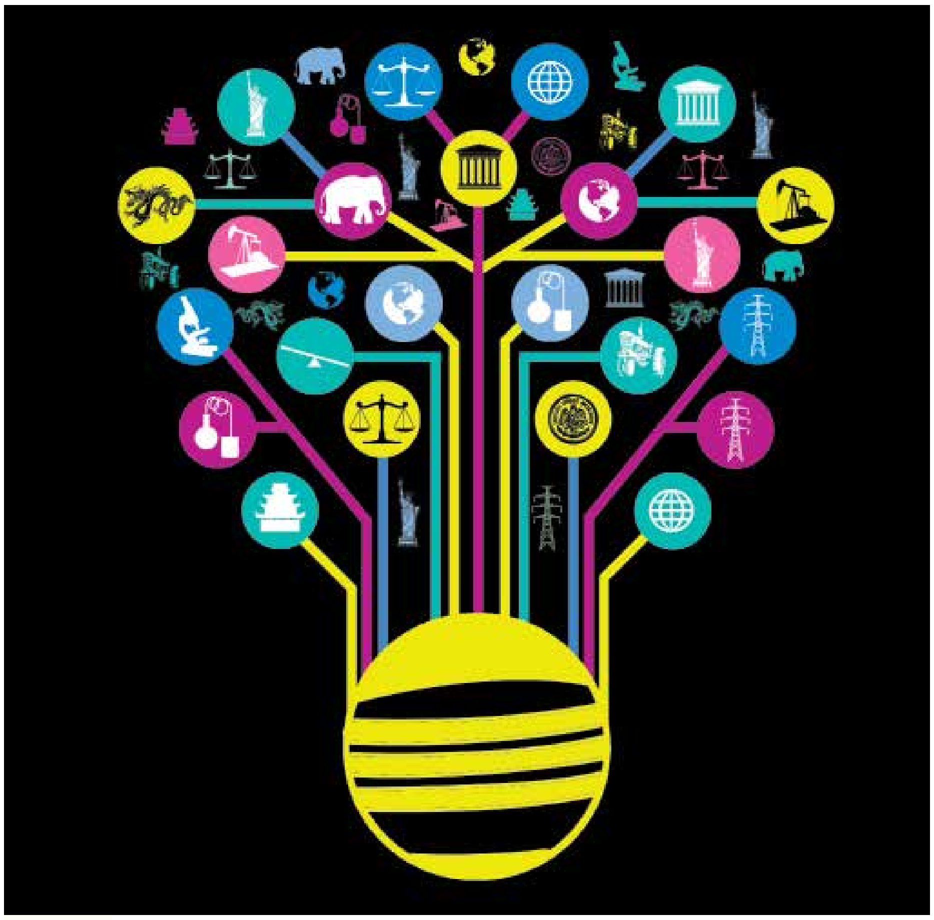
Investors shifted away from fixed-income ETFs last year, nervous about the U.S. Federal Reserve Board's intention to taper its bond-buying stimulus, and warmed up to equity-based ETFs on a relative basis. Equity ETFs accounted for $3.8 billion of new ETF creations in 2013, more than triple the $1.1 billion created in fixed-income. By contrast, of the $11.8 billion in total ETF creations in 2012, $6.2 billion was in fixed-income, with $5.1 billion in equity ETFs.

The original ETFs focused on giving clients exposure to all the stocks contained within a broad market index — such as the S&P/TSX composite or S&P 500 index — with the purchase of a single security. But despite last year's slower growth, ETFs also have made major inroads in the fixed-income category as baby boomers head into retirement. There are ETFs that invest in government, corporate, high-yield, floating-rate and laddered bond portfolios, as well as in convertible bonds and preferred shares. There also are "target date" ETFs that have a predetermined maturity date, much like an actual bond.

About $22 billion, or 37%, of the $63 billion in Canadian ETF AUM is made up of fixed-income products, with $38 billion in equity ETFs and the remaining $3 billion in a mix of commodities, balanced, currency, multi-asset class, inverse and leveraged ETFs. Five years ago, fixed-income made up just 20% of the ETF market, which was then was half the size, at $32 billion.

In Canada, there are nine ETF manufacturers, including Bank of Montreal (BMO) and Royal Bank of Canada. The largest provider is BlackRock Canada Asset Management Ltd.'s iShares division, with ETF AUM of $41.7 billion — about two-thirds of the industry total. Second-largest is BMO, with $12.6 billion; followed by Horizons Exchange Traded Funds Inc., with $4 billion; and Vanguard Investments Canada Inc., with $2 billion.

The largest ETF in Canada is iShares S&P/TSX 60 Index Fund, a broad-based index ETF, with AUM of $12.2 billion and almost 20% of the Canadian ETF market. Canada's biggest seller in 2013 was BMO S&P/TSX Laddered Preferred Share Index ETF, an income-paying ETF that appealed to investors last year because of its attractive yield



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Much of the rising demand for ETFs is coming from dissatisfied mutual fund buyers, as well as from traders of individual stocks

and ability to keep up if market interest rates head upward.

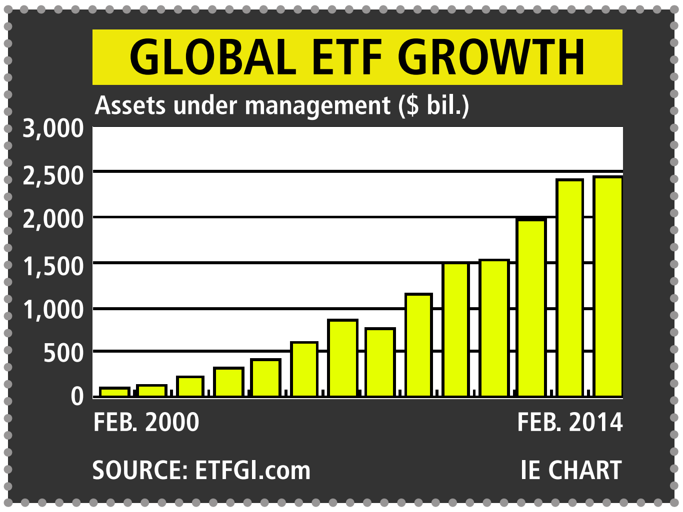
Much of the ETF demand is coming from dissatisfied mutual fund buyers and traders of individual stocks. Low interest rates on bonds and poor equities returns in the wake of the global financial crisis of 2008-09 have caused many investors to question the eroding effects of the fees they are paying for active management on mutual funds, especially when many mutual funds fail to beat market averages over time.

In addition, the management expense ratios (MERs) of ETFs typically are lower than those of mutual funds. Among the low-fee ETF offerings are Horizons S&P/TSX 60 ETF, with its annual MER of only seven basis points (bps), and Vanguard FTSE Canada Index ETF, nine bps.

However, ETF MERs are higher on products that incorporate more complex and active strategies than simply matching an index. For example, Horizons Seasonal Rotation ETF, which is based on a portfolio of stocks, bonds, currencies and commodities that are traded according to changing seasonal trends, has an MER of 75 bps. According to figures from Toronto-based Morningstar Canada, the average Canadian equity mutual fund has an MER of 2%, while the average foreign equity fund charges 2.7%.

Like mutual funds, some ETFs pay trailer fees to advisors that range from 50 bps to 100 bps, which is added to the annual management fee on "advisor class" units. Although the advisor class has encouraged commission-based advisors to use ETFs, the "no trailer" versions work particularly well for fee-based advisors. A fee-based advisor assembling a portfolio for a client using ETFs can add his or her own annual advisor fee of 1% to 1.5% of AUM and still offer the client a reasonable value proposition relative to mutual funds.

Some of the newer incarnations of ETFs are designed to improve index returns by creating a portfolio of underlying investments based on customized selection criteria rather than designed simply to track a traditional index. These more sophisticated ETF strategies — known as "intelligent



indexing," "factor-based" or "smart beta" — differ from traditional, index-based ETFs that base the weighting of securities on their market capitalization.

"Factor-based or smart-beta strategies," says Gordon, "seek to exploit inefficiencies in the traditional capitalization-weighted marketplace and generate a superior return."

The most popular of First Asset's 29 ETFs is First Asset Morningstar Canada Value Index, designed to invest in securities representing "good value," based on characteristics such as low price/earnings and low price/cash flow ratios. As of mid-February 2014, this ETF had a two-year average annual return of 20.5%, which bettered the 12.1% return of the S&P/TSX composite total returns index, thus more than earning its annual MER of 60 bps.

Most smart-beta ETFs use a quantitative approach to manage their underlying portfolios, employing a rules-based, semi-active strategy that automatically screens securities for inclusion and does not rely on the analytical skills or subjective judgment of an active fund manager. Some of these ETFs offer access to fundamental indexing strategies, in which the weighting of individual companies is based on value measurements related to dividend yield, cash flow or earnings. Other smart-beta ETFs are designed to provide access to low-volatility, covered-call or momentum strategies.

"We're seeing quasi-active, factor-based investment strategies being wrapped up in the ETF package," says Chiefalo. "A lot of these new products have been introduced, and they're getting strong take-up from investors."

Although creativity and subjective decision-making may go into the development of a smart-beta ETF's strategy, once the rules are formed, the selection and weighting of securities is automatic. Typically, portfolios are rebalanced on a quarterly basis, then the latest holdings disclosed to investors on the sponsoring company's website. Because these portfolios are not actively managed in the traditional sense, the MERs tend to be lower than those charged by regular mutual funds but higher than those on passive ETFs that are based on a broad market index. This evolution blurs the line between ETFs and mutual funds, but presents more choice for clients.

"There are all kinds of intelligent indexing or smart-beta strategies out there, and each may have its day in the sun," says Howard Atkinson, CEO of Horizons. "We will have to wait and see which strategies can outperform over time."

Only a handful of ETFs in Canada are fully actively managed like a traditional mutual fund, whereby a portfolio manager makes decisions about when to buy and sell particular securities. The active segment of the ETF market is expected to gain traction in the next few years as more portfolio managers currently employed by mutual funds and private money-management firms package their securities-selection skills in the ETF format.

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"For the most part," says Chiefalo, "the low-cost, traditional, index-based product is well entrenched and has carved out the biggest share of the market. The ETF market was built on the plain-vanilla products with low fees. But, increasingly, there is a shift toward searching for incremental return. ETFs are just beginning to tap into active strategies, but eventually we will see more that go all the way to [being] purely active. There are some successful mutual funds out there with potential to put an arm of the fund into an ETF wrapper."

Horizons is the Canadian pioneer in the development of actively managed ETFs. Its entire family of income-oriented ETFs offers fully active management strategies — rather than basing returns on recognized bond indices. This active strategy allows the managers of the ETF portfolios to choose which securities to hold and trade, and to add value by making adjustments when the investing environment changes.

Horizons' suite of actively managed, fixed-income ETFs includes products based on floating-rate bonds, corporate bonds, high-yield bonds and preferred shares. The firm also offers a selection of actively managed ETFs on the equities side, including an emerging-markets dividend ETF, a Canadian dividend ETF and a global dividend ETF, all offering the stock-picking skills of Toronto-based Guardian Capital LP as money manager within the ETF structure. Also part of the Horizons ETF family are a variety of actively managed covered-call ETFs and alternative-strategy ETFs employing hedging techniques.

"When you're not just blindly following the index, there is an opportunity to add some alpha or outperform," Atkinson says. "The difficulty of duplicating an index — particularly in some illiquid, fixed-income markets where there is no central exchange — is that some names are not easily tradable, especially if you're buying in size."

The portfolio managers of actively managed ETFs can enjoy the same freedom in choosing their strategies as mutual fund managers do — including holding a high level of cash if markets appear to be overvalued. The goal is to outperform market indices by the portfolio managers making their own decisions on the inclusion of individual securities, their weightings and the timing of trades, rather than merely track an index or adhere to a fixed set of rules.

"Over the next few years," Atkinson says, "we will see more asset-management firms make the services of their high-profile [portfolio] managers available through ETFs along with their existing stable of funds to address different avenues of distribution." •