ETFs

Exchange-traded funds 2020: where they are, where they're going

Without a lot of fanfare, 2018 heralded a sea of change in Canadian investing – for the first time in more than a decade, exchange-traded funds (ETFs) outsold traditional mutual funds among retail investors.

That trend continued through 2019 and into 2020, with an astonishing $34-billion flowing into ETFs this year, as of October 31, 2020. This is despite the Canadian economy coming to a screeching halt with the first pandemic shutdown, and market volatility reflecting the global uncertainty about what COVID-19 meant for our collective future.

As the markets have acclimated to the new normal, the growing presence of ETFs in retail investor portfolios has shown no signs of slowing, says Pat Dunwoody, executive director of the Canadian ETF Association (CETFA). "Initially, ETF investments were largely made by institutions; today, ETFs are the investment vehicle of choice for retail investors as well," she notes.

Canadian-listed ETF assets have continued to reach new all-time highs, with assets of more than $232-billion, at the end of October 2020.

The industry has been growing alongside an exponential expansion of ETF product selection.

"It's been exciting to watch the industry grow in this regard," says Steve Hawkins, chair of CETFA and CEO of Horizons ETFs Management (Canada) Inc. (Horizons ETFs).

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On Canada's exchanges, ETFs are making up a larger stake of daily trading activity, says Mr. Hawkins. "Canadian investors today are being empowered by technology, and they're taking the time to learn how to invest. And ETFs are their tool of choice in this regard."

With near-zero interest rates making it challenging to stay ahead of inflation with Canadian fixed income investments, more investment dollars are flowing into equity ETFs this year, he says. "Last year, 55 cents of every dollar that went into ETFs went into a fixed income product. We've seen a reversal this year, and I think it's a trend that won't be going away any time soon."

Major changes in the global ETF markets include the growth of synthetic ETFs in Europe and active ETFs in the U.S. — trends that were already well established in Canada.

"Within the Canadian regulatory system, we were able to launch our first active ETF over 11 years ago; the same structure has only recently become possible in the U.S.," says Mr. Hawkins. "We're seeing more and more active ETFs joining the marketplace here in Canada. I believe asset allocation has changed, and investors are looking for opportunities to rotate their assets in and out of different themes. This is where active ETFs really have an opportunity to grow; they make up the majority of new ETFs being launched in Canada, another trend I believe will continue."

Horizons ETFs introduced the first synthetic ETF in Canada just over 10 years ago.

"BlackRock is now looking to launch a synthetic ETF in Europe; Invesco already has a large synthetic ETF presence there. We have also seen continuing growth in synthetic ETFs in the U.S.," reports Mr. Hawkins. "We're very happy to see this global validation of the structure."

All this product selection means that, as always, investors can't overlook their obligations to know what they're investing in, says Ms. Dunwoody. "As with all investments, it starts with the investor or investor and adviser identifying what's needed in the portfolio and then choosing the best assets to fulfill those objectives."

As an asset class, ETFs are expected to continue to grow because of their primary investor advantage – fees that started low and have fallen even further with increased competition among providers.

"ETFs provide exposure to almost every single asset class and sector that mutual funds do. If you can own the same underlying securities for a lower fee, it will have a significant impact on your long-term returns," says Mr. Hawkins.

RETIREMENT PLANNING, PANDEMIC STYLE

Baby boomers are tired of being called baby boomers. They're stuck in a pandemic, often away from their grandchildren, the economy is precarious, and interest rates have never been lower. Is there any good news on the horizon for Canadians wondering how to make their savings outlast their lifespan?

"As dire as things can look from day to day, the future is still quite bright," says Michael Cooke, vice-chair of the board of the Canadian ETF Association (CETFA) and head of Exchange Traded Funds for Mackenzie Investments. "We will get through this. The economy is on a much better footing than it was at the depths of the 2008 financial crisis, for example. The banking system is much healthier. Debt levels are not what they were then."

Although future return expectations are different than they've been in the past, investors can now access opportunities that were only available to large institutional investors until recently, he says. "ETFs have levelled the playing field. We've seen a proliferation of multi-asset products, variations on the balanced fund theme, where a portfolio might be actively managed in terms of asset allocation but be comprised of ETFs."

To achieve their objectives, investors need to overcome their bias for the familiar Canadian markets and consider international equity and fixed income investment, says Mr. Cooke. "There is a growing list of Canadian-listed emerging market debt ETFs, for example, with yields several times higher than in most developed markets. There's a greater associated risk in some cases, but if you are taking proper measures to diversify a portfolio, you can still achieve your objectives.

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A World Economic Forum report found that Canadians are expected to outlast their savings by 10 years. ETFs can help to fill the gap. **ISTOCK.COM**

"Diversification benefits, liquidity, cost-effectiveness and transparency make ETFs a very efficient way to build a well-diversified portfolio, inclusive of asset classes and geographies beyond Canada's borders," he says.

"The challenge of having enough to live on has been exacerbated in the low-interest environment that we have today," says Kathleen Bock, managing director and head of Vanguard Investments Canada. "A report last year by the World Economic Forum found that Canadians are expected to outlast their savings by 10 years."

In other words, help is needed.

Vanguard launched its first ETF retirement income portfolio product in September, comprised of eight underlying Vanguard ETFs, totalling 29,000 securities. At 0.29 per cent, the management fee is about one-third that of the average mutual fund income product.

"We're leading with some of the needs of investors that became clear through our research. For retirees in particular, we thought that an all-in-one solution made a ton of sense," says Ms. Bock. "It's diversified and we're managing the asset allocation."

Asset allocation ETFs have attracted about $4.5-billion in just the last two years, she stresses. "They're often used by retail investors, but we also see a lot of advisers using these asset allocation ETFs. Increasingly, they're adopting these scalable, simple solutions that are available at an attractive price point. Then they can spend their time building trust and understanding with clients and focus on behavioural coaching to build wealth."

NEW TO ETF INVESTING? HERE IS A PRIMER BASED ON QUESTIONS WE ASKED THE CANADIAN EXCHANGE TRADED FUND ASSOCIATION

WHAT IS A "SYNTHETIC ETF"?

Let's start with what a regular exchange traded fund is: a collection of assets (generally stocks or bonds or both) that replicate the performance of an index. This collection is divided into **units** that are bought and sold on stock exchanges. If the value of the index goes up, the value of the ETF goes up.

What's an **index**, you ask? It is a hypothetical collection of assets used to measure the performance of a stock exchange or a segment of that exchange. The most well-known indexes are the **S&P 500** – 500 stocks that are felt to best represent the broad American economy – and the **Dow Jones Industrial Average** – 30 stocks that are felt to best represent the U.S.'s largest companies.

A synthetic ETF is designed to track an index in the same way regular ETFs do, but instead of holding the assets themselves, it holds derivatives. (**Derivatives** are agreements between two parties that are valued based on the performance of other assets.)

One advantage is that a synthetic fund can more closely replicate the value of the underlying index, because they avoid the logistical challenges of buying and selling the appropriate assets needed to track an index. This also translates into an investor tax advantage; because no stocks or bonds are bought or sold, there is little or no taxable activity except when investors sell their units.

The offsetting risks are related to the use of derivatives: can all parties be counted on to fulfill their obligations?

WHAT IS A "CORE ETF"?

If you think in pantry or wardrobe terms, these are your basics. Core ETFs are designed to give investors access to the kinds of assets that will serve their primary investment needs over the longer term, such as saving for retirement.

Other terms used in relation to core ETFs are "core" and "satellite," where core investments make up the bulk of the portfolio and satellite ETFs are purchased to participate in segments of the markets an investor believes may perform better than the core markets. (And is aware that this focus comes with higher risks as well as higher potential returns.)

WHAT IS A "FACTOR" OR "ACTIVE" ETF?

The earliest ETFs became wildly popular because they tracked an index versus paying human money managers to choose individual investments. The advantage was all the diversification without the cost of the impressive salaries and bonuses money managers pull down.

With technological progress, however, it became possible to offer many of the advantages of professional stock-picking without the professionals. Using pre-set algorithms or formulas, these funds aim to replicate the performance of investment professionals in specific sectors, without the errors associated with human emotion and at a much lower cost.

WHAT IS AN ASSET ALLOCATION ETF?

A typical **diversified portfolio** will include a wide variety of stocks and bonds across many markets and sectors. An asset allocation ETF (also sometimes known as **all-in-one or single ticket** ETFs) is designed to serve as a whole-portfolio solution.

OK, GOT IT. HOW DO I INVEST IN ETFS?

ETFs are sold on stock exchanges, so investors must have an account that gives them access to the exchanges. This may be with a traditional brokerage firm, a discount brokerage firm, or one of the many new **robo-adviser** firms, where investor support is provided using a mix of technology and human expertise.

"An investor can access all ETFs with the same ease – it really depends on how much time they have to investigate the products and what their needs and risk tolerance are," says Pat Dunwoody, executive director of the Canadian Exchange Traded Fund Association.

WHAT ARE SOME OF THE PRIMARY CONSIDERATIONS WHEN DECIDING BETWEEN DIFFERENT PRODUCT OPTIONS?

According to Ms. Dunwoody, everything that applies to investing in other types of investments applies here too. "An adviser or self-directed investor must start with their need – what they want in their portfolio – and then match that need with the best product. It may be easier to do this with ETFs because of their transparency (the ability of investors to see what is actually in the fund portfolio) – but the questions are the same.

WHAT ARE THE PRIMARY ADVANTAGES OF ETFS?

Transparency, cost and liquidity, says Ms. Dunwoody. "It is easy to know exactly what you are invested in, the cost of diversification is very low compared to other investment funds, and, for those investors who prefer to buy and sell their investments more often, it is easier to do so.

cetfa Canadian ETF Association

The mandate of the Canadian ETF Association (CETFA) is to support the growth, sustainability and integrity of Canada's ETF industry. CETFA aims to provide greater depth of ETF education to advisers and investors about their usage, to deal with industry-specific issues, whether regulatory or structural, that affect all member firms and to create broader awareness about ETFs outside the industry.