BMO Global Asset Management ETF Outlook 2016

Mid-Year Update

The exchange traded fund (ETF) industry has continued to capture investor interest and add record breaking inflows as investors use ETFs both as long term holdings in their portfolios and as trading tools to manage through market events.

Market volatility has consistently caused a spike in ETF volume as a percentage of exchanged traded activity and 2016 has been no exception. The surprise Brexit vote, where the U.K. voted on June 23rd to leave the Eurozone, caused the largest trading event for London listed ETFs, which recorded their highest value trading day ever. As well, in London ETFs were popular tools to position portfolios in front of Brexit, as the value traded in June was 88% higher than the same month last year.[1] This reflects the value to be found in ETFs, namely a highly efficient, single-ticket solution to move between markets and asset classes. These benefits are particularly valuable in harder to trade asset classes such as fixed income. ETFs are now considered to be a leading market indicator in terms of investor confidence and asset flows as investors have recognized their benefits in repositioning portfolios.

ETFs are now considered to be a leading market indicator

Market uncertainty, and continued downward revisions on global growth expectations, has dovetailed investor demand with the growing choice in smart beta ETFs. As investors look for more defensive factor exposures, equity ETFs focused on income, quality, and low volatility—and ETFs that combine these factors—are capturing increased market inflows.

As well, global events have caused scrutiny on currency exposures, where local market returns and currency returns have been significantly decoupled. The expansion of ETFs offering currency hedged and unhedged exposure has given investors effective tools to manage currency within their portfolios.

In fixed income, global events continue to push off central bank activity despite consistent indications that interest rates will rise, resulting in strong performance across full market and longer term bond ETFs. Immediately following the Brexit vote, we saw a rotation to safety, towards government bonds and longer duration. Following longer term trends, we are seeing a bias towards investment grade exposures, both globally and within local markets, where ETFs that target precise maturity bands, such as short-term, mid-term, and long-term, are providing benefits to investors to act on their market views.

The increased scrutiny on fees has played to the benefits of ETFs

The increased scrutiny on fees has played to the benefits of ETFs, both as efficient, diversified portfolio building blocks and as low cost long term holdings. As jurisdictions around the world either outright ban embedded trailer fees, such as in Australia and the U.K., or increase disclosure requirements, such as Client Relationship Model 2 (CRM2) in Canada, investor awareness and media attention around low cost ETFs has only multiplied.

This outlook report examines the first half of the year and looks forward to anticipate key industry developments over the remainder of 2016.

Global Trends

The global ETF market continues to grow, hitting a record high of US$3.2 trillion as of June 2016, with over US$122 billion in new assets this year. With the uncertainty surrounding the global economic landscape, ETFs prove to be effective positioning tools with more investors looking to take advantage of short term market movements through ETFs.[2]

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The U.S. ETF market now stands at US$2.3 trillion in assets, showing slower growth than previous years as equity ETFs have seen year to date outflows of US$2.6 billion. Fixed income ETFs in the U.S. however, are on pace to surpass last year's flows gathering over US$44 billion in the first six months of this year. The European market has also had a slower start to the year, with year to date inflows of just over US$22 billion and total assets reaching US$529 billion. The Asia Pacific market has had a strong first half of the year with year to date inflows of US$11 billion and the total ETF market surpassing US$123 billion.[2]

The Canadian ETF industry has crossed the C$100 billion milestone, doubling in less than four years and is on track for another historic year with C$10.6 billion inflows year to date. Equity ETFs added C$5.8 billion in inflows, as investors increased their Canadian and U.S. exposures. Fixed income ETFs continued to attract investor interest, accumulating over C$4.6 billion in inflows.[2]

The Canadian equity ETF with the most inflows year to date is BMO US Dividend ETF (Ticker: ZDY), as investors looked to the strength of the U.S. market, followed by BMO Low Volatility Canadian Equity ETF (Ticker: ZLB) capitalizing on the rebound in Canadian equities. These ETFs demonstrate that investors are gravitating towards risk reduction strategies with lower risk than the broad market.[2]

The Canadian fixed income ETF with the highest inflows year to date is BMO Aggregate Bond Index ETF (Ticker: ZAG), further demonstrating that investors recognize the diversification and liquidity benefits of using ETFs for fixed income exposures. In the low yield environment, the low fees of fixed income ETFs help investors maintain their net income.[2]

Market Volatility and ETFs

Events around the world have continued to keep volatility at the forefront of investor's concerns. The Brexit vote caused over a 10% fall in U.K. equities over the next two trading days, once the currency impact to Canadian and U.S. Dollars is factored in. Earlier in the year, in Canada, market confidence was approaching a low with the precipitous drop in oil, bottoming out to US$26.21 per barrel on February 11th. While markets have since rebounded based on strong U.S. economic data, the uneven path over the course of the year has given investors a rough ride. The benefits of risk adjusted exposures have only become more appealing.[1]

Investors use ETFs to address volatility by moving to smart beta exposures

Investors use ETFs to address volatility by moving to smart beta exposures that have lower risk than the broad market. Low volatility strategies, investable more recently as ETFs, have proven to deliver returns in excess of the market over the long term, based on staying away from high risk investments, mitigating market downturns, and thereby benefitting from compounding returns. Income based ETFs

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cushion investors from market turbulence, by increasing the dividends from the portfolio and biasing the portfolio towards mature, industry leading companies. Quality ETFs also lower risk by selecting industry leading companies that are positioned to withstand downturns, while at the same time providing growth when markets accelerate.

Recognizing the trading efficiency of ETFs, particularly in more difficult-to-trade asset classes, institutional and retail investors are using ETFs as liquidity tools, rather than trading the underlying securities.

As ETFs mature, more of the trading activity occurs on the secondary market, between buyers and sellers on the exchange. Trading activity on the exchange that balances buyers and sellers does not affect the underlying portfolio. As an added benefit, mature ETFs can develop better liquidity than their underlying asset classes.

In addition, ETF portfolio construction typically lowers risk relative to other products. By investing in a diversified portfolio of securities ETFs aim to provide exposure to a market, not just to a subset of securities.

Capturing Yield

Income oriented investors continue to have a difficult time generating enough yield from their portfolios. Despite expectations of rising rates reaching back to 2009, central bank bond buying programs and investor uncertainty has led to persistently low interest rates. As of June 30th, German and Japanese 10 year bonds offered negative yields, with Canadian and U.S. equivalents at 1.06% and 1.47% respectively[1]. Investors are selecting ETFs that offer higher yielding fixed income segments, increased equity dividends from smart beta income and quality factor portfolios, and specialty ETFs to support cash flow requirements. The efficiency of trading in liquid, diversified ETFs makes accessing these strategies easier than ever before.

Sector ETFs

We have also seen heightened inflows into sector specific ETFs. This has reflected the divergent return trends in the underlying sectors and also investor approaches to the market. Resource sectors have enjoyed a bounce back year allowing investors to capture market growth. Conversely, defensive sectors, such as consumer stocks and utilities, have helped concerned investors keep equity exposure while reducing risk profiles.

After oil struggled through 2015, and fell as far as US$26.21 per barrel on February 11th, oil has bounced back and has since risen by 84% to US$48.33 per barrel on June 30th. As a flight to safety, gold has also had a strong performance, up almost 25% year to date to US$1322 per ounce as of June 30th.[1]

We have seen investors migrate away from single security holdings, with associated concentration risks, to sector based ETFs that offer a diversified exposure in a single ticket solution. Global sector ETFs provide further investment benefits by providing a combination of global exposure with sector precision. Within local markets, equal weight smart beta ETFs further address market concentration, particularly in sectors dominated by leading companies.

Fixed Income

Like equities, market volatility has led to increased activity in fixed income ETFs. Post Brexit, we saw immediate inflows into full term and long term government bonds. Interest rate curve and credit positioning has become more important in portfolio construction as investors look for yield and solutions to position around market events. The ETF industry, while traditionally offering broad exposure bond ETFs, has added more precise exposures, slicing the credit spectrum and segmenting by maturity to create short-term, mid-term, and long-term exposures.

As well, fixed income ETFs have been developed to meet market demand for both global fixed income and country specific portfolios. With divergent economic growth expectations across countries, and yields remaining at low levels, investors are much more focused on investing in ETFs that provide the desired exposure.

We expect the growth of fixed income ETFs to outpace equity ETFs

We expect the growth of fixed income ETFs to outpace equity ETFs as investors, from large institutions through to individual investors, have difficulty sourcing and trading bonds. While the liquidity of the ETFs is tied to the underlying asset class, exchange trading between buyers and sellers of mature ETFs adds an effective layer of liquidity.

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Impact of Currency

Unlike 2015, where the U.S. dollar appreciated against most major trading currencies based on relative economic strength and expected interest rate increases, 2016 has seen higher currency volatility, and multiple reverses of currency momentum. The Canadian Dollar went below US$0.69 in January, based on energy pessimism, rebounded to almost US$0.80 in May, and settled back to over US$0.77 at June 30th. We saw Brexit weaken the British Pound by over ten percent, and cause the U.S. Dollar to strengthen against most currencies as a flight to safety. Investors have needed to be nimble, both from a strategic economic view, and from a shorter term tactical view when considering currency exposure.[1]

ETFs are excellent tools to address currency exposure. With both hedged and unhedged ETFs available, investors can easily switch currency exposures while maintaining or shifting underlying portfolio exposures with a simple trade. Following Brexit, we saw the most immediate trading occur in favour of hedged international ETFs.

The Opportunities Ahead

We have seen the number of providers continue to expand over the past 18 months, globally from 239 to 284, in Canada from 9 at year end 2014 to 16 as of June 2016. As well, the number of ETFs has risen by 15% globally and 23% in Canada. The jump in both providers and number of ETFs puts increasing emphasis on innovation, to create products that stand out in the marketplace. Investors benefit by having more choice than ever before; to target portfolio risk exposures, to precisely position fixed income, and build diversified, efficient portfolios that focus on ETFs.[2]

In Canada, we expect the value traded on ETFs to double over the next few years, and to approach the U.S. levels, which are typically between 20% to 30% of the value traded.[1] We expect that ETFs will grow to a consistently higher level of total exchange traded value, as ETFs successfully help investors navigate through events, demonstrating their value as highly effective positioning tools.

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[1] Bloomberg - June 30th, 2016

[2] ETFGI Global Insights – June 30th, 2016

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