ALL GROWN UP

By Martha Porado

Exchange-traded funds have evolved significantly from the days when they were largely index-based products and are now facing a future where they'll likely be more complex, diverse and subject to endless potential for customization

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In the wake of the tragic shooting at a high school in Parkland, Fla., earlier this year that left 17 dead and sparked a renewed and vigorous debate about gun control, certain members of the investment world took swift action.

BlackRock Inc., the world's largest institutional investor with US$6.3 trillion under management as of the end of 2017, found itself in the spotlight over the fact that, through its funds based on third-party indexes, it's technically the world's largest owner of stock in firearms manufacturers.

Just 16 days after the Parkland shooting, the company released a statement highlighting the fact that such companies made up 0.01 per cent of its overall holdings. It also noted it doesn't hold any of the three publicly traded U.S. companies with a core business in gun manufacturing — American Outdoor Brands Corp., Vista Outdoor Inc. and Sturm, Ruger & Co. — in its actively managed funds.

In a direct response to investor sentiment, the company announced it would be exploring ideas for funds that would eliminate exposure to gun manufacturers and major gun retailers, putting companies like Walmart Inc. and Dick's Sporting Goods Inc. in the hot seat.

"Given the situation, it's definitely hit an important area for a lot of people . . . so it certainly created its own urgency," says Pat Chiefalo, managing director and head of iShares Canada at BlackRock.

BlackRock's speedy nod to divestment from gun exposure reflected how much interest the company was seeing around the issue. "This was top of mind for a lot of different investors, and so we felt like it was critical for us to move in that direction as quickly as we can to ensure that they can express those views as quickly as they wanted to," says Chiefalo.

Access granted

Firearms are just one example of how ETFs are becoming less of a broad buy-and-hold passive strategy and more of an active play. With so many choices on the market, selecting a basket of ETFs has become a lot more like selecting individual securities, says Zev Frishman, chief investment officer of Morneau Shepell Asset and Risk Management Ltd.

"This is really history. Today, you can get very, very sophisticated and complex strategies through ETFs," he says.

While the selection process involves a certain amount of effort, pension plans have the opportunity to use ETFs to gain exposure to virtually any industry, strategy or geographical area, he says. It's also possible to tailor the decisions they make to their views, he adds.

"If you believe interest rates are going to rise, you can buy a short-bond index for very low fees. You can buy a corporate bond index. If you're a little bit more brave, you can buy either a Canadian or U.S. or global high-yield portfolio, and you can buy it hedged or not hedged, currency-wise," says Frishman.

Traditionally muzzled by the challenge of performing adequate research to make prudent choices in publicly traded securities in a broad range of countries, an ETF likely exists that can expose a smaller pension plan to virtually any locality, he notes.

"You can buy ETFs based on their country indexes. So if you want to be really aggressive, and your valuation models show you that . . . Russia, Turkey, Brazil now have among the cheapest markets in the world and you think that they will mean-revert some time, you can get these countries' ETFs instead of worrying about the custody for emerging market stocks and trading them, which for most people will be quite complex," says Frishman.

The further from home a market is, the more likely the need to perform intensified research will slow down a pension plan's attempt to access an opportunity, says Scott Anderson, vice-president of retirement at Hub International Ltd. "Domestic managers have trouble picking good foreign stocks. It's hard enough to pick good domestic stocks. So I think the index gives you some insulation from having to do that. Then, you don't have to be this stock picker and have the perfect timing," he says.

In their efforts to diversify by seeking broader geographical exposure, however, pension plans should be careful about getting swept up in the bigger menu of options and investing in new areas simply because they can, he says. It's still important to grasp the nature of the underlying securities in an ETF thoroughly and have a strategy through which exposure to a foreign market is playing a distinct role.

For example, a pension plan may seek exposure to emerging-market debt if it believes emerging-market currencies are broadly undervalued, says Frishman. Using an ETF that gives exposure to that debt, without going through the complexities of trading securities in a wide range of countries, could result in a boon if the thesis is correct and rising currencies boost the ultimate value of the investment.

Even for the largest pension funds, ETFs are still a very efficient option when it comes to seeking access to emerging markets, says Jim Keohane, president and chief executive officer of the Healthcare of Ontario Pension Plan. While HOOPP doesn't make much use of ETFs, they make sense for emerging markets, he says, since "it's just too difficult, from a technical point of view, to actually execute in all those markets."

As for specific sectors, Dino Vivaina, vice-president and director of TD Asset Management Inc., agrees that ETFs are a way for smaller plans to seek a level of customization they wouldn't have the resources to access otherwise. "Really, you're piggybacking off the infrastructure of some of the larger firms that are providing that exposure," he says.

"There are many issuers that are coming to the market with thematic products, like blockchain and artificial intelligence," he adds, noting that while smaller players can choose to get into those areas if they want, there's a certain amount of noise coming from the plethora of themes to choose from.

"For a smaller plan, you need more due diligence, you need more review. There's a lot to choose from. Larger clients aren't getting sucked into all that noise."

Getting granular

In implementing specific factors, even some of the largest pension plans are using ETFs, in particular as part of their responsible investment strategies. For example, the Ontario Municipal Employees Retirement System made a $100-million initial investment following the launch of the RBC Vision Women's Leadership MSCI Canada Index ETF on International Women's Day on March 8, 2018.

Such offerings show how ETFs can no longer be broadly described as a passive strategy, according to Frishman. Looking at such a specific, factor-tilt investment, "it has no resemblance really to the broad market," he says.

Unless a pension plan is holding a pure index fund, ETFs in today's market represent an active strategy, he says. "Some stocks, which perhaps were value stocks yesterday, are becoming tomorrow's growth stocks. Low-volatility stocks may become high-volatility stocks, so the portfolio changes. It's not passive whatsoever. It's just not run by a traditional investment manager that uses the traditional fundamental analysis tools. It is run by a model that decides what are the factors that are going to drive the performance of the stocks in the future? And let's tilt it towards those factors."

There are, of course, many factors to consider when it comes to responsible investing. "The beauty of ETFs is that they're flexible, so you can do things depending on what the circumstances dictate," says Hugh O'Reilly, president and chief executive officer of the OPSEU Pension Trust.

In November 2017, OPTrust announced it was divesting from publicly traded tobacco companies. ETFs, says O'Reilly, are one way it can easily screen out undesirable stocks. "As an almost-always rule, our approach with responsible investing is to engage with the companies. . . . But our view on tobacco is, the drug addicts you, kills you or makes you sick — that's it. We think, over time, that liability curve is not going in the right direction."

Tip me over and pour me out

Another aspect of ETFs that has been allowing access to specific strategies is their liquidity, says Frishman. A particular strategy might require significant assistance from outside managers; however, in the time it would take to conduct the appropriate due diligence to find them, the market may have shifted and the initial opportunity the analysis identified could be gone, he says. An ETF can solve that problem by allowing a plan to establish a tactical position very quickly.

ETFs can inject liquidity into just about any segment of the portfolio, says Bobby Eng, vice-president and head of business development in Canada for State Street Global Advisors' SPDR ETF business. "We're noticing this quite heavily," he notes, citing the example of fixed-income strategies. While fixed income is normally a less liquid segment, maintaining an allocation to ETFs within the broader allocation to that area would increase options to use strategies that would require the plan to act quickly to capture any upsides.

"It enables the portfolio management team to manage cash flow, to get in and get out, take advantage of swings in the marketplace and not have to disrupt their underlying holdings," says Eng.

Boosting overall liquidity in a portfolio could be attractive as investors become wary of potential volatility after the February sell-off and partial rebound, says O'Reilly. He offers a word of caution, however. The nimbleness ETFs can provide through their liquidity makes them useful, but pension plans should be careful not to trip themselves by moving too fast and neglecting to be thorough in their due diligence, he suggests.

Cheap as chips

Another advantage of ETFs is their low cost, relative to the fees investors might rack up through other strategies that would get them the same exposure.

The low costs mean institutional investors can't ignore them, says Philip Falls, a partner at PBI Actuarial Consultants Ltd. "ETFs have created a situation where they have reminded [institutional investors], because they have been continuously reducing their fees on average, that they can get a lot lower fees."

Indeed, the relative cheapness of ETFs has led to, and may still increase, downward pressure on the fees managers of other assets can justify, he says.

Anderson agrees, suggesting that the additional appeal of long-term, stable returns from broad-based index funds creates a tangible advantage for ETFs over other more actively managed investments.

"Fund managers, to put it bluntly, have times when they outperform an index or an ETF in the short term, but over the long term, they just don't seem to be able to manually outperform," he says.

As a result, ETFs are likely going to continue to muscle in on other collective investment vehicles like actively managed pooled funds, says Anderson. "I'm getting an outperformance, and I'm getting a lower fee. When you combine those two things over the long run, it makes a monumental difference to the returns."

TRACKING THE WORLDWIDE GROWTH OF ETFS

Year	Assets
2008:	US$0.7 trillion
2009:	US$1.1 trillion
2010:	US$1.3 trillion
2011:	US$1.4 trillion
2012:	US$1.8 trillion
2013:	US$2.2 trillion
2014:	US$2.6 trillion
2015:	US$2.8 trillion
2016:	US$3.4 trillion
2017:	US$4.7 trillion
2018:	US$5.4 trillion*
2019:	US$6.4 trillion*
2020:	US$7.6 trillion*

* Projected figures

Source: Morningstar Inc.

> ***“Although achieving alpha in certain market environments can be challenging in high yield, those who believe they can capture the market beta through ETFs might be disappointed.***

Investors should, however, also keep an eye on the total cost of ETF ownership and go beyond looking only at the management expense ratio, according to Eng. In addition to the expense ratio, investors should look at bid/ask spreads and transaction costs that add to the total outlay. “And looking at the total cost of owning that particular product over the time period is important,” he says, suggesting investors should also evaluate an ETF provider to ensure it has a long track record of success.

Sophisticated strategies

Beyond the face value of an ETF as an investment vehicle, there are alternative ways to use them, especially on the fixed-income side of a portfolio. One case study, authored by Bill Ahmuty, vice-president and head of State Street’s SPDR ETF fixed-income group, and a colleague, Colin Ireland, demonstrates a way to take advantage of the relationship between fixed-income ETFs and their underlying securities.

“If a large institutional client has several hundred or maybe even 1,000 bonds in their inventory, they can effectively deliver those bonds back to us as an ETF provider through an authorized participant or market maker, which is an institutional trader, in exchange for units of a particular ETF,” says Eng.

The strategy can be useful when an investor is looking to change money managers. Consolidating the investments into the ETF makes them easier to hold during the transition process, thus allowing the investor to maintain its fixed-income exposure during its manager search. Once it establishes a new relationship, it can convert the ETF shares back into the underlying securities and hold the bonds that way, if it prefers.

Investors can also profit from such bundling and unbundling in another way. If an investor is looking to buy specific securities found in an ETF, it can purchase it and untangle the underlying holdings through a process called in-kind creation and redemption.

Investors can seek further profit from the exercise if traders take advantage of an ETF share being cheaper than the net asset value of the underlying securities. Bid/ask spreads for fixed-income ETFs tend to be much tighter than for the securities underlying them, the case study noted, and by deconstructing the shares, traders can then sell the resulting individual holdings at a profit.

While that may be a rather complex strategy for many investors to undertake, it does illustrate some of the new income-generating possibilities from ETFs.

If, however, an investor is intending to hold fixed-income ETFs, another factor that could give investors pause is the extent to which bond ETFs can mirror the behaviour of bond indexes in full. As a paper by Daniel Natale, a U.S.-based fixed-income researcher at Mercer, noted, U.S. corporate high-yield bond ETFs have consistently performed differently from the broader market.

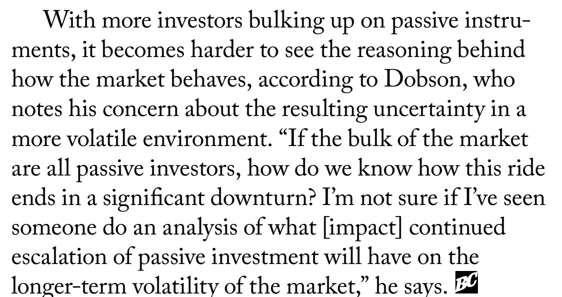
Due to the large number of issuers listed in a given bond index and liquidity limitations, bond ETFs “cannot achieve full index replication,” the paper noted. It’s especially difficult for high-yield bond ETFs, which can move particularly fast in terms of both price and market composition, to replicate the index during moments of higher volatility, according to the paper.

Because of those difficulties, an active approach may be better for that segment of the market, Natale suggested. “Although achieving alpha in certain market environments can be challenging in high yield, those who believe they can capture the market beta through ETFs might be disappointed.”

Skeptics of the trend towards passive investing more generally include Derek Dobson, chief executive officer and plan manager of the Colleges of Applied Arts and Technology pension plan. His concerns include questions about what may happen if, as he puts it, the trend towards passive investments through ETFs and other mechanisms continues. “My question is, which I’ve not received a satisfactory answer to, if there are no people doing fundamental research on the sustainability of the businesses underlying those equities, how is the market going to behave in a downturn overall?”

When bundled together, there may be less scrutiny of any particular business underlying an equity within an ETF, Dobson notes. “Who’s making the call on whether Company A is sustainable or not? And what happens when Company A fails? Is there some sort of domino effect where we don’t know where the end is?”

With more investors bulking up on passive instruments, it becomes harder to see the reasoning behind how the market behaves, according to Dobson, who notes his concern about the resulting uncertainty in a more volatile environment. “If the bulk of the market are all passive investors, how do we know how this ride ends in a significant downturn? I’m not sure if I’ve seen someone do an analysis of what [impact] continued escalation of passive investment will have on the longer-term volatility of the market,” he says.



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