ETFS 3.0

The Canadian ETF industry has come a long way from its humble beginnings in 1990. Although our neighbours to the south typically choose 1993 as the year ETFs began, we know better up here in Canada: the Toronto Stock Exchange launched the world's very first ETF in March 1990, which at the time tracked the TIPS-35 Index. And even though we are quickly approaching the quarter-century milestone for ETFs in Canada, it could be argued that these are still early days. On a global basis, less than 5% of the world's equity markets are invested using ETFs, while for fixed income, barely 1% of the global bond market is invested using ETFs. Today, innovation in ETFs continues and the industry is evolving as quickly as ever.

There are three distinct phases, or "eras," in the evolution of ETFs. While these phases are not in exact chronological order, the ETFs that exist in today's market can generally be attributed to at least one of them. And, as adoption rates changed and investment professionals began integrating ETFs into client portfolios at a greater rate, the phases evolved.

Phase I – Broad beta

Early ETFs were characterized by broad beta. Ten to 15 years ago, almost all ETFs available offered broad exposure only. This phase was marked by a passive investment theme. Interestingly, despite academic evidence suggesting a passive investment approach is often appropriate, ETFs did not gather much traction back then for several important reasons:

1. **Fee-based asset management was nascent.** Investment advisors would often lament the fact that ETFs did not pay trailers. Since advisors were used to earning trailers every quarter, it was difficult to convince them to take on infrequent commissions instead. Of course, this was during a time when the industry itself changed and clients began to pay for expertise and management, instead of pure access to product.
2. **Optics mattered.** Investment professionals often had concerns about their value proposition. For example, if they were to allocate a large client portfolio to perhaps three or four ETF positions, they might run into perception roadblocks. In other words, the risk of client accounts looking "too simple" or "unsophisticated" ruled the day.
3. **Passive investing assumes perfect discipline and ignores all of the behavioural finance pitfalls that plague investors the world over.** When markets rally 20%, an ETF returns very close to 20%, but when the market loses 30%, an ETF subsequently loses 30% as well. Passive investing assumes that an investor (a) readily accepts the return, (b) does not panic and abandon their asset allocation, and (c) happily rebalances into the asset class that has lost them the most – a challenging endeavour for anyone.

Phase II – Specialized beta

Cue the second phase, when ETFs evolved to cover narrower and narrower slices of the pie. Sector and sub-sector products, products touching different durations and quality tranches of the bond market, and country-specific ETFs all bloomed. Assets in ETFs took off because more and more types of investment professionals could begin using them. In fact, the industry began to call using ETFs "indexing," rather than passive investing –professionals could use them to express specific investment ideas, some of which had finite time horizons or clear-cut objectives.

For instance, those professionals who traditionally used manager search and due diligence as one of their value-adds could now keep those managers very honest, as there was an ETF alternative for almost every asset class. Not to suggest that ETFs were automatically going to win every comparison, mind you. But, rather, blending active and passive investing became *en vogue* – advisors could add additional value in choosing where to hire managers for alpha and where straight exposure via ETFs was the best approach.

At the other end of the spectrum, there were investment professionals who picked individual equities for clients. Always on the hunt for mispriced assets, these professionals might have been more tactical and nimble, looking for opportunities as they arrived. They now had the luxury of choosing whether they wanted to take on security-specific risk by either picking names or investing in the sector at large via ETFs. As an example, many more professionals were using ETFs instead of stocks for exposures like health care, infrastructure and international dividend-paying equities.

Phase III – Strategic beta

In the third phase in the ETF evolution, we have seen the introduction of ETFs with a number of different labels, including rules-based and factor-based ETFs. Some even "smart beta," which is not a very accurate term, considering many of these ETF products are expressly designed to deliver "alpha" – or excess returns versus the market. Other products still aim to provide lower volatility while some aim to do both. All ETFs in this phase could be characterized as attempts to improve upon the Sharpe ratio of the underlying benchmark. They present a vast and diverse set of offerings. Quant strategies, low volatility and covered-call writing ETFs are all very different offerings, but all fall into this diverse category. In 2014, investment professionals have shown a consistent preference for this type of ETF over others.

New leaders to emerge

Taking into consideration the phases of the ETF industry we have examined thus far – and as the third phase continues to develop – here are some important considerations and takeaways:

1. **The first phase will be won by the firm that can commoditize their offerings and charge the lowest fees.** The second phase will be won by the provider that has the widest selection – the biggest "grocery store" – to provide one-stop shopping. However, those that led in the first and second phases are not necessarily in the best position to lead the third phase, which calls for experts in active management and in alpha-seeking and income-oriented solutions.
2. **For clients, reputation matters.** As ETFs become more complex, it will not be enough to simply track an index closely. Instead, a legacy of experience and thoughtful commitment to process are critical. Investment professionals must be able to define this process to clients by explaining how a particular ETF solution fits into their portfolios.
3. **The winners of the third phase will be those that bring innovation to the ETF space.** In this converging world, bringing liquidity, transparency and reasonable fees towards active solutions will be the way forward, but if – and only if – there is value for money and a well-thought-out, clearly defined process.

The road ahead

The ETF industry has changed. With all of the choices available, it is now more important than ever to have a clearly defined selection process as investment professionals further their use of ETFs in their client portfolios. Going forward, they will need to partner with a short list of ETF firms that are committed to the space and determined to innovate the landscape.

From our ETF beginnings in 2011 to today, RBC Global Asset Management is aiming to contribute to and ultimately lead the third phase in the evolution of ETFs – our assets in this space are up almost 200% in 2014 alone. Portfolio manager Bill Tilford and his team bring over 50 years of combined quant experience to the industry. To differentiate ourselves, we evaluate unique, forward-looking criteria and apply a proprietary weighting methodology to our ETFs – expertise that is uniquely Canadian and developed in-house.

To find out more about RBC ETFs, please contact your financial advisor or visit **rbcgam.com/etfs**.

RBC Global
Asset Management

108507 (11/2014)
014_287_GAM_108507 (11-2014)_ARTICLE_ETFS3_EN_FNL 11/04/2014