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Quick Hit — ETFs taking over the world?

The world may have just gotten a little more crowded, the ETF one that is. As it relates to our asset class of interest, i.e. Canadian fixed income ETFs, our colleagues at NBF ETF Research & Strategy estimate that Canadian fixed income AUM's have topped $50 billion or so YTD (up until the end of May), accounting for about one third of total Canadian ETFs, up from in and around 10% back from 2000 to 2008.

Allow us a brief lookback in time/refresher here: fifteen years ago, and roughly a decade after equity ETFs were first introduced, investors could for the first time access fixed income ETFs—the first ones were on U.S. Treasuries. This created a story of increased access at low(er) cost to an asset class that was previously rather difficult to tap into for your average retail investor, with the added benefit of the diversification of a mutual fund. As widely telegraphed, fixed income ETFs generally seek to track underlying bond indices, offering exposure to all corners of the market. As equity ETFs, they trade on stock exchanges. To that point, putting fixed income securities into an ETF wrapper certainly represents one of their biggest challenges, as bonds typically trade over the counter in the secondary market whereas ETFs are listed on exchanges. Some fixed income ETFs do not employ in-kind creation and redemption, a direct result of bonds and other fixed income securities being much less liquid and exhibiting less observable/reliable market prices than equities.

Some of the primary factors impacting investors' decisions when evaluating fixed income investments —think interest rate, credit/default risks, etc.— should likewise directly pertain to fixed income ETFs. Tracking error risk is also not to be neglected and is very unique to ETFs, representing the difference between the returns of the ETF itself to the underlying index it strives to track. And as far as liquidity risk is concerned, it should be highlighted that fixed income ETFs are generally perceived as having equity-like liquidity but that in times of stress, this liquidity may prove illusory for some funds.

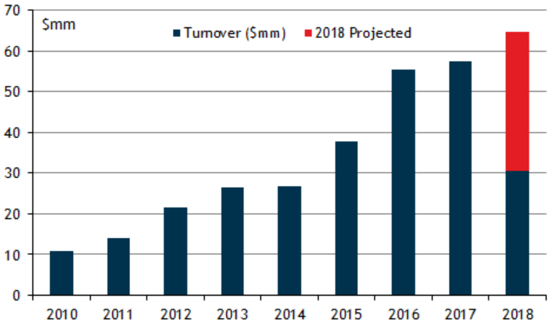
As we write these lines, domestic fixed income ETF traded value has reached $30.6 billion, up approximately 12% from the same period last year (Chart 1). And again based on our highly-esteemed ETF colleagues, total traded value should reach a little under $65 billion in full-year 2018, up ~13% from 2017. Excluding the early booms, 2015 and 2016 each registered the steepest spikes in additional traded value, respectively exhibiting YoY increases of 42% and 47%. In terms of number of different Canadian fixed income ETFs available to investors, they are now in excess of 170, well above the 30 or so witnessed back in 2010 (Chart 2).

Whereas ETFs were mainly used by retail investors in their early stages, we nowadays see a broadening range of institutional investors going into the product as well. Interestingly, our ETF colleagues estimate institutional participation into the broad ETF space in Canada at 15% (Chart 3) whereas institutional participation in the fixed income ETF segment alone is closer to 35%, testifying of an acute institutional interest in the sector. Among the primary uses would be the building of a liquidity sleeve around a portfolio to aid liquidity management in scenarios of quick changes of exposure style, managing cash inflows and outflows as well as during a period of market stress. [Institutional] investors also use [fixed income] ETFs for strategic asset allocation in which target allocation likely remains the same regardless of market conditions, with this type of passive ETF strategy being remarkably straightforward. Another notable use of fixed income ETFs would be as a hedging tool and is often believed to be a cost-effective alternative.

But there's still some way to go with bond ETF market penetration remaining low relative to equities. What's more, total Canadian fixed income ETFs' AUM represented only about 6.4% of that of U.S. fixed income ETF's as at the end of May 2018. Assuming financial market conditions remain favorable, a broadening of the Canadian ETF investor base and a gradual increase in penetration could signal a further vibrant growth ahead in Canadian fixed Income ETFs.

Chart 1: Canadian Fixed income ETF traded value

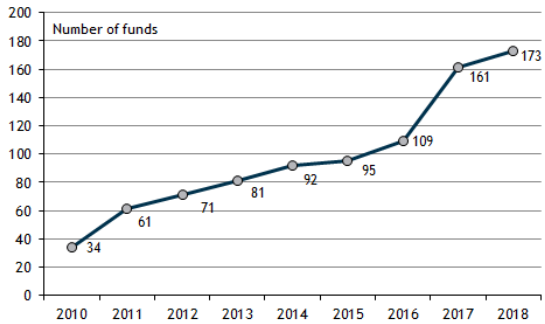
Projection for 2018 estimated using 2017 Jan-May traded value as a percentage of 2017 all-year traded value



Source: NBF, Bloomberg

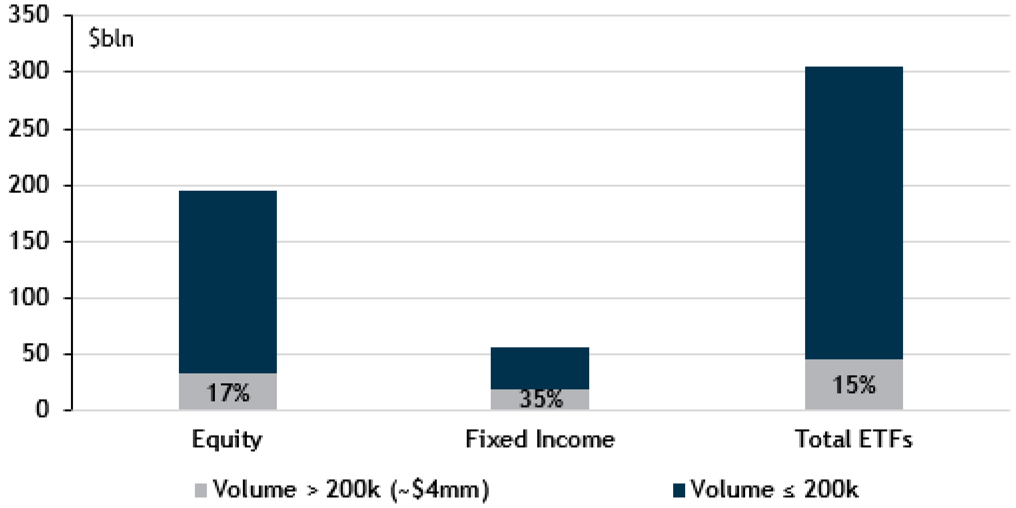
Chart 2: …and fund evolutions through the year

Regular class, excluding dual listing units, 2018 YTD



Source: NBF, Bloomberg

Chart 3: Large and growing institutional participation in fixed income ETF in Canada
Estimated Canadian ETF institutional trading value by asset class, data as of 2017



Source: NBF, Bloomberg

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