IIAC LETTER

The Evolution of Canadian ETF Product Offerings 2021

INTRODUCTION

Exchange Traded Funds (ETFs) have come a long way in Canada since they were initially launched as Index Participation Units on the Toronto stock exchange in 1990. Investments in and liquidity of ETFs has grown dramatically in the last decade and, on balance, this growth has held up well through the recent COVID-19 crisis period as well. This paper examines both past and anticipated future performance of ETFs in addition its primary focus, the ongoing development of new product offerings as the market matures and evolves.

The most common type of ETF is a market ETF which tracks major market indexes like the S&P/TSX. Some of these market ETFs do track lower-volume indexes as well. There are also sector and industry ETFs which have a narrower focus and may, not surprisingly experience higher volatility in some circumstances.

Industry ETFs that primarily trace a given sector index were created to emulate the underlying industry, such as energy, technology, or pharmaceuticals. While sector and industry ETFs allow investors to gain exposure to subsectors of the market, they often do not exactly mirror the desired industry or sectors performance because their composition is usually slightly different.

As is evidenced by Figure 1 below, as of May 2021 equity ETFs accounted for 63% of total outstanding ETFs in Canada and approximately 50% of total monthly inflows. In addition, cap-weighted ETFs accounted for 59% of outstanding equity ETFs and 66% of monthly equity inflows (33% of total monthly inflows). So, while there has been diversification and product development in the ETF space, traditional cap-weighted equity ETFs remain a significant presence.

Figure 1

MAY 2021 AUM AND MONTHLY ETF FLOWS

Asset Class	AUM ($M)	Mkt Shr	Flow ($M)	Flow/AUM
Equity	$175,794	63%	$3,562	2.1%
Fixed Income	$82,666	30%	$1,561	1.9%
Commodities	$2,046	1%	-$24	-1.2%
Multi-Asset	$12,217	4%	$642	5.6%
Inverse / Levered	$1,324	0%	-$13	-1.0%
Crypto-Asset	$2,892	1%	$1,310	44.0%
Total	**$276,940**	**100%**	**$7,039**	**2.6%**

Focus	AUM ($M)	Mkt Shr	Flow ($M)	Flow/AUM
Cap-weighted	$104,229	59%	$2,333	2.3%
Dividend / Income	$18,073	10%	$488	2.8%
Factor: Low Vol	$8,052	5%	-$21	-0.3%
Factor: Multi-factor	$3,955	2%	$44	1.1%
Factor: Fundamental	$4,428	3%	$31	0.7%
Sector	$23,832	14%	$354	1.6%
Thematic	$9,099	5%	$152	1.7%
Other	$4,100	2%	$155	4.0%
Total	**$175,768**	**100%**	**$3,537**	**2.1%**

Maturity	AUM ($M)	Mkt Shr	Flow ($M)	Flow/AUM
Broad/Mixed	$46,034	56%	$946	2.1%
Ultra Short Term	$3,574	4%	$169	5.0%
Short Term	$17,699	21%	$458	2.7%
Mid Term	$4,950	6%	$73	1.5%
Long Term	$3,643	4%	$20	0.5%
Real Return	$1,388	2%	$59	4.5%
Target Maturity	$111	0%	-$2	-2.2%
Cash Alternative	$5,268	6%	-$159	-2.9%
Total	**$82,666**	**100%**	**$1,561**	**1.9%**

Source: National Bank of Canada, Bloomberg

ETF PRODUCT DEVELOPMENT

There is no doubt that the Canadian ETF industry has grown rapidly, as have global ETF markets, and evolved a great deal in the past decade. According to the CETFA 'Seven years ago, just 10 firms offered Canadian-listed ETFs, with assets totalling $66 billion. By the end of Q4 2020, the segment had grown to 39 sponsors, and had achieved $257 billion in assets under management. This represents a cumulative compound annual growth rate (CAGR) of 20% over a decade".[1]

As the ETF market has grown and evolved, strategies have become more varied and complex. ETF underwriters have continued to expand and distinguish their product mix to meet investors needs. It must be noted however, that traditional market ETFs still dominate the space.

As is the case elsewhere globally, in Canada, ETFs have evolved far beyond their traditional index-replicating origins. With less ability to scale and compete against the broader index trackers, new entrants have emphasized alpha-seeking solutions. These ETFs feature **actively managed strategies** ("non-index tracking"), **tracking strategic-beta indexes**, employing **quantitative models**, or providing exposure to a **thematic investment mandate**.

Non-index tracking ETFs have dominated product development in recent years, making up 232 of the 486 launches over the three-year period ending December 2018. By comparison, funds

[1] CETFA Guide to the Canadian ETF Industry A Road Map 2021

tracking strategic-beta and market capitalization-weighted indices accounted for 142 and 112 funds, respectively, over the same period. Ongoing development gave non-index tracking ETFs the lion's share of the product shelf in Canada, while index-tracking funds, as outlined above, continue to retain most of the current total AUM.

Asset classes and allocations continue to evolve with an expansive range spanning many strategies and styles. In totality, Canadian ETFs cover a broad range of asset classes, from fixed-income and equities to commodities, real estate, and alternative mandates.

Even as new types of asset classes have emerged, the largest ETFs in Canada are still conventional index tracking funds, with equity tracking funds still outpacing fixed income funds in growth and AUM. According to CETFA data "as of December 2019, equity-based ETFs accounted for 66.1%; fixed-income for 30.5%; multi-asset class for 2.5%; commodity ETFs for 0.8%, and currency ETFs for 0.1% of all assets".[2]

To date, there are still a greater number of Index tracking ETFs, but this gap is slowly narrowing. In 2020, approximately two-thirds of ETFs launched were non-index-tracking strategies. Periodically fixed-income ETFs are preferred over equity ETFs, but this preference by investors is often only short lived during volatile rate movements or equity downturns. According to the CETFA, "in 2020, the appetite for equity ETFs revitalized. Of the annual inflow, 57% were in equity funds, 34% in fixed-income funds, 7% in multi-asset funds and 2% in commodities".[3]

Thematic and alternative strategies ETFs have seen many new launches in recent years, with strategies that included high interest deposit investments, cannabis, esports and AI investments. There has also been a recent interest in thematic equity ETFs that have investments in environmental, social and governance (ESG) related industries and projects, cryptocurrency and blockchain.

Overall growth in ETF AUM has been quickly increasing and a large number of new ETFs have been launched, with many in response to expanding investor demand and appetite for a diverse range of products with low transaction costs and fees. The long-term trends for ETFs in Canada are therefore positive, strong and show continuing promise, in part because Canadian investors are also increasingly fee sensitive. As a broader population of investors becomes more familiar and comfortable with ETFs and seeks lower-cost and tax-efficient alternatives to achieve their financial goals, the prospects for increased uptake and adoption remain promising.

While COVID-19 temporarily slowed and skewed economic and investing behaviours, the resurgence of ETFs over the course of 2020 to record levels indicates that ETFs continue to benefit from their increasing appeal to investors and that they are very likely to have ongoing robust long-term growth potential. Looking at authorised participants, (APs), there have previously been concerns voiced by market analysts and regulators that ETF AP arrangements could break down in times of market stress. However, during the recent COVID-19 crisis there is little or no evidence of this being the case in Canada in either fixed income or equity ETFs. In fact, ETF trading appears to have been one of the most stable sectors of the market from a trading continuity perspective.

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[2] CETFA Guide to the Canadian ETF Industry A Road Map 2021

[3] CETFA Guide to the Canadian ETF Industry A Road Map 2021

There have also been conflicting statements in the mainstream news media and from financial firms, partly as a reflection of complex evolving markets and a vast array of products with different risk profiles. However, after examining trade volumes, temporary divergence of ETF prices to the NAV and the price discovery that ETFs provided in choppy markets, it is clearly apparent that ETFs performed quite well and as designed during one of the most volatile markets in recent history.

In terms of regulations, Canada's regulators have supported ETF innovation and there has been some of the most innovative product development anywhere in the world in this country. As a result, there is no pressing need to go to the U.S. to invest in the ETF sector.

CONCLUDING THOUGHTS AND FUTURE OUTLOOK

Overall ETF product offerings and ETF technology will likely continue to experience growth into the foreseeable future. However, with this anticipated growth in the total size of the market, the inclusion of additional strategies, and a greater number of ETF providers and APs, investors need updated information to keep abreast of ongoing developments.

The current ETF structure in Canada has shown to be robust, liquid and functioning well, impressively weathering the recent pandemic, and it does not currently appear to require any material changes or additional changes market regulation.

New ETF product development will be a function of investor demand as well as initiatives undertaken by ETF providers to develop products themselves in a proactive fashion. These new products will offer a wider suite of options but must be accompanied by thorough and thoughtful disclosure.

Appendix 1

BEST PRACTICES FOR TRADING ETFS ARE PARTICULARLY IMPORTANT DURING A PERIOD OF CRISIS

As we have published before, there are some best practices that industry participants can observe that can help receiving the most competitive pricing on ETFs.

Avoid Trading at the Open of the Market

The first 10-15 minutes of a trading day should be avoided to get optimal pricing and execution of a transaction.

Transact Only When the Underlying Market is Open

Trading when the underlying market is closed can result in wider spreads. The price of constituents will have to be modeled and a wider spread will likely be used.

Industry Participants should Always Use Limit Orders

Using a limit order enables a set price to be filled on the trade. In volatile markets that are moving fast limit orders may need to be reset during the day as prices change.

Be Cognizant of Overall Market Instability and Volatility

While an ETF is, at a minimum, as liquid as its underlying equities it is important that the ETF is constructed with a portfolio that has trading volume requirements.

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