

# IIAC LETTER

## THE DEVELOPMENT OF ACTIVE STRATEGY ETFs IN CANADA—JANUARY 2022

### EXECUTIVE SUMMARY

In Canada, Exchange Traded Funds (ETFs) have continued to evolve since they were initially conceived and launched as Index Participation Units. Initially ETFs were mostly based on the concept of market cap-weighted indexing. Over time there was the development of strategic beta ETFs. These ETFs track an index, but the composition of the ETF is not cap-weighted, and the ETF may only represent a portion or sector of the index.

As the ETF market has grown and developed, strategies have become more varied and complex. As ETF underwriters expanded their strategies and varied their product mix to meet investors appetite, they have developed ETFs that feature actively managed strategies (“non-index tracking”). These include strategies that track the aforementioned strategic-beta indexes, strategies that employ quantitative models, or provide exposure to a thematic investment mandate. The goal of these ETFs is to outperform the underlying index and/or to provide diversification in an investor’s portfolio.

Non-index tracking ETFs have dominated new product development in recent years, but despite this fact, index-tracking funds continue to retain most of the current total AUM. Thematic and alternative strategies ETFs have seen many new launches in recent years, as investors have gained greater familiarity and understanding in these investments, such as strategies that include 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.

FIGURE 1: ETF FLOWS BY CATEGORY - FULL YEAR 2021

	AUM (\$M)	Mkt Shr (%)	December 2021		Full Year 2021	
			Flow \$M	Flow/AUM	Flow \$M	Flow/AUM
<b>Equity</b>	<b>\$209,249</b>		<b>\$2,647</b>	<b>1.3%</b>	<b>\$30,196</b>	<b>19.0%</b>
Canada	\$76,186	24%	\$1,164	1.6%	\$10,094	18.6%
United States	\$74,448	23%	\$1,193	1.7%	\$9,320	16.5%
International	\$58,615	18%	\$290	0.5%	\$10,782	22.6%
<b>Fixed Income</b>	<b>\$88,528</b>	<b>27%</b>	<b>\$1,182</b>	<b>1.4%</b>	<b>\$10,120</b>	<b>11.7%</b>
Commodities	\$1,897	1%	-\$33	-1.7%	\$109	5.8%
Multi-Asset	\$15,797	5%	\$311	2.0%	\$5,624	61.8%
Inverse / Levered	\$1,759	1%	-\$20	-1.1%	\$491	41.5%
Crypto-Asset	\$5,885	2%	\$197	2.7%	\$5,967	NA
<b>Total</b>	<b>\$323,114</b>	<b>100%</b>	<b>\$4,285</b>	<b>1.4%</b>	<b>\$52,506</b>	<b>20.4%</b>

Source: National Bank of Canada and Bloomberg

As Figure 1 above illustrates, equity related ETFs accounted for over 58% of net flows in 2021 and 62% of net flows into ETFs in December 2021 and have a 65% share of ETF assets under management (AUM) in Canada.

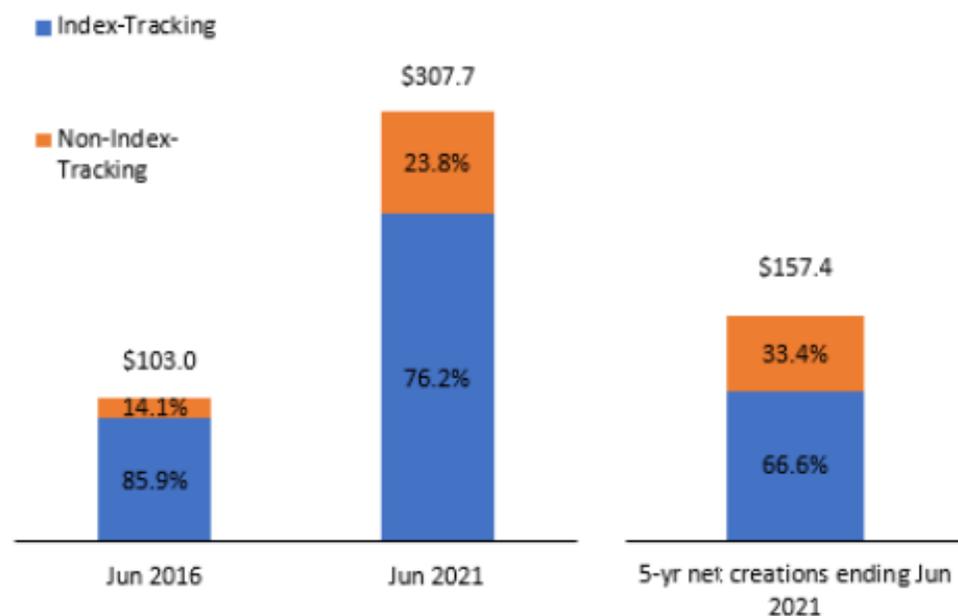
FIGURE 2: ETF EQUITY FLOWS BY FOCUS - DECEMBER 2021

Focus	AUM (\$M)	Mkt Shr	Flow (\$M)	Flow/AUM
Cap-weighted	\$125,025	60%	\$15,346	16%
Dividend / Income	\$21,334	10%	\$2,870	17%
Factor: Low Vol	\$8,867	4%	-\$419	-5%
Factor: Multi-factor	\$4,274	2%	\$51	1%
Factor: Fundamental	\$5,136	2%	\$808	22%
Sector	\$28,823	14%	\$5,342	27%
Thematic	\$10,447	5%	\$4,277	84%
Other	\$5,345	3%	\$1,921	69%
<b>Total</b>	<b>\$209,249</b>	<b>100%</b>	<b>\$30,196</b>	<b>19.0%</b>

Source: National Bank of Canada and Bloomberg

In general, new ETF entrants do not have the scale to compete against existing large cap weighted passive equity funds and have looked to develop more bespoke active strategies. These include ETFs that track strategic-beta indexes, use active trading strategies that utilize mathematical models or use other active trading strategies.

FIGURE 3: ASSETS AND NET CREATIONS IN BILLIONS OF DOLLARS



Source: Investors Economics, A Division of ISS Market Intelligence and CETFA

Over a longer timeframe, as can be seen in Figure 3, non-index tracking ETFs have come to represent a sizable portion of AUM and have begun to become a material portion of new product development in the last 5 years.

While it is clear that there has been significant development of active strategies in Canada, the core narrative of the ETF revolution remains firmly grounded in low cost, passive investing for many investors. Passive market-cap weighted ETFs still dominate the marketplace and investors' portfolios despite the innovations and shocks in 2021 and the attention-grabbing headlines that highlight stories on fintech, cryptocurrencies and ESG themes.

#### USES OF NON-PASSIVE ETFS

Many investors are using ETFs to take a tactical approach to the market. Because there is a large and growing selection of product choices across the ETF universe it is quite simple and cost effective to use ETFs to tactically align investors portfolios to desired market weightings.

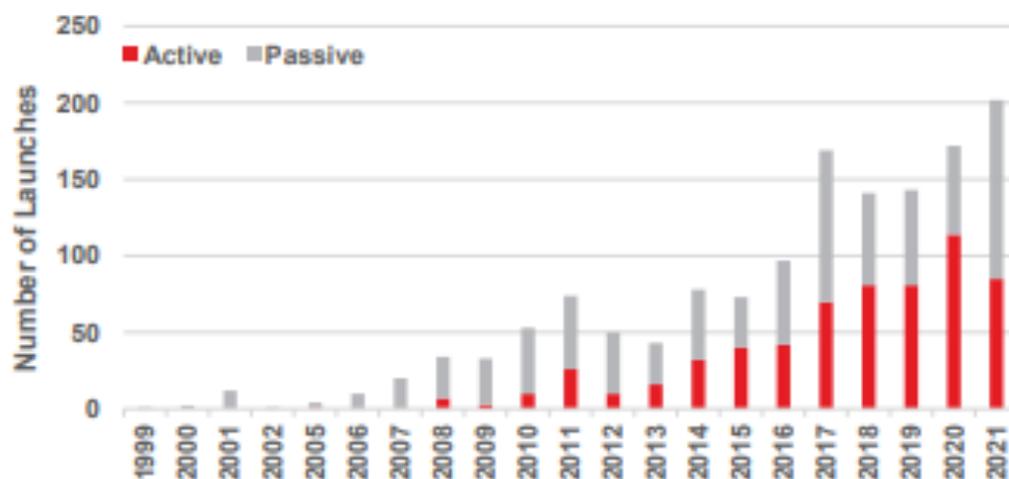
ETFs holding crypto assets such as Bitcoin and Ether have grown explosively since recent launches and now have AUM in excess of \$5Bn in Canada. As thematic and active trends continue to broaden, new product development will likely continue. In the fixed income space, based on historical patterns, low yields may increase in the near term and medium term and may support an active management strategy. As a result, fixed income ETFs focus may shift to risk-adjusted returns.

Active equity ETFs can be used to generate income, manage risk, and will outperform passive indexes when managed properly. In addition, in periods of uncertainty and volatility, portfolio managers can take defensive stances that better manage risks.

Environmental, social and governance (ESG) ETFs, will likely continue to grow and attract investor interest as the transition away from fossil fuels to alternative and renewable clean energy sources becomes a dominant theme. This sector will benefit further when the development of agreed upon and consistent international frameworks is completed, and disclosure issues are resolved.

While it is almost a given that ETFs AUM will still grow into the foreseeable future, it remains to be seen how investors will increase their use in their broader portfolios and how new product development will split between active and passive strategies.

FIGURE 4: CANADIAN ETF LAUNCHES



Source: National Bank of Canada and Bloomberg

As Figure 4 indicates, ETF launches in Canada have leveled off to some degree in the last few years, with 202 ETFs launched in 2021. This brings the total number ETFs outstanding in Canada to 1,177. In addition, it is of note that passive strategy launches overtook active strategy launches for the first time in four years.

## CONCLUDING REMARKS

As discussed, the majority of AUM and new ETF flow continues to have very low cost and passive, index-tracking investments. However, there is growing interest by many investors in the use of a barbell approach, where they invest a material portion of their assets in low-cost passive issues, with much of the remaining investments distributed among higher risk/return ETFs that have higher MERs.

There is also some evidence that investors tend to turn to actively managed funds in high volatility periods. In 2022, with the threat of Omicron continuing and regulatory changes ongoing, markets may continue the wild ride experienced in the latter half of 2021. A higher volatility market is the kind of environment where stock pickers and active managers are expected to outperform and may draw a greater share of investments.