WisdomTree Canada 2018 ETF Industry and Market Outlook

The Canadian exchange-traded fund (ETF) industry reached new highs in 2017, with more than C$26 billion in inflows and approximately C$147 billion in assets under management (AUM) as of November 30, 2017[1] – an increase of 30% from 2016. The strong year of flows can be attributed to an increased awareness of the benefits of the ETF structure as well as the bull market in global equities. Flows into equity ETFs were strong at C$15 billion,[2] with just over half of the flows in this asset class moving into international equity products. Fixed income ETFs continued to see sizable inflows of more than $10 billion.[3]

WisdomTree believes the accelerated rate of adoption of ETFs as a vehicle for Canadian investors will continue into 2018 given increased investor education, as well as increased regulation in the asset management industry. From an investment perspective, WisdomTree sees opportunity in variably hedged international equities as well as fixed income ETFs with less interest rate sensitivity, given the likelihood of U.S. and Canadian rate hikes in the year ahead. Finally, WisdomTree anticipates investors will increasingly look to fundamentally-weighted indexed ETFs, commonly known as "smart beta" ETFs, for income and risk mitigation.

Industry Overview – 2017 Canadian and Global Trends

ETFS ARE GROWING AS INVESTMENT VEHICLE FOR CANADIANS

In 2017, investors continued to shift their assets into low-cost ETFs from actively managed mutual funds. Nevertheless, WisdomTree estimates that there remains $10 in Canadian mutual funds for every $1 in ETF assets,[4] indicating that the ETF industry's development in Canada is still in the early stages.

ETFs provide strong sources of income and diversification among asset classes. Investors are increasingly attracted to the benefits of the ETF structure, including the daily liquidity, lower costs, and tax efficiency. WisdomTree anticipates the industry will continue to take market share away from mutual funds.

FROM SMART BETA TO MODERN ALPHA

While in previous years, providers were focused on traditional "beta," or market capitalization-weighted ETFs, 2017 marked a greater adoption of smart beta ETFs, with many new entrants taking this approach with their offerings. While smart beta ETF products have been around for some time, much of the early innovation in this space has been on the equity side. More recently, WisdomTree has seen an increased focus on smart beta products in the fixed income space.

Nevertheless, WisdomTree believes the term smart beta places a number of ETF providers in a hypothetical box that may not fit the asset manager's core objectives. Some ETF providers are separating themselves from the smart beta naming convention, with WisdomTree increasingly using the term "modern alpha" to differentiate its product set.

1 Source: TD Canada as of November 30, 2017.
2 Ibid.
3 Ibid.
4 Mutual fund assets by the Investment Funds Institute of Canada, which reports $1.43tn in mutual fund assets as of 9/30/2017.

IMPACT OF CURRENCY

As of mid-December, the Canadian dollar (CAD) had strengthened to C$0.7790 from C$0.7441 at the start of the year.[5] At its 2017 peak, the loonie was changing hands near C$0.83, but it started to give back gains in early September as the Trump administration in the U.S. focused heavily on tax reform. Most of WisdomTree's purchasing power parity metrics have the CAD a bit undervalued relative to the U.S. dollar (USD). The consensus anticipates a narrowing of U.S.-Canadian interest rate differentials in 2018, and it also foresees about $0.04 in CAD appreciation. At current exchange rates, WisdomTree sees little reason to have much conviction beyond "neutral" with respect to the greenback exchange rate.

As Canadians know well, a generalized strengthening of foreign currencies in recent years has greatly influenced returns. For example, in the past five years through November 2017, the S&P 500 returned 15.7%, however, in CAD terms (the unhedged view), the return was approximately 22% per year. Similarly, MSCI Europe rose 10.1% in euros but 13.9% in CAD because of CAD weakness. Variably hedged classes of foreign equity ETFs appear favorable at the moment, as they have the potential to reduce volatility while offering tactical currency metrics to the low-conviction investor.

Looking Ahead at 2018 ETF Trends

ACCELERATED ADOPTION AND GROWTH

In Canada, while the ETF user base has broadened, the overall adoption rate still lags compared to the U.S. WisdomTree believes there may be an acceleration in the growth rate of ETF AUM in the next few years as the industry reaches a critical mass, making ETF usage more mainstream. If, hypothetically, the industry experiences 20% annual rises in AUM in the coming years, and underlying assets appreciate 4% per year, the Canadian ETF industry would be about one-third the total size of the mutual fund industry by 2024 (assuming mutual funds do not experience net outflows).

FIXED INCOME AND INTEREST RATES IN 2018

Investors continue to look for fixed income solutions to satisfy needs from a global, diversified portfolio perspective. Developed to meet Canadian and global demand, core fixed income ETFs are of paramount importance, serving as building blocks for an overall portfolio. With developed market interest rates at historically low levels, investors will continue to look for strategies that can potentially enhance yield while maintaining familiar risk characteristics.

After somewhat surprising the markets with two consecutive rate hikes this summer, the Bank of Canada (BOC) may be ready to take a pause to assess incoming inflation data. Market expectations for additional rate increases are placed at over 60% for the BOC meeting in March 2018 and better than 70% for April. In the U.S., the Fed will have new leadership, but the course of monetary policy is not expected to be altered in any visible way from its current path, where guidance has been placed at three rate hikes. As a result, investors are likely to shift allocations toward fixed income ETFs that are weighted more toward credit and have less concentration to interest-sensitive sectors such as government bonds. In addition, investors may also consider shorter duration instruments if they wish to mitigate interest rate risk.

[5] Source: Bloomberg, as of 12/13/2017.

THE SEARCH FOR "SMARTER" SOLUTIONS

An evolution continues to take place in investment solutions, and this trend is expected to continue in 2018. Many investors who traditionally utilized individual stocks and bonds and/or mutual funds have been increasingly turning their attention to ETFs. With the possibility of global central banks such as the Fed, the BOC and the Bank of England raising interest rates, 2018 may pose some challenges as the normalization process for monetary policy becomes more visible.

Not all ETFs are ideal for such an environment, and investors will be looking for "smarter" solutions that can provide income while mitigating interest rate risk. As the industry becomes more sophisticated, WisdomTree anticipates that many investors who had previously utilized market capitalization-weighted ETFs will move toward more optimal strategies such as fundamentally weighted ETFs.

THEMATIC INNOVATION

While competition in the Canadian ETF marketplace has certainly increased, and will likely continue into 2018, sharp fee disparities between ETFs and mutual funds should enable the industry to grab material market share from mutual funds in the year ahead. Against this backdrop, WisdomTree anticipates 2018 will be a year of heightened innovation for ETF providers, as increased demand for solutions that provide low-cost alpha continues. This trend is expected to occur across the globe, but notably in Canada, given that this market is still a few years behind other markets, namely the U.S., in terms of adoption.

The emergence of thematic ETFs is also expected to continue in 2018. In Canada, WisdomTree expects to see more ETFs tied to millennial demand, artificial intelligence, robotics and political and social trends.

CRM3 PROPOSAL

The industry could begin to see heightened discussions around CRM3, a proposal to extend advisor disclosure requirements to encompass not only their advisory fee, but the full Management Expense Ratio (MER) of the underlying investments they manage. As clients come to demand more transparency around fees, financial advisors will increasingly consider ETFs because they typically have lower fees than mutual funds.

With Morningstar's 2017 Global Fund Investor Experience Study[6] giving the Canadian fund industry a "bottom" grade on fees and expenses—meaning Canada is one of three nations with the highest expense ratios compared to 22 other countries in the survey—CRM3 cannot come soon enough for ETF providers. For example, in fixed income, the median Canadian fund still charges an MER of 1.15%, whereas the ETF median is 0.29%.[7] With 10-year Canadian Treasuries yielding only 1.87%,[8] this kind of yawning gap in fees presents a prohibitive obstacle for traditional active managers who are caught between the desire to maintain profit margins and market share. A deterioration in both is expected in 2018.

[6] Source: Morningstar Global Fund Investor Experience Study 2017.
[7] Source: Fund universe data from WisdomTree, Morningstar, as of 6/30/2017. Screens are for respective universes of Canadian fixed income funds.
[8] Source: Bloomberg, as of 12/13/2017.