

C A N A D I A N

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ETF Watch

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Avoiding the Market-Cap Trap



- Hedging US Equity Risk with Unhedged Investments
- Why Fixed Income ETF of ETFs?
- The Active Versus Passive Debate



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Canada

PXG
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PZC
Canada
small/
mid-cap

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Global
small/
mid-cap

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Although September was another roller coaster ride for investors they allocated US\$32 billion in net new assets to ETFs/ETPs listed globally during the month. This marks the 20th consecutive month of positive net inflows, according to ETFGI's preliminary ETF and ETP global insights report for the September 2015.

In the first three quarters of 2015 record levels of net new assets have been gathered by ETFs/ETPs listed globally, with net inflows of US\$251 Bn marking a 25% increase over the prior record set at this time last year. In the United States, net inflows reached US\$146 Bn, which is 8.5% higher than the prior record set in 2012, while in Europe year to date (YTD) net inflows climbed to US\$62 Bn, representing a 30% increase on the record set YTD through end of September 2014. In Japan, YTD net inflows were up 143% on the record set last year, standing at US\$36 Bn at the end of September 2015.

"Uncertainty on China and when the Fed will raise interest rates continues to weigh the markets and investor sentiment. The S&P 500 decreased 2.6% in September, and is down 6.7% year to date." according to Deborah Fuhr, managing partner at ETFGI.

The Global ETF/ETP industry had 5,978 ETFs, ETPs, with 11,518 listings, assets of US\$2.8 trillion, from 270 providers listed on 63 exchanges in 51 countries.

ETFs/ETPs listed globally gathered net inflows of US\$32 Bn in September 2015. Equity ETFs/ETPs gathered the largest net inflows with US\$17 Bn, followed by fixed income ETFs/ETPs with US\$12 Bn, while commodity ETFs/ETPs experienced net outflows of US\$590 Mn.

YTD through end of September 2015, ETFs/ETPs listed globally have gathered net inflows of US\$251 Bn. Equity ETFs/ETPs have gathered the largest net inflows YTD with US\$156 Bn, followed by fixed income ETFs/ETPs with US\$64 Bn, and commodity ETFs/ETPs with US\$3 Bn.

At the end of September 2015, the Canadian ETF industry had 370 ETFs, with 518 listings, assets of US\$62 Bn, from 12 providers on 1 exchange.

Source: etfgi.com

ETFGI is a wholly independent research and consultancy firm providing services to leading global institutional and professional investors, the global exchange traded fund and exchange traded product ecosystem, its Regulators and its advisers. Founded in 2012 by ETF and ETP strategists, **Deborah Fuhr**, **Shane Kelly**, CFA and **Matthew Murray**, ETFGI produces extensive ETF-specific analysis covering over 4,700 ETFs and ETPs, across 9,500 exchange listings.

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¹Source: Morningstar.



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Avoiding the Market-Cap Trap



The RAFI methodology is one of the cornerstones of PowerShares Canada's suite of smart beta ETFs, which break the link between price and weight in an effort to avoid the flaws inherent to market-cap-weighting.



Christopher Doll
AVP,
Product Management,
PowerShares Canada

Avoiding the market-cap trap

Canadian investors have poured billions of dollars into low-cost exchange-traded funds¹ (ETFs) that track familiar indices, such as the S&P 500 and the S&P/TSX Composite.

But these indices were not originally designed to form the basis of a sound investment strategy, and they share a fundamental flaw: they select and weight their components based solely on market capitalization.

The underlying methodology of market-cap-weighted indices is more than a century old and was based on the latest technology available at the time. Today, however, we can pinpoint several potential problems inherent in cap-weighted indices.

Overweight overvalued stocks

By its very nature, a cap-weighted index tends to overweight overvalued companies and underweight undervalued companies. Market-cap weighting tacitly accepts that all securities are priced accurately by the market, at all times.

In choosing a market-cap weighted index, investors are chasing performance, by holding overweight positions in companies that have already grown substantially. A company like Valeant Pharmaceuticals² may have many strong years ahead of it, but investors would have been better served overweighting it before its meteoric rise, rather than raising their allocation after the fact.

Conversely, market-cap weighting will underweight companies that are temporarily undervalued by the market. These may represent the best investments, assuming the underlying businesses are healthy. In a broad market decline, good companies are often oversold as investors seek the perceived safety of cash.

Mirror volatility of stock prices

Market-cap-weighted indices tend to mirror the volatility of stock prices, which can be significantly affected by several factors, such as earnings projections, news and speculation. This can lead cap-weighted indices to underestimate the importance of the underlying economic size and strength of the companies that make up the overall market.

Historically, many of the largest companies have increased in price as optimistic positive earnings projections buoy prices. As the prices rise, so too does the market cap and therefore the index weighting.

Incorporate market speculation

Because market-cap-weighted indices reflect current market sentiment, they include not only critical analysis, but also sheer speculation, which can cause significant mispricing and improper index weights. This occurred during the 2008–2009 financial crisis. As panic gripped the market, U.S. financial stock prices were overly depressed, and their index weights fell far below what was warranted by their fundamentals.

The focus on market cap effectively creates two biases: one in favour of growth as a style; and another in favour of large-cap stocks, reflecting the past growth of these businesses, which may not be repeated. Both of these biases have been shown to underperform over a full market cycle.³ Basing an investment on past performance is seldom a good idea, and very large companies may already have delivered their highest returns on the way to becoming very large.

Buying high, selling low

Market-cap-weighted indices chase winners forever, increasing their weightings to reflect gains that have already been made. Some of these companies will suffer set-backs. Many will recover, but some will continue to fall in value and, in the worst cases, may even find themselves delisted by the stock exchange if the underlying businesses no longer meet listing requirements.

An investment that strictly adheres to a market-cap-weighted index will only divest from a falling company when it no longer qualifies for the index. This ensures that investors will ride a falling company right into the ground.

If there's one thing that cap-weighting does well, it's reflecting gains made as a bubble inflates. Unfortunately, it also captures the downside as a bubble bursts.

A smarter way to invest

Given the faults inherent in market-cap weighted indexing, investors may want to consider a strategy that severs the link between security price and portfolio weight.


There are several single-factor approaches that effectively do just that, but each may create a portfolio with its own inherent biases.

| Metric | May cause overexposures to... |
|------------|---|
| Sales | Large companies with thin margins |
| Cash flow | Cyclical stocks at cyclical peaks |
| Dividends | Mature high-yield companies and exclusion of growth companies |
| Book value | Companies with aggressive accounting |

A multi-factor index can help to mitigate these biases.

Research Affiliates' Fundamental Indexing (RAFI®) methodology selects and weights securities based on four business metrics: five-year average sales, cash flow and dividends, as well as the current book value. Taken together, these metrics provide a basis for evaluating the fundamental health of each company within the investible universe.

The RAFI methodology is approaching its 10-year milestone as a live index, with the FTSE RAFI US 1000 Index providing an average of 1.40% per annum in excess return over the S&P 500 since its inception on November 28, 2005⁴.

The RAFI methodology is one of the cornerstones of PowerShares Canada's suite of smart beta ETFs, which break the link between price and weight in an effort to avoid the flaws inherent to market-cap-weighting. 

PowerShares Canada offers a broad suite of TSX-listed ETFs based on the RAFI methodology, ranging from core holdings to diversifiers.

| | |
|--|------|
| PowerShares FTSE RAFI Canadian Fundamental Index ETF | PXC |
| PowerShares FTSE RAFI Canadian Small-Mid Fundamental Index ETF | PZC |
| PowerShares FTSE RAFI U.S. Fundamental Index ETF – CAD | PXS* |
| PowerShares FTSE RAFI U.S. Fundamental (CAD Hedged) Index ETF | PXU |
| PowerShares FTSE RAFI Global+ Fundamental Index ETF - CAD | PXG* |
| PowerShares FTSE RAFI Global Small-Mid Fundamental ETF - CAD | PZW* |

¹ Source: ETFGi, Top 20 ETFs in Canada account for 29,997 (US\$ Mn), and a total of 45.8% of market share as at July 31, 2015

² The company was selected for illustrative purposes only and is not intended to convey specific investment advice.

³ Fama, E. F.; French, K. R. (1992). "The Cross-Section of Expected Stock Returns". The Journal of Finance 47 (2): 427.

⁴ Returns are calculated in USD.

*PXS, PXG and PZW are also available in U.S.-dollar-denominated units. U.S.-dollar-denominated units do not provide a currency hedge between the Canadian dollar and the U.S. dollar

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Hedging US Equity Risk with Unhedged Investments



Conventional wisdom has led many investors to believe that investing south of the border exposes them to increased risk due to exchange rate fluctuations between Canadian and US dollars. But is that actually the case? Or, asked another way, what has historically resulted in greater performance volatility – hedged or unhedged US equity?

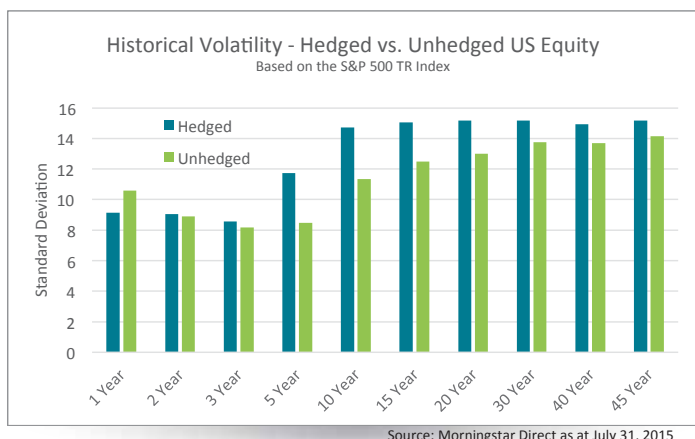


John Pagliacci
*Product Strategist,
First Asset
Exchange Traded
Funds*

As of July 31, 2015, the performance of the S&P 500 TR Index in Canadian dollar terms (i.e. unhedged) has resulted in lower volatility, as measured by standard deviation, dating all the way back to 1970, the year in which Morningstar's performance data for the S&P 500 TR Index begins¹. Virtually every standard period since then tells the same story. The one main exception is the past year, where unhedged exposure resulted in slightly higher volatility. But, that increased volatility is simply reflecting large monthly gains attributable to the significant appreciation of the US dollar of late; which has provided unhedged investors with tremendously positive performance.

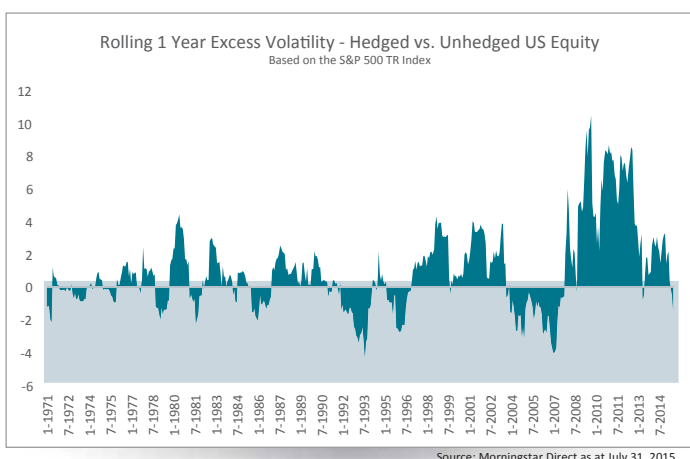
Some may quickly dismiss these findings as data mining, thinking back to a time when they were burned by a falling USD. They might claim that using long-term data, as we have, overlooks the very real possibility of being on the wrong side of a short-term trend. Without a doubt, there have indeed been shorter periods of time over which unhedged US equity exposure has been significantly more volatile than its counterpart. Take for example the 1 year period ended March 31, 1996. Over this 12 month span, the performance of unhedged US equities, based upon the S&P 500 TR Index, was almost 50% more volatile than hedged returns and saw the unhedged investor underperform by almost 400 bps. On the flip side, the 1 year period ended August 31, 2009, showed 50% greater volatility for the hedged investor with roughly 300 bps of underperformance.

We can counter the claim of data mining a number of different ways. As mentioned previously, the past 45 years is not the only longer-term period over which unhedged US equity has been less volatile. To be exact, volatility has been lower on unhedged US equity over the past 2, 3, 5, 10, 15, 20, 30 and 40 year periods.



If that's not convincing enough, perhaps because you think this data is 'end-date specific' (meaning you think the data could have told a different story 6 months or 1 year ago), we also ran the rolling 1 year volatility figures dating all the way back to 1970, giving us 535 months of data. In 326 of those rolling 1 year periods, or 61% of the time, the 1 year volatility figure was higher for CAD hedged returns. Additionally, the average rolling 1 year volatility for unhedged returns was 7% lower (standard deviations of 14.16 for CAD hedged and 13.23 for unhedged).

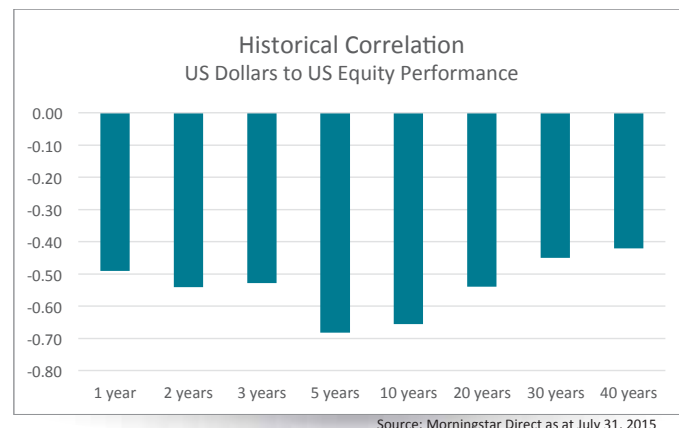
The graphic below shows the magnitude and duration of periods where the volatility of CAD hedged performance was greater than for unhedged.



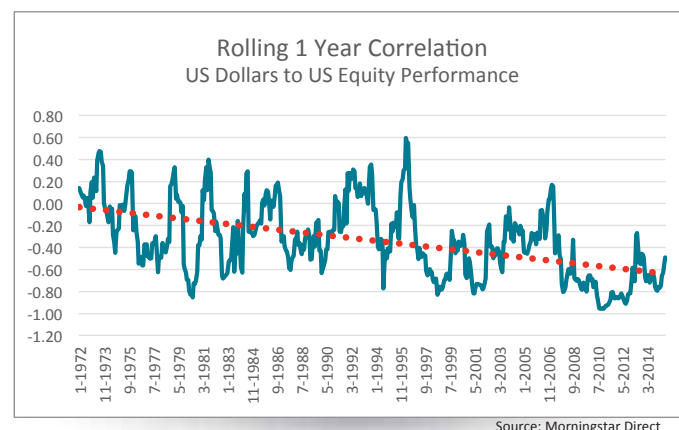
Now that we've identified this phenomenon, it's equally as important to determine its cause, allowing us to postulate as to whether this is something that we can expect to continue in the future.

Economic theory teaches of the benefits afforded to a country's economy – and by extension, its stock market – when its currency is less expensive relative to other nations. All else being equal, a weak US dollar, relative to other major foreign currencies, stimulates the US economy by boosting the demand for its goods and services in other countries (increased export demand). Why? Because consumers in other countries can potentially buy US goods and services for less than they would have to pay in their own domestic market, or even other foreign markets. It also encourages foreigners to invest in US stocks, because they, too, look relatively less expensive. All of this increased demand, and the increased inflows into the US, generally leads to greater profits for US companies and increased stock valuations.

This correlation between a weak US dollar and a strong US stock market has certainly been evidenced over the last few decades. To be exact, the correlation over the past 40 years is -0.42, meaning that for every 1% depreciation of the US dollar, relative to the Canadian dollar, the US stock market has risen by 0.42%.



Not only are the correlations negative, but the trend-line (as represented by the red dotted line in the chart below) is downward sloping, indicating that USD strength has become increasingly detrimental to US stock returns, notwithstanding the slight uptick of late.



Skeptical readers might now concede that unhedged US equities have, in fact, been less volatile, but only because they haven't performed as well. Not so. A similar rolling 1 year analysis shows average unhedged outperformance of 30 bps.

There's no question that there are opportunities for advisors to add additional alpha to client portfolios by taking a tactical allocation approach to currency. What likely isn't as well known is that advisors, historically, have also been able to (perhaps unintentionally) minimize client's portfolio volatility, not by taking on a more conservative asset mix, but rather by investing in unhedged, rather than hedged, US equity.

While the data makes a compelling case for sticking with unhedged exposure over time, we recognize that Canadians have very different investing needs and goals, and for some, unhedged exposure might not be the best fit. Our job, as an asset management firm, is to ensure we offer up solutions that meet these real world needs of investors. In this particular case, it means offering CAD hedged, unhedged, and US dollar ETFs.

Two of First Asset's ETFs worth considering for US exposure, particularly in light of recent equity market volatility, with their associated ticker symbols are:

| | CAD Hedged | Unhedged | USD |
|---|------------|----------|-------|
| First Asset Core US Equity ETF | CES | CES.B | CES.U |
| First Asset MSCI USA Low Risk Weighted ETF | RWU | RWU.B | - |

First Asset Core US Equity ETF provides diversification of smart-beta factors by holding four ETFs in a one-ticket portfolio solution, while First Asset MSCI USA Low Risk Weighted ETF seeks to provide superior downside protection and better risk-adjusted returns through investing in a portfolio of low volatility stocks. [e](#)

1. Source: Morningstar Direct

In order to get the longest string of historical data possible, the S&P 500 TR USD Index was used to calculate all referenced US equity performance data. This Index, converted into Canadian dollar terms, was used to represent unhedged returns. This communication is intended for informational purposes only and is not intended to provide specific financial, investment, tax, legal or accounting advice, and should not be relied upon in that regard. First Asset ETFs are offered by prospectus. Individuals should seek the advice of professionals, as appropriate, and read an ETF Fund's prospectus prior to investing. Investments in ETF Funds may not be suitable for all investors. Some conditions apply. Copies of the prospectus may be obtained from your investment advisor, First Asset or at www.sedar.com. Commissions, trailing commissions, management fees and expenses all may be associated with investments in exchange traded funds. Exchange traded funds are not guaranteed, their values change frequently and past performance may not be repeated. The First Asset ETFs are managed by First Asset Investment Management Inc.

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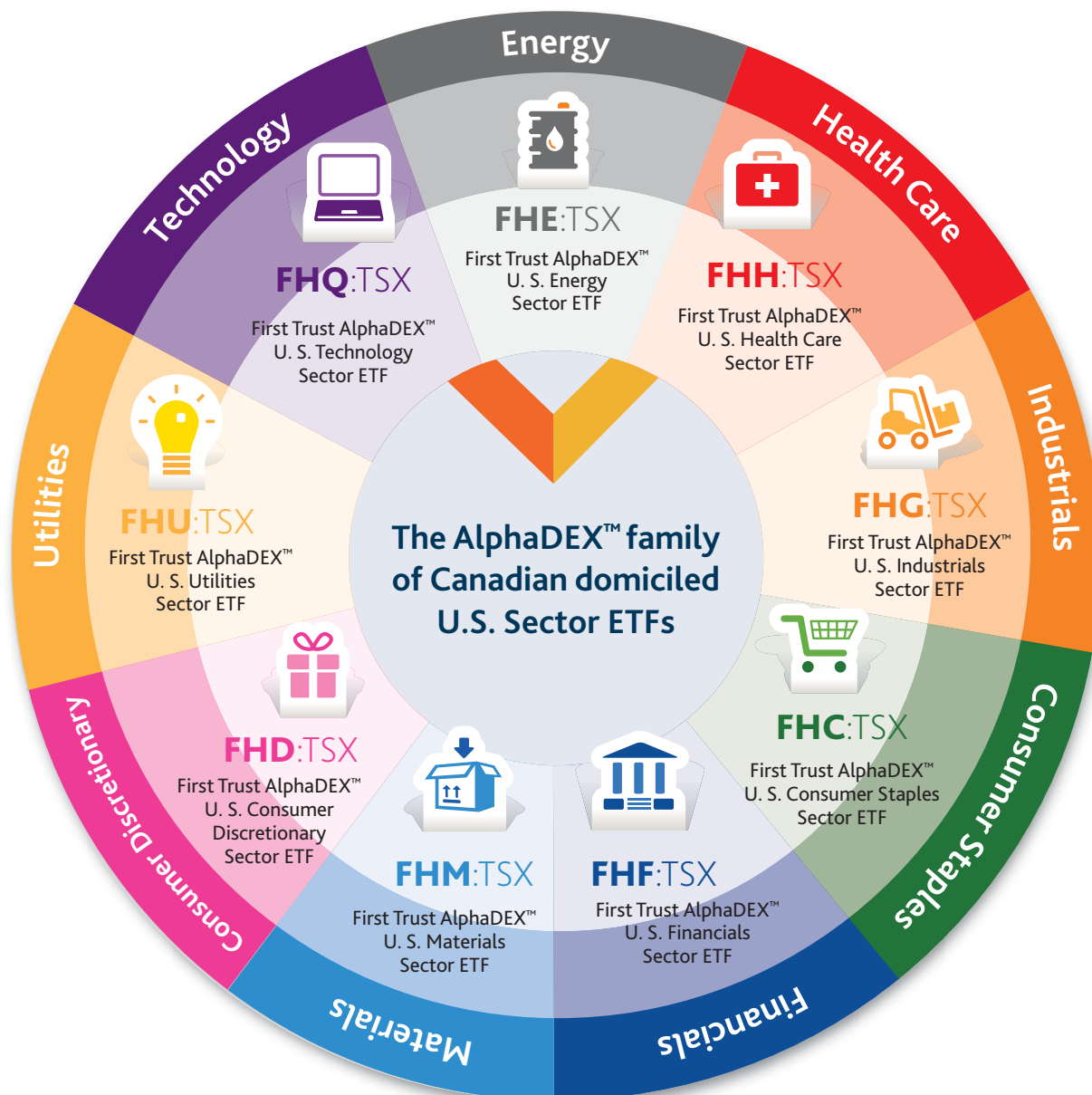
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Why Fixed Income ETF of ETFs?



With tens of billions of dollars invested in fixed income products, cost-effective Bond ETF portfolio solutions could be the next big thing .



Karl Cheong
*Partner,
Head of ETFs,
Canada
First Trust Portfolios
Canada*

Fixed income will always be a mainstay of clients' portfolios, despite the investment industry's volatile sentiment regarding the asset class. So while the durability of fixed income's presence cannot be disputed, the avenue through which many people own bonds may change dramatically over the next several years. There are currently tens of billions of dollars invested in fixed income products, but less than 20% of the assets invested within fixed income is in ETFs¹. We believe that a significant portion of this may soon shift to ETFs, for the following reasons:

1. IIROC²-regulated advisors have embraced ETFs as a means of obtaining exposure to equity markets. Many advisors are currently looking to shift to ETFs for the fixed income portion of client portfolios as well, but are limited by the number of rules based and actively managed bond ETFs to choose from. Naturally, investors default to fixed income mutual funds because they do not want to be responsible for determining the credit, duration, and global allocation of client portfolios.
2. It is both simpler and more efficient to use ETFs to adjust credit and duration risk in a fixed income portfolio than to buy or sell individual bond positions or to invest through large mutual fund managers. This is particularly important, as the majority of gains and losses for fixed income asset managers is typically derived from credit and duration movements.

3. The bond market has become less efficient since the market collapse of 2008. Many of the major bond dealers now keep less than 10% of the inventory held prior to 2008³, and many investment dealers no longer even maintain a bond desk. This has created inefficiencies in the bond market. At times ETFs act as the leading price discovery instrument in the bond market.

4. The costs of owning an ETF of fixed income ETFs are generally favorable compared to mutual funds. At a time when a ten-year government bond of Canada yields 1.33%, the asset-weighted management expense ratio for domestic bond funds of 1.60%⁴ is too high. By contrast, fixed income ETF portfolios charge lower fees on average with MERs ranging from 0.53% to 1.03%. In today's low interest rate environment, fees can eat into already low yields. Reducing costs can help clients keep more of what they earn.

5. Bond mutual funds offer little or no transparency. Without extensive online research, it is difficult to find out about key variables such as yield to maturity and duration of your favorite bond mutual fund portfolio. ETF companies such as First Trust Canada offer an extensive profile of all their fixed income ETFs with a full list of holdings which is updated daily. For bond ETFs such as the First Trust Short Duration High Yield Bond ETF (TSX: FHY) you can find data points on the weighted average coupon rate, weighted average effective duration, weighted average yield to maturity and credit ratings of the bonds in the portfolio.

6. Lastly, bond mutual funds can only be traded at end of day NAVs whereas a bond ETF can be traded at any time during the stock market hours, with better transparency on the prices that other investors are bidding and asking. First Trust Senior Loan ETF (CAD-Hedged) (TSX:FSL), an actively managed fixed income ETF and the First Trust Global Risk Managed Income Index ETF (TSX:ETP), an ETF of ETFs, demonstrate the opportunity for fixed income ETFs and ETFs of ETFs to expand their market share within the investment fund industry. More recently, First Trust Canada launched a quantitative, rules-based fixed income index ETF called the First Trust Tactical Bond Index ETF (TSX:FTB) which seeks to replicate the performance of the NASDAQ IBIS Canadian Preservation Index CAD TRSM, net of expenses. FTB invests only in TSX-listed fixed income ETFs and complements both active bottom up and strategic index approaches within an investment portfolio. We believe the next big evolution in the ETF space will be in actively managed ETFs (and ETFs of ETFs), and like many other instances in the financial industry, we expect that pioneer investors will benefit enormously. ☑


¹ Source: IFIC, Credo Consulting Inc.

² IIROC - Investment Industry Regulatory Organization of Canada

³ Source: Deutsche Bank

⁴ Source: Morningstar

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The Active Versus Passive Debate



Obscuring the lines between core and satellite.

The active versus passive portfolio debate concludes with a traditional portfolio model comprised of core and satellite components. In this approach, the inexpensive beta fulfills the core portion while the active (or satellite) investment is an overlay. The conventional wisdom is excess returns are captured by non-index strategies, whether through managers that attempt to outperform specific indices or non-traditional asset exposure and targeted strategies.

The rationale is clear: less than 20% of large cap fund managers outperformed their bogeys in 2014 (SPIVA 2015 report card). In addition, high fees for closet indexers and the lack of inexpensive alternatives to specific themes also contribute to this challenge.

Times are changing

In the decade up to 2014 there was an eight-fold increase in the number of ETFs. More recently, this includes a proliferation of innovative, cost-effective products that makes it feasible to express niche investment themes that were previously too expensive or complicated for the average investor. The advent of these solutions makes it possible to express short to mid-term investments theses that cover a broad spectrum of investments, specific market segments or styles, and strategies.

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Given the tremendous run-up over the past six years (since the S&P 500 reached 666 in March of 2009), the halcyon days of double digit returns are over. Most pundits state it's a stock picker's market. I would add it is also sector/country/style market/alternative market choice is crucial. To mix metaphors, you can no longer rely on the overall market to lift all boats. The U.S. bond market underscores this.

Today

Today, the financial landscape is drastically different as we are now seeing a shift in thinking about core and satellite.

The anemic economic recovery has nevertheless produced 5.3% unemployment rate with a 96.1 figure (prelim. July) from the University of Michigan Consumer Confidence Index. This up 16.5% from a year ago. Tighter monetary policy is not a question of if but when: September or December. In the face of rising interest rates, it's difficult to justify the core of your bond portfolio in U.S. corporates and treasuries. Perhaps the position should be inverted, whereby your core is an active manager who has mitigated duration risk while seeking yield enhancement or an inflation-protected (TIPs) ETF.

Traditionally difficult markets, such as new bond issues, are now available in actively managed ETFs. Likewise, an active market thesis is available in global equities ETFs.

In this new model, core investments consist of cost-effective alpha (excess positive returns) strategies and beta exposure. To put it another way, this is an active cost-effective core with targeted strategies using smart beta as the overlay.

Through price compression, ETFs have democratized the investment landscape. Sophisticated and average investors alike can employ similar sophisticated strategies and use the same instruments to express those views. When reviewing portfolios, consider low cost alpha strategies as the core with smart beta overlays. [e](#)

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1. Source: NBF - Canadian ETF Flows 2015.

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