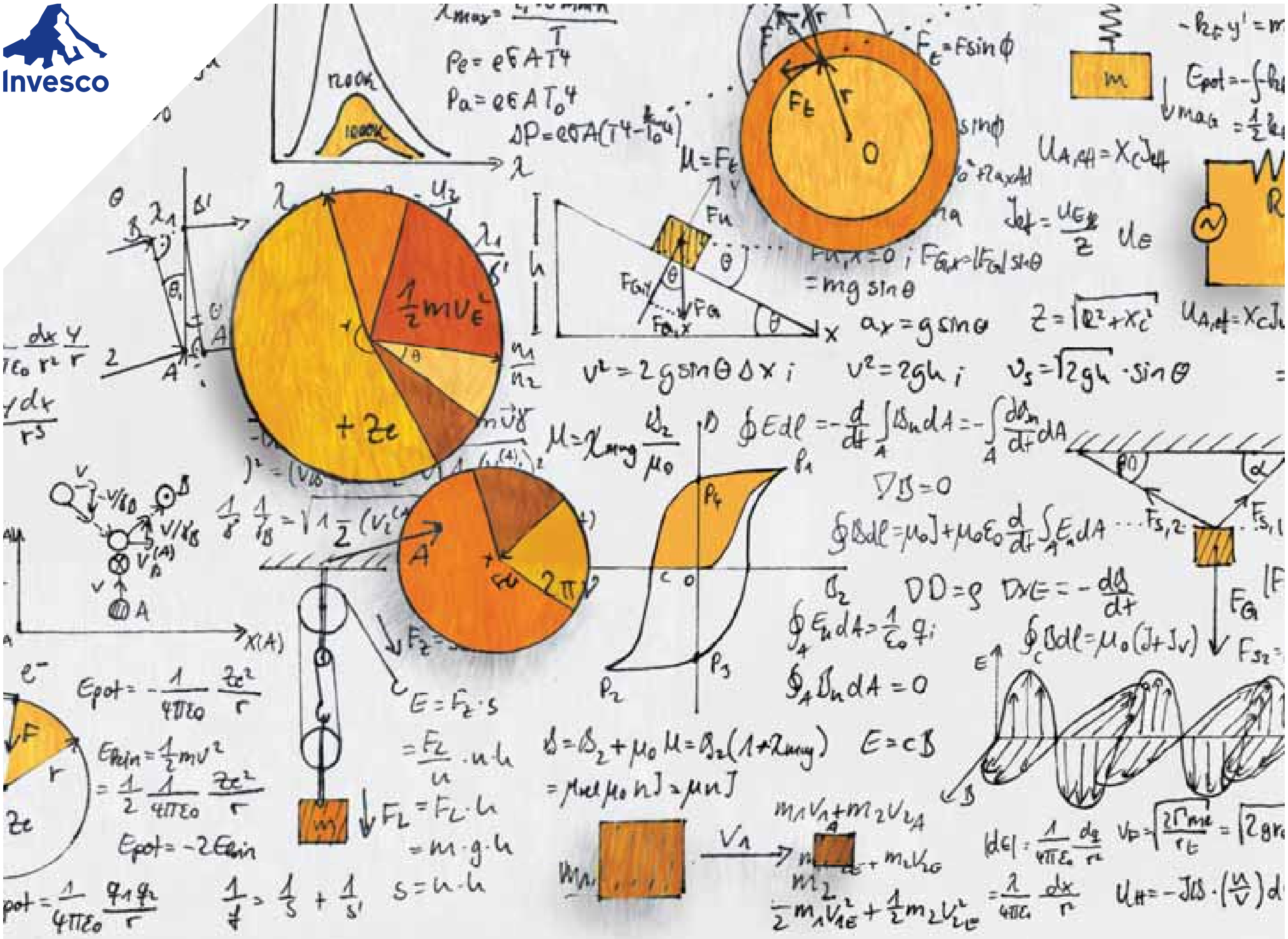
CANADIAN
ETF Watch
VOL 5 ISSUE 5 SEPTEMBER 2014
canadianetfwatch.com

ETFs 3.0

The Canadian ETF industry has come a long way from its humble beginnings in 1990.

- The Investing World Has Changed
- The Advantages of Low-volatility Global Strategies
- Why put protection can beat buy and hold investing over the long haul
- Clearing the Air: Explosion of ETFs Clouds Investors' Decisions
- The (not so) New Kid on the Block: Why Bond ETFs Are Finally Taking Centre Stage

Invesco



The intelligent choice for your portfolio

PowerShares Canada offers you a broad suite of ETFs and mutual funds that delivers access to specialized assets classes, intelligent indexes and innovative strategies.

Join the intelligent investing revolution.
Visit **www.powershares.ca**.

powerSHARES®
Leading the Intelligent ETF Revolution®

ETFGI'S RESEARCH SHOWS ASSETS INVESTED IN ETFS AND ETPS LISTED IN CANADA REACHED A NEW RECORD HIGH OF 67.9 BILLION US DOLLARS AT THE END OF AUGUST 2014

LONDON – September 8th, 2014 – ETFGI's research finds ETFs and ETPs listed in Canada reached a new record high of 67.9 billion US dollars at the end of August 2014. The Canadian ETF industry had 312 ETFs, with 432 listings, from nine providers listed on one exchange according to preliminary data from ETFGI's end August 2014 Global ETF and ETP industry insights report.

New record highs in assets were reached at the end of August by ETF/ETP industries in Canada with US$67.9 Bn, Asia Pacific (ex-Japan) with US$103.7 Bn, Europe with US$477.4 Bn, the United States with US$1.91 Tn and globally with US$2.70 Tn. YTD NNA flows reached record levels for the ETF/ETP industries in Japan at US$16.5 Bn, Europe at US$50.4 Bn, the US at US$107.3 Bn and globally at US$185.0 Bn.

"In August investors invested net new money into an array of equity and fixed income exposures due to concerns over the situations in Ukraine and Gaza. The S&P 500 was up 4% in August and closed above the 2,000 threshold for the first time on August 26th. Developed markets were up slightly, emerging markets gained 3% and Latin America was up 9% in August. August was also a good month for fixed income." according to Deborah Fuhr, Managing Partner at ETFGI.

In August 2014, ETFs/ETPs saw net inflows of US$643 Mn. Fixed income ETFs/ETPs gathered the largest net inflows with US$294 Mn, followed by equity ETFs/ETPs with US$289 Mn, while commodity ETFs/ETPs saw net outflows of US$5 Mn.

Source: ETFGI.com

Terry Krowtowski, Vice President
Radius Financial Education

CANADIAN ETF Watch
canadianetfwatch.com
SEPTEMBER 2014 | VOL. 05 NO. 05

Contact Information
Canadian ETF Watch
1235 Bay Street, Suite 400, Toronto, Ontario M5R 3K4
tel: 416.306.0151

Media, Advertising & Editorial
info@radiusfinancialeducation.com

Subscriptions
info@canadianetfwatch.com

Canadian ETF Watch is published 6 times per year by **Radius Financial Education.** We welcome articles, suggestions and comments from our readers. All submissions become the property of Canadian ETF Watch, which reserves the right to exercise editorial control in accordance with its policies and educational goals.

If you would like to cancel your subscription at any time, please contact **info@radiusfinancialeducation.com**

radius Financial Education
radiusfinancialeducation.com

CONTENTS

CONTENTS

ETFs 3.0

The Canadian ETF industry has come a long way from its humble beginnings in 1990.

Trevor Cummings
Head of Business Development, RBC ETFs, RBC Global Asset Management

Although our neighbours to the south typically choose 1993 as the year ETFs began, we know better up here in Canada: the Toronto Stock Exchange launched the world's very first ETF in March 1990, which at the time tracked the TIPS-35 Index. And even though we are quickly approaching the quarter-century milestone for ETFs in Canada, it could be argued that these are still early days. On a global basis, less than 5% of the world's equity markets are invested using ETFs, while for fixed income, barely 1% of the global bond market is invested using ETFs. Today, innovation in ETFs continues and the industry is evolving as quickly as ever.

There are three distinct phases, or "eras," in the evolution of ETFs. While these phases are not in exact chronological order, the ETFs that exist in today's market can generally be attributed to at least one of them. And, as adoption rates changed and investment professionals began integrating ETFs into client portfolios at a greater rate, the phases evolved.

Phase I – Broad beta

Early ETFs were characterized by broad beta. Ten to 15 years ago, almost all ETFs available offered broad exposure only. This phase was marked by a passive investment theme. Interestingly, despite academic evidence suggesting a passive investment approach is often appropriate, ETFs did not gather much traction back then for several important reasons:

1. Fee-based asset management was nascent. Investment advisors would often lament the fact that ETFs did not pay trailers. Since advisors were used to earning trailers every quarter, it was difficult to convince them to take on infrequent commissions instead. Of course, this was during a time when the industry itself changed and clients began to pay for expertise and management, instead of pure access to product.

2. Optics mattered. Investment professionals often had concerns about their value proposition. For example, if they were to allocate a large client portfolio to perhaps three or four ETF positions, they might run into perception roadblocks. In other words, the risk of client accounts looking “too simple” or “unsophisticated” ruled the day.

3. Passive investing assumes perfect discipline and ignores all of the behavioural finance pitfalls that plague investors the world over. When markets rally 20%, an ETF returns very close to 20%, but when the market loses 30%, an ETF subsequently loses 30% as well. Passive investing assumes that an investor (a) readily accepts the return, (b) does not panic and abandon their asset allocation, and (c) happily rebalances into the asset class that has lost them the most – a challenging endeavour for anyone, myself included!

Phase II – Specialized beta

Cue the second phase, when ETFs evolved to cover narrower and narrower slices of the pie. Sector and sub-sector products, products touching different durations and quality tranches of the bond market, and country-specific ETFs all bloomed. Assets in ETFs took off because more and more types of investment professionals could begin using them. In fact, the industry began to call using ETFs “indexing,” rather than passive investing –professionals could use them to express specific investment ideas, some of which had finite time horizons or clear-cut objectives.

For instance, those professionals who traditionally used manager search and due diligence as one of their value-adds could now keep those managers very honest, as there was an ETF alternative for almost every asset class. Not to suggest that ETFs were automatically going to win every comparison, mind you. But, rather, blending active and passive investing became en vogue – advisors could add additional value in choosing where to hire managers for alpha and where straight exposure via ETFs was the best approach.

At the other end of the spectrum, there were investment professionals who picked individual equities for clients. Always on the hunt for mispriced assets, these professionals might have been more tactical and nimble, looking for opportunities as they arrived. They now had the luxury of choosing whether they wanted to take on security-specific risk by either picking names or investing in the sector at large via ETFs. As an example, many more professionals were using ETFs instead of stocks for exposures like health care, infrastructure and international dividend-paying equities.

Phase III – Strategic beta

In the third phase in the ETF evolution, we have seen the introduction of ETFs with a number of different labels including rules-based and factor-based ETFs. Some even “smart beta”, which is not a very accurate term, considering many of these ETF products are expressly designed to deliver “alpha” – or excess returns versus the market. Other products still aim to provide lower volatility while some aim to do both.

All ETFs in this phase could be characterized as attempts to improve upon the Sharpe ratio of the underlying. They present a vast and diverse set of offerings. Quant strategies, low volatility and covered-call writing ETFs are all very different offerings, but all fall into this diverse category. In 2014, investment professionals have shown a consistent preference for this type of ETF over others.

New leaders to emerge

Taking into consideration the phases of the ETF industry we have examined thus far – and as the third phase continues to develop – here are some important considerations and takeaways:

1. The first phase will be won by the firm that can commoditize their offerings and charge the lowest fees. The second phase will be won by the provider that has the widest selection – the biggest “grocery store” – to provide one-stop shopping. However, those that led in the first and second phases are not necessarily in the best position to lead the third phase, which calls for experts in active management and in alpha-seeking and income-oriented solutions.

2. For clients, reputation matters. As ETFs get more complex, it will not be enough to simply track an index closely. Instead, a legacy of experience and thoughtful commitment to process are critical. Investment professionals must be able to define this process to clients by explaining how a particular ETF solution fits into their portfolios.

3. The winners of the third phase will be those that bring innovation to the ETF space. In this converging world, bringing liquidity, transparency and reasonable fees towards active solutions will be the way forward, but if – and only if – there is value for money and a well-thought-out, clearly defined process.

The road ahead

The ETF industry has changed. With all of the choices available, it is now more important than ever to have a clearly defined selection process as investment professionals further their use of ETFs in their client portfolios. Going forward, they will need to partner with a short list of ETF firms that are committed to the space and determined to innovate the landscape.

From our ETF beginnings in 2011 to today, RBC Global Asset Management is aiming to contribute to and ultimately lead the third phase in the evolution of ETFs – our assets in this space are up almost 200% in 2014 alone. With our suite of RBC Quant Dividend Leaders ETFs. Portfolio manager Bill Tilford and his team bring over 50 years of combined quant experience to the industry. To differentiate ourselves, we evaluate unique, forward-looking criteria and apply a proprietary weighting methodology to our ETFs – expertise that is uniquely Canadian and developed in-house.

Please visit **rbcgam.com/etfs** for information regarding the RBC Quant Dividend Leaders ETFs.

Trevor Cummings, Head of Business Development, RBC ETFs, RBC Global Asset Management ***etfs.investments@rbc.com***

The Advantages of Low-volatility Global Strategies

While smart beta has become a buzz word in the ETF industry, the concept is far from new. Institutional investors have used alternative weighting and factor-driven strategies since the 1970s, albeit not labelled "smart beta."

Michael Cooke
Head of Distribution
PowerShares
Canada

Smart beta seeks to offer investors an alternative to the black-and-white world of active versus passive portfolio construction. Unlike actively managed approaches, smart beta ETF strategies provide investors passive rules-based exposure while retaining the possibility of generating excess returns when compared to a cap-weighted benchmark index. And unlike traditional cap-weighted indices, smart beta may provide better risk-adjusted returns by allowing investors to capture risk premiums from various factors.

Through smart beta ETF strategies, investors have the opportunity to retain broad market exposure, potentially achieve long-term outperformance when compared to an index and reduce portfolio risk in a liquid, transparent and low-cost way.

The low-volatility anomaly

One increasingly popular form of smart beta is low-volatility investing. Conventional wisdom dictates that investing in riskier stocks should provide higher potential returns over time than investing in less risky stocks. However, the data tells a different story: Investors who took on less risk tended to outperform those who assumed more. This contradiction between theory and data is often referred to as the "low-volatility anomaly."

With the recent increase in market volatility, demand for investment products designed to minimize volatility is seemingly growing. Focusing on that concern, PowerShares Canada has provided investors access to low-volatility investing since the launch of PowerShares S&P 500 Low Volatility (CAD Hedged) Index ETF (ULV) in January 2012, followed soon after by PowerShares S&P/TSX Composite Low Volatility Index ETF (TLV) in April 2012. On September 8, PowerShares Canada enhanced its commitment to smart beta investing with the launch of two new global low-volatility ETFs: PowerShares S&P International Developed Low Volatility Index ETF (ILV) and PowerShares S&P Emerging Markets Low Volatility Index ETF (ELV). Now investors are able to access low-volatility strategies in equity markets beyond North America.

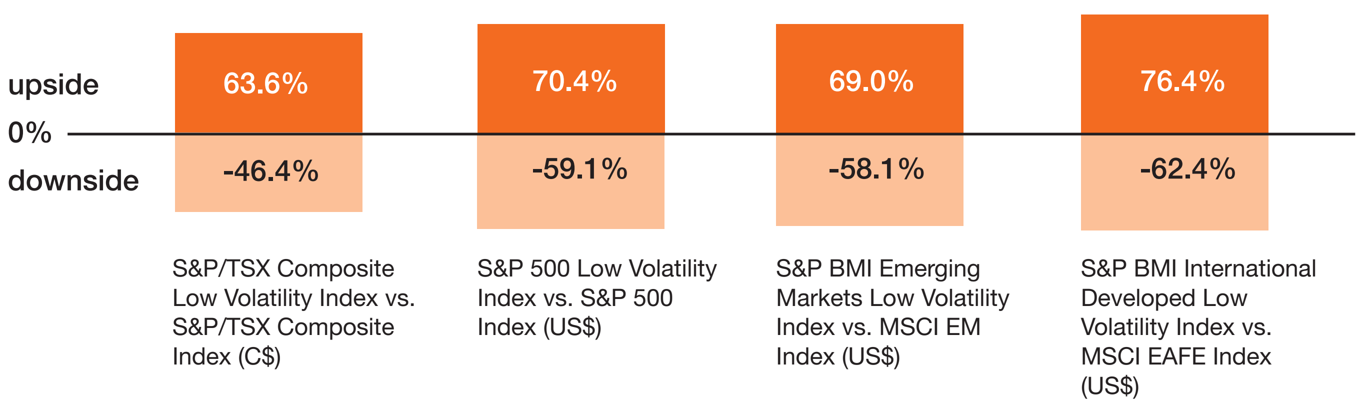
For investors concerned about volatility but seeking to maintain exposure to global equities, low-volatility strategies deliver:

- **Potential downside protection** - In down markets, low-volatility stocks have historically captured a smaller portion of the downside movements relative to the broader market.
- **Higher yield potential** - Historically, low-volatility stocks have had higher dividend yields relative to securities in the broader market.
- **Capital appreciation potential** – Historically, low-volatility stocks tend to outperform their market benchmarks over the long term.

Seeking To Mitigate Risk

Potential downside protection with upside participation†

Since their inception, the S&P low-volatility indices have exhibited downside protection relative to their benchmark indicies while participating in upward-trending markets.



Michael Cooke, Head of Distribution,PowerShares Canada ***michael.cooke@invesco.com***

Commissions, management fees and expenses may all be associated with investments in exchange-traded funds (ETFs). ETFs are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus before investing. Copies are available from Invesco Canada Ltd. at **www.powershares.ca**.

There are risks involved with investing in ETFs. Please read the prospectus for a complete description of risks relevant to the ETF. Ordinary brokerage commissions apply to purchases and sales of ETF units. Most PowerShares ETFs seek to replicate, before fees and expenses, the performance of the applicable Index, and are not actively managed. This means that the sub-advisor will not attempt to take defensive positions in declining markets, and the ETF will continue to provide exposure to each of the securities in the Index regardless of whether the financial condition of one or more issuers of securities in the Index deteriorates. In contrast, if a PowerShares ETF is actively managed, then the sub-advisor has discretion to adjust that PowerShares ETF's holdings in accordance with the ETF's investment objectives and strategies.

† Refers to the reduced potential for loss during market declines with the capacity to benefit during markets increases.

The Investing World Has Changed

Over 60 years ago, some of the brightest minds in academia changed the way people thought about investing with the introduction of what is known as the Capital Asset Pricing Model, or CAPM.

Barry Gordon
CEO & President, First Asset Exchange Traded Funds

CAPM gave us a framework in which we could assess the price and risk of securities. Its postulation that once you diversify all idiosyncratic company risk, all you have left is systemic risk, led to the conclusion that the only smart risk to take was beta. This led to the concept of creating a broad market portfolio that allowed investors access to market beta, which in turn spawned index mutual funds and ultimately the most popular form of ETF that currently exists – the broad market capitalization weighted index ETF. There are some real, observable and persistent flaws in the CAPM that flow through to capitalization weighted index portfolios – more on that later. However, it doesn't detract from the fact that capitalization index ETFs were revolutionary, smart, and addressed a real world need. They facilitated simple, cost effective access to an entire market portfolio.

FirstAsset™ Exchange Traded Funds

During the past 20 years, but the last decade in particular, the world of ETFs has evolved. We have more data to draw on, and different technologies to facilitate the advancement of solutions for the market. Now there are index ETFs that cover most, if not all, sectors, sub-sectors, industries, regions, company size, and asset classes. Those ETFs are ubiquitous. In addition, the market has seen the advent of ETFs the employ different weighting methodologies and screens to select stocks and bonds. However, investor needs have evolved beyond simple solutions that facilitate ready access to different markets, and even beyond solutions differentiated by style. Mutual fund providers have, frankly, done a much better job until very recently with tailoring solutions to address the needs of investors. Modern investors and advisors look at the world in a very different way than purely academic categorizations based on region or sector or asset class. They are looking for solutions that address their real world needs – income generation, capital appreciation and risk mitigation.

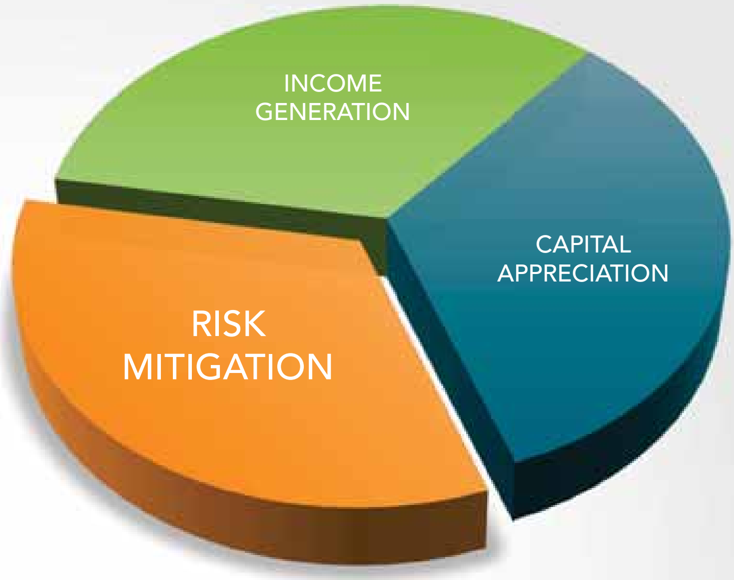
The new generation of smart exchange traded solutions – like those offered by First Asset – align themselves with the goals of investors and don't just provide cheap market access. They are smart because they: (a) address real needs; and (b) provide better risk adjusted returns than their more simple brethren. As indicated above at the end of the first paragraph, we know empirically that there are (at least) two big flaws with CAPM. First, we know that almost any method of diversification – even simple equal weighting – will outperform capitalization weighting over the long term, due to concentration and diversification issues that arise from capitalization weighting. Second, capitalization weighted portfolio have, by their nature, a "growth" tilt, and we know there are persistent factors or "effects" like value, momentum, volatility, and size, that generate better long term risk adjusted performance than a simple capitalization weighted, or growth, approach. The market does not reward growth as a "risk", which is why value strategies, for example, outperform over the long term. The key has been finding the right ways to harness these factors, in a low cost format, that negates the orthodox view that nothing outperforms a capitalization weighted portfolio over the long term. On a cost neutral basis, that view is clearly incorrect. The historic problem has been that the fees associated with mutual funds and the extra costs associated with portfolio turnover, have effectively negated the out-performance potential identified for years. Fast forward to the adoption of rules based value, momentum, volatility methodologies in the ETF structure, and the very recent launching of ETFs that employ active management, together with the modern reality that trading costs are a small fraction of what they used to be. The result has been a clear and powerful challenge to the orthodoxy of capitalization weighting. It's early days yet, but the gauntlet has been thrown down and the risk-adjusted outperformance is clear.

All of this leads to a world where investors can access solutions that provide them with better risk adjusted returns, in a low cost format that are designed to meet their real world needs and in combination help them achieve their personal financial goals. Smart solutions indeed.

First Asset – Smart Solutions™

First Asset is an independent investment firm, with AUM in excess of $3.1 billion, focused on providing smart, low cost solutions that address the real-world investment needs of Canadians - capital appreciation, income generation and risk mitigation. Rooted in strong fundamentals, First Asset's smart solutions strive to deliver better risk-adjusted returns than the broad market while helping investors achieve their personal financial goals.

Barry H. Gordon, CEO & President, First Asset Exchange Traded Funds



SMART SOLUTIONS FOR RISK MITIGATION

First Asset offers smart, low cost investment solutions that address the real-world needs of Canadian investors, including risk mitigation. Our ETFs built from MSCI indexes aim to deliver superior risk-adjusted returns by capturing broad equity exposure with low risk attributes.

ETF INFORMATION

Ticker	Fund Name
RWC	First Asset MSCI Canada Low Risk Weighted ETF
RWU	First Asset MSCI USA Low Risk Weighted ETF (CAD Hedged)
RWE	First Asset MSCI Europe Low Risk Weighted ETF (CAD Hedged)
RWW	First Asset MSCI World Low Risk Weighted ETF (CAD Hedged)

LOW RISK INDEX METRICS*

Up Capture	Down Capture	Sortino Ratio
79.99%	58.64%	0.75
71.59%	53.56%	0.54
71.21%	46.27%	0.66
58.78%	28.99%	0.71

as at Aug 31, 2014

WE'LL DO THE ANALYSIS FOR YOU

Investment Advisors call us for a comprehensive portfolio comparison: (416) 642-1289 / 1(877) 642-1289

First Asset - **Smart Solutions™**

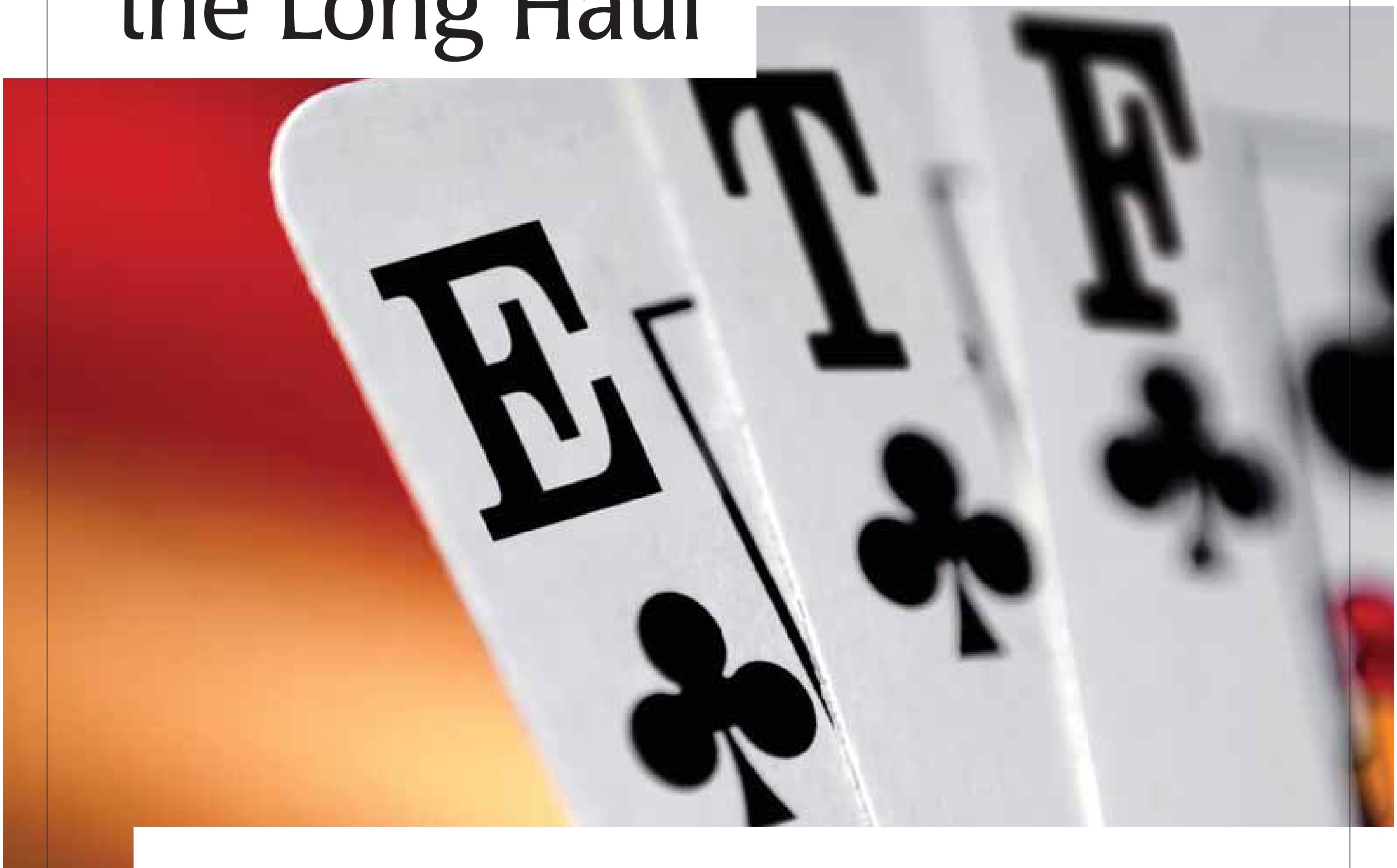
First Asset is an independent investment firm, with AUM in excess of $3.1 billion, focused on providing smart, low cost solutions that address the real-world investment needs of Canadians - capital appreciation, income generation and risk mitigation. Rooted in strong fundamentals, First Asset's smart solutions strive to deliver better risk-adjusted returns than the broad market while helping investors achieve their personal financial goals.

Find the solution that's right for you
www.firstasset.com/smartsolutions

FIRSTASSET™

* Risk metrics represent those of the ETF's underlying MSCI Indexes since their inception. MSCI index performance data results prior to Dec 26, 2013, and Jan 20, 2014, are hypothetical, but are calculated using the same methodology that has been in use by the index provider since the Index was first published. Information regarding the MSCI index and applicable index methodology, is available at http://MSCI.com/products/indices. As a result of the risks and limitations inherent in hypothetical performance data, hypothetical results may differ from actual Index performance. This communication is intended for informational purposes only and is not, and should not be construed as, investment and/or tax advice to any individual. Particular investments and/or trading strategies should be evaluated relative to each individual's circumstances. Individuals should seek the advice of professionals, as appropriate, regarding any particular investment. There is no assurance that an exchange traded fund will achieve its investment objectives. Commissions, trailing commissions, management fees and expenses all may be associated with investments in exchange traded funds. Please read the prospectus before investing. Exchange traded funds are not guaranteed, their values change frequently and past performance may not be repeated. MSCI is a trademark of MSCI Inc. The MSCI indexes have been licensed for use for certain purposes by First Asset. The funds or securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such funds or securities or any index on which such funds or securities are based. The prospectus of the funds contains a more detailed description of the limited relationship MSCI has with First Asset and any related funds. The exchange traded funds are managed by First Asset Investment Management Inc.

Why Put Protection Can Beat Buy and Hold Investing Over the Long Haul



Nick Piquard, *CFA®*
Vice President,
Portfolio Manager &
Options Strategist

You have probably heard that, for the long-term investor, a 'buy and hold' strategy is the way to go. For example, if you invested $1 in the S&P/TSX 60™ Index on December 31, 1999, it would be worth $2.39 today. While you may have encountered a few bears along the way, like Nortel, the "tech bubble" and the Financial Crisis of 2008, your investment would still have survived, and paid off well by 2014. This is the reason why buy and hold investing has a good reputation, it stands the test of time.

However, if you are only looking at the growth of that $1 dollar invested, you aren't considering the volatility investors experienced along the way. When the tech bubble burst, the S&P/TSX 60™ Index was down 47.9% between August 2000 and September 2002; similarly, when the financial crisis hit in 2008, the Index fell 43% between May 2008 and February 2009.

While you may think that buy-and-hold investors eventually end up ahead of the game, you aren't accounting for the rollercoaster of emotions they experience by having to wait out bearish events like the ones aforementioned.

What if you could avoid the rollercoaster and opt for a smoother road for returns? For example, what if you had an investment strategy in place that allowed you to pay a small premium to avoid the losses like those of the tech bubble bursting in 2000 and the financial crisis of 2008?

The answer could be a long-dated put options strategy on your equity holdings. Think of long-dated puts like buying insurance for your home, it gives you peace of mind should the market experience extreme conditions.

With a period of one year or more until expiry, long-dated puts have the potential to protect you in the case of a major market correction. By holding long-dated puts on equity already owned, investors can sell their puts for a premium when a market correction occurs. Puts generally become more valuable as their underlying market declines. In turn, this helps generate returns that can offset some of the losses you experience when your equities lose value.

If the market continues to rise or remains flat, investors, who use a put protection strategy, can generally expect a return that is equal to approximately the returns of the market less the cost of the puts they purchased.

If stocks continue to rise, you will moderately underperform the market, but you will also have protection in place that could potentially offset any losses experienced on equity holdings. The good news is that there is a way to potentially smooth out the rollercoaster.

Let's flashback to six years ago on June 17, 2008, when the S&P/TSX 60™ Index closed near its all-time high of 899.97. At the time, puts were more expensive and would have cost close to 3% of notional exposure or $27 for a December 10% out-of-the-money put. At expiry, those puts ended up being worth $293, more than 10 times your investment, and would have sheltered your portfolio from a significant portion of the 43% drawdown the Index experienced between 2008 to 2009.

Puts are historically inexpensive right now. S&P/TSX 60™ Index puts with an 800 strike expiring in December cost approximately $7.95, which is about 1% of the Index, and with – the corresponding right amount of notional coverage, could protect you from a sudden market drop in excess of 10% of the S&P/TSX 60™ Index's current 877 level.

Buying puts can be difficult, fortunately there are exchange traded funds (ETFs) in Canada which are easy to buy that already incorporate put protection into their investment strategies, such as the Horizons Canadian Black Swan ETF (HUT:TSX) and Horizons US Black Swan ETF (HUS.U:TSX). These two ETFs primarily invest in a broad equity index – HUT invests in the S&P/TSX 60™ Index and HUS.U invests in the S&P 500® – and then they allocate a small proportion of the portfolio to options strategies, which includes buying puts, so that the overall ETF returns are potentially protected from significant and sudden market declines.

A hard landing in China's economy? A new rebellion in Iraq? Russia invades Ukraine? Disappointing bank earnings? With put protection, you aren't worried so about what bear will hit the Index next, you know you own protection. You have insurance on your house and car, so why not purchase some insurance for your portfolio?

Nick Piquard, CFA, Vice President, Portfolio Manager and Options Strategist, Horizons Exchange Traded Funds email@email.com

Toronto Stock Exchange:
Home to Canada's Exchange Traded Products

More than 300 ETPs

Canada Equity
- Growth
- Dividend
- Value
- S&P/TSX 60
- S&P/TSX Composite
- Low Volatility
- High Beta
- S&P/TSX Small Cap
- Covered Calls
- S&P/TSX Venture Select
- MSCI Canada
- FTSE RAFI Canada
- Morningstar Canada
- Dow Jones Canada

International Equity
- Emerging Markets
- Europe
- Global Funds
- Japan
- Latin America
- United States
- BRIC (Brazil, Russia, India & China)
- EAFE (Europe, Australia, Asia, and the Far East)

Currencies
- Euro
- Pound
- U.S. Dollar
- Yen

Commodities
- Agriculture
- Base Metals
- Precious Metals
- Energy
- Broad

Volatility & Alternative Strategies
- VIX Short-Term Futures
- VIX Mid-Term Futures
- Managed Futures
- Hedge Fund

Multi-Asset
- Active Diversified Income
- Core Portfolio Funds
- Completion Portfolio Builders
- Monthly Income Funds

Fixed Income
- Corporate
- Convertible
- Government
- Real Return
- High Yield
- Target Maturity
- Laddered
- Barbells
- Senior Loan

Sector Equity
- Agriculture
- Consumer Staples
- Energy
- Financial
- Healthcare
- Infrastructure
- Information Technology
- Materials
- Metals & Mining
- Real Estate
- Socially Responsible
- Utilities
- Water

Exchange Traded Products ETPs | TMX | Toronto Stock Exchange

tmx.com/etp

amelia.nedovich@tsx.com | 416 947-4499
jeff.foster@tmx.com | 416 947-4229

Clearing the Air: Explosion of ETFs Clouds Investors' Decisions

Morningstar currently tracks some 316 exchange traded funds in Canada.

Karl Cheong, CFA
Senior Vice President, Head of Product Development, First Trust Portfolios Canada

While just a fraction of the 3010 mutual funds it tracks, advisors are finding it increasingly difficult to cut through the clutter of an ever-growing universe of ETFs for their clients. In particular, these choices are clouded by an emerging genre of non-traditional ETFs. These ETFs were created for the purpose of attempting to deliver "better beta" or alpha and many are branded as being "fundamentally" based. So with more of these non-beta ETFs expected to hit the market, advisors will likely need help identifying and differentiating the host of investment solutions.

Having so many choices is a good problem to have but it is important to understand the differences between them in order to properly construct an investment portfolio that suits its intended purpose. It may be helpful to begin by putting all ETFs into two broad categories: Beta and Alpha. ETFs designed to seek market risk and return fall under the beta umbrella. They typically track "market" indexes where all of the stocks in a relevant market are included and they are weighted based on market capitalization. The ETF market has long served advisors looking to simply replicate the returns of the market and delivering beta was preferred. Because of the additional benefits provided by ETFs such as low costs, exchange-traded liquidity, and transparency, the ETF industry has evolved to include alpha-pursuing index funds for investors and their advisors looking to achieve potentially better investment results. These funds don't own all of the stocks in a respective market and often use alternative methods to weight them rather than market capitalization. Of note, these ETFs may track a dynamic index or they may be actively managed.

First Trust
Portfolios Canada®

ETF Categories

	Beta		Alpha	
Category				
Sub-Group	Traditional	Non-Traditional	Non-Traditional	Traditional
Description	A passive index approach of owning all stocks in a respective market and weighting by market capitalization.	An alternative beta approach of owning most or all stocks in a respective market but using alternative metrics to weight the stocks such as total sales, total dividends, book value, etc.	ETF tracking an index designed to seek alpha by owning a select basket of stocks from a market or index and weighting based on investment merit. Different from traditional alpha to the extent index changes are generally made less frequently.	Actively managed, ability to modify portfolio on a regular basis.
Example	S&P/TSX Index	S&P/TSX Equal Weight Index	S&P/TSX Fundamentally Weighted Index	Actively managed large cap blend ETF benchmarked against the S&P/TSX Index

Source: First Trust Portfolios Co.

These two broad categories, beta and alpha, could be further grouped as traditional or non-traditional.

Beta and alpha are both statistical measurements used to evaluate the risk-reward profile of an investment. The four investment strategies we listed in the table are all subject to market risk – that is the risk that the underlying securities will lose value – however, each approach presents some unique risk-reward characteristics. Traditional beta strategies mitigate a degree of individual security risk through diversification but, because they are market capitalization-weighted, the largest companies in the index can represent a significant weighting and create unwanted risk. The non-traditional beta and alpha approaches attempt to limit exposure to the largest stocks and increase exposure to others in an attempt to provide better returns. There are, however, times when alternative weighting approaches and stock level factors, such as valuation may become less meaningful and their effectiveness may diminish.

The area of the ETF market where we have found causes the most confusion is between the non-traditional beta and non-traditional alpha. Non-traditional beta generally tries to provide returns slightly different but better than the market. That is, an alternative passive strategy. More often than not, these ETFs track indexes that vary slightly from cap-weighted indexes. In most cases they own the same stocks as the index but the constituents are either equal weighted or use alternative measures of size to weight. Many of these ETFs are marketed as tracking "fundamental" indexes because the constituents are weighted based on total book value, total sales, total dividends or other factors.

It begs the question: what are fundamentals? Do book value, total sales, and total dividends really provide informational value of the future stock price of a company? Or is it just another way of measuring how big the company is. After all, the largest US companies tend to have greater book value, sales, and dividends. We don't believe these measures are "fundamental" factors.

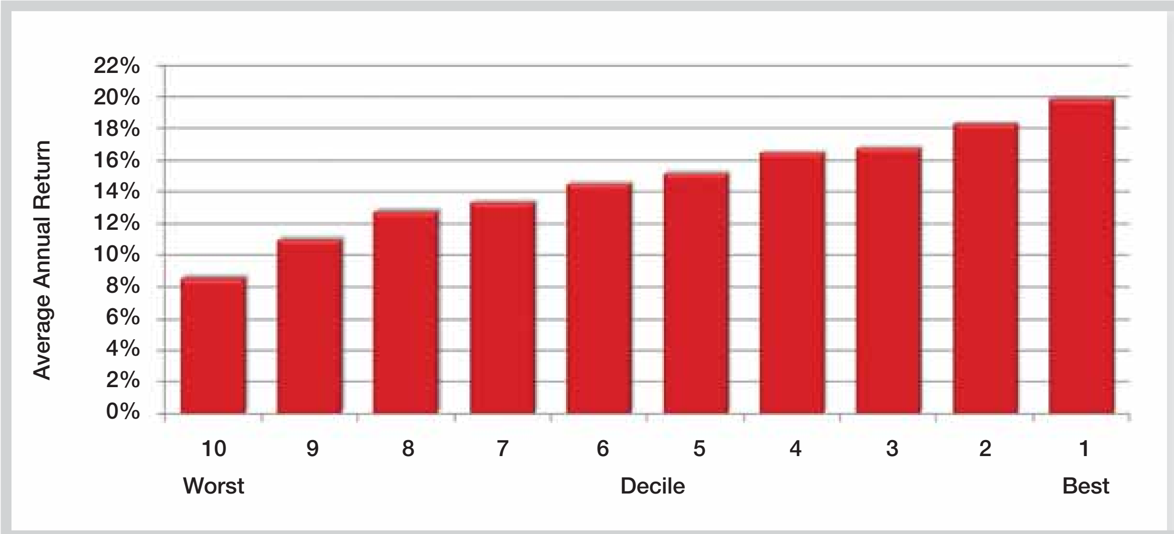
The other sub-category of the ETF market that focuses on non-traditional alpha seems to be getting a majority of the attention among advisors looking for more than better beta. These ETFs typically track indexes designed to seek risk-adjusted excess returns. Because stock prices are subject to market factors that can make them deviate from a company's true value, these indexes use fundamental evaluation measures to select and weight constituents commonly used by most professional money managers such as price-to-book, return on assets, price momentum, sales growth etc. These indexes mimic in many ways the approach and behavior of active managers by applying certain rules relating to when to buy, when to sell, and from what universe of stocks to select from while attempting to limit exposure to over-priced stocks and increase exposure to those which are trading at more attractive valuations.

Academic literature supports the possibility of generating outperformance through the use of purely quantitative fundamental measures. To illustrate this point, we started with a large universe of stocks and divided them into deciles based on their ranking on a single valuation factor – price to cash flow. The following chart shows the average annual performance of the stocks in each decile held for one year with the process repeated each year. Although past performance is no guarantee of future results, this example shows that stocks with a better price to cash flow valuation historically outperformed those with a worse price to cash flow valuation. The fact is, fundamental valuation matters.

Continued on page 18

Continued from : Clearing The Air... page 17

Price to Cash Flow: 1952-2012



Source: Kenneth R. French data library using the CRSP database. The universe includes all NYSE, AMEX & NASDAQ stocks. Stocks are equally weighted. Past performance is no guarantee of future results. This example is for illustrative purposes and does not represent any actual investment.

While many single valuation factors can be useful in stock selection, we believe multi-factor models are a more prudent approach and generally more consistent over time. The stability of a quantitative selection model over time is an important consideration when choosing the proper mix of valuation factors.

Consider the example of one such fund that follows a non-traditional alpha approach – the First Trust AlphaDEX U.S. Dividend Plus ETF (TSX:FUD). This fund is based on First Trust's proprietary AlphaDEX stock selection methodology. This methodology is designed to use fundamental valuation factors to select and weight stocks based on their investment merit. Over the last year and since inception of the ETF, FUD has outperformed its primary benchmark, the S&P 500 CAD Hedged Index by 2.19% and 4.16% respectively. We believe this is a remarkable example of the significance of fundamental security selection and weighting when seeking alpha. It is important to note that there can be no assurance that the fund will continue to achieve or maintain its investment objective.

While different methods of indexing will have inherent limitations at different times, we believe that a weighting methodology based on fundamental investment merit, rather than firm size, is a more rational long-term approach to investing. Cutting through the clutter of new ETFs and in particular those in the better/alternative beta vs. the fundamentally-based alpha ETFs may still be a challenge for many investors and advisors. But putting them into one of the four sub-groups can go a long way toward finding the right ETF to help clients reach their financial goals.

Performance (as at 29/08/2014)

	1 Mos	3 Mos	6 Mos	YTD	1 Year	Since Fund Inception
FUD Performance						
NAV	4.22%	6.58%	12.69%	13.92%	28.18%	22.84%
Index Performance						
S&P 500 Hedged Canadian Dollar	4.06%	4.83%	9.20%	10.17%	25.99%	18.68%

Inception Date: 15/05/2013

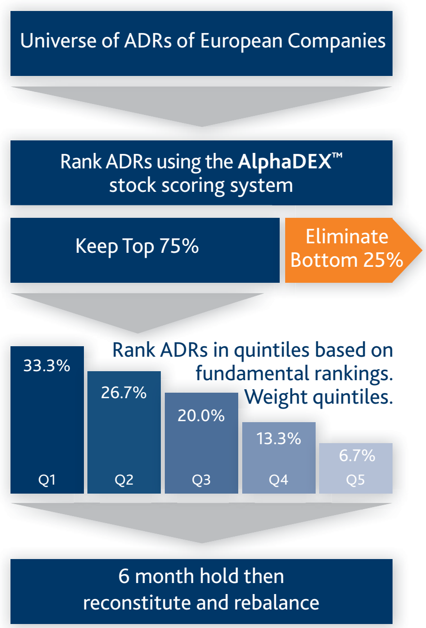
The indicated rate(s) of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales or distribution charges or income taxes payable by any security holder that would have reduced returns. Returns are average annualized total returns, except those for periods of less than one year, which are cumulative.

Karl Cheong, CFA, Senior Vice President, Head of Product and Capital Markets, First Trust Portfolios Canada ***karlcheong@firsttrust.ca***

Now is the time to capitalize on attractive European dividend yields with TSX:EUR, First Trust AlphaDEX™ European Dividend Index ETF (CAD-Hedged).

- **European equities** provide excellent opportunities for performance and yield
- Proprietary **AlphaDEX™** methodology delivers a disciplined, rules-based investment approach
- **Currency-hedged** to help mitigate against currency risk
- All the **benefits of an ETF** including intraday trading, transparency and liquidity and low fees
- Management fee of 0.60%*

AlphaDEX™ Methodology



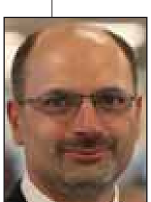
Find out why **EUR** is the right European fund for your portfolio. Go to **www.firsttrust.ca** or call **1-877-622-5552**.

First Trust Portfolios Canada®

* Maximum annual management fee of 0.80%

Commissions, trailing commissions, management fees and expenses all may be associated with ETF investments. ETFs are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus before investing.

The (not so) New Kid on the Block: Why Bond ETFs Are Finally Taking Centre Stage



Pat Chiefalo
Managing Director, Head of iShares Product, BlackRock Asset Management Canada Limited

As an analyst, I was a very strong advocate that one of the best ways for investors to gain exposure to fixed income securities is through an exchange traded fund (ETF). Here at BlackRock I continue to support this. To my mind, ETFs offer a number of key advantages over individual bonds, but I appreciate that not all investors are fully aware of these aspects. Equity ETFs have been around in Canada for 25 years, which makes bond ETFs relatively new entrants having launched only 10 years ago. Retail investors are, in general, probably more familiar with investing in equities than in bonds. So even though fixed income ETFs have come a very long way in a relatively short time, it's understandable that the investing public is still getting to know them.

As investors become more familiar with these products, I think they will see some pretty clear advantages over direct bond holdings. First, bond ETFs are relatively low-cost and are easy to buy and sell. Second, they provide immediate diversification, with sometimes hundreds or thousands of bonds in each fund. And third, ongoing portfolio management of the ETF ensures that investors maintain their target exposures in terms of credit, duration and so on.

This suggests to me that there is still an education gap among investors when it comes to bond ETFs. To fully appreciate the benefits, it's important to understand how they work. So here are three key elements that every investor should know about bond ETFs:

1. A bond ETF typically tracks an index. While there are a few actively managed fixed income ETFs, for our purposes we'll focus on index-based products, which generally seek to track the performance of an index (minus fees and expenses). These products comprise the majority of bond ETFs out there.

Like equity indexes, bond indexes typically target a specific part of the market, such as a sector (e.g. government, corporate investment grade, corporate non-investment grade), a region (e.g. Canada, US, International, etc.), or maturity range (e.g. short – typically with one-to-five-year maturity bonds, mid – with seven-to-10-year maturity bonds, long – with 10-year-plus maturities, and so on). Bond indexes can also combine these elements in a variety of ways, allowing investors to access both broad and narrow segments of the bond market through the ETFs that track them. For example, you can access the broad Canadian bond market through a fund like the iShares Canadian Bond Universe Index ETF (XBB), focus further and gain exposure to high-quality, short-duration Canadian bonds to hold in the core of your portfolio with the iShares Core Short Term High Quality Canadian Bond Index ETF (XSQ), or you can target a laddered strategy of shorter-maturity corporate bonds with a fund like the iShares 1-5 Year Laddered Corporate Bond Index ETF (CBO).

Bottom line: Understanding the underlying index is key to knowing what you own in a bond ETF.

2. A bond ETF's current price is visible and updated throughout the day on an exchange. While some investors appreciate the fact that they can trade an ETF intraday, others may never take advantage of this feature. And that's okay, because the mere fact that bond ETFs trade on the stock exchange is still a benefit for these buy-and-hold investors. The reason: they provide price transparency in an otherwise opaque market.

Individual bonds trade over-the-counter (OTC), which means that buyers and sellers negotiate individually in order to reach a deal. As a result, bonds can be hard to track down and quotes from different brokers can vary widely. In contrast, investors can see bond ETF execution prices on an exchange throughout the trading day, as well as live bid/ask prices at which investors are willing to buy and sell these ETFs. Being able to see the price at which you can buy and sell the ETF allows you to make more informed decisions about your bond investments. This can be particularly powerful during periods of time when markets are moving quickly or segments of the bond market are experiencing illiquidity (as happened, infamously, during the global financial crisis of 2008).

Bottom line: Whether you intend to trade or not, the fact that bond ETFs offer low cost transparent pricing arms you with valuable information that can help you make an informed investment decision.

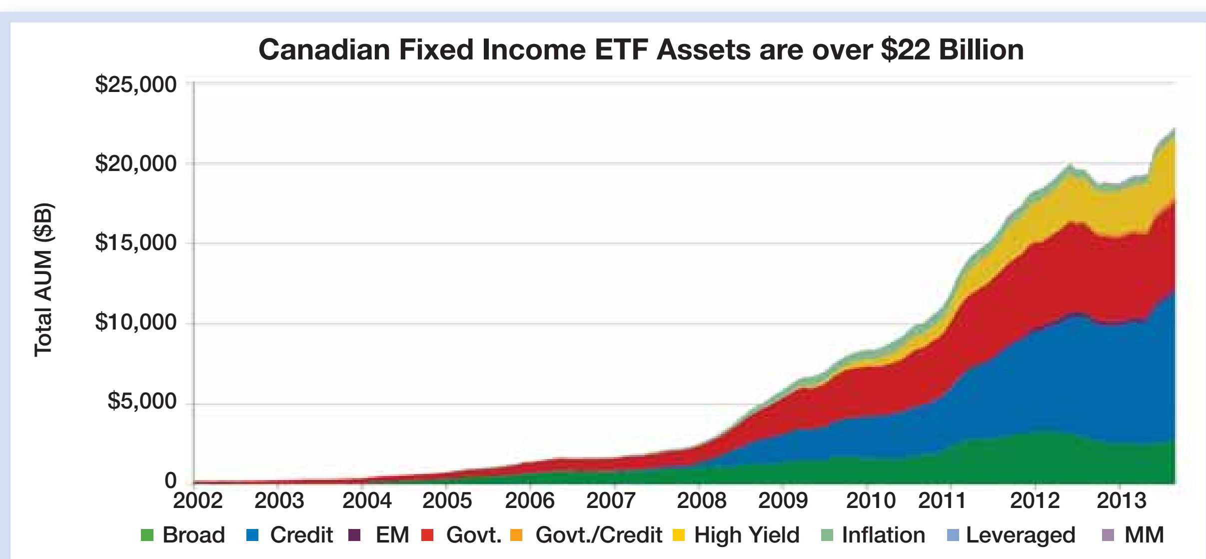
3. A bond ETF is managed by a human (sometimes several). A common misconception about bond ETFs is that they simply hold all the securities in the index they track, rendering a portfolio manager unnecessary. This is actually a flattering assumption, because if a bond ETF manager is doing the job correctly, investors are simply getting the exposure they expect, without much deviation from the performance of the underlying index (otherwise known as tracking error). Ideally, the actions of the bond ETF manager are invisible.

The truth is that a lot of work goes on behind the scenes to make this happen. Bond indexes can hold hundreds and sometimes thousands of bonds, some of which are illiquid or thinly traded. At iShares, our ETF managers place a priority on sound fund construction and leverage the knowledge and global resources of the world's largest asset manager – BlackRock – to ensure that bond portfolios track their underlying indexes as closely as possible, using only the securities that are available at any given time. This can be particularly tricky in certain situations (for example, an illiquid market segment like high-yield), but a good manager is able to navigate a range of market environments.

Bottom line: Bond ETFs do have portfolio managers, and not all of them are created equal. A skilled manager will continually work to minimize tracking error so that investors get the exposure they want.

Of course, there's much more to the story than this, but these three points really get to the heart of what a bond ETF is.

Pat Chiefalo, Managing Director, Head of iShares Product, BlackRock Asset Management Canada Limited ***pat.chiefalo@blackrock.com***



Source: BlackRock and Bloomberg as of August 31, 2014 expressed in $ millions

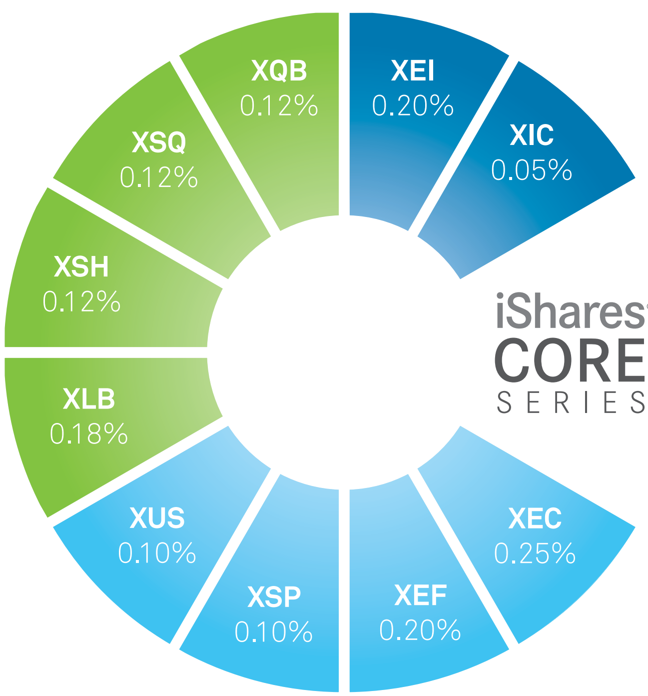
It's never been more affordable to own Canada. And the US. And the world.

Strengthen your clients' core investments.

The iShares® Core Series is the most affordable suite of funds available for the core of your clients' portfolios. These low-cost funds can be used to help strengthen portfolios and can provide a solid long-term base for investors. They're essential building blocks for any portfolio.

Whatever your clients' investment goals, the iShares Core Series can help you tailor a cost-efficient portfolio for them.

Visit **iShares.ca/core**



iShares® CORE SERIES

CANADIAN EQUITIES	
BROAD MARKET	XIC
EQUITY INCOME	XEI

CANADIAN FIXED INCOME	
BROAD BOND	XQB
SHORT BOND	XSQ
SHORT CREDIT	XSH
LONG BOND	XLB

US EQUITIES	
US EQUITY	XUS
US EQUITY (HEDGED)	XSP

INTERNATIONAL EQUITIES	
INTERNATIONAL EQUITY	XEF
EMERGING MARKETS EQUITY	XEC

iShares® by BLACKROCK®

canadian hedgewatch

Canada's Premier Source of Hedge Fund Information

Stay informed with all the latest hedge fund news and performance data with in-depth analyses.

Also includes:

- Current and historical Canadian hedge fund data
- Distribution of assets in Canadian hedge funds
- Average asset size of funds
- Return information, average and detailed
- Correlation tables
- Comprehensive Canadian hedge fund listings
- Tables of new funds, the best funds and the worst funds
- CHW Index update sheet

Stay Informed with a **Canadian Hedge Watch** Membership

Canadian Hedge Watch is published 11 times per year by **Canadian Hedge Watch Inc.**
We welcome articles, suggestions and comments from our readers. All submissions become the property of Canadian Hedge Watch Inc., which reserves the right to exercise editorial control in accordance with its policies and educational goals.

canadian hedgewatch

canadianhedgewatch.com

Contact Information
Canadian Hedge Watch Inc.
1235 Bay Street, Suite 400, Toronto, Ontario M5R 3K4
tel: 416.848.0277 fax: 416.848.0278
toll free: 1.877.249.9249
Media, Advertising & Editorial: **info@canadianhedgewatch.com**
Subscriptions: **info@canadianhedgewatch.com**