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# Seeking Yield in a Low-Rate Environment



:::: The Success of Factor Based Investing    :::: Preferred Shares Commentary (HPR)  
 :::: ETFs Approach The Tipping Point: The Next 25 Years    :::: A Perfect Storm For ETFs

 $\{s\beta\}$ 

**Smart beta:** An index methodology that uses alternative weighting and security selection criteria with the goal of outperforming a market-capitalization-weighted benchmark, reducing portfolio risk, or both.\*



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\* Smart beta exchange-traded funds (ETFs) may underperform cap-weighted benchmarks and/or increase the portfolio risk. † **PowerShares Canada has partnered with Invesco PowerShares Capital Management LLC to offer a diverse lineup of smart beta strategies in Canada through ETFs listed and traded on TSX or through mutual funds.** Commissions, management fees and expenses may all be associated with investments in mutual funds and ETFs. Trailing commissions may be associated with investments in mutual funds. Mutual funds and ETFs are not guaranteed, their values change frequently and past performance may not be repeated. There are risks involved with investing in ETFs and mutual funds. Please read the prospectus for a complete description of risks. Copies are available from Invesco Canada Ltd. at [www.powershares.ca](http://www.powershares.ca). Ordinary brokerage commissions apply to purchases and sales of ETF units. PowerShares Canada is a registered business name of Invesco Canada Ltd. This piece was produced by Invesco Canada Ltd. Invesco<sup>®</sup> and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence. PowerShares<sup>®</sup>, Leading the Intelligent ETF Revolution<sup>®</sup> and all associated trademarks are trademarks of Invesco PowerShares Capital Management LLC (Invesco PowerShares), used under licence. © Invesco Canada Ltd., 2015



## Assets in ETFs/ETPs listed in Canada reached a new record of 69.9 billion US dollars

Assets in ETFs/ETPs listed in Canada reached a new record of 69.9 billion US dollars, according to ETFGI's preliminary monthly ETF and ETP global insight report for April 2015. The Canadian ETF industry had 360 ETFs, with 511 listings, from 10 providers listed on 1 exchange.

Record levels of assets were reached at the end of April for ETFs/ETPs listed globally at US\$2.998 trillion, in the United States at US\$2.132 trillion, Europe at US\$511 billion, Asia Pacific ex-Japan at US\$125 billion, Japan at US\$112 billion and Canada at US\$69.9 billion.

In April 2015, ETFs/ETPs saw net inflows of US\$885 Mn. Fixed income ETFs/ETPs gathered the largest net inflows with US\$701 Mn and equity ETFs/ETPs with US\$56 Mn, while commodity ETFs/ETPs saw net outflows of US\$24 Mn.

YTD through end of April 2015, ETFs/ETPs have seen net inflows of US\$4.6 Bn. Equity ETFs/ETPs gathered the largest net inflows YTD with US\$2.1 Bn, followed by fixed income ETFs/ETPs with US\$1.9 Bn, while commodity ETFs/ETPs experienced US\$63 Mn in net outflows.

BMO AM gathered the largest net ETF/ETP inflows in April with US\$586 Mn, followed by Vanguard with US\$211 Mn, First Asset with US\$69 Mn, RBC Global AM with US\$68 Mn and PowerShares with US\$61 Mn.

## Assets in ETFs/ETPs globally reached a new record 2.998 trillion US dollars

Assets in ETFs/ETPs globally reached a new record 2.998 trillion US dollars but fell short of breaking through the 3 trillion milestone at the end of April according to ETFGI's preliminary monthly ETF and ETP global insight report for April 2015. Our forecast was that assets will break through 3 trillion by the middle of 2015.

Record levels of assets were also reached at the end of April for ETFs/ETPs listed in the United States at US\$2.132 trillion, Europe at US\$511 billion, Asia Pacific ex-Japan at US\$125 billion, Japan at US\$112 billion and Canada at US\$69.9 billion.

The global ETF/ETP industry had 5,719 ETFs/ETPs, with 11,077 listings, from 250 providers listed on 63 exchanges in 51 countries.

In April 2015, ETFs/ETPs saw net inflows of US\$10.6 Bn. Through the end of April record levels of net new assets (NNA) have been reached by ETFs/ETPs listed globally, gathering US\$108.8 billion – a significant increase on the US\$71.7 billion in the first four months of 2014. Products listed in the United States gathered US\$72.1 billion which is more than double the US\$34.9 billion gathered over the same period in 2014, while ETFs/ETPs listed in Europe gathered US\$38.4 billion, which is significantly higher than the US\$20.4 billion gathered during the same period in 2014.

*"Market performance outside the United States contributed to the overall increase in assets invested in ETFs/ETPs. Developed and emerging markets had a very good month, gaining 5% and 8%, respectively while in the United States the S&P 500 and Dow were up less than 1%", according to Deborah Fuhr, managing partner of ETFGI.*

Fixed income ETFs/ETPs gathered the largest net inflows with US\$9.8 Bn, followed by equity ETFs/ETPs with US\$1.8 Bn, while commodity ETFs/ETPs saw net outflows of US\$1.1 Bn.

Equity ETFs/ETPs gathered the largest net inflows YTD with US\$53.2 Bn, followed by fixed income ETFs/ETPs with a record level of US\$41.2 Bn, and commodity ETFs/ETPs with US\$5.6 Bn in net inflows YTD.

Vanguard gathered the largest net ETF/ETP inflows in April with US\$8.1 Bn, followed by DB/x-trackers with US\$5.9 Bn and WisdomTree with US\$4.1 Bn net inflows.

Source: [www.etfgi.com](http://www.etfgi.com)



**Terry Krowtowski**, Senior Vice President  
Radius Financial Education

**Editor**

Sovaida Pandor

**Contributing Writers**

Chris Doll, Barry Gordon,  
Mark Noble, Kevin Rusli, Mark Yamada

**Sales Director**

Terry Krowtowski

**Art Director**

Vic Finucci

**Online Developer**

Ferenc Schneman

**Contact Information**  
**Canadian ETF Watch**

1235 Bay Street, Suite 400, Toronto, Ontario M5R 3K4  
tel: 416.306.0151 fax: 888.905.3080

**Media, Advertising & Editorial**

info@radiusfinancialeducation.com

**Subscriptions**

info@canadianetfwatch.com

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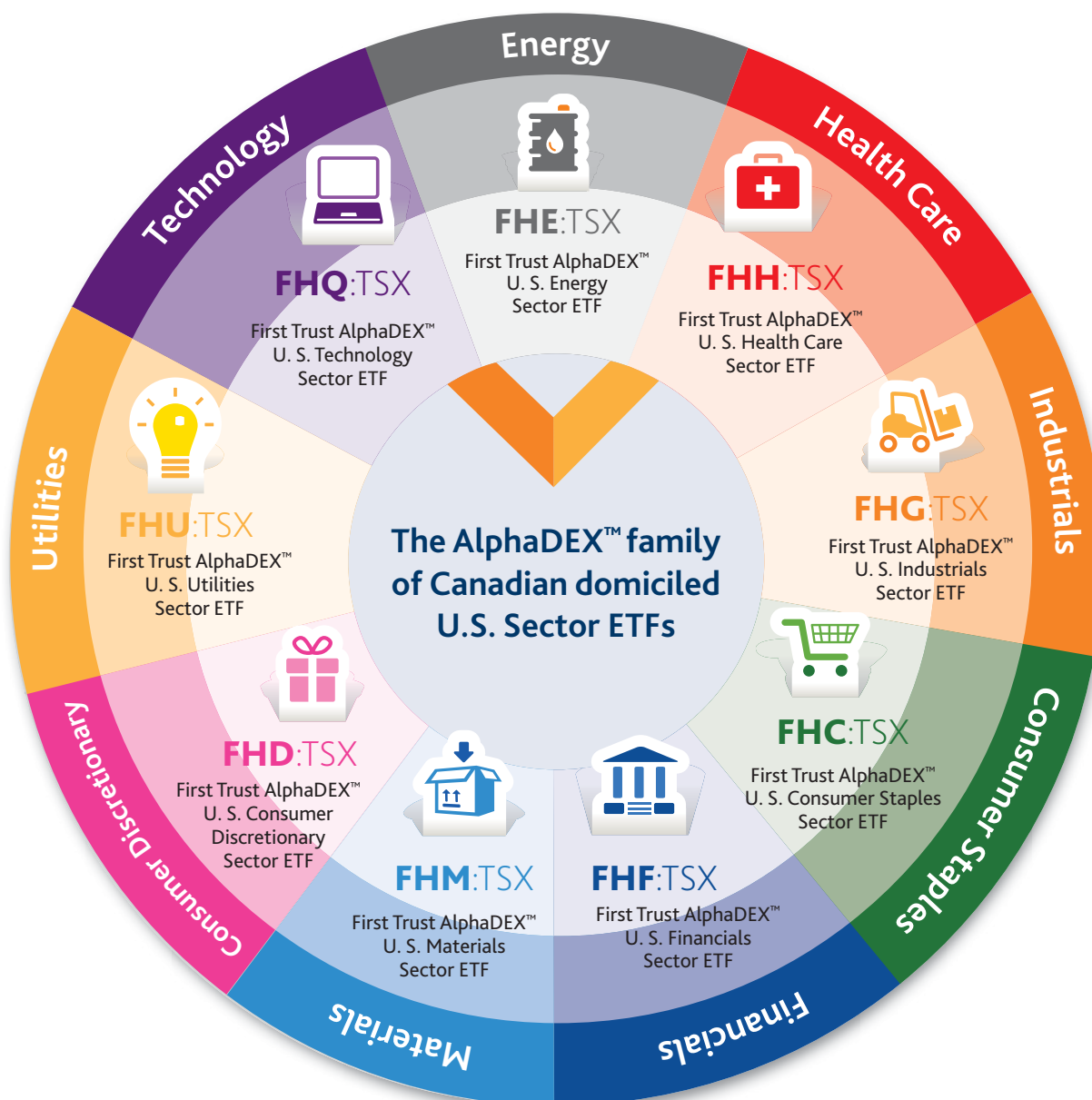
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From zero assets in 1989, to \$79 billion in 2000, to \$2.7 trillion into 2015, it has been quite a ride for global exchange-traded funds (ETF). Few financial sectors have approached the over 25% compounded annual growth that ETFs have enjoyed. Yet many industry observers are disappointed.

## 16 A Perfect Storm For ETFs

The birth of the exchange traded fund structure marked a turning point for the asset management industry that would not be fully understood at the time. In fact, even 25 years later, some would argue that the full impact of what the ETF model could mean to the industry, including the way the retail public thinks about managing its investments, has yet to come to fruition.

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<sup>1</sup>Source: Morningstar.

# Seeking Yield in a Low-Rate Environment



**Striking a balance between income and growth is a common investment goal. As fixed-income yields remain anchored at historic lows, many investors now recognize they must maintain a substantial exposure to equities if they are to achieve these dual objectives.**

For relatively conservative investors, a strategy that extracts value from equities on an ongoing basis may be more appealing than pursuing a potentially riskier growth strategy.

Companies that return free cash flow to their shareholders typically do so through share buybacks, dividends or a combination of both. Together, these form the basis of shareholder yield, as a measure of free cash flow returned to investors.

Share buybacks allow companies to increase their earnings per share by reducing the number of shares outstanding. This may concentrate profits into the hands of fewer investors, even in periods of stagnant earnings growth.

By consolidating ownership of the company into fewer shares, each remaining share is worth more after a buyback is completed, assuming the value of the underlying business has not declined.

Historically, companies that reduce the number of outstanding shares through buybacks have tended to outperform the broad market, while also exhibiting lower volatility.<sup>1</sup>

Dividends have become increasingly popular in recent years as retiring boomers seek a source of income. Like share buybacks, dividends may also contribute to capital appreciation.

**Chris Doll**  
AVP Product  
Management,  
PowerShares  
Canada



U.S. companies that increased their dividend payments (“growers”) have historically outperformed those that simply maintained existing dividends (“payers”). Both growers and payers have historically outperformed companies that do not pay dividends at all.<sup>2</sup>

A portfolio focussed on either dividends or share buybacks may deliver superior risk-adjusted returns relative to the broad market. Blending the two provides the potential for growth, as well as income that may be harvested or reinvested.

As with any equity strategy, a globally diversified portfolio may mitigate the risks associated with investing in individual securities, sectors or jurisdictions.

**PowerShares Global Shareholder Yield ETF (PSY)** provides cost-effective, equal-weighted exposure to both buybacks and dividends. Each of these strategy allocations is equally split between U.S. and international developed countries (ex-U.S.). The dividend portfolio seeks to provide current income and growth, while the buyback portfolio seeks to provide growth.

	U.S.	International ex-U.S.
Buybacks	25%	25%
Dividends	25%	25%

PSY seeks to generate both income and capital growth over the long term by investing in four NYSE Arca-listed PowerShares ETFs:

- 25% PowerShares Dividend Achievers™ Portfolio (PFM)<sup>3</sup>
- 25% PowerShares International Dividend Achievers™ Portfolio (PID)<sup>3</sup>
- 25% PowerShares BuyBack Achievers™ Portfolio (PKW)<sup>3</sup>
- 25% PowerShares International BuyBack Achievers™ Portfolio (IPKW)<sup>3</sup>

PSY is also available for purchase in U.S. dollars, listed on the Toronto Stock Exchange as PSY.U, allowing clients to save on foreign-currency conversion transactions when purchasing the ETF in a U.S.-dollar denominated account.

PSY.U does not provide a currency hedge between the Canadian dollar and the U.S. dollar. [E](#)

<sup>1</sup> Source: Ford Equity Research, as of March 2014

<sup>2</sup> Source: 2014 © Ned Davis Research, Inc. Over a 30-year period ended Dec. 31, 2013, the average annual total returns were as follows: S&P 500 dividend growers, 10.1%; dividend payers, 7.6%; non-payers (2.3%); MSCI dividend growers, 6.5%; dividend payers, 4.6%; and non-payers, -1.6%.

<sup>3</sup> The investment objectives of these underlying ETFs is to seek investment results that generally correspond (before fees and expenses) to the price and yield of the Nasdaq US Broad Dividend Achievers™ Index, Nasdaq International Dividend Achievers™ Index, Nasdaq US BuyBack Achievers™ Index and Nasdaq International BuyBack Achievers™ Index, respectively.

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](http://www.powershares.ca).

An investor cannot invest directly in an index.

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Chris Doll, AVP Product Management,  
PowerShares Canada  
[inquiries@invescopowershares.ca](mailto:inquiries@invescopowershares.ca)



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ETRs issued through the Mint's Canadian Gold Reserves and Canadian Silver Reserves programs offer a secure, efficient and low cost investment in gold or silver.

### Secure

- Direct beneficial ownership of gold or silver (no intermediaries)
- Stored at the Royal Canadian Mint, a Crown Corporation

### Convenient

- TSX listed in both C\$ and US\$ (MNT/MNT.U for gold and MNS/MNS.U for silver)
- Qualified investments for all Canadian registered accounts including RRSPs and TFSA's
- Flexible redemption options for newly casted bullion products including 99.9% pure silver London Good Delivery bars and 100 oz bars; 99.99% pure 1 oz Maple Leaf coins, gold kilobars and London Good Delivery bars

### Low Cost

- All-in annual service fee of 0.35% for gold ETRs and 0.45% for silver ETRs

## Reçus de transactions boursières de la Monnaie royale canadienne

Les reçus de transactions boursières (RTB) de la Réserve d'or canadienne et de la Réserve d'argent canadienne sont des produits d'investissement en or ou en argent sûrs, efficaces et abordables.

### Sûr

- Propriété directe d'or ou d'argent physique (aucun intermédiaire)
- Entreposés à la Monnaie royale canadienne, une société d'État

### Pratique

- Négociés à la Bourse de Toronto (TSX) en \$CAN (MNT pour l'or et MNS pour l'argent) et en \$US (MNT.U pour l'or et MNS.U pour l'argent)
- Admissibles à tous les régimes enregistrés d'épargne canadiens, y compris les REER et CELI
- Options de rachat flexibles – produits d'investissement nouvellement frappés, y compris les lingots de bonne livraison et les lingots de 100 oz en argent pur à 99,99 %, les pièces Feuille d'érable de une once, les lingots de un kilogramme et les lingots de bonne livraison en or pur à 99,99 %

### Abordable

- Frais annuels de 0,35 % pour les RTB – Or et de 0,45 % pour les RTB – Argent

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# The Success of Factor Based Investing



**There's no question that factor based investing, what the market generally refers to as "smart beta", is experiencing broad support from advisors and investors alike, with flows into ETFs based on factor-strategies growing substantially and becoming a significant part of the market. That success leads, naturally, to smart beta having a target on its back.**



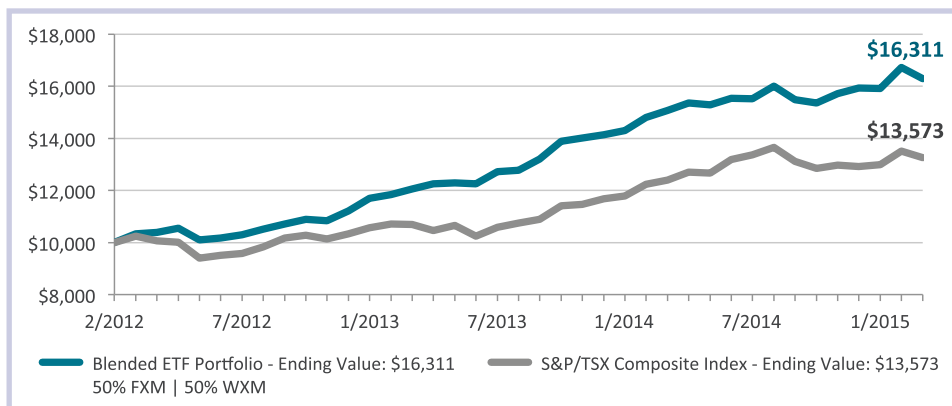
**Barry Gordon**  
CEO & President,  
First Asset  
Exchange Traded  
Funds

*There are critiques of everything from the name "smart beta" to the methodologies used to harness the various well documented factors. At First Asset, we are no different than others in being skeptical of simulations and back tests that purport to always outperform. The truth is, investors do need to be skeptical of such claims and focus their attention on methodologies that are explainable and have demonstrable benefits such as consistent outperformance and lower volatility of returns over longer periods of time.*

There are two very important things for investors to understand about smart beta. First, the existence of outperformance exhibited by factors such as "value", "momentum" and "volatility" is well known, well documented and empirically proven. Second, although these factors outperform over long periods of time, they can experience periods of underperformance relative to cap-weighted benchmarks. In particular, it is those interim periods of relative underperformance that those who proselytize the orthodoxy of cap-weighting dwell on – they will focus on, for example, that factor "X" underperformed the market last year; ipso facto, factor strategies are inferior and investors should stick with cap-weighted solutions. This is, of course, predictable – history is replete with heretics like Galileo who have been persecuted for arguing that the Sun doesn't rotate around the Earth.

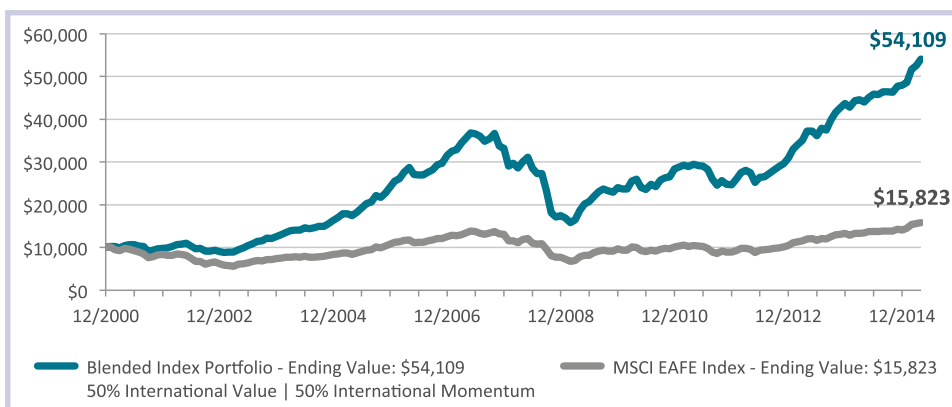
When First Asset was first looking for an index partner to provide the engine of our factor-based ETF lineup, we wanted to ensure that we covered the two major critiques identified above: (1) that there be an extensive track record to avoid claims of data mining; and (2) that there be clearly superior long-term performance over the cap-weighted benchmark. Morningstar's proprietary CPMS investment strategies hit all the right notes. As a quant driven stock selection methodology, CPMS has a track record of model portfolios dating back to the mid-1980s. The long-term performance was impressive. Most importantly, the risk-adjusted performance metrics were vastly superior.

Thus, FXM (First Asset Morningstar Canada Value Index ETF) and WXM (First Asset Morningstar Canada Momentum Index ETF) were launched in February of 2012, utilizing Morningstar's CPMS methodology. Now both of those ETFs have achieved 5-star ratings in recognition of their superior long-term performance. We've been actively educating that if you combine factors such as value and momentum in the same portfolio, for example, WXM and FXM, you can help maximize the long-term outperformance for investors. The results speak for themselves:



Source: Morningstar Direct as at April 30, 2015.  
Inception date: Feb 13, 2012.

The success and outperformance since inception of WXM and FXM and their factor-based methodologies led to the launch of XXM (First Asset Morningstar US Value Index ETF) and YXM (First Asset Morningstar US Momentum Index ETF) in 2013. Most recently, in late 2014, First Asset launched two international ETFs – VXM (First Asset Morningstar International Value Index ETF) and ZXM (First Asset Morningstar International Momentum Index ETF). The underlying Morningstar Indexes all use exactly the same basic value or momentum screens in order to identify stocks that best exemplify the “factor” sought. There is no variation by jurisdiction, no tweaking in order to improve results; which are impressive.



Source: Morningstar Direct as at April 30, 2015.

First Asset believes in the intelligence behind factor based investing. We're dedicated to it and will continue to develop smart solutions that address the real world needs of Canadian investors. [E](#)

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

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**Use of benchmark:** The S&P/TSX Composite TR Index is a capitalization-weighted index designed to measure market activity of stocks listed on the Toronto Stock Exchange. This index is used as a benchmark to help you understand the Blended ETF Portfolio's performance relative to the general performance of broader Canadian equity market.

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# Preferred Shares Commentary (HPR)



**Recently preferred shares have been a difficult asset class to be invested in as interest rates continue to decline. In late January, the Bank of Canada's surprise rate cut had those invested in the asset class scratching their heads, wondering what went wrong.**



**Mark Noble**  
Vice President &  
Head of Sales  
Strategy, Horizons  
ETFs Management  
(Canada) Inc.

*Effectively, what went wrong was the composition of the broader preferred share market. Most of the flow over the last two to three years has gone to rate-reset preferred shares, which are shares that pay a fixed rate for a period of time and then reset at a new rate which is typically set at a spread above the five-year Government of Canada bond rate.*

In a market expecting an interest rate rise, these issues do well, presumably because the floating rate is expected to be higher than the current fixed rate. The opposite holds true in a declining rate environment. So with more than two-thirds of the Canadian preferred shares market tied up in the rate-reset structure, the impact was felt by most investors.

On the other hand, perpetuals, which are preferred shares that offer a fixed rate, have done well compared to rate-resets during this time, especially when compared to those that reset at a lower rate than new issues.

The ability of the Horizons Active Preferred Share ETF ("HPR") to navigate the market and weight the portfolio towards issues that offer the best relative value, whether they are perpetuals or rate-resets, has allowed the ETF to generate noticeable outperformance when compared to other Canadian preferred share ETFs.



**HORIZONS**  
EXCHANGE TRADED FUNDS

ALPHA \* BENCHMARK \* BETAPRO



Product	Ticker	1 Month	3 Month	6 Month	YTD	1 Year	3 Year	5 Year	Since Inception*	Distribution Yield**	Mgmt Fees***
Horizons Active Preferred Share ETF	HPR	-0.31%	-4.13%	-3.13%	-4.13%	-0.22%	1.85%	N/A	3.26%	3.95%	0.55%
iShares S&P/TSX Canadian Preferred Share Index Fund	CPD	-0.48%	-4.93%	-4.12%	-4.93%	-1.41%	0.56%	3.17%	1.78%	4.86%	0.45%
PowerShares Canadian Preferred Share ETF	PPS	-1.23%	-5.62%	-4.59%	-5.62%	-2.16%	-0.31%	N/A	N/A	4.56%	0.45%
BMO S&P/TSX Laddered Preferred Share Index ETF	ZPR	-0.79%	-8.41%	-8.81%	-8.41%	-6.47%	N/A	N/A	N/A	4.54%	0.45%
S&P/TSX Preferred Share Index	TX-PRAR	-0.47%	-4.86%	-3.97%	-4.86%	-1.04%	1.04%	3.73%	2.25%	4.57%	N/A

Source: Bloomberg as at March 31, 2015

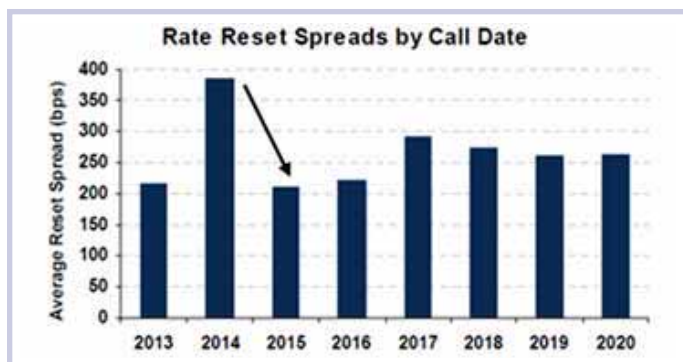
The indicated rates of returns in the table are the historical annual compounded total returns including changes in per unit value and reinvestment of all dividends and distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Past performance is not a guarantee of future results. Performance greater than one year is the average annual return.

\*Since Inception performance is from November 22, 2010, the inception date of HPR.

\*\*Based on last distribution (for the index, based on distributions paid by index constituents over the past 12 months)

\*\*\* Plus applicable sales taxes.

A recent RBC report sounded a warning on this topic: The problem with rate-resets is exacerbated by a glut of new issues expected to offer a higher reset spread than the issues currently in the secondary market. The chart below shows the anticipated average rate-reset spreads by call date for the next five years; ultimately, it illustrates that the average rate reset will likely be below a 3% dividend yield.



Source: RBC Capital Markets, January 2015

Fiera Capital Corporation “Fiera”, the sub-advisor for HPR, has identified these rate-reset spreads as problematic, particularly for issues that are resetting in the next two years, when compared to new issues that offer a higher-rate spread.

As Nicolas Normandeau highlighted on a February 4th online conference call, this is a great opportunity to get back into preferred shares at compelling valuations.

- Fiera views the fixed and floating rate-reset preferred shares as an attractive opportunity right now, since valuations are below the early 2015 selloff, apart from bank issues and low-rate reset issues. Currently, they consider the rate-reset space a buy opportunity
- Fiera does not anticipate a credit crisis, despite recent interest rate declines
- Much of the flow in new issues is retail money, and retail demand has been generally soft with this weaker market, particularly in the rate-reset market. In some cases, Fiera sees the opportunity to get into some of these issues more effectively in the secondary market if the issuer has trouble placing all of the new issue

- Generally, Fiera is being cautious about the new Non-Viability Contingent Capital (NVCC) bank issues (from a pricing perspective), as they feel that banks will continue to offer more new issues with more attractive spreads
- For example, the recent Royal Bank NVCC (RY.PR.M) issue that came out at 2.62+ over the 5-year GOC bond, a spread that Fiera doesn't think is all that attractive (on a new issue basis). Fear about the reset space (considering this low rate environment) deterred new buyers from participating in the issue and enabled Fiera to 'clean up the deal' and buy the issue in the secondary market at a remarkable discount to its par valuation
- If an investor feels strongly about maintaining high levels of rate-reset exposure, we offer the Horizons Active Floating Rate Preferred Share ETF (HFP). This ETF uses active management, but focuses on the fixed-to-floating segment of the preferred share market. It also uses an interest rate swap to protect against rate rises and then removes the interest rate coverage when the preferred share converts/resets to a floater
- HPR seeks to outperform the broad Canadian preferred share market, but does maintain a strong anchor in the benchmark weights; it will not make a concentration bet in a single issue the way that some other active strategies might. This is critical, since Nicolas highlights that liquidity is a huge issue in the market, even finding strong sourced liquidity for \$250,000 of an issue can be challenging. This means that highly concentrated bets in single names could be problematic, particularly when the time comes to sell
- Fiera holds the view that preferred shares offer more attractive valuations than bonds on an after-tax basis, assuming they are held in non-registered accounts. The HPR portfolio has a yield-to-maturity of approximately 4.8%, based on internal assumptions using the call dates of the holdings. This equates to approximately a 6% yield (assuming it was taxed as income at the marginal tax-rate of an investor in a higher-tax bracket) on an after-tax basis
- HPR has a 60% weighting in rate-reset preferreds and is particularly underweight the bank NVCC and the lowerron bank resets, compared to the 66.5% weight of rate-rest preferreds in the S&P/TSX Preferred Share Index. HPR is overweight Non-NVCC bank fixed resets

Continued on page 12

- HPR has a 28% weighting in perpetuals versus 30.5% in the index and about 6.5% in floating rate preferreds; of that, about 2.4% is in non-NVCCC Bank floating-rate issues, which will likely be redeemed in 2020/2021
- HPR is generally underweight any issues that have a weaker credit quality, based on Fiera's own internal credit process, and generally will not hold those issues even if the spreads seem a bit more attractive. HPR also has a small allocation, about 3%, in U.S. preferred shares.

All Holding Data is at March 31, 2015.

## Investment Objectives

### HPR

The investment objective of the Horizons Active Preferred Share ETF is to provide dividend income while preserving capital by investing primarily in preferred shares of Canadian companies. The ETF may also invest in preferred shares of companies located in the United States, fixed income securities of Canadian and U.S. issuers, including other income generating securities, as well as Canadian equity securities and exchange traded funds that issue index participation units. The ETF, to the best of its ability, seeks to hedge its non-Canadian dollar currency exposure to the Canadian dollar at all times.

### CPD

iShares S&P/TSX Canadian Preferred Share Index Fund seeks to track, less fees and expenses, the S&P/TSX Preferred Share Index.

### ZPR

BMO S&P/TSX Laddered Preferred Share Index ETF has been designed to replicate, to the extent possible, the performance of the S&P/TSX Preferred Share Laddered Index, net of expenses. [E](#)

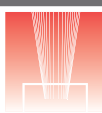
*Mark Noble, Vice President & Head of Sales Strategy, Horizons ETFs Management (Canada) Inc. [info@horizonsetfs.com](mailto:info@horizonsetfs.com)*

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# ETFs Approach The Tipping Point: The Next 25 Years



**From zero assets in 1989, to \$79 billion in 2000, to \$2.7 trillion into 2015, it has been quite a ride for global exchange-traded funds (ETF). Few financial sectors have approached the over 25% compounded annual growth that ETFs have enjoyed. Yet many industry observers are disappointed.**



**Mark Yamada**  
President  
PUR Investing Inc.

*ETFs' value proposition is well known: diversification, professional management, shared expenses, all the benefits of mutual funds at a fraction of the price plus better transparency and continuous intraday trading. Yet ETFs represent only 12% of US and 6% of Canadian mutual fund assets (10% if US-traded ETFs owned by Canadians are included). If ETFs are so much better than mutual funds, why haven't they replaced them by now?*

## **Adopting new ideas**

The theory of diffusion of innovation was introduced in 1962 by Everett Rogers who wondered why the adoption of hybrid corn seed took 13 years even though it offered a 20% improvement in yields. Rogers describes the stages through which products and ideas pass from introduction to acceptance; awareness, interest, evaluation, trial, and adoption. The chart shows the progression from innovators to early and late adopters and finally laggards. Laggards are described by author Simon Sinek as those who purchase a touch tone telephone because they can't buy a rotary one anymore. Early adopters evaluate new products and ideas, see benefits and take the risk to incorporate them into their lives. An important and critical "tipping point" or critical mass occurs at 15%-18% acceptance.

When achieved, the 68% early and late majority follow early adopter leadership in short order. Bridging this critical 15%-18% has been described as "crossing the chasm" by venture capitalist and author Geoffrey Moore.

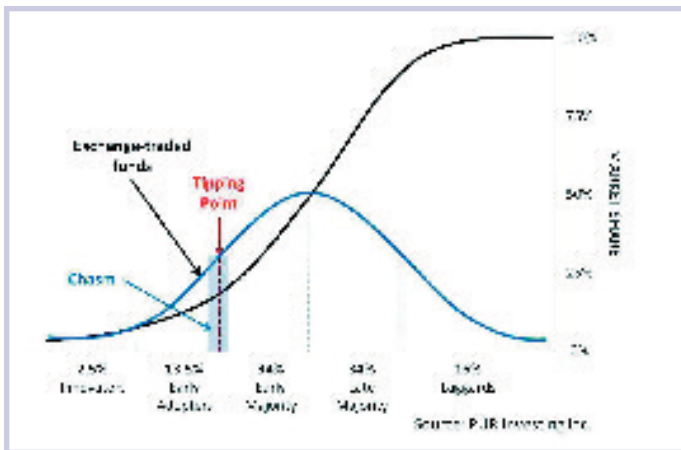


INVESTING INC.



This is where ETFs find themselves today. Will they cross the chasm into broad acceptance or remain a subset of retail investing?

### Dispersion of innovation: ETFs



### Why people buy mutual funds

Canadian mutual fund sales generally languished for 58 years from their introduction in 1932 until 1990 when the banks entered the fund business and validated the space. Over the next 25 years, a generation of Canadian investors (baby boomers) has gotten into the habit of using funds. Behavioral finance tells us that old habits die hard, even more so when complex issues like finance and investing are involved. Anchored to old beliefs, investors rely on advice. In Canada, many advisors are paid by product suppliers - loads and trailing commissions in the case of mutual funds. This arrangement compromises the advice through no fault of the advisor. A consequence is the steady growth of another part of financial services, compliance. The 1976 Securities Act in Canada consisted of about 270 pages; today it exceeds 4,000!

### Changing behavior

The elimination of trailing commissions in the UK and Australia in recent years has started a transformation. Formally aligning advisor compensation with their clients' interests through fee-based relationships is doing advisor credibility a great favour. If a doctor attends a convention in an exotic location with all expenses paid for by a drug company and then prescribe you that company's drug, how would you feel? Even if it were the best course of treatment, the advice is tainted by the compensation structure. Advisors claim they already have their clients' best interests in mind but the compensation system should reinforce their advice not compromise it. In the UK, 11,000 advisors dropped out. But every industry has marginal players and if the average level of advice improves, consumers benefit. Pursuant to the tipping point, Australia is instructive. Aussie ETF assets under management doubled in a year following the elimination of trailers.

Canadian advisors are encouraged by their firms to transition to higher-value fee-based practices. As the industry continues to unbundle and CRM 2 disclosure improves transparency of costs and performance, will ETF use increase or decrease? What if 83,000 MFDA registered fund sales people could sell ETFs?

Advisor acceptance of ETFs is important in moving across the chasm, but not essential. A new generation will look to the internet for investing information and some will try robo-advice, a proliferating form of on-line investment guidance. The \$15.7 billion AUM for US robos is expected to grow to \$155 billion in 5 years (MyPrivate Banking GmbH). All major robo-advisors use ETFs exclusively.

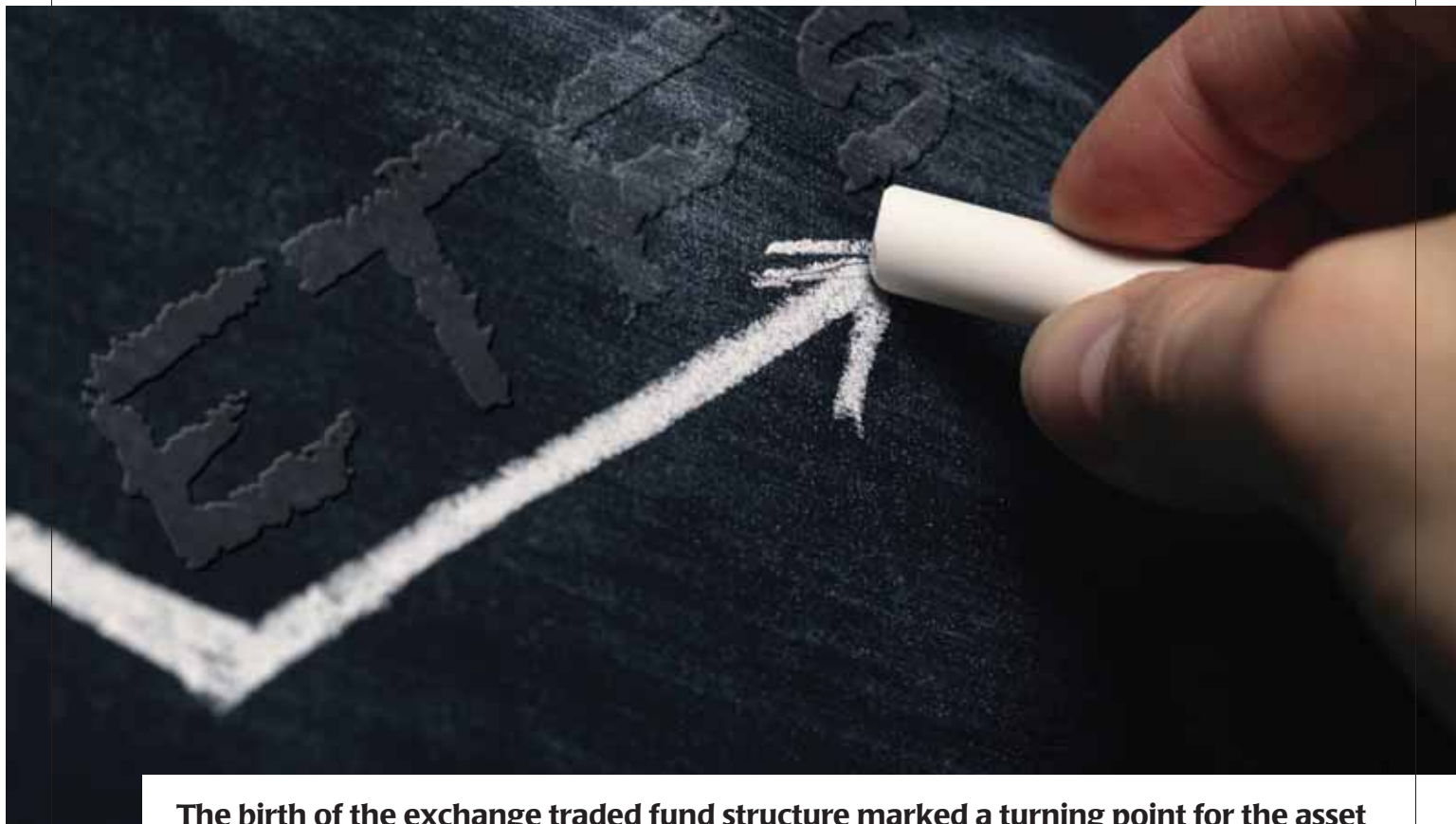
### Crossing the chasm

The internet took 20 years to hit its tipping point because the cost of computer access slowed adoption. Today, robo advisors and discount brokerage accounts make ETF access easy. Millennials will use ETFs but what about baby boomers who control most of the wealth? Costs in retirement for boomers become acutely important. Furthermore, if the only investment strategy an advisor can recommend is a conservative balanced portfolio, boomers may decide to save 1.0% a year and go it alone. Advisors prepared with comprehensive ETF solutions when the tipping point hits will win... big! [E](#)

Mark Yamada, President, PIR Investing Inc.



# A Perfect Storm For ETFs



**The birth of the exchange traded fund structure marked a turning point for the asset management industry that would not be fully understood at inception. In fact, even 25 years later, some would argue that the full impact of what the ETF model could mean to the industry, including the way the retail public thinks about managing its investments, has yet to come to fruition.**



**Kevin Rusli**  
*Partner*  
*Blake, Cassels &*  
*Graydon LLP*

On the surface, the retail and the advising communities have come a long way toward understanding the role and importance of transparency, liquidity, diversification and the increasing demand for low cost alternatives. And while mutual fund managers continue to grapple with how to respond to the relatively recent rise in the popularity of ETFs, there is a more important intellectual evolution underpinning the trajectory and direction of the asset management industry that deserves to be acknowledged. On a deeper level, the current media and investor focus on ETFs reflects the democratization of the investment product industry and identifies an existing desire to level the informational asymmetry that can occasionally exist between the portfolio manager, advisor and end-investor. The ETF structure has not only produced transparency, instant diversification, low fee products and liquidity, but in so doing it has empowered, challenged and encouraged the average investor to think about why these things should matter when constructing their portfolios and managing their investments.

*Blakes*  
LAWYERS

This paradigm shift is not entirely attributable to the ETF structure alone, but to the multiple external forces that are pushing the industry forward and that will ultimately steer the ongoing commercialization of ETFs toward success. And while ETFs have been positively disruptive; like a perfect storm, their success is in part a by-product of the clashing multiple forces, some predicted and some unforeseen, some central and some peripheral, some regulatory and some commercial, that are now beginning to converge at a single moment in time. By these forces, I am referring to the meteoric rise and popularity of the robo-advisor (reports suggest that robo-advisors managed over US\$19 billion in the U.S. as at the end of 2014), the proliferation of ETF investment strategies and investment solutions, the regulatory focus on enhanced cost of advice and investment disclosure, the heated debate regarding a statutory fiduciary duty standard for all advisors, the global trend away from trailer fees toward fee based accounts, the opening up of new distribution channels (such as among MFDA dealers) and the increasing role ETFs now play in both retail, as well as institutional, accounts - all of which hints that the growth opportunities for ETFs are far from over. Although none of these factors alone will be responsible for the ETF success story, each will play a critical role to shaping the future of the industry and potentially leading to the adoption of ETFs – en masse.

One of the key drivers of the growth of ETFs is innovation. As competition in the Canadian ETF market heats up, it will breed efficiency and creativity by breathing new life into what is considered by many to be an already cutting edge Canadian industry, one that

introduced the world's first equity and fixed income ETF and that currently offers active and currency products. Not surprisingly, four of the 10 current ETF providers were at some point, or still are, product manufacturers in the most innovative segment of Canada's asset management industry, closed-end funds. And notwithstanding each of foregoing factors, there continues to be several who ask whether the Canadian ETF industry is saturated, or whether the market can sustain new issuances and new ETF managers. But it would be a mistake to consider ETFs in isolation from their mutual fund counterparts, which continue to represent a \$1.2 trillion dollar industry in Canada (as compared to \$83 billion in ETFs). Instead, ETFs and mutual funds should be considered relative slices of the same pie, and rather than ask why one might hold an ETF version of a mutual fund, investors may soon be thinking about it the other way around - why hold the mutual fund when you can hold the ETF? This is where the laws of supply and demand should govern and good products, regardless of the size of the ETF market, will continue to find prominence and success, just as good mutual fund products currently do in the larger mutual fund market. The ETF slice of the Canadian pie may only be a sliver but it has plenty of room to grow. [E](#)

*Kevin Rusli, Partner, Blake, Cassels & Graydon LLP*  
[kevin.rusli@blakes.com](mailto:kevin.rusli@blakes.com)

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## \* Exchange Traded Forum (ETF North Toronto)

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