Industry Outlook

BMO® | Exchange Traded Funds

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INTRODUCTION

A Thriving Industry Providing Canadian Investors New Options for Growth

Sara Petrcich
Head of ETF & Structured Solutions

The Canadian ETF industry saw another year of sharp expansion, adding CA$38.4 billion in assets under management (AUM), and an 11.3% increase from 2022.[1]

The collective industry AUM now stands at CA$383.2billion, with a 10-year Compound Annual Growth Rate (CAGR) of 20%.[2]

As central banks carried out more interest rate hikes in the first half of the year to combat inflation, bond yields rose to levels not seen since before the Great Financial Crisis. Cash and cash-like ETFs dominated fund flows as risk-free rates delivered the most robust returns in years.

Despite the demand for and dominance of cash ETFs, we did see a renewed appetite for calculated risk-taking. Bonds and equities delivered positive returns, as both the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC) seem to have reached their terminal values in rate hikes. In equities, we saw investors focus on traditional broader market exposures. We also saw some sector-based ETFs inflows. Investor flows were seeking to target parts of the market that either provided growth or were attractively valued. The Financial sector, for example, experienced strong ETF inflows, as various types of institutional and retail investors were attracted by lower historical valuations.

Fixed Income made a comeback after experiencing two years of persistent, declining returns. Investors focused on investment grade exposures, as higher yields meant investors did not have to reach to sub-investment grade in order to achieve competitive and attractive returns. Investors were looking to add duration to end the year as yields began to fall in the fourth quarter—which was further accelerated after the "Fed Pivot."

Looking Forward

Despite the sizable growth in the last decade, the assets held in ETFs still represents only 21.5% of the mutual fund industry in Canada.[3] The relative size of the two industries is often used to illustrate the potential upside in asset growth for ETFs. However, this measure can be understated given ETFs can be purchased by a much broader user base which includes institutions and also can be applied in far more ways with ETFs now offering features that were once only available to high-net-worth investors.

Looking ahead, we expect the pace of growth in ETFs to continue, estimating the industry to hit CA$550 billion in AUM in the next five years.[4]

We believe growth will come through increased demand in portfolios across all user types and through new and innovative offerings in the marketplace.

The advisor community were early adopters of ETFs in Canada and we expect penetration to continue in this segment. With more advisors moving to fee-based models, users have increasingly looked to ETFs as building blocks for client portfolios. Covered call strategies, in particular, remain popular with advisors, allowing them to generate additional income for investors. As the level of investor sophistication grows, we see defined outcome ETFs that have non-linear returns as a way for advisors to better manage risk and return in portfolios. This is particularly important during times of market uncertainty where downside protection and defined payoff become attractive.

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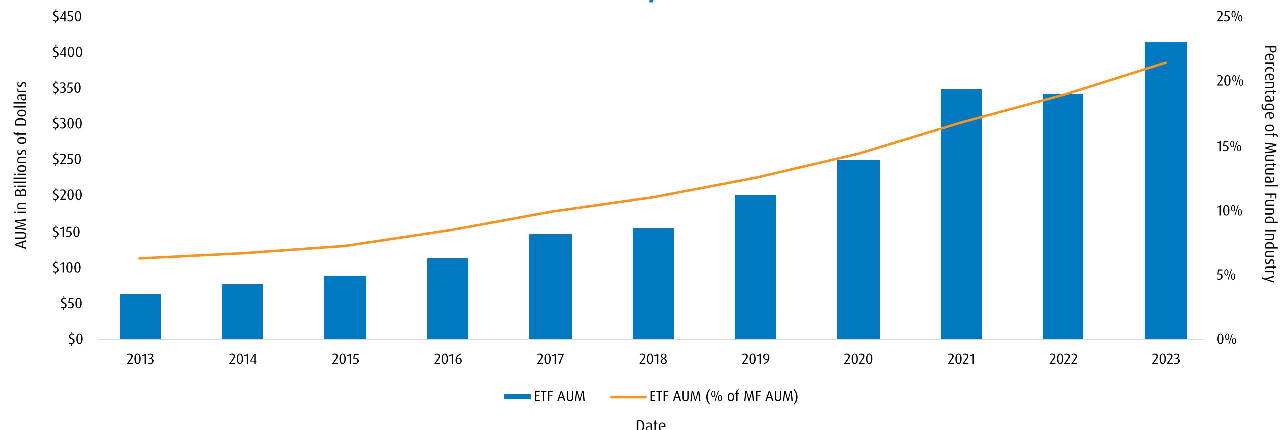
A Thriving Industry Providing Canadian Investors New Options for Growth (Continued)

Institutional usage of ETFs similarly continues to rise as asset owners and managers recognize their benefits. We are also seeing established users find new, sophisticated ways to use ETFs through strategies like custom creations of bonds, which allow them to deliver a basket of fixed income securities in exchange for a bond ETF—or the opposite way, allowing investors to take delivery of a basket of bonds through the purchase of an ETF. Within institutions, index-based equity and fixed income ETFs continue to be the easiest way into institutional conversations, given the many ways in which they can be implemented. In the direct channel, we continue to see a rise in the usage of ETFs, both as core holdings and as complements. With the targeted exposures offered in ETFs, they are now often used as a replacement for individual stocks and bonds to better manage a portfolio. "Financial influencers" and respected ETF providers have increased education and awareness, further helping to grow ETF popularity as individual investors have come to know the benefits they bring to portfolio construction and management.

Canada remains a hotbed for innovation within the global ETF landscape. In addition to being the birthplace of ETFs over 33 years ago, many ETF "firsts" belong to Canada[5]—and we anticipate the theme of innovation to continue in the local market. A growing audience also means the need for more bespoke solutions, where we believe the use of derivatives[6]-based strategies will better allow investors to target their financial goals. For the industry to continue its growth, education will be important. Ensuring that users are well-equipped with the financial knowledge of how to appropriately incorporate ETFs into their portfolio is a core responsibility across the industry. While innovation amongst products will drive growth, so too will technology, which will evolve and expand the eco-system and ultimately make ETFs even more adaptable.

Canadian ETF Industry AUM: 2013 – 2023



Source: National Bank Financial and Canadian ETF Association (CETFA) to December 31, 2023; unadjusted numbers used for ETF assets.

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Stock Replacement: “The Magnificent Seven” and Beyond

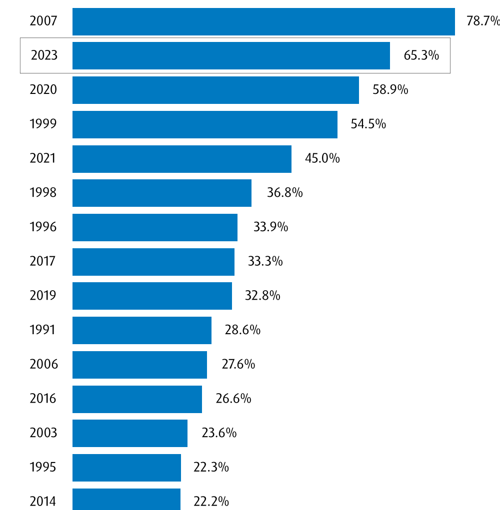
Alfred Lee, CFA, CMT, DMS
Director, Portfolio Manager and Investment Strategist

U.S. equities made a strong comeback in 2023. Investors can thank the so called “Magnificent Seven”—Apple Inc., Microsoft Corp., NVIDIA Corp., Amazon.com Inc., Meta Platforms, Tesla Inc. and Alphabet Inc.—as returns would have been much more muted without their contributions. Looking forward to 2024, investors have concerns in terms of how much further upside is left in these mega-cap technology and communications companies. With the dawn of Artificial Intelligence (AI) and other technological advancements on the horizon, these companies will doubtlessly play a prominent role in societal and economic advancement. In the more immediate term, how they perform in 2024, will be dependent on central bank policy and hence, inflation.

In terms of consumer prices, we have seen a tremendous improvement in the last twelve months through tighter monetary conditions and supply-side healing. Continued disinflationary pressure would pave the way for central bankers to cut rates, which would benefit the broader technology sector, which tends to be longer duration the further you go down in market capitalization. As such, how you play an exposure to the Magnificent Seven, really depends on your inflation outlook. Those who anticipate multiple rate cuts by the Fed may look to the technology-heavy **BMO Nasdaq 100 Equity Index ETF (Ticker: ZNQ)** or its hedged equivalent, the **BMO Nasdaq 100 Equity Hedged to CAD Index ETF (Ticker: ZQQ)**.

It should be noted however, that while Fed Fund Futures are currently pricing in at least 6 quarter-point cuts in 2024, the U.S. economic backdrop, and particularly the labour market, remains robust. It is likely Chairman Jerome Powell and other committee members would want to see the Consumer Price Index (CPI) remain at or near the 2.0% range or lower for successive months, before being confident in easing its overnight rate. Moreover, as the year progresses, the Fed may decide to hold off on rate moves, in order to stay clear of the U.S. presidential election, unless economic conditions really warrant. Consequently, the runway for rate cuts may not be as long as the market anticipates. Those who foresee a less dovish Fed may look to the **BMO MSCI USA High Quality Index ETF (Ticker: ZUQ)**, which focuses on cash-rich companies with durable balance sheets, but also has a healthy technology exposure. Alternatively, the **BMO Covered Call Technology ETF (Ticker: ZWT)**, focuses on large-cap U.S. technology names with a call writing overlay in order to generate additional yield. Regardless of your view, it may prudent to diversify your stock exposure through the use of an ETF.

Contribution to Returns of 10 Largest S&P 500 Weights During Positive Performance Years



Source: **Alliance Bernstein**, BMO Asset Management Inc., Bloomberg (calculated for years of positive returns on the S&P 500 Composite).

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The Adoption of Alternative Exposures

Chris Heakes, **CFA, M.Fin.**
Director, Portfolio Manager

Markets continue to present challenges for investors, while alternative investment exposures that can potentially enhance returns, and diversify sources of returns continue to be of high interest. A study release by Manager Partners Group in 2023 predicted the share of high-net-worth and retail alternative assets in portfolios to grow from 5% to 9% by 2030, with some predicting for even stronger adoption rates.[7]

The ETF market is increasingly offering alternative investment strategies to investors under the "liquid alternative" investing framework. Long/Short Equity investing has the potential to significantly mitigate volatility, by profiting from selloffs on the short side of the portfolio. The ability to short individual stocks provides more opportunities for investors to both hedge long equities, as well as profit from declining prices in lower-quality equities. The **BMO Long Short Canadian Equity ETF (Ticker: ZLSC)** and the **BMO Long Short US Equity ETF (Ticker: ZLSU)** are well diversified exposures investors may consider to improve overall portfolio risk and return characteristics.

Additionally, alternatives are increasingly on the radar of investors as they seek to create more resilient portfolios.

Another alternative asset class that gained steam towards the end of 2023 is Gold, which grew 13.1% as of December 31.[8] Gold traditionally hedges against equity and inflation risk, as well as acting as a store of value against growing central bank and government balance sheets. The correlation of Gold to the S&P 500 Index is 0.1, and also a low 0.4 correlation to the FTSE/TMX Universe Bond Index—underscoring the potential diversification benefit to portfolios.[9] The combination of a wider scale usage of alternative assets in portfolios and the ability of ETFs to efficiently deliver these exposures is a trend we see growing through 2024 and beyond.

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STRUCTURED OUTCOMES

Managing Risk Through Structured Outcomes

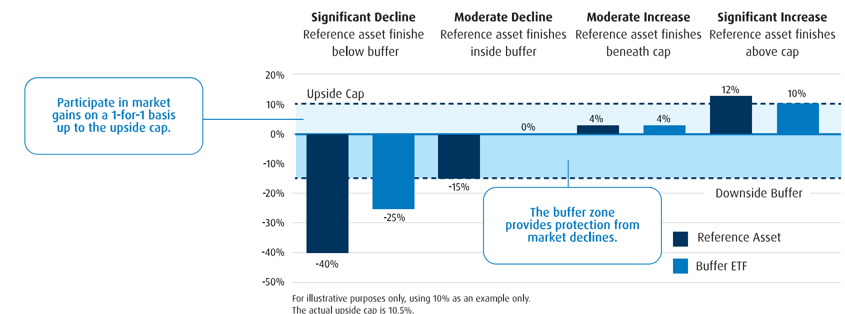
Chris McHaney, CFA
Director, Portfolio Manager

Markets rallied to close out 2023, as investors cheered the long awaited "pivot" from the Fed from a rate-hiking regime to a rate-cutting one. However, it should be noted that the opening statement from that press conference was "Inflation is still too high, ongoing progress in bringing it down is not assured, and the path forward is uncertain." On one hand, if monetary conditions ease—as the market anticipates—risk assets can experience a sizable rally. Yet, should higher inflation persist and central banks are forced to keep interest rates elevated, even in the face of slowing economic growth, this could eventually weigh on equity markets as risk is repriced.

In this unique environment, investors and advisors should consider utilizing Structured Outcome ETFs to provide an added level of transparency around their investments, and how they may perform going forward. Investors who want to participate in equity market growth but are concerned about a potential recession and the impact that would have on an equity portfolio should consider utilizing a Buffer ETF, such as **BMO US Equity Buffer Hedged to CAD ETF – October (Ticker: ZOCT)**, which provides explicit downside protection through the use of a protective option overlay. In exchange for a cap on potential upside growth, investors in ZOCT can stay invested in the equity market with built-in downside protection within the ETF's buffer zone.

For investors who are not as concerned about downside protection, but do not expect significant equity market growth due to a potential slowdown, they can consider accelerating lower expected returns through the use of an Accelerator ETF, such as **BMO US Equity Accelerator Hedged to CAD ETF (Ticker: ZUEA)**, which approximately provides double the price returns, up to a cap, with only single downside exposure of an underlying reference asset.[10] This ETF is a great way for investors to potentially outperform the market in a low return environment—while not adding any additional risk to their portfolios.

Anyone looking to use a Structured Outcome ETF can visit the BMO ETFs website, which provides important information about the ETF (including Target Outcome Period start- and end-dates, and the cap and buffer, as applicable) as well as information relating to the potential outcomes. This provides a level of transparency on what return expectations should be relative to the market. The chart below illustrates the expected outcomes for ZOCT. Similar charts for BMO's other Structured Outcome ETFs are available on the BMO ETFs website.



Source: BMO Global Asset Management.

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SHORT-TERM BONDS

Cash Is Trash No Longer

Matt Montemurro, CFA, MBA
Director, Portfolio Manager Fixed income

Despite the recovery in risk assets, cash and ultra short-term bond exposures resonated with investors in 2023. With the overnight rate at levels not seen in decades, it provided an attractive risk-free rate for investors even in real terms, when netting out inflation. Money market ETFs (which include traditional money market, High Interest Savings Accounts and ultra short-term bonds gathered $10 billion, alone, in 2023, increasing their overall segment AUM to $30 billion.[11] Fixed income markets also experienced elevated volatility, particularly on the long end. Bond yields fluctuated over the year as central banks kept a hawkish tone, despite pausing on tightening mid-way through the year in the cases of the Fed and BoC. After a very rare two-year period of consecutive losses, bond markets finally posted strong positive returns on the year in 2023.

As we look forward to 2024, we expect the market to remain focused on central bank policy.

While the market is pricing in aggressive cuts from both the BoC and the Fed, we believe this may be optimistic. Though we expect deflationary pressures to continue, quick and successive rate cuts seem inconsistent with the "soft-landing" narrative that the market is pricing in. Given this, we believe the short-end of the curve remains attractive from a risk-adjusted perspective, particularly if the yield curve looks to normalize. Short-term yields remain attractive and exposure to that part of the curve may be warranted when we do see central banks start to cut rates.

With the recent ruling from the Office of the Superintendent of Financial Institutions (OSFI) on HISA ETFs, it will leave these ETFs with no yield advantages over traditional money market ETFs, like the **BMO Money Market Fund ETF Series (Ticker: ZMMK)** and **BMO USD Cash Management ETF (USD Units) (Ticker: ZUCM.U)** once these regulatory changes come into effect in late January 2024. Ultra-Short-term bonds such as the **BMO Ultra Short-Term Bond ETF (Ticker: ZST)** and the **BMO Ultra Short-Term US Bond ETF (USD Units) (Ticker: ZUS.U)** will likely become the choice for those investors who want an additional yield pick up over money market instruments. We expect cash will continue to experience strong flows in 2024. With the current geopolitical uncertainty and upcoming U.S. presidential elections, investors may seek to have some "dry powder" on hand to take advantage of potential mispricing in the market.

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INSTITUTIONAL CHANNEL

Accessibility, Innovation Drive Institutional ETF Interest

Mark Webster,
Director, ETF Distribution, Institutional Sales & Service

Institutions continue to deepen their interest in ETFs, and 2023 was no exception. Usage of ETFs amongst institutions climbed because of their characteristic ease of implementation into portfolios (without any requirements for Investment Management Agreements) and the ability to trade ETFs fluidly and anonymously, providing greater flexibility in changeable markets. Additionally, ETFs allow institutions to have a more robust data set in order to better model risk and return of assets.

An increasing number of types of institutions are utilizing ETFs to execute sizable block trades across all asset classes.

Of particular note, pension plans are interested in ETFs to complement unlisted real assets, such as Infrastructure **(BMO Global Infrastructure Index ETF – Ticker: ZGI)**, and Real Estate **(BMO Equal Weight REITs Index ETF – Ticker: ZRE)**, with additional interest being shown in agriculture **(BMO Global Agriculture ETF – Ticker: ZEAT)**. Initially, ETFs were used as plugs to combat placement delays due to unlisted managers lack of capacity but, increasingly, ETF exposures in real assets are now running in parallel. Their operational advantages and cost-effectiveness increase the control asset owners want to exert on outcomes in challenging market conditions.

We believe institutional adoption of ETFs will continue. In addition to real asset exposure and liquidity management, fixed income and core equity beta[12] have resonated with clients. The ability to transact in size with tighter bid-offer spreads than the underlying market has been a primary driver, as well as the ability to deliver individual bonds in exchange for an ETF (custom creations), which in many cases has been more operationally efficient. Both broad *Beta* equity index and Factor *Beta* ETFs have been used to either access market segments at scale, or to align exposures with objectives, respectively.

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ADVISOR CHANNEL

Managing Tax Using Discount Bonds ETFs

Kevin Prins,
Managing Director, Head of Distribution,
ETFs and Digital Distribution

Bonds and bond ETFs are back. With higher rates combined with its traditional aspects of lower risk and diversification, fixed income is becoming a more compelling part of any portfolio. ETFs have long been an efficient way to access a basket of bonds due to the enhanced liquidity of being able to trade through the stock market. Within the ETF market, there are a number of choices for fixed income. One category in particular has been gaining a greater share of flows—and for good reason. Discount bond ETFs.

Discount bonds are simply bonds that tend to have lower coupons (income paid out). They are similar in all other ways with respect to credit quality, term and overall yield to maturity. As the coupon is lower, the mix of the overall yield to maturity shifts more towards capital appreciation. This creates some natural tax efficiency[13] relative to traditional interest income, which is subject to greater taxation compared to capital gains. Ten years ago, BMO was the first to launch an ETF that focused on discount bonds, with the BMO Discount Bond Index ETF (Ticker: ZDB). Prior to ZDB, it was difficult to access these types of bonds, while bundling them into an ETF as a basket made them far more accessible to investors. This first discount bond ETF effectively offers a broad market exposure like other known ETFs, such as the BMO Aggregate Bond Index ETF (Ticker: ZAG), but with the added benefit of some natural tax efficiency. Since the launch of this ETF back in 2014 there have been a few more products that focus on this part of the market, including the BMO Short-Term Discount Bond ETF (Ticker: ZSDB) and the BMO Corporate Discount Bond ETF (Ticker: ZCDB). This allows further choice to target credit or duration[14]/term exposures, while still maintaining the added benefit of natural tax efficiency. As we look forward in 2024, the trend towards bonds is expected to continue. For those investors who hold fixed income outside of their registered plans, discount bond ETFs provide a tax consideration when building a fixed income portfolio. ETFs continue to enhance access and provide tools to build better portfolios, and discount bonds are a good example of ETF innovation.

DIRECT INVESTING CHANNEL

Drawn to Efficiency in Investing

Danielle Neziol,
Vice President, ETF Online Distribution

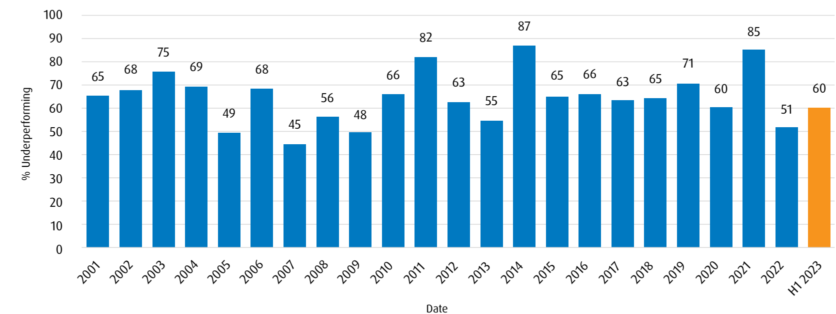
Index investing via the ETF structure continues to remain popular among do-it-yourself (DIY) investors. ETFs allow direct investors a vehicle to own the entire market, without having institutional trading systems to make thousands of trades a year. Additionally, indexing allows investors to take the guesswork out of investing—rather than stock picking, investors can simply own the market with cost efficiency.

Index investing is also popular amongst DIY investors as empirical data such as the SPIVA report, show that beating the market over the long-run is extremely difficult, even amongst the best stock pickers. The S&P 500 has returned an annualized 12.1% over the last 10 years[15], a return which has been hard to beat (see Exhibit 1). In the first half of 2023 alone, the S&P 500 returned 16.9%, outpacing 60% of active large-cap U.S. equity managers.[16] And underperformance rates typically rise as time horizons lengthen. The largest and most liquid S&P 500 ETF in Canada is the **BMO S&P 500 Index ETF (Ticker: ZSP)**. With over $11 billion in assets[17], this ETF underscores that the index investing trend isn't going anywhere. Institutions, advisors and direct investors all look to this ETF for instant S&P 500 exposure.

Asset allocation ETFs such as the **BMO Balanced ETF (Ticker: ZBAL)** also continue to resonate with direct investors that have gravitated towards indexing. These ETFs have made investing even more simplistic by having a one-ticket portfolio, that are professionally allocated across assets using ETFs. These ETFs allow investors to simply "set it and forget it," as they are automatically rebalanced on a regular basis and investors can simply add capital to their positions over time.

Timing the market is almost impossible to do, but time in the market, and staying invested in the long run, has proven itself year after year, making index and asset allocation ETFs ever more popular in the direct channel.

Exhibit 1: Percentage of Large-Cap Domestic Equity Funds Underperforming the S&P 500 Each Year



Source: S&P Dow Jones Indices LLC, CRSP. Data as of June 30, 2023. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

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CONCLUSION

Mckenzie Box,
Vice President of Product Management and Strategy

Our expectations are for the growth rate in ETFs to continue climbing in Canada despite the ongoing maturity of the marketplace, driven by trends in regulation, demographics and technology. While the more obvious exposures have been already been taken, the investment landscape continues to evolve, while investors continue to further utilize ETFs as their primary access vehicles.

ETF providers have pushed further into the liquid alternative space, resulting in new strategies and exposures being offered.. An aging population in Canada will also see investable assets passed down to younger generations, where ETFs are more widely used. Furthermore, Canada's population is estimated to grow to as much as 52.5 million by 2043[18], which will also expand the investable assets in the country. Lastly, evolving technology should further cement ETFs into the investing ecosystem allowing the transition between ETFs and underlying assets such as equities, bonds, commodities and digital holdings to be more fluid. As a result, we don't anticipate the tailwinds in ETF growth to dissipate anytime in the near future.

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[1] National Bank Financial and Canadian ETF Association (CETFA) to December 31, 2023, using adjusted data.

[2] *Ibid*.

[3] *Ibid*.

[4] Using adjusted data.

[5] The Canadian ETF Association.

[6] A financial security with a value that is reliant upon, or derived from, an underlying asset or group of assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its price is determined by fluctuations in the underlying asset.

[7] Steve Randall, "Alternative assets set to gain from HNW and retail investors," Wealth Professional, June 27, 2023.

[8] Bloomberg, in USD terms.

[9] Bloomberg, as of December 31, 2023.

[10] BMO Accelerator ETFs seek to provide unitholders with income and approximately double (2x) the price return of a Reference Index that gives exposure to equity securities up to a cap (before fees, expenses and taxes).

[11] National Bank Financial ETF Research, as of December 31, 2023.

[12] A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

[13] Capital gains are regarded as more tax-efficient compared to interest income, since only half of the capital gain is taxable. Interest income is fully taxable.

[14] A measure of the sensitivity of the price of a fixed income investment to a change in interest rates. Duration is expressed as number of years. The price of a bond with a longer duration would be expected to rise (fall) more than the price of a bond with lower duration when interest rates fall (rise).

[15] Morningstar, November 30, 2023.

[16] SPIVA, September 2023.

[17] As of December 31, 2023.

[18] Statistics Canada, August 2022.

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An investor that purchases Units of a Structured Outcome ETF other than at starting NAV on the first day of a Target Outcome Period and/or sells Units of a Structured Outcome ETF prior to the end of a Target Outcome Period may experience results that are very different from the target outcomes sought by the Structured Outcome ETF for that Target Outcome Period. Both the cap and, where applicable, the buffer are fixed levels that are calculated in relation to the market price of the applicable Reference ETF and a Structured Outcome ETF's NAV (as defined herein) at the start of each Target Outcome Period. As the market price of the applicable Reference ETF and the Structured Outcome ETF's NAV will change over the Target Outcome Period, an investor acquiring Units of a Structured Outcome ETF after the start of a Target Outcome Period will likely have a different return potential than an investor who purchased Units of a Structured Outcome ETF at the start of the Target Outcome Period. This is because while the cap and, as applicable, the buffer for the Target Outcome Period are fixed levels that remain constant throughout the Target Outcome Period, an investor purchasing Units of a Structured Outcome ETF at market value during the Target Outcome Period likely purchase Units of a Structured Outcome ETF at a market price that is different from the Structured Outcome ETF's NAV at the start of the Target Outcome Period (i.e., the NAV that the cap and, as applicable, the buffer reference). In addition, the market price of the applicable Reference ETF is likely to be different from the price of that Reference ETF at the start of the Target Outcome Period. To achieve the intended target outcomes sought by a Structured Outcome ETF for a Target Outcome Period, an investor must hold Units of the Structured Outcome ETF for that entire Target Outcome Period.

Commissions, management fees and expenses all may be associated with investments in BMO ETFs and ETF Series of the BMO Mutual Funds. Please read the ETF facts or prospectus of the relevant BMO ETF or ETF Series before investing. The indicated rates of return are the historical compounded total returns including changes in share or unit value and the reinvestment of all dividends or distributions and do not take into account the sales, redemption, distribution, optional charges or income tax payable by the unitholder that would have reduced returns BMO ETFs and ETF Series are not guaranteed, their values change frequently and past performance may not be repeated.

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