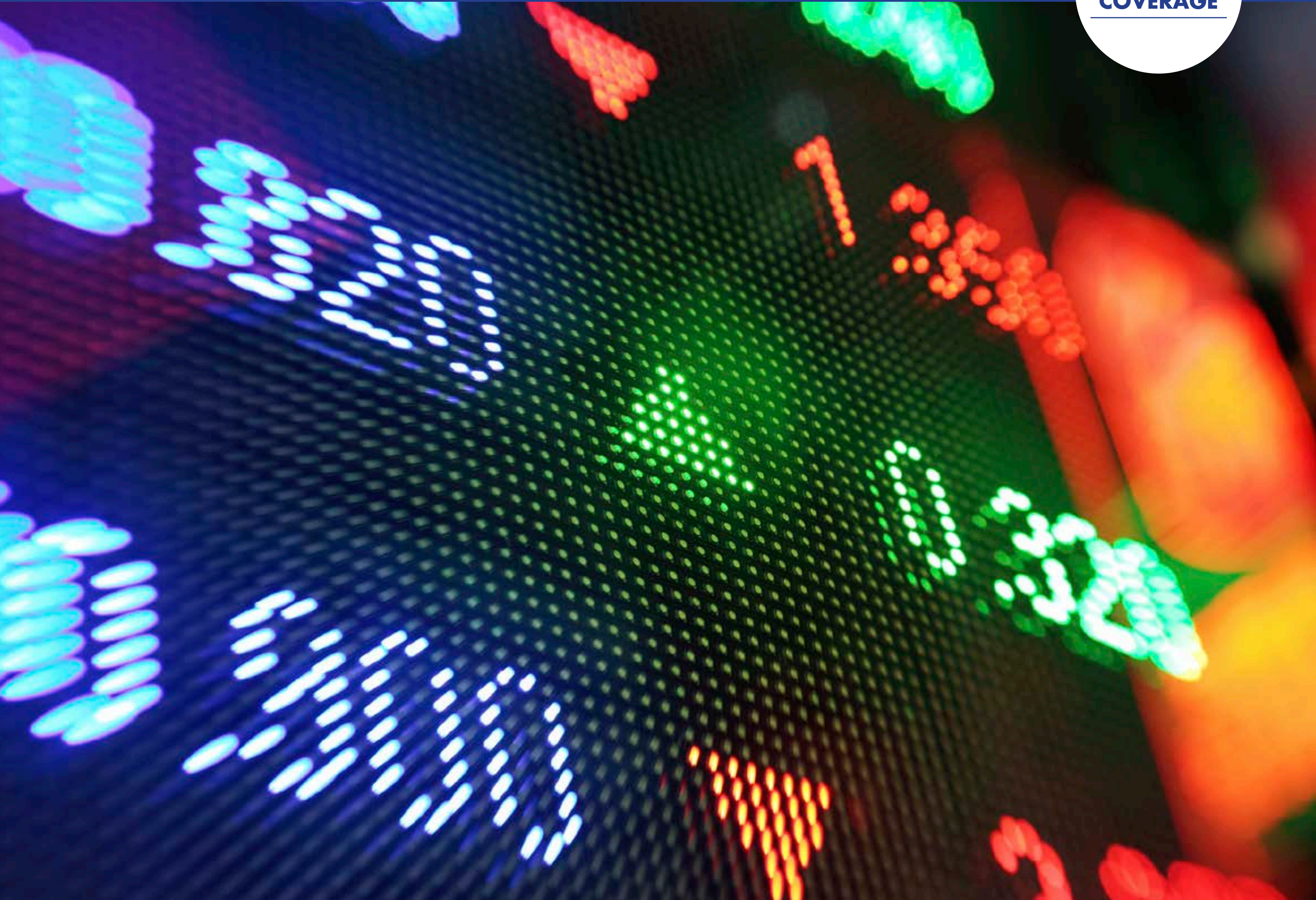
Canadian Investment Review
ETF SUMMIT
CONFERENCE COVERAGE



Strategic Planning

ETF use is set to go beyond tactical for Canadian pensions

BY CAROLINE CAKEBREAD, EDITOR, *CANADIAN INVESTMENT REVIEW*

The exchange-traded fund (ETF) industry in Canada continues to pick up steam and this past March, Canadian-listed ETF assets reached a record total of $66 billion. Although they've typically been packaged as a low-cost DIY option for retail investors, ETFs are being used increasingly by some of the most sophisticated investors in the world—institutions such as pension plan sponsors. Here in Canada, plans have been using ETFs primarily for tactical reasons such as transition management. But as we learned at the 2014 ETF Summit, hosted by *Canadian Investment Review* in Toronto on March 5, more and more pension funds are finding strategic uses for these products. And as the ETF landscape continues to evolve, it looks like their role in pension funds is set to grow in the years ahead, according to speakers at the Summit.

THE PENSION PERSPECTIVE

To get a closer look at how pension funds are using ETFs, the event kicked off with an expert panel of plan sponsors and consultants who shared their experiences with the products. Panellists included Kevin Duggan, vice-president, tactical asset allocation, with the Ontario Teachers' Pension Plan; Zev Frishman, executive vice-president and chief investment officer with Open Access Ltd.; Clive Morgan, senior investment consultant with PBI Actuarial; and Mark Yamada, president and CEO of PUR Investing Inc. ›

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>
> **ALFRED LEE, VICE-PRESIDENT, PORTFOLIO MANAGER AND INVESTMENT STRATEGIST, BMO GLOBAL ASSET MANAGEMENT INC.**

One question on everyone's mind: are pension investors using ETFs mainly for tactical asset allocation, or are they getting more creative and using them for strategic purposes as well? The answer is both. As Frishman pointed out, the explosive growth in product creation in the ETF space has meant more options for use among pensions, and many of them are taking advantage of that: "You can actually get fairly granular with ETFs nowadays," he said, noting that investors can now make specific country allocations (e.g., U.K. ETF, Japan ETF, etc.) or buy low-volatility funds.

At the same time, Frishman pointed out that leveraged ETFs and commodity-based ETFs are also changing the game for many institutional investors looking to make specific bets on which way the market is headed. "However, you have to do your due diligence," he stressed.

While the panel discussed the different ways some plan sponsors are using ETFs, Morgan believes that, for now at least, intensive use of the products on a strategic basis is mainly limited to all but the biggest plans. "I think you've got to break down the size of the plan sponsor," he said. "If you're large, like a Teachers' or an OMERS, you have the resources in-house to understand, research and trade an ETF. If you go to a smaller pension plan—let's say, $700 million or smaller—they don't actually have the in-house expertise." In the end, size matters—and so does the improved performance of active managers in the last year or two. Indeed, the push for passive might be slowing down as active equity managers deliver solid returns, said Morgan, noting that 2013 was a particularly good year for them.

But while some plan sponsors haven't yet embraced ETFs, "there is momentum growing," noted Yamada, particularly in the U.S. For example, according to a recent Greenwich Associates study, the use of ETFs for transition (tactical) purposes rose to more than 68% in 2013 from 38% in 2012. From a strategic standpoint, "fully 47% of endowments in the U.S. use ETFs—and, primarily, it's for access to difficult markets," he added. "ETFs are terrific at providing already pre-diversified packets of risk."

Yamada sees the defined contribution (DC) market as a big area of growth for ETFs looking to make headway in the pension space, and he noted that in the U.S., Schwab recently launched a 401(k) program based on selected low-cost ETFs.

UNDERSTANDING ETFS

While panellists pointed out that plan sponsors could make even better use of ETFs, they do need a solid understanding of how they are constructed, according to speaker Alfred Lee, vice-president, portfolio manager & investment strategist, BMO Global Asset Management. In his presentation, ETFs: Under the Hood, Lee explained that ETF use has broadened and investors are using them not just for exposure to broad beta asset classes, but also for exposure to sectors, factors, strategies and more.

Given the expanding menu of choices, however, investors need to make sure they are using the right criteria to assess whether or not a product is appropriate. Where to start? "First, choose your exposure type," Lee recommended. "In the past, when investors wanted to access beta, a market capitalization weighted index was the only option. Today, there are many different types of beta based on different weighting methodologies, which leads to different risk and return characteristics. The appropriate exposure type may vary depending on the outcome the investor is seeking."

Investors also need to consider that the total cost beyond the management expense ratio (MER), including the total expense ratio (TER), also considers trading and withholding costs. "The bid-ask spread should be considered as it will impact implementation," Lee added.

Investors should focus on ETFs with the tightest tracking error to ensure the purest exposure to the underlying market and also liquidity, which can't be determined by daily volume. Rather, investors should look at the liquidity of its underlying constituents: "A well-designed ETF will also consider the liquidity of the underlying market in its construction. This helps market makers keep a tight spread," said Lee. Finally, investors should understand how ETFs attain exposure to an underlying market (synthetic versus physical) and whether or not a particular approach exposes investors to counterparty risk. ›

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> **ROBERT C. TRUMBULL, VICE-PRESIDENT AND HEAD OF INSTITUTIONAL ETF SALES, STATE STREET GLOBAL ADVISORS**

USING ETFS

Institutional investors are boosting their ETF use to meet some of their most pressing challenges, according to speaker Robert C. Trumbull, vice-president and head of institutional ETF sales, State Street Global Advisors. In his presentation, Global ETF Utilization Trends, he pointed out that institutions are using ETFs for longer periods of time and for several different purposes across asset classes.

"The most common uses we see from institutions include cash equitization, tactical overlay strategies, building entire portfolios for smaller pools of capital, accessing difficult to reach asset classes such as gold, and transitioning assets," said Trumbull, who also noted that ETFs now offer more tailored exposures and greater liquidity than ever before.

Trumbull pointed out that institutions often begin using ETFs for very specific purposes, perhaps cash equitization or transition management. "Once they realize the benefits of the product structure and the ease of use, they are more inclined to find other challenges across their portfolio where they can apply ETFs as a solution," he explained. For example, institutional investors use ETFs as portfolio completion vehicles to either round out existing exposures or plug gaps in their portfolio. "Examples of asset classes we've observed that use this include Emerging Market Small Caps, Single Country Exposures, Specific Targeted Fixed Income Duration or Yield Cap Adjustments," he said.

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> **GREG WALKER, MANAGING DIRECTOR, HEAD OF iSHARES INSTITUTIONAL BUSINESS, BLACKROCK ASSET MANAGEMENT CANADA LIMITED**

The fact that ETFs trade on an exchange makes it important for institutional investors to fully understand the best ways to implement their trades and engage ETF liquidity, Trumbull stressed. "ETFs trade in the secondary market but also offer the ability to create or redeem shares in the primary market through Authorized Participants." That means that many of the largest ETF providers offer extensive capital markets resources including dedicated contacts to ensure that investors have the best possible experience buying and selling their ETFs.

WHAT'S NEXT?

While more and more institutional investors are using ETFs, that use is set to grow exponentially in the coming years, according to Greg Walker, managing director, head of iShares institutional business, BlackRock Asset Management Canada Limited. In his presentation, The ETF Frontier: What's Next for Institutional Investors, Walker pointed out that big investors aren't just using ETFs for tactical purposes. He cited data from Greenwich Associates that shows 31% of institutions are now using ETFs to create liquidity overlays compared with only 3% in 2010—a 1,000% increase in just three years.

"The result is that holding periods are getting longer," he said. "In 2011, the most common ETF holding period was seven to 12 months—today it's more than two years."

Why the shift in use? Walker noted that part of the reason lies in changes in the traditional fixed income markets, where many of the traditional participants have faced increased constraints in providing liquidity. Meanwhile, "Spreads for some funds have tightened to the point where ETFs can be less expensive to trade than the securities in the underlying index," he explained. At the same time, institutions are using ETFs to gain more "surgical" exposure to sub-indices to customize their allocations, both in fixed income and equity. "For instance, a Europe, Australasia and Far East (EAFE) fund gives investors the good with the bad in Europe, Australasia and the Far East," Walker said. "But by rebalancing EAFE allocations through individual country funds—for instance, reducing exposure to underperforming countries, or increasing allocations to outperforming countries such as Japan in 2013—institutional investors can limit downside risk and seek to outperform the underlying benchmark."

Walker also noted that in fixed income, investors can also more easily adjust target duration or credit requirements through the use of ETFs.

A growing number of institutions are maintaining liquidity sleeves comprising ETFs, dialing up or down their duration or credit exposures in just a few trades and providing operational flexibility while keeping transaction costs in check. ■

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