The Future of ETF Investing

Description

The entry of two more Canadian mutual fund companies into the domestic ETF industry is certainly worthy of note. But what I found particularly interesting about the entry of Excel Funds Management and Franklin Templeton Investments Corp. is that both firms have particular expertise in emerging markets: a market segment that's arguably better approached through traditional active investment management than the passive-indexing approach that exchange-traded funds are famous for.

A cynic might trot out the old saying, that "if you can't beat them, join them," them being the fast-growing industry of ETFs, which increasingly seems to be grabbing both media mindshare and consumer wallets at the expense of the much older mutual fund industry.

The addition of Excel and Franklin Templeton brings the number of ETF providers in Canada to 24 — all vying for a piece of industry assets that have grown to $126 billion in Canada alone. The two new entrants are by no means the first mutual fund companies to dip their toes into the ETF waters; Invesco Canada's PowerShares ETFs have been around a while now, and, in the past year, we've seen other domestic mutual fund powerhouses, like AGF Management Ltd., also enter the fray.

What's interesting about Excel Funds' entry is that president and CEO Bhim Asdhir continues to believe that the emerging markets niche his firm is famous for is best approached through boots-on-the-ground stock-picking. So, there are no immediate plans for a broad-based Excel emerging markets ETF providing passive exposure to the asset class. Instead, the initial ETFs are actively managed global balanced and asset allocation funds, launching at the end of May. Both derive from partners in Europe and respond to requests from the company's distribution channel for products that target returns with low volatility.

While no investment firm can absolutely guarantee positive returns, the combination of asset allocation and active management allows Excel to target, in the one case, a 5% annual return in Canadian dollars with a maximum drawdown of 5% in a given year and target volatility of five, Asdhir said in an interview with the Motley Fool. The Excel Global Balanced Asset Allocation ETF would be appropriate for institutional investors.

The second — Excel Global Growth Asset Allocation ETF — targets an 8% return with a maximum drawdown of 8% and volatility of eight. Asdhir described both as “core holdings with low fees.” He couldn’t specify the fee level but said they are “in line with other ETFs” and lower than mutual funds. While they do not pay trailer commissions, the ETFs target advisors looking for core solutions that they don’t have to rebalance themselves. Other targets are “institutions, corner offices, endowments and people happy with a 5% or 8% annual return and low volatility: a pretty big audience.”

Over at Franklin Templeton, the story is similar. Based on my interview with Franklin Templeton’s global head of ETFs Patrick O’Connor, it doesn’t appear we can expect ETF clones of the classic Templeton legacy mutual funds anytime soon (such as the mountain-chart-famous Templeton Growth Fund or Mark Mobius’s Templeton Emerging Markets fund).

Instead, the company announced that a Canadian version a one-year-old U.S. ETF platform (The Franklin LibertyShares, which is actively managed) will now be offered in Canada. It will consist of two actively managed ETFs and two strategic beta ETFs that will be launched on the Toronto Stock Exchange between May 30 and June 5. Those four new ETFs are “just the beginning,” O Connor said.

In the United States, the Franklin LibertyShares ETF platform has accumulated US$623 million, and Canada is just the second country to roll out a local version of the platform. Europe follows this summer. The Franklin Liberty Risk Managed Canadian Equity ETF and Franklin Liberty Canadian Investment Grade Corporate ETF launch on May 30, with TSX ticker symbols FLRM and FLCI, respectively. The Franklin LibertyQT U.S. Equity Index ETF (ticker FLUS) and International Equity Index ETF (ticker FLDM) launch on June 5. Templeton says each of the strategic beta ETFs seek to replicate a rules-based index that applies four custom factor weightings to its underlying index: 50% quality, 30% value, 10% momentum, and 10% low volatility.

As for advisor compensation, “We are not paying trailers. Let’s be very clear,” O’Connor said. Fee-based advisors are, of course, free to tack on whatever fee they and their client negotiate. Management expense ratios (MERs) are 0.25% for FLUS, 0.40% for FLDM, 0.30% for FLRM, and 0.40% for FLCI.

To be sure, these are complicated products and quite a departure from the low-cost, broadly diversified, purely passive, index-based products that first populated the Canadian ETF landscape (chiefly from BlackRock Canada’s iShares and Vanguard Canada). What we are now seeing are new hybrid vehicles that attempt to marry the best of the mutual fund and ETF industries.

For example, in its press release issued on May 3, Franklin Templeton president and CEO Duane Green is quoted as saying investors have embraced ETFs for the “benefits of intra-day trading, liquidity, tax-efficiency and transparency.” The firm believes “the future of ETF investing is in continuing to provide these foundational benefits while innovating beyond the limitations of passive investments.”

If nothing else, it’s now clear that the simplistic “mutual funds are active, ETFs are passive, conversation is now dead,” says Tyler Mordy, chief investment officer of Vancouver-based Forstrong Global Asset Management. “ETFs simply supply a different wrapper to execute a variety of strategies — both active and passive,” said Mordy, who was recently nominated as ETF Champion of the Year.

“The paradigm shift ETFs have brought to the world of active management is the ability to outperform through dynamic asset allocation," Mordy added. As a result, the asset management industry is moving away from stock-picking, benchmarks, and relative performance to an emphasis on asset allocation, investment goals, and individual performance. "In my view, the ultimate result is client portfolios that can thrive."

Mordy pointed to a succinct quote by BlackRock Inc. founder Larry Fink in a recent issue of *Bloomberg*: "One of the unknown secrets about the growth of ETFs is that they're heavily used by active managers."

Ironic!

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Date
2025/07/22
Date Created
2017/05/09
Author
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