BMO Global Asset Management ETF Outlook 2021

It was an extraordinary year, and ETFs were central to all the market activity. The global pandemic brought the economy to a standstill and prompted the worst market collapse in a decade. Monetary and fiscal response then led to a strong market rebound, although returns were concentrated among new economy companies who were less affected by the economic shutdown and stay-at-home orders. During all of this, exchange traded fund (ETF) trading volume increased, a sharp contrast to some of the less liquid underlying asset classes that were stalled by the turmoil. ETFs displayed resiliency and provided liquidity to rebalance portfolios, particularly during the March 2020 quarterly rebalance period.

Global ETF Flows in 2020

Assets in ETFs grew globally, mostly driven by flows, as investors recognized the benefits of using ETFs, especially in times of heightened volatility and developing economic events. At the end of December 2020, the Global ETF industry had 7,602 ETFs from 485 providers on 73 exchanges in 60 countries, and assets of US$7.7 trillion.[1] The U.S. had the largest share of these assets with US$5.3 trillion, an increase of 23% year over year driven by net new flows of US$457 billion.[1] The European ETF market grew 22.6% to US$1.2 trillion and in Asia ETF assets grew 48% to US$438 billion.[1]

In 2020, the Canadian ETF industry reported another year of record numbers with $257 billion in assets, and $41 billion in net new flows.[2] Five ETFs reported more than $1 billion in new flows, including **BMO S&P 500 Index ETF (ticker: ZSP)**.[2] Success was concentrated, as the top 20 selling ETFs accounted for 40% of the total flows and 65% of all tickers reported positive flows.[2] 175 new ETFs were launched, and five new providers entered the industry. There are now over 1000 tickers (13% of global tickers are here in Canada) and 39 ETF providers.[2] In 2020, BMO ETFs led the industry with net new flows of $8.4 billion; 22 BMO tickers reported inflows greater than $100 million.[2]

Megatrends

Thematic investing has captured investor interest more so than any other style of investing in 2020. It's easy to see why, with 2020 returns concentrated in companies exposed to new economy technologies or to emerging global themes. Of the close to 16% return of the S&P 500 Index, almost half of the contribution came from only three names: Apple, Amazon, and Microsoft.[3] This story of investing in disruptive innovations was championed out of the U.S. by active ETF manager ARK Invest and their flagship ETF the ARK Innovation ETF (ticker: ARKK), returned over 150% last year, in USD terms.[3]

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This is a new way of looking at the market, where the approach seeks to identify megatrends: future drivers of market growth driven by the adoption of new economy technologies and disruptive innovations which will impact our behaviours, our needs, and how we interact with the world. Megatrend ETFs are agnostic to sector, region or market cap. These innovations are believed to transform business, industries, society and behaviours as they evolve and play out, and investors are aware of the exponential growth profiles of the companies who are best positioned to be the beneficiaries of these trends.

In the U.S., the top 10 best performing ETFs in 2020 were from ETFs exposed to a megatrend, with six of these ETFs being exposed to the emerging theme of clean energy.[4] Clean energy companies had many tail winds in 2020, including a global movement to support green energy producers, and an incoming Biden Administration who has been clear on its commitment to supporting clean energy. Up until this year, Canada did not have a clean energy ETF. BMO ETFs launched the **BMO Clean Energy Index ETF (ticker: ZLCN)** in January of 2021, and tracks the popular S&P Global Clean Energy Index, which returned 142% in 2020.[3]

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In Canada, nine of the top ten performing tickers of 2020 were disruptive innovation megatrends such as genomics, artificial intelligence, blockchain technologies, big data, cyber security and gaming.[4] BMO ETFs recently launched a suite of innovation ETFs which includes the **BMO MSCI Innovation Index ETF (ticker: ZINN)** which provides exposure autonomous technology & industrial innovation, genomic innovation, fintech innovation, and next generation internet innovation.

While not a megatrend index ETF, the **BMO NASDAQ 100 Equity Index ETF (ticker: ZNQ, ZQQ)** is probably the most exposed of the broad beta indexes to emerging themes. This index has also captured investor interest, positioned on the leading edge of the new economy wave by investing in the largest NASDAQ listings (ex-financials), resulting in a heavy technology weight. To best illustrate the story of concentration of returns, and the haves and have-nots of the recovery, ZQQ returned 45.0% in 2020, compared to 5.8% for the Canadian market, as measured by **BMO S&P/TSX Capped Composite Index ETF (ticker: ZCN)** which is underweight to technology stocks.[3] Of note, within ZCN, Shopify rose to the top weight of the market-weighted index, now having a larger market share than the largest Canadian bank, evidencing the strength of new economy

companies this year was not limited to U.S. equities. The ease by which ETFs can add instant access to other markets is critical to get exposure to new economy companies.

Responsible Investing

Environmental, Social, and Governance (ESG) investing was a leading theme in 2020, both because of ETF launches and performance, but also from a growing awareness from investors and companies of the financial benefits of responsible investing, as firms with stronger ESG ratings may avoid negative surprises. The groundswell of environmental concerns, the march forward of social causes, and the disdain for poor corporate governance were all important themes in 2020. With the onslaught of products, the importance of education and ESG measurement continues to grow, where investors look to partner with a provider that delivers both. Education around active ownership, where the ETF provider can be active in proxy voting and company engagement, is a key differentiator.

While the ETF industry has focused on broad equity exposures, such as **BMO MSCI Global ESG Leaders Index ETF (ticker: ESGG)**, we expect there to be further growth in thematic exposures and fixed income ESG ETFs in 2021. As track records grow, including through the turbulent markets of 2020, confidence in responsible investing products will continue to develop.

Rotation in Factor Based ETFs

While broad markets rebounded with the outsized returns from growth stocks, factor investing was a mixed bag, as defensive portfolio positioning with dividend, low volatility, and value factor ETFs trailed the market, while quality factor ETFs kept up with positive returns while enduring downturns better than the market. As we saw the market in 2020 evolve from a devastating collapse to an extreme bull run, we also witnessed the rotation of factor performance. Low Volatility, the winner in 2019, lagged the broad market in 2020 through the rebound as its lower beta stocks could not keep pace in the rally. As quality investing identifies market leaders, these ETFs captured investor interest, such as **BMO MSCI USA High Quality Index ETF (ticker: ZUQ)**, by outpacing the broad market by over 5% during 2020 and providing some downside protection for future corrections, given that these companies have lower debt and higher cash flows, two resilient characteristics to ride out market volatility.[3] With the vaccine development news later in the year, we saw companies who had yet to participate in the market rally rebound, especially those from the Energy and Financials sectors. This pulled up dividend and value based strategies into year end, and we could continue to see strength from these factors as the reopening trade plays out.

Emerging Markets

Emerging Markets gained popularity in 2020 among Canadian investors looking to add growth solutions to portfolios, and we expect this to continue in 2021. The composition of emerging markets has evolved, with increasing weights in Information Technology and the Consumer sectors. Canadians are recognizing the domestic growth story in emerging markets, in addition to the diversification benefits which are more than before when emerging markets had a higher exposure to exporting natural resources. As a proof point, the correlation between the Canadian market and emerging markets has dropped meaningfully, from 0.91 ten years ago to 0.78 today.[5] Emerging markets include some of the largest companies in the world and are exposed to new economy businesses and a growing middle-class consumer. The **BMO MSCI Emerging Markets Index ETF (ticker: ZEM)** saw inflows of $758 million in 2020 displaying the growing investor appetite among both institutions and advisors to get exposure to this asset class.[2]

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The regional composition of emerging markets has changed as well, now over 40% Chinese equities, a reflection of China's ascent to the world's second largest economy.[3] In 2020, the performance of Chinese equities could not be ignored, returning 29.5% (as measured by the MSCI China Index) compared to U.S. equities return of 18.4% (as measured by the S&P 500 Index), in USD terms.[3] Adding emerging markets exposure with an ZEM is an efficient way to add exposure to China to a portfolio.

Fixed Income ETFs: Liquidity and Ease-of-Use Help Investors Switch up Bond Exposures

The fixed income market was one of the most dramatic stories in 2020, with bond markets freezing up during March, particularly in credit markets, with a gradual recovery post the U.S. Federal Reserve and Bank of Canada announcements to support markets. The benefits of fixed income ETFs were extremely evident during this stressed market as fixed income ETFs continued trading when the underlying bonds were not.

This did create confusion for investors, as active market prices reflected deteriorating market conditions and dislocated from stale net asset values. ETFs provided liquidity when it was needed, as markets whipped around, a benefit that can't be overstated, allowing investors to react to market changes.

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As fixed income recovered throughout the summer of 2020, fixed income ETFs were utilized by investors to rotate into and out of different exposures to react to a quickly changing market. Within the BMO ETF product shelf, we saw flows move from aggregate exposures to segmented ETFs as investors looked to capitalize on specific dislocations across credit and term and rotated into more defensive fixed income to offset rising equity risk. In the summer as sentiment improved, flows moved into broad corporate exposures such as the **BMO Corporate Bond Index ETF (ticker: ZCB)** as investors looked to capture tightening corporate spreads. As market uncertainty ramped up again in the fall heading into a U.S. election and facing a surge in virus cases, investors rotated back into government bonds, taking profits from the corporate trade and heading back into more defensive exposures. This is a perfect example of how big an opportunity fixed income is for ETFs by efficiently trade an over the counter (OTC) asset class. The most defensive exposures gathered the most assets in 2020: broad government exposures such as the **BMO Government Bond Index ETF (ticker: ZGB)**, which saw $464 million in net new flows.[2]

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Many investors looked to add some duration risk in long bonds in the hunt to increase yield in an ultra low rate environment. This was evident in the **BMO Long Federal Bond Index ETF (ticker: ZFL)** which was BMO's largest growing fixed income ETF in 2020 (by assets), gathering $559 million.[2] Duration risk is relevant in the fixed income space, as debt issuers are also looking to issue longer bonds to capture low rates. This has increased overall market duration by about one year: in Canada we have seen the

aggregate universe duration increase to 8.3 years.[3] For investors who are concerned about duration risk, short-term ETFs are a suitable building block to add to a fixed income portfolio if you're looking to take some duration off the table.

Preferred Shares

Since the market bottomed on March 23, 2020, the preferred share market in Canada returned 64.3% by year end, and these returns were thanks to two key factors: three emergency rate cuts by the Bank of Canada, tightening credit spreads, and most notably the launch of Additional Tier One Limited Recourse Capital Notes (LRCNs) Offerings in the Canadian marketplace.[3] The **BMO Laddered Preferred Share Index ETF (ticker: ZPR)**, which is the largest preferred share ETF in Canada at $2 billion in assets, returned 69.3% during the same time.[3] The introduction of LRCNs was the largest driver for the preferred share market as overall shares decreased in supply as they were being redeemed. Regulators permitted LRCNs as a new way for banks to raise Tier 1 Capital. LRCNs are classified as debt and so for the issuer, they are a less expensive way to raise capital as interest incurred can be expensed. The capital raised by LRCNs may be used to redeem outstanding preferred shares and so many preferred shares have since pulled to par or even began trading at a premium (especially those with high reset spreads). This may reduce the overall supply of preferred shares.

Inflation

Inflation is a concern on more investors' minds heading into 2021. While reported inflation was muted in 2020 (0.7% in Canada)[6], this reflected the pandemic driven economic collapse during 2020 and low energy prices, and is not forward looking. There were signals in 2020 that have investors concerned about inflation, including the U.S. Federal Reserve's statement that they will allow inflation to run above 2%. Monetary stimulus that flooded the market in 2020 in both Canada and the U.S. is at historic levels. Government spending has skyrocketed in order to prop up shut down economies. Many goods and services have had increased input costs based on investing in PPE, sanitary requirements, and increased wages for front line workers. With all these tail wins for inflation, investors are searching for ways to add inflation hedges to a portfolio. In the fixed income space, investors can look to **BMO Real Return Bond Index ETF (ticker: ZRR)** or **BMO Short-Term US TIPS Index ETF (ticker: ZTIP)**. ZRR is suitable as a hedge for long bonds (duration of 16 years) while ZTIP is suitable to inflation hedge and lower overall duration risk (duration of 2.5 years).

The Path Ahead

The impact of COVID-19, from both market volatility and a transition to work from home has been a challenge for the ETF market, just as it has been elsewhere in financial services. With a growing switch to digital platforms and online interaction with financial advisors and planners, the importance of transparency and the ease of use that ETFs bring to the table is only growing. The ETF industry is well positioned to support portfolios, either through broad market exposures or more precise market segments. It is critical to work with a provider that delivers the support, education, and partnership required to succeed in this changing environment.

With the momentum of another record year in 2020, the path forward for the ETF industry looks bright. The opportunity for growth remains significant as the efficiency, low cost and tradability of ETFs keeps bringing in new investors. New ETFs

and new providers will continue to fight for market share, looking to differentiate themselves in emerging trends, such as megatrend investing and responsible investing in 2020. We expect to see 50 providers in the Canadian market, particularly with the growth of the industry supporting more unique strategies. The global ETF industry is projected to double to more than US$16 trillion over the next five years, and the Canadian industry to grow beyond C$600 billion by 2026.

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[1] ETFGI Industry Insights Report, December 31, 2020.
[2] BMO Global Asset Management, December 31, 2020.
[3] Bloomberg, January 27, 2021. The annualized returns for ZQQ are 1 year 45.0%, 3 year 24.8%, 5 year 22.2% and 10 year 19.3%. The annualized returns for ZPR are 1 year 6.1%, 3 year -0.7%, 5 year 3.6%, since inception (Nov. 14, 2012) -0.4%.
[4] RBC ETF Global Roundup, January 4, 2021.
[5] Morning Star Direct, December 31, 2020.
[6] statcan.gc.ca, Consumer Price Indexes, January 28, 2020. Year over year inflation as of December 31, 2020

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