Russell Investments

Investor

Helping you make informed investment decisions

A PRIMER ON ETFs

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In the face of volatile markets and low returns, many Canadian investors have focused on reducing the cost of their investments. According to Investor Economics, assets in Exchange-Traded Funds (ETFs) rose to $89.5 billion in 2015 compared to $38.3 billion only five years earlier.

In contrast, the annualized asset growth rate for mutual funds in Canada has been slower at only 9.8%. However that is from a much larger asset base of $808.6 billion in 2010. Overall, net flows into mutual funds in 2015 were $43.6 billion compared to ETF net creations of $16.5 billion.

As a wider variety of ETF and mutual fund strategies become available, we believe Canadian investors should learn more about these investment options and their risk and return profiles. Both strategies have their uses and can complement each other, depending on the outcomes investors are trying to achieve.

The lowest common denominator – Cost

Cost should play a role in any investment decision you make, as fees reduce your return. While cost is one of many factors to consider, active management does have the potential to add value over time. According to the Russell Investments' Active Manager Report, in the five years ending December 2015, 71% of large-cap active managers had beaten the S&P/TSX Composite Index, with a medium manager return of 270 basis points above that key Canadian benchmark.[1]

What is a reasonable amount to pay for active management that has the potential to add value? With ETFs, the general rule of thumb is "lower is better". For actively managed mutual funds, the decision is slightly more complex based on the assessment of the manager's skill. The average management fee for long-term mutual funds (excluding money market funds) in Canada was 208 basis points at the end of 2015.[2]

Active or Passive? Depends on the region

Investor preference for active and passive investing has ebbed and flowed over time, but there is an argument to be made to pair the two to seek better outcomes. Some markets are more efficient and can benefit to a greater degree from a passive component, while other markets, such as global equities that are more complex, can benefit from a higher active component.

Our research into ETFs show that even those designed to closely track their benchmarks, aren't always able to do so. As the chart shows, it is clear that Canadian ETFs – which follow the S&P/TSX Composite or FTSE TMX Universe – generally perform in line with their benchmarks. But that is not necessarily the case with ETFs that track non-Canadian markets.

While this may sound like a positive for Canadian ETFs, when there are periods of significant negative volatility, active managers have tended to protect investors better from significant losses. In 2000, 2008 and more recently in 2015 when markets were challenged, active management outperformance spiked[1], possibly due to the cyclical nature of the Canadian market because of the significant weighting to the volatile energy and materials sectors. Fund managers have traditionally been more cautious in their investments in these areas and therefore have delivered less downside risk than the benchmark.

[1]Russell Investments Active Manager Report. 2015 Annual Report. Median manager performance using annual returns from a survey of 148 Canadian institutional money managers.
[2]Investor Economics

The possibility of unintended "Active Risk"

The term "active risk" is commonly used in investment management to measure how much an active strategy deviates from its stated benchmark. Actively managed products have some level of active risk naturally because portfolio managers are mandated to seek better returns in areas of the market where they believe there are compelling opportunities. It is this deviation and the expectation of added value that you pay for when you buy an actively managed mutual fund.

The opposite applies to most ETFs, many of which are designed to stay as close as possible to a selected benchmark. Since the goal of a passive strategy is to produce benchmark (-like) returns, it should have very little active risk, otherwise known as tracking error.

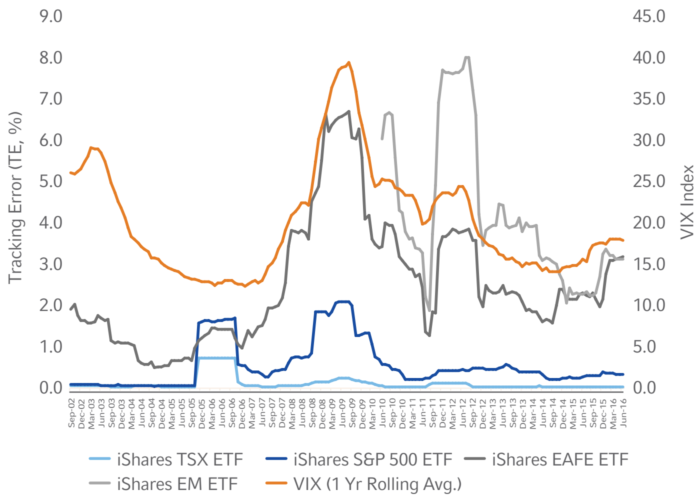
Our analysis shows this goal is generally achievable in "normal" environments, when markets closely adhere to the business cycle. However, we found that when markets were extremely volatile, some ETFs had difficulty maintaining benchmark-like performance. This was especially true for passive strategies in non-Canadian equities.

The chart shows the tracking error based on NAV for iShares ETF strategies that follow the equity market in Canada, the U.S., European and Asian developed markets, and Emerging Markets. Of these, the iShares S&P/TSX Composite Index ETF – which follows Canada's benchmark equity index – shows very little tracking error and its performance closely matches the benchmark. The iShares US Equity ETF that tracks the S&P 500, a broad U.S. benchmark, shows slightly higher tracking error. But the iShares ETF tracking the MSCI EAFE Index for Europe and Asia, and the MSCI Emerging Markets Index, show significant tracking error.

As the chart shows, the tracking error was most pronounced during the 2008 financial crisis and its aftermath, when market volatility was at its height.

We conducted a similar analysis on ETFs that follow fixed income benchmarks, such as the iShares FTSE

Annualized Tracking Error Based on NAV (1 Year Rolling)



Source: iShares, Russell Investments, FactSet. Note: VIX Index is a measure of market volatility based on the S&P 500 Index. Tracking Error measures the volatility (standard deviation) of the excess return for the respective ETF. An increase in TE is reflective of greater deviation in the relative performance of the ETF versus the respective benchmark. Based on monthly data as of June 2016.

TMX Universe Bond Index, which tracks the broad Canadian bond market, as well as the iShares FTSE TMX Corporates Index ETF, which follows Canadian investment grade corporate bonds. While the deviation in tracking error was not as notable, that could change in the future, when and if bond yields move off their historic lows.

Multi-asset – the best of both worlds

Going solely passive results in investments that simply roll with the market. This is in contrast to actively working to manage risk and seek opportunities, as with active strategies.

But we believe the active-versus-passive discussion is out of date and we believe there is room for both active and passive strategies in a multi-asset solution.

Multi-asset solutions focus on achieving a specific investment outcome, rather than beating a specific benchmark. They employ active decisions in allocating

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assets, finding the right securities to harvest various risk premiums, hiring the right sub-advisers, and dynamically responding to changing market conditions. Multi-asset solutions may also include passive factor exposures, such as currency overlays, based on a carefully considered set of portfolio needs and with particular investment outcomes in mind.

Combining active and passive strategies within a multi-asset approach can help an investor feel more confident that their total portfolio is well-positioned to help manage the downturns and catch the upswings in the years to come.

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