- ETFs

A Toronto Stock Exchange logo is seen in Toronto November 9, 2007. (Mark Blinch/Reuters)

ETF-type products on pace to soon overtake stocks in 'a ridiculous moment' for the TSX Add to ...

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The stock market is starting to look more like an ETF market.

Every year, the ranks of exchange-traded funds listed on the Toronto Stock Exchange get more crowded, and every year, the roster of publicly traded stocks thins out.

If those trends continue at their current pace, within the next two years, structured products such as ETFs will outnumber operating companies on Canada's senior exchange.

"You could see as many investment vehicles as you will actual companies to invest in, which is going to be a ridiculous moment," said Bryce Tingle, who holds the Murray Edwards chair of business law at the University of Calgary.

The decline of the publicly traded stock in Canada is a long-term trend with many contributing forces, as a recent Globe and Mail story explored. Among them: the rise of private capital as an alternative to public markets, growth in the regulatory burden for public companies and a wave of takeovers swallowing up smaller companies.

ETFs have partially filled the void. Ten years ago, there were 25 TSX-listed ETFs. Today, there are 465, according to TMX Group figures. In a year that saw just three corporate IPOs, 77 new ETFs began trading on the TSX. ETFs account for a large majority of structured products trading on the TSX, which also include closed-end funds and special purpose acquisition corporations.

The proliferation of ETFs has attracted critics resorting to ever-more alarming rhetoric. Often denounced synonymously with index investing, ETFs have recently been called "weapons of mass destruction," characterized as "worse than Marxism" and accused of inflating stock bubbles.

But despite their explosive growth, ETFs still command a relatively small share of the market's value. The risks they present, at least to the average investor, are more likely to result from familiar self-defeating tendencies: buying high, selling low and trading too much, said Yves Rebetez, managing director and editor of ETF Insight in Oakville, Ont.

"Investors can cheat themselves out of a significant chunk of the benefits, just as they did with individual stocks."

The cost advantage of ETFs is crucial to their value for the ordinary investor. Like mutual funds, ETFs offer exposure to segments of the stock, bond and commodities markets, but with substantially lower fees attached.

Investors in recent years have become increasingly aware of fees as a potent spoiler of portfolio returns. And a growing body of research generally supports a low-cost, passive approach as the most effective for the investing masses. The ETF has proven well-suited to execute that kind of approach.

The spread of passive and ETF investing together has proven a powerful, global force that is still gaining in strength.

In April, the value of assets invested in ETFs and other exchange-traded products worldwide broke through the $4-trillion (U.S.) mark for the first time, according to industry research firm ETFGI. That number has quadrupled since 2009. As of the end of April, the global industry numbered 6,835

funds from 313 providers on 68 exchanges in 56 countries, the firm's report said.

Momentum in ETFs still appears to building. Globally, exchange-traded products gathered net inflows for the 39th straight month in April, ETFGI said. And year-to-date net new assets hit a record $235-billion, dwarfing the $81-billion inflow seen over the same period last year.

Also in April, investors were introduced to a brand new kind of ETF – one that invests in ETFs themselves. The ETF Industry Exposure & Financial Services ETF trades on NYSE Arca (ticker TEFT) and tracks an index built on exploiting growth in the ETF industry.

Calling it an "ETF ETF," Michael Hartnett, Merrill Lynch's chief investment strategist, used the occasion of the new fund's listing to declare "peak ETF," citing colossal net inflows over several years, in a note to clients.

As ETFs have grown, so too have concerns that this instrument is serving to distort the market.

The most common argument suggests that ETFs indiscriminately plow money into broad indexes without regard for the profit fundamentals underlying the component stocks.

"When the world decides that there is no need for fundamental research and investors can just blindly purchase index funds and ETFs without any regard to valuation, we say the time to be fearful is now," managers of the $800-million Los Angeles-based FPA Capital Fund (the firm behind the "weapons of mass destruction" assertion) said in a letter to investors in April.

It was research firm Sanford C. Bernstein & Co., in another colourful bit of criticism, that issued the report in August that called index investing "worse than Marxism," on the basis that it undermines the productive allocation of capital.

U.S. hedge fund investor Seth Klarman, meanwhile, wrote in a letter to investors in February that as more investors migrate to passive investing, "the more inefficient the market is likely to come."

And Goldman Sachs argued that the spread of ETFs and index investing tends to raise equity correlations, meaning stocks rise and fall in unison.

What those arguments tend to ignore is that ETFs are still far from the dominant force in today's markets, said Eric Kirzner, a professor of finance at the University of Toronto's Rotman School of Management. ETFs and passive investing may be quickly growing, but the market is still largely rooted in mutual funds and active investing approaches.

U.S. equity ETFs, for example, have about $1.7-trillion in assets, representing just 6 per cent of the $27-trillion domestic stock market. The Canadian ETF industry, meanwhile, reached assets of $126-billion at the end of April, accounting for just 4 per cent of the total value of the TSX.

The Canadian stock picker isn't going anywhere, Prof. Kirzner said. "There is always going to be a large number of people who think they can find value out there, and will compete to find it."

The idea that ETFs could cause asset prices to become divorced from intrinsic value ignores another key trend: that index funds can be used in active investment strategies, said Tyler Mordy, president and chief investment officer at Forstrong Global Asset Management Inc., in Kelowna, B.C.

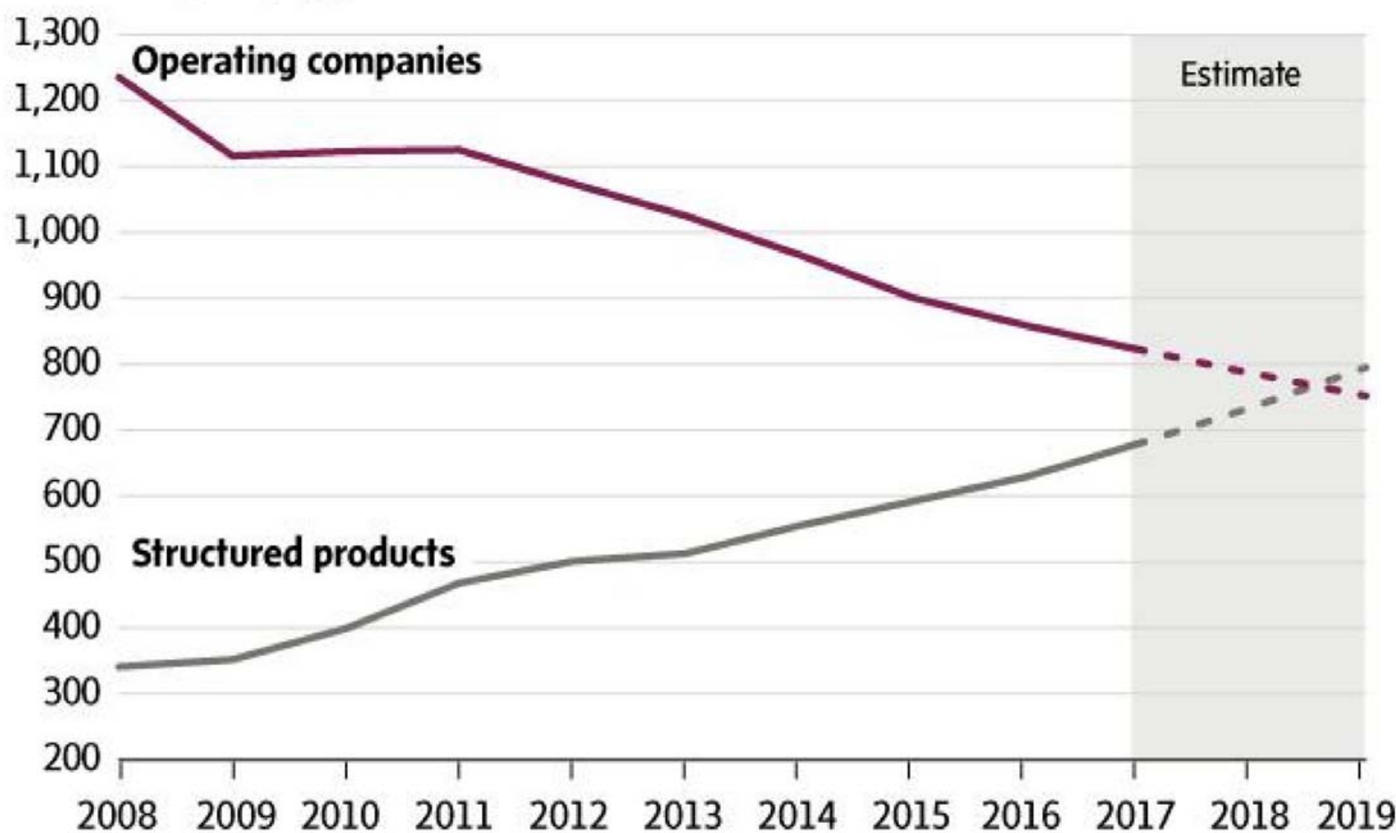
"Many of the users of ETFs are not passive investors but are actively involved in picking themes, trends, sectors and countries. They're active global asset allocators," Mr. Mordy said. "There is still a capital allocation exercise going on."

Consider the largest ETF in existence: the $231-billion SPDR S&P 500 ETF Trust. According to Morningstar, the average holding period of that ETF is just 15 days. That is not exactly the kind of long-term horizon essential to true passive investing.

What ETFs lack in relative size, they are more than making up for in terms of trading volumes, at least in the U.S. The Canadian market is still dominated by corporates, with ETF volume accounting for about 8 per cent of Canada-wide trading in the first quarter of this year, according to figures provided by TMX Group. But in the U.S., ETFs accounted for seven of the 10 most actively traded securities on U.S. stock markets in 2016. On any given day, ETFs account for around 30 per cent of volume traded.

Mr. Rebetez of ETF Insight said he's concerned that passive investing is starting to resemble active, and that investors will undermine the whole point of index exposure. And he doesn't suspect the financial industry will step in to discourage them.

"As the ETF wave continues to expand, you're likely to see the financial industry try to convince people of the merits of trading and adjusting positions, just as they did for individual stocks."



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