Inside: Top ETF trends

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- Rising rates making bond ETFs attractive
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2022 Mackenzie Investments year-end ETF report

ETFs thrive in a volatile market environment

MACKENZIE Investments

Inflation, interest rate hikes, recession, risk and geopolitical uncertainty have put the global economy in a volatile state in 2022. Indeed, 2022 is one for the history books, with Canada's consumer price index climbing well above 6% for most of the year and interest rates going from an ultra-low 0.25% to 4.25% within a mere nine months. Everyone from Bay Street to Main Street is now keeping their eyes on a possible economic downturn in 2023.

This uncertainty has played out in financial markets with the S&P 500 Index dropping by nearly 20% last year, as many of the tech stocks that outperformed during the pandemic gave back gains. The S&P/TSX Composite Index only fell by 8.6% in 2022, but it could have fared worse if it weren't for rising oil prices buoying the country's energy sector.

Despite all the volatility, many investors still put their money in the market – and especially into exchange-traded funds (ETFs). While ETFs didn't break records like in 2021, they still had one of their best years since debuting in 1990. Unlike mutual fund flows, which were negative in 2022, Canadian ETF inflows topped $35 billion, while assets under management (AUM) reached $314 billion, exceeding the $300-billion mark for the second time in history.

Michael Cooke, Head of ETFs at Mackenzie Investments, isn't surprised by the continued interest in ETFs, even though this year's economic and market environment was, he says, "almost unprecedented." ETFs have always done well in periods of upheaval, he notes, pointing out that U.S.-listed inflows reached $91.5 billion in October 2022, a new monthly record, while full year flows of $610 billion were the second highest ever. "Periods of market dislocation, economic uncertainty, heightened volatility have generally led to accelerating ETF usage," he explains. "People increasingly recognize the benefits of ETFs such as the cost-effectiveness, liquidity, transparency and the increasing breadth of product choices, all of which makes it easy to enhance and improve a portfolio."

ETFs' ease of use may be their biggest attribute these days. Rather than sell their investments when times get tough, investors can tweak their asset allocation, improve their diversification, reduce concentration risk from being too heavily weighted to one area or de-risk a portfolio with great precision and efficiency. That's is what we have seen in 2022. As bond yields have climbed, fixed-income ETFs have become more popular, taking in more than $19 billion in inflows in 2022, the most in the history of the Canadian ETF industry. Interest in inflation-protection solutions, such as real return bonds and TIPS (Treasury Inflation-Protected Securities) has grown, while cash alternative products such as HISA (High Interest Savings Account) ETFs have been popular as well.

"When you have a year like 2022 where investors have to take a closer look at the current construction of their portfolio, they think about ways they can make enhancements," notes Cooke. "They're more inclined to consider different investment options. Are there better solutions? Are there better alternatives, better substitutes they should be thinking about? And oftentimes, that thinking leads to the increasing usage of ETFs."

TOP TRENDS:

Where's the money going?

While Canada's ETF industry continues to expand – as of December there were 1,299 funds and 42 sponsors, up from 553 funds and 27 sponsors five years ago, according to National Bank of Canada – there are several short- and long-term trends that could impact asset growth going forward.

Changing of the guard

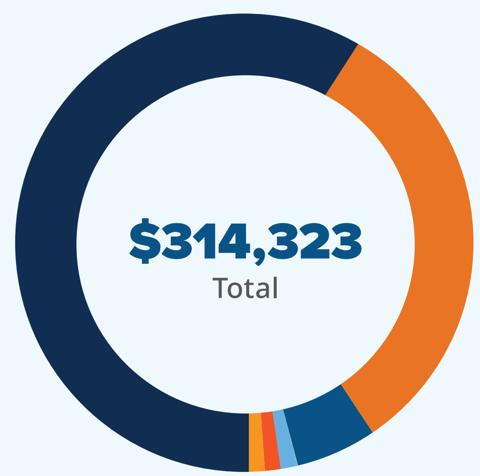
Cryptocurrency ETFs were all the rage last year, with billions flowing into bitcoin and ethereum funds. Now, with investors thinking twice about holding risky assets, many of these ETFs have seen massive outflows. "They've taken quite the performance hit and they're leading outflows as well," says Prerna Mathews, Vice President of ETF Product and Strategy at Mackenzie Investments. While Canadian, U.S. and international equity markets also suffered declines, investors took the opportunity to increase allocations to low cost, market-cap weighted equity ETFs with $7 billion in net flows. As well, previously unpopular sectors are now making a comeback, such as infrastructure. "The sector's provided consistent returns and yield," says Mathews. "Companies have long-term contracts with private-public partnerships, and oftentimes contracts are inflation-linked. Infrastructure is an exciting opportunity in periods where defensiveness is more attractive."

Bonds to continue their boom

With inflation likely remaining elevated in 2023, and a possible recession on the horizon, the markets should remain volatile in the coming year, says Cooke. As a result, inflows into fixed-income ETFs could continue. "We're going to see a strong appetite for increasing exposure to fixed income and at much more attractive entry points given where yields and coupons have risen significantly," he explains. Core solutions – the

ETF AUM (CAD$) by asset class

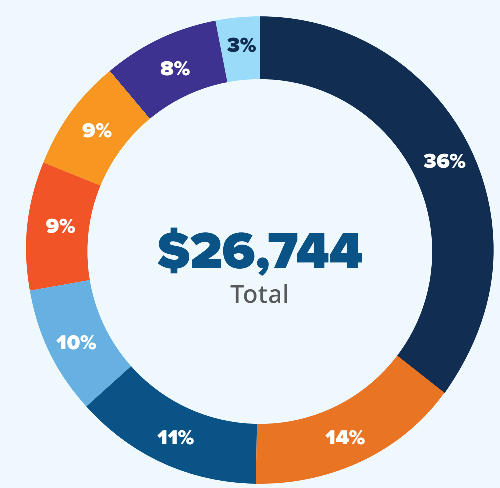
Source: National Bank of Canada



- **Equity** $195,653 / 61%
- **Fixed Income** $96,669 / 31%
- **Multi-Asset** $15,700 / 5%
- **Crypto-Asset** $1,661 / 1%
- **Commodities** $1,643 / 1%
- **Inverse/Leveraged** $2,998 / 1%

Equity AUM (CAD$) by sector

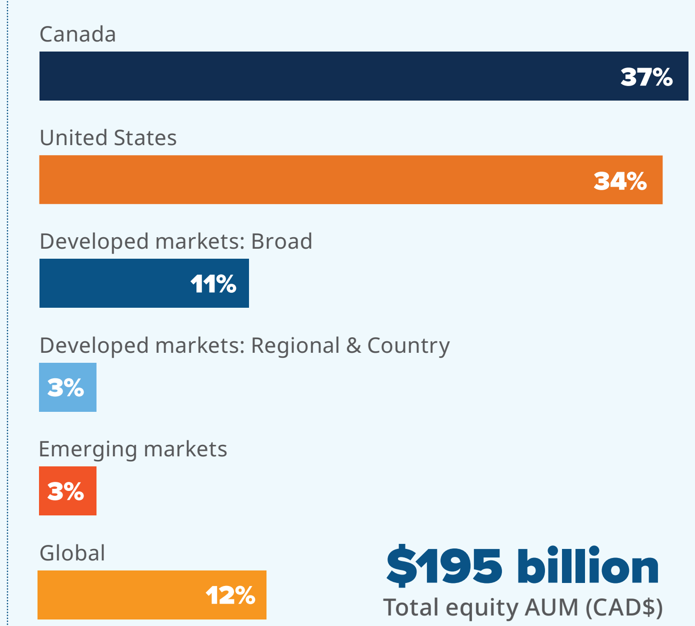
Source: National Bank of Canada



- Financials
- Energy
- Real estate
- Health care
- Technology
- Utilities
- Materials
- Other

Equity ETF AUM by geography

Source: National Bank of Canada



$195 billion
Total equity AUM (CAD$)

Crypto and commodities

Source: S&P Capital IQ

Bitcoin	Natural Gas	Gold	Oil
$16,529 (U.S.)	$3.81 /Mmbtu (U.S.)	$1,823.56 /oz. (U.S.)	$80.26 WTI/barrel (U.S.)

Year-end returns

Source: S&P Capital IQ

Stock Markets (1-yr returns)	-8.66% S&P/TSX	-19.4% S&P 500	-19.5% MSCI World
Canadian Economy	5.0% Unemployment rate (Dec. 2022)	0.7% GDP growth (Q3 2022)	6.8% Inflation rate (Nov. 2022)

ETFs in 2022

Source: National Bank of Canada/ETFGI

$35 billion
Total inflows for 2022

-2.7%
Year-over-year increase in AUM

1,299
Number of ETFs in Canada

9.3%
Year-over-year increase in ETFs

27%
Year-over-year increase in total inflows

$9.5 trillion
Global ETF assets under management (As of Nov. 2022)

11,073
Number of ETFs and ETPs for purchase globally (As of Nov. 2022)

All stats, unless otherwise noted, as of December 31, 2022 building block ETFs in a portfolio – also did well last year, as people have gone back to investing basics, and they should continue to see inflows in 2023, he says.

Solutions will take centre stage

Looking longer term, Mathews expects to see more solutions-oriented ETFs come to market in the coming years. Many companies now offer all-in-one ETFs, which give investors access to an array of investments in one product, but there's an opportunity to create even more single-ticket funds – or objective-oriented ETFs, as they're also called. These include drawdown solutions, which can help retirees remove money from their portfolios, and buffer ETFs, which focus on downside protection while taking advantage of growth opportunities.

Digital economy driving interest

Once investors start taking on more risk, thematic funds, and specifically ones focused on exponential technologies, could be in demand, says Cooke. Digital infrastructure, green technology and energy transition are examples of investment themes that may pique future investor interest. "The digital economy is transforming the world," he explains. "And more generally, I'm excited about the sheer breadth of product choices in the ETF industry. Chances are that investment professionals and investors can find the ETF solution they're looking for."

Back to basics

There's no question in either Cooke or Mathews' mind that the booming ETF industry will continue to see inflows and assets expand in the coming years. If ETF usage continues to break records in the U.S., which is still a more mature market than in Canada, then it's safe to assume growth will continue to expand here. "Canada is still a nascent market compared to more traditional investment fund markets, so the adoption rate is still very much accelerating," says Cooke, adding that gains are coming from both the institutional and retail side.

In terms of the latter, now's the time for investors and their advisors to consider ETFs if they haven't already. Finding the right products among the many on the market requires an understanding of one's risk tolerance level, time horizon and cash flow needs. "It goes back to basics," says Mathews. Once that's figured out, investors can start picking from the 1,200-plus ETFs on the market. "Starting from the product set itself can be overwhelming," she explains. "Instead, think about the investment outcome you're seeking and then the choices start making sense."

"So many trends in financial services indicate that ETFs will continue to grow in relevance, and set records for inflows and assets under management."

Michael Cooke
Senior Vice President and Head of ETFs,
Mackenzie Investments