**INVESTOR SUMMIT KEY TAKE-A-WAYS**

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# Peak ETF is nowhere in sight

**Martin Small**
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Nearly 30 years after the first exchange-traded fund debuted in Canada, most institutional investors know the textbook definition: ETFs are mutual funds listed on exchanges. Yet they are also much more than that, says Martin Small, Managing Director, Head of U.S. & Canada iShares, who spoke at the 2018 BlackRock Canada Investor Summit. Small contends that it's time to think about ETFs through a different lens – one that helps explain why investors are increasingly adopting them across a range of styles, strategies and models.

## Of soda pop and shipping containers…

Small began by making a surprising – though apt – analogy between ETFs and two completely unrelated things: Coca-Cola and intermodal shipping containers.

Small said that the idea behind Coke, which comes in all different sizes, flavours and packages, is to "meet the customer and buying behaviours where they are." It's the same with ETFs, which like soda pop are "flexible and customizable, and offer bundled delivery." As for shipping containers, Small pointed out that their development in the 1950s revolutionized the transport industry through standardization and bundled delivery – and cut shipping costs by 97 per cent. ETFs, he suggested, do the same for investors, by bundling all kinds of investments into one "container" and lowering costs dramatically.

In short, ETFs "deliver the world of investments in a single transparent basket."

## Structural forces driving ETF adoption

Why have net assets in ETFs been growing by 10 to 15 percent a year? Small argued that structural, rather than cyclical, forces are driving the trend:

- **Unbundling of alpha factors and cap-weighted exposures:** The flexibility of ETFs has led investors to unbundle and repackage alpha factors from beta products, as well as reframe index exposures beyond the traditional (e.g. S&P 500) and into other transparent, rules-based and investable criteria.



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- **Move toward lower-cost multi-asset portfolios:** Institutions are looking for ways to simplify portfolio construction and spend fewer resources on research. ETFs have increasingly become essential building blocks in expressing an investing strategy. The rise of fee-based advisories is also driving the lower-cost trend.

- **Increasingly networked markets:** Technology is allowing more and more buyers and sellers to transact "without an investment bank in the middle of them," Small noted. "The ETF is made for that environment."

## How far can ETFs grow?

The pace of ETF adoption raises the question of how long the growth trajectory can continue, and has raised concerns among some investors that indexing might be creating systemic risk. Yet as Small pointed out, index investing still has a relatively tiny footprint on financial markets. The outstanding market value of all securities in the world is about US$162 trillion, he noted, but all index investing strategies put together, including ETFs, amount to only about 10 percent of that total.

Meanwhile, ETF creations, which are the primary layer of liquidity in the funds, remain a very small fraction of overall equity dollar trading volume – a reality that suggests that indexing actually has little impact on underlying stock volumes. In fact, Small noted a tiny part of secondary market activity – the largest liquidity factor for ETFs – trickles down to the creation/redemption level. Another reality: rather than a threat to stability, a substantive system of beta products allows "for better price formation and less volatility on the markets," even during market selloffs like the recent short-volatility unwind.

Indexing, Small concluded, not only has room to grow, but also has the potential to "make markets a lot better."



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