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ETF Trends to Watch in 2017

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The turn of the calendar to a new year brings new year's resolutions—and predictions. While many market pundits are now making their prognostications for the year ahead, David Mann, head of Capital Markets, Global Exchange-Traded Funds (ETFs), doesn't claim to have a crystal ball that will reveal where the market is headed next. He does, however, offer some practical insight on the state of the ETF industry and some trends to look out for in the year ahead.

I hope everyone had a happy and healthy holiday season! Last month, I discussed one of the great end-of-year traditions, tax-loss harvesting. Right up there on the "traditions" scale (although less of an ETF tradition) is to have a January predictions post about what we should be expecting in the new year.

While this is a financial industry blog, let's start with some predictions I will not be making here:

- The end-of-year price of the S&P 500 Index
- The number of interest rate hikes we will see in 2017
- A market call on a particular country or sector

I am also going to refrain from making any predictions specific to ETFs, such as where industry-wide ETF assets under management and flows are headed in 2017 or where ETF trading volume will net out. Though, if pressed, directionally, I'd say that I think each is likely to be higher, as I do believe we'll see a continuation of current trends.

Instead, what I really want to touch on are a few issues or topics that will be on my radar in 2017, which I think ETF investors should pay attention to, as well.

Non-Traditional ETF Strategies Are Here to Stay

There is no question that ETFs have been growing in popularity worldwide and have been attracting an increasing share of investor dollars. In 2016, more than $270 billion flowed into ETFs—the majority of which were US ETFs.[1]

Within the ETF marketplace, investors have been increasingly gravitating toward relatively new types of ETFs known as "strategic beta" or "smart beta" ETFs, which have garnered more than $40 billion in new assets globally in 2016.[2] These funds offer an alternative to purely market capitalization index-tracking vehicles.

We are also seeing increased interest in active ETFs, especially those holding fixed income securities. As investors have become more and more comfortable with the ETF wrapper, they are becoming more open to different solutions within the general asset class beyond a basket defined by market capitalization. I expect this trend to continue.

For decades, market capitalization-weighted indexes (such as the S&P 500 Index for US large-cap investing) have served as the foundation of a passive approach to ETF investing, with many investors viewing them as an efficient way to gain broad market exposure.

However, many are discovering that traditional index investing comes with certain drawbacks and inherent risks that more advanced approaches to index construction may help to mitigate. One such methodology (strategic beta) constructs indexes based on criteria other than market capitalization.

This could include a simple set of rules (holding securities in equal weights) or a more complex methodology (using multiple factors such as quality and value). In contrast, with traditional, cap-weighted indexes, the largest, highest-priced companies will make up the largest portion of an index. That may not be desirable.

Looking at active ETF products, the key distinction is the word "active."

Active ETFs, unlike the more traditional market-cap weighted index ETFs, seek to outperform their benchmark index in various ways. Portfolio managers have the opportunity to actively respond to market events, navigating through various market environments by changing allocation. In some instances, they may even invest outside the confines of the benchmark index.

There are other factors to consider when it comes to investing in both strategic beta and active ETFs. The reality is the lines between active and passive, index and non-index are getting quite blurry. The attention should rightfully be focused on the rules and methodologies of the underlying basket of securities.

I encourage you to learn more at www.libertyshares.com.

Potential New ETF Regulations

With a new US administration coming on board, it's hard to know what could happen on the regulatory front. However, the potential for new ETF regulations is something to keep an eye on, and I've been tracking this issue since 2008 when the Securities and Exchange Commission (SEC) issued a rule proposal that would formally exempt ETFs from certain provisions of the Investment Company Act of 1940.

Here is the link, if you'd like to have a look at the 2008 proposal: https://www.sec.gov/rules/proposed/2008/33-8901.pdf

As everyone is well aware, a lot of things happened to the financial markets in 2008 and 2009 (e.g., the global financial crisis) that put this proposal on the back-burner. In 2015, there were signs it was going to be revisited as the SEC requested public comment about the listing and trading of ETFs.

In the wake of the recent US election, however, it is difficult to try to predict what President-elect Trump's administration may or may not focus on in this area (it's really anyone's guess). But given the continued popularity of ETFs, it would not surprise me to see further review of existing ETF-related regulations in the year(s) ahead.

Without getting too far into the weeds, any potential industry-wide "ETF rule" would set standards for all ETF issuers regarding their creation/redemption practices as well as the liquidity and diversification required of its underlying basket of securities. I think this will become even more important as the non-traditional ETF strategies I discussed earlier continue to gain traction.

Trading an ETF vs. Trading a Single Stock

There has been a lot of discussion on the best practices for trading ETFs. From a regulatory perspective, trading an ETF is no different than trading a single stock. However, one of the reasons ETFs were under scrutiny after the "flash crash" of August 2015 was because they actually have an underlying value based on the intraday value of the underlying securities. In fact, the concept of ETF arbitrage is for the creation and redemption process to keep the value of the ETF in line with the value of its basket, a process which broke down during the August 2015 "flash crash."

I have written before on the ways investors can avoid trading during high levels of market uncertainty as well as the types of orders I think should be used (and avoided) for trading ETFs in general.

We in the industry have debated whether there should be dedicated market structure rules for ETFs. (You can let me know what you think via our LinkedIn page or on Twitter.) An example of the topics being debated is tighter limit up/limit down bands (that is, trading curbs or maximum price movements) that are based on the ETF's underlying value instead of its last traded price.

Currently, approximately a third of all exchange trading comes from nearly 2,000 ETFs listed in the United States.[3] As both of those amounts continue to rise, it would not surprise me to see new proposals that acknowledge that ETFs are different than single securities.

From my perspective, anything that gives investors more confidence in trading ETFs—especially newly listed ETFs—would be a positive development.

While I'm sure you are probably going to hear many bold predictions on global financial news networks (probably making for more exciting headlines or sound bites than what I've outlined here), I'll leave you with this quote from ancient Chinese philosopher Lao Tzu: "Those who have knowledge, don't predict. Those who predict, don't have knowledge."

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What are the Risks?

All investments involve risks, including possible loss of principal. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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1. Source: Bloomberg. See www.franklintempletondatasources.com for additional data provider information.

2. Source: Morningstar. See www.franklintempletondatasources.com for additional data provider information.

3. Source: Bloomberg, New York Stock Exchange. Data as of December 2016.