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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
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IIAC LETTER

Equity ETF Performance and Outlook - 2020

INTRODUCTION

The marketplace of equity ETFs during the COVID-19 crisis period through the latest six months March to August 2020 was marked by volatile swingeing prices, mirroring the underlying equity markets in the same period and other ETF markets during this time. However, liquidity of equity ETFs has held up well through the crisis period, in contrast with liquidity problems in fixed income ETFs and underlying fixed income markets.

Real estate investment trusts (REITs) which normally perform well in low interest rate environments fared poorly early in the pandemic and remain well off their highs. There is fear that a weak economy could result in a large number of defaults by commercial and residential tenants. Preferred share ETFs have also underperformed the broader markets.

This paper examines both the performance of ETFs during this period compared to the underlying equity markets as well as liquidity and operational issues.

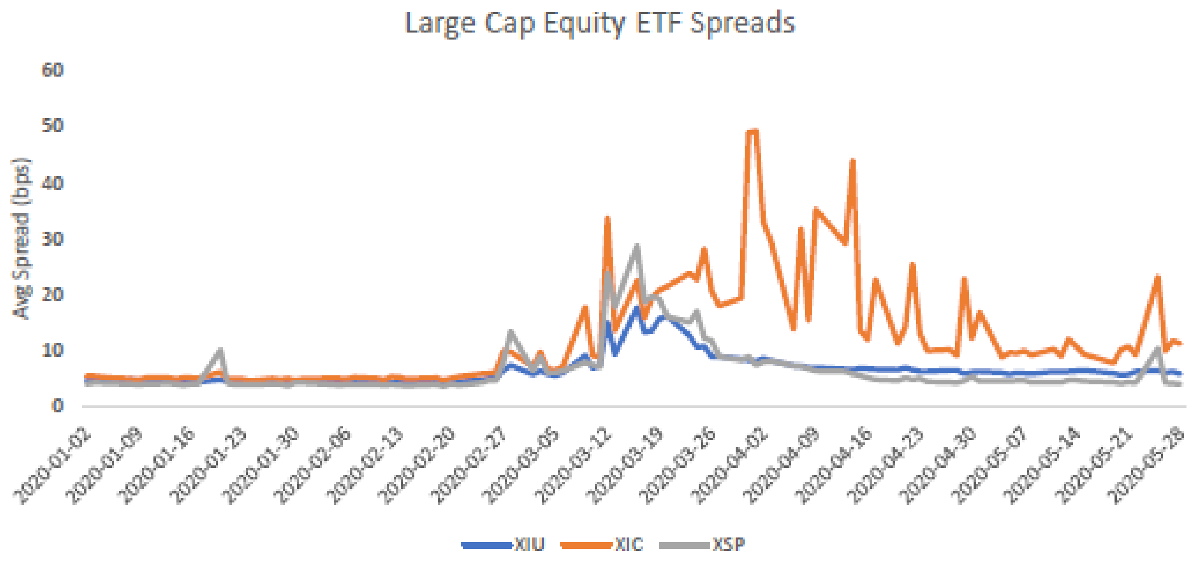
The most common type of ETF is a market ETF which tracks major market indexes like the S&P/TSX. Some market ETFs do track lower-volume indexes as well. Sector and Industry ETFs may track sectors that experience higher volatility. Market ETFs that track major market indexes are only as volatile as the index itself.

Industry ETFs that primarily trace a given sector index were created to emulate the underlying industry, such as energy, technology, or pharmaceuticals. While sector and industry ETFs allow investors to gain exposure to subsectors of the market, they often do not exactly mirror the desired industry or sectors performance because their composition is usually slightly different.

RECENT EQUITY ETF PERFORMANCE AND CHALLENGES

During the months of March and April there were instances where industry and sector ETFs traded in the secondary market at larger than normal bid-offer spreads. This occurred across many sectors and is demonstrated in Figure 1 below for selected large cap equities. As a testament to their resilience and liquidity, by the beginning of April, bid offer spreads for broadly based ETFs had largely returned to normal.

Figure 1:



Source: NBF

It must be noted, however that in strained and volatile markets, ETFs, and in particular equity ETFs facilitated continuous market liquidity and material trading volumes, and also provided transparent price discovery for many underlying equity products.

It is important that we recognize that market challenges experienced by ETFs was experienced throughout the capital markets. The sell-off in March for the broader markets and ETFs was followed by a recovery that began in April 2020 and has continued in early September, but while volatility has decreased, there have been pockets where all markets have whip sawed in a sometimes-disorderly manner.

EXAMINING RISKS AND OTHER ISSUES

Looking at authorised participants, (APs), there have been concerns voiced and raised by regulators and others that ETF AP arrangements could break down in times of market stress. During the recent crisis there is little or no evidence of this being the case in Canada in either fixed income or equity ETFs. Despite the extreme volatility experienced through the crisis and in particular in the middle of March 2020 the broad AP system appears to have functioned very effectively. It can be seen that a robust and well designed and diverse AP network is of great importance to market functioning in times of stress.

There have also been conflicting statements in the mainstream news media and from financial firms, partly as a reflection of complex evolving markets and a vast array of products with different risk profiles. However, after examining trade volumes, temporary divergence of ETF prices to the NAV and the price discovery that ETFs provided in choppy markets, it is clearly apparent that ETFs performed quite well and as designed during one of the most volatile markets in recent history.

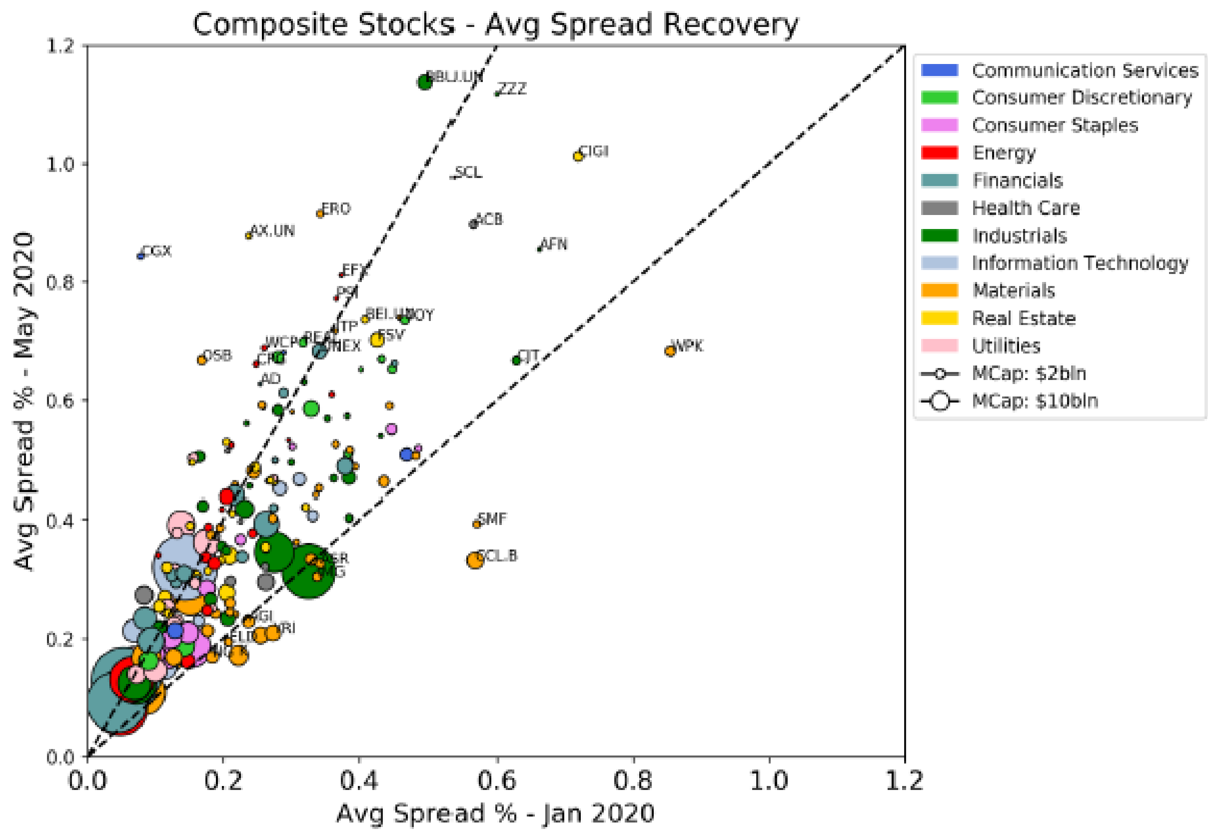
Re-balancing did present some challenges during this period of stress, but the trades were able to be executed as required.

BEST PRACTICES FOR TRADING ETFS ARE PARTICULARLY IMPORTANT DURING A PERIOD OF CRISIS

As indicated, since the beginning of March 2020, the COVID-19 pandemic has led to a period of increased market volatility and more importantly has shaken the confidence of investors across the broader financial markets. On a positive note there has also been some discussion and empirical evidence that ETFs have actually made re-balancing of investors' portfolios easier through less transactions.

That said, as stated earlier there were instances of widening ETF spreads during this burst of high stress that was experienced throughout the entire financial market as well as with ETFs. Figure 2 illustrates however, that many of these bid-offer spreads across many industry sectors recovered by May to where they were in January 2020.

Figure 2:



Source: NBF

There are some best practices that industry participants can observe that can help receiving the best pricing on equity ETFs.

Avoid Trading at the Open of the Market

The first 10-15 minutes of a trading day should be avoided to get optimal pricing and execution of a transaction.

Transact Only When the Underlying Equity Market is Open

Trading when the underlying market is closed can result in wider spreads. The price of constituents will have to be modeled and a wider spread will likely be used.

Industry Participants Should Always Use Limit Orders

Using a limit order enables a set price to be filled on the trade. In volatile markets that are moving fast limit orders may need to be reset during the day as prices change.

Be Cognizant of Overall Market Instability and Volatility

While an equity ETF is, at a minimum, as liquid as its underlying equities it is important that the ETF is constructed with a portfolio that has trading volume requirements.

CONCLUDING THOUGHTS AND FUTURE OUTLOOK

Overall ETF markets and ETF technology will likely continue to experience strong growth into the foreseeable future. However, with this anticipated growth in the total size of the market, the inclusion of some riskier strategies, and a greater number of ETF providers and APs, investors and regulators need to keep informed and responsive to changes in the marketplace.

In the recent strained and volatile markets equity ETFs positively enhanced continuous market liquidity and also provided transparent price discovery for some equity products that were not readily trading in the underlying market.

Another lesson that recent ETF performance during the pandemic has taught us is that, to date, the current equity ETF structure in Canada is robust, liquid and functioning well and it does not currently appear to require material changes or additional regulation.

Appendix I

LESSONS LEARNED FROM U.S. AND INTERNATIONAL ETF MARKETS

The Equity ETF market in the U.S. also performed well despite the exceptional market volatility and liquidity issues faced during the first few months of the COVID-19 crisis.

ETFs in the U.S. were initially conceptualized and created in response to the US stock market crash on October 19, 1987. The US Securities and Exchange Commission's (SEC's) Division of Market Regulation determined that the heavy selling of stock-index futures, largely by institutional investors, accelerated the market decline. ETFs did not actually launch in the U.S. until 1992 and the world's first ETF was introduced on the Toronto Stock Exchange in 1990.

The SEC suggested that basket trading could help alleviate large market swings in the future and that this "could provide an additional layer of liquidity to the system and cushion somewhat individual stocks from the intraday volatility caused by program activity."[1]

In the U.S. there have been also been several market enhancements that were implemented as a result of market turmoil events in 2010 and 2015. Those measures have materially helped reassure market participants that they will be able to find liquidity in ETF markets in all market conditions.

Very recently, market processes such as the equity market circuit breaker worked as hoped and this tool was activated four times early on in the pandemic. "Additionally, several regulators and stock exchanges around the globe enhanced their processes and implemented new regulations to adapt to the COVID-19 crisis and improve market resilience amid extreme volatility. These changes include:

- Euronext & Nasdaq revisiting their (re)opening process
- Change in market-making obligations or incentives in London and Frankfurt
- SFC issued guidance on the oversight of ETF market maker activities"[2]

As in Canada, ETFs in the U.S. and elsewhere globally play an important role in providing additional market liquidity and price transparency. As a testament to their importance in stressed market environments, ETF activity increased across the globe in the most recent period of stress.

Todd Evans
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[1] October 1987 Market Break report by the SEC Division of Market Regulation.
[2] SPDR® ETFs Throughout the COVID-19 Crisis July 2020