INVESTSMART

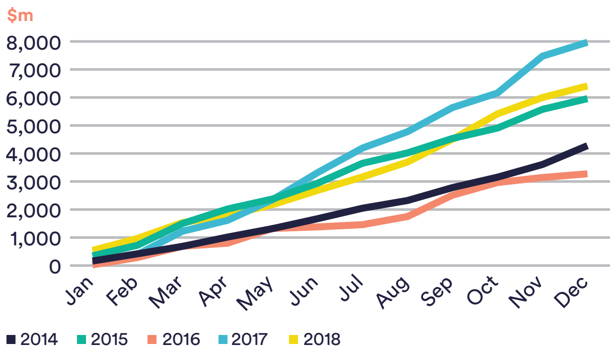
Australian Exchange Traded Fund Report

December Quarter 2018

Why ETFs provide surety on uncertain times

The Australian Exchange Trade Funds (ETF) market continues to grow at an unprecedented level. 2018 saw over A$6.4 billion in cumulative inflows into Exchange Traded Products (ETPs) – the second-best year of the past five. This in spite of fact, 2018 was one of the most volatile years in the past 6 and one of the worst returning years in the past 7.

Cumulative Flows – Market

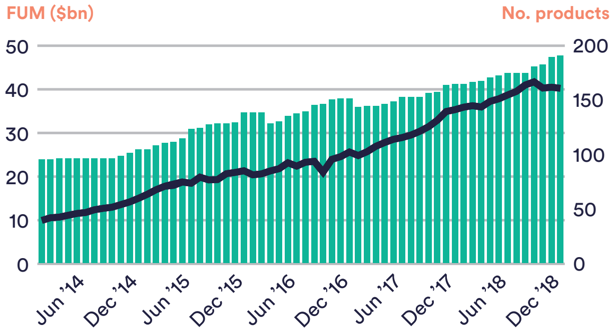


Source: ASX, InvestSMART

Also noteworthy is the fact that 2018 was the year with the greatest number of ETPs on record in Australia, which would explain the cumulative inflows. This is despite the fact that most asset classes declined in value over 2018.

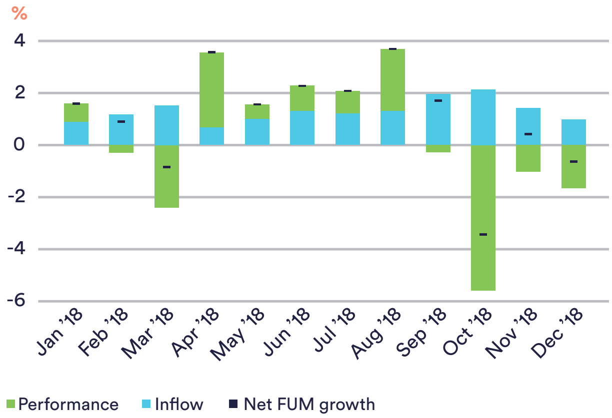
The market performance issues did impact inflows in the final two months of the year. We saw inflows peak in October. The choppiness of markets in November and December saw volatility hit its highest level since

Market Growth



February 2018. Markets also sustained an above-average level of volatility for more than 45 days, which was the longest run above-average since mid-2015. All this led to net funds under management (FUM) declining, yet not on the same level as the market

% of FUM growth: Inflow vs Performance



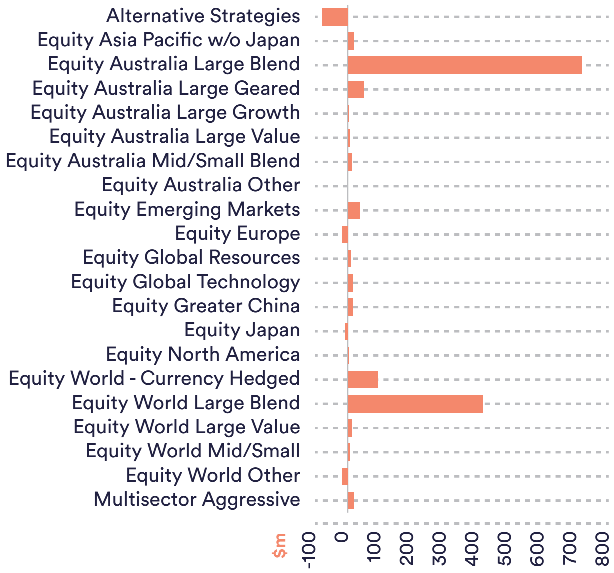
Source: ASX, InvestSMART

We observed similar investment trends in the US ETP market, albeit on a much larger scale. In 2018 the US saw just shy of US$280 billion in cumulative flows. Even more interesting was the fact that December saw net inflows of US$50 billion despite US equity markets having their worst December trading month in over 50 years.

The 2018 flow data actually follows the historical trading data though. In periods of volatility over the last 25 years, US investors have increased their allocations to passive investment over active management every time. According to our data, that is a trend coming back in again.

The strong drive into ETFs is down to the fact these products provide higher levels of liquidity than direct investments in times of heightened volatility. Both professional and retail investors alike are clearly attracted to the liquid nature as outflows from direct investment were above-trend in the two months to December 31. In fact, ETF flow levels were 66% higher than average stock counterparts in the US.

Flows – Equities ($m)



Source: ASX, Morningstar, InvestSMART

The biggest flows are toward large cap blended funds. In the main it's into Australian large caps, again highlighting the investor drive towards passive investment. Investors are better able to ride out volatility through passive exposures and achieve investment 'scale' as they can have weighting to larger companies even with small investments.

However, our data also highlights ETF operation risks. ETFs rely upon flow for earnings, and although we saw net inflow into ETFs as a whole, there were several classes (sector-focused etc.) and 'designs' (market directional, geared etc.) of ETFs that suffered from the volatility and saw net outflows, or even closures.

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The ASX saw 10 ETPs closed out last year, and we saw the same phenomenon occurring in US markets as well, despite the fact they are much larger and more mature markets. This illustrates the risks that providers face.

We have gauged from our data that 'sector' and 'single factor' ETFs are still seeing cautious flows. Furthermore, funds that are 'economic sensitive' (i.e. leveraged to an economy or space that needs growth e.g. construction) or 'growth' funds have actually seen outflows over 2018. So far, in 2019, funds have shown more resilience to macroeconomics. However, there is a clear sign that Chinese and European growth is slowing and that geopolitical issues such as Brexit, the US-China trade war and global elections are stirring economists and strategists alike to downgrade expectations.

If 2019 does descend into a lower growth, lower return, higher volatility environment, our historical data for ETFs may better still tell us a few more things. In environments like the one described, flows are likely to be into large blended market funds with no leverage that can 'look through' the issues. Conversely, in these environments, sector-specific or factor funds are likely to face further outflows after already having experienced a tough trading year in 2018.

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