FRANKLIN TEMPLETON

ETFS FOR ALL: THE MULTI-ASSET EVOLUTION

Multi-Asset ETF portfolios offer investors some of the best features of mutual funds and ETFs

August 2020

Executive Summary

The universe of exchange traded funds (ETFs) has evolved substantially since the original index (or passive) vehicles were introduced in Toronto over 30 years ago. Over time, they have been joined by rules-based—so-called "smart beta"—and actively managed ETFs.

Today, ETFs are available in virtually all traditional asset classes, alternative investments like commodities, specific sectors and geographical groupings such as emerging and developed markets, as well as single countries.

ETF assets have grown considerably in Canada and around the world. Institutional investors have embraced ETFs as a flexible, low-cost way to gain exposures to specific markets and asset classes. Individual investors have also warmed up to ETFs, primarily for their low fees, but mutual funds are still the preferred investment solution for most Canadians. Recent surveys of Canadian investors found a lack of knowledge about ETFs to be the main barrier to their use in retail investor portfolios[1].

Despite the benefits that ETFs can offer, knowledge gaps, an abundance of choice, and the potential for emotion-driven decision making (resulting from market and economic uncertainty and investor biases), can lead to poor investment outcomes.

ETFs in Canada: A Few Fast Facts

204	910	572	229
Billion dollars, net assets of the Canadian ETF market	Number of individual ETFs registered in Canada	Number of equity ETFs registered in Canada	Number of stocks in the S&P/TSX Composite Index

Sources: Franklin Templeton and Morningstar Research Inc; as of April 30, 2020.

1. Source: Investment Executive September 20, 2019. (link)

Recently, professionally managed mutual funds were introduced to offer Canadians a diversified and more sophisticated option for investing in a portfolio of passive, active and smart beta ETFs. We view a multi-asset ETF portfolio as a logical step in the evolution of ETF usage. This paper examines the benefits that this investment vehicle can offer Canadian investors.

Franklin Multi-Asset ETF Portfolios provide investors with access to a diversified basket of passive, smart beta, and active ETFs. They are offered in a familiar, convenient mutual fund structure that millions of Canadians already own. Each of the three ETF portfolios are professionally managed and available at attractive fees.

A Growing ETF Universe

Exchange traded funds continue to proliferate in response to increasing demand from investors worldwide. In 2018, global ETF assets under management surpassed US$5 trillion and at current growth rates are forecast to surpass US$7 trillion by 2021.

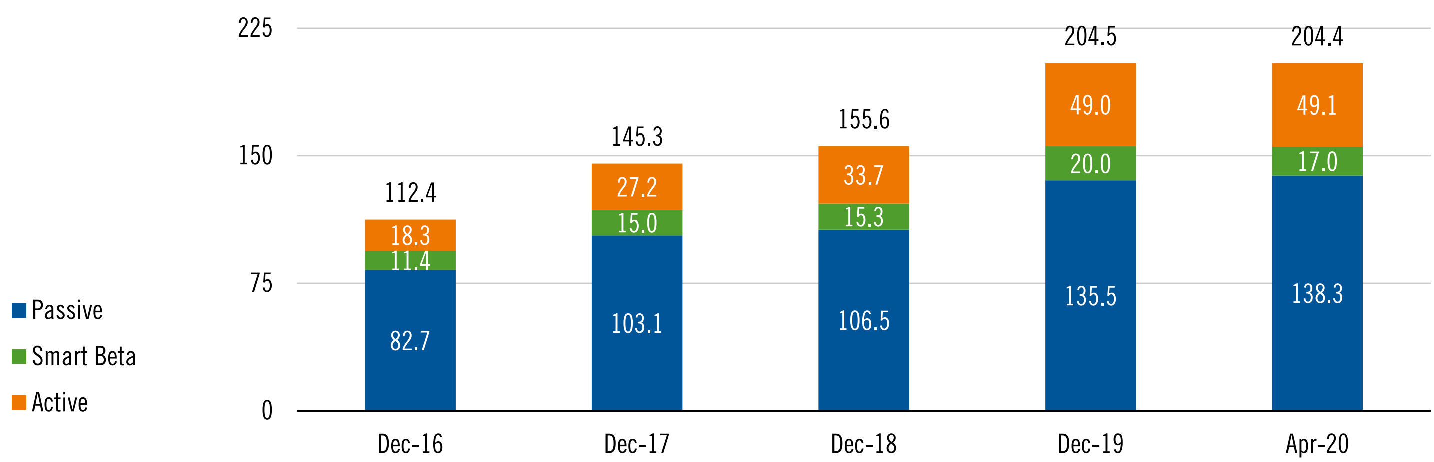
The ETF universe has evolved substantially since the original index-based or passive vehicles were introduced on the Toronto Stock Exchange nearly 30 years ago[2]. While passive ETFs still command a significant portion of the market, they now share the spotlight with rules-based “smart beta” instruments and active ETFs.

In Canada, passive, smart beta and active ETFs span virtually all traditional asset classes, alternative investments such as commodities and real estate, specific sectors and geographical groupings such as emerging and developed markets, as well as single countries (Figure 1).

Figure 1. Passive, Smart Beta and Active Share of the Canadian ETF Market

As of April 30, 2020

ETF Assets by Management Style (CDN$ billion)



Number of funds					
Passive	199	242	278	316	340
Smart Beta	103	151	172	195	195
Active	152	201	268	341	375
Total	**454**	**594**	**718**	**852**	**910**

Source: : Investor Economics ETF and Index Funds Report – Canada Q1 2020

2. In 1990, the Toronto Stock Exchange launched the Toronto 35 Index Participation Units (Tips 35), designed to track the TSE-35 Index. The better-known S&P 500 Trust ETF (SPDR) was introduced in 1993 and is still traded today.

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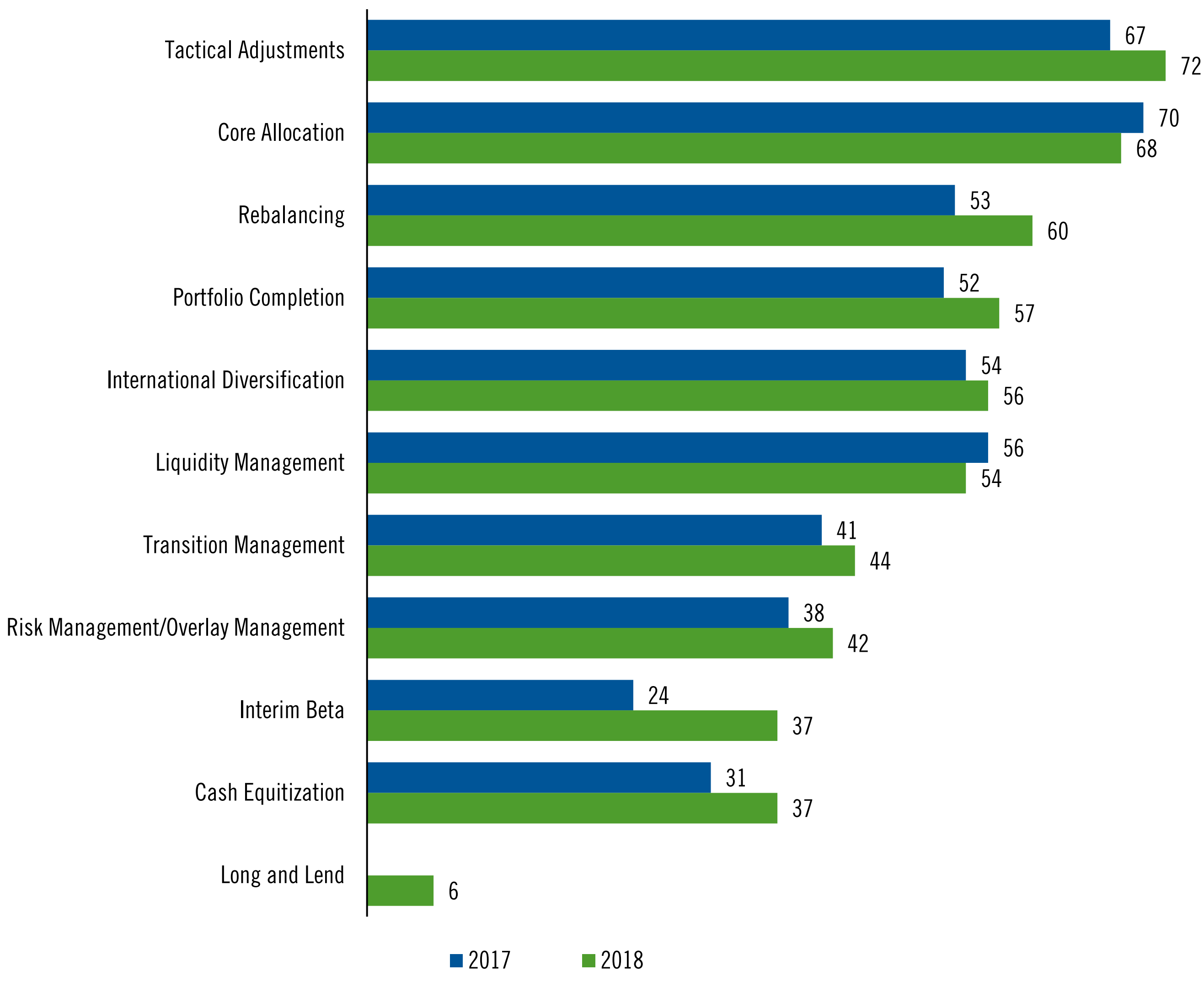
Along with the rest of the world, the Canadian market for ETFs grew significantly over the past decade. While traditional index ETFs have seen the largest historical growth globally, the growth potential of various types of ETFs can differ considerably by region. Canada, for example, has experienced the largest growth in the market for active ETFs[3].

Institutional Investors Have Embraced ETFs

ETFs have become central components of many institutional portfolios as they offer a flexible, low-cost way to implement investment decisions ranging from dynamic allocation to core market or pure beta exposures for each major asset class. These efficient portfolio tools deliver responsive, highly selective and nuanced exposures where needed, such as sub-asset class regional, style, sector tilts and fixed income exposures, including duration and quality preferences (Figure 2).

Figure 2: ETFs are Proliferating Throughout Institutional Portfolios (%)

Reasons for ETF Usage by Institutional Investors (%)[4]



3. Source: PWC, Annual Global ETF Survey 2015. (link) In this survey, Asian managers considered traditional index products to have greater potential, while North America and European firms were more interested in the growth of new forms of indexing, referred to as smart beta or strategic beta. Active ETFs have been slow to develop, except in Canada, where active ETFs comprise 14% of total ETF AUM.

4. Source: Greenwich Associates 2018 U.S. Exchange-Traded Funds Study. Note: Based on 144 respondents in 2018 and 138 in 2017.

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Yet ETFs May be Less Effective if Used Improperly

Attracted primarily by low fees, many individual investors have warmed to the idea of ETFs. Yet their portfolios have met with lower success rates than professionally managed portfolios. Studies show that do-it-yourself investors demonstrated poor timing and selection when using ETFs in their portfolios concluded that their use of ETFs did not improve portfolio performance[5].

As mentioned, market volatility can spur short-sighted investment decisions based on emotion, and these can have long-term consequences for an investor's goals. ETFs have the potential to exacerbate behavioural finance problems, such as chasing past performance and following the herd, because ETFs can be easily bought and sold at prevailing market prices throughout the trading day.

ETFs can be great tools for efficient portfolio construction, especially if the portfolio is guided by research-driven asset allocation and the management of risk. In our view, the use of ETFs should be based on goals related to portfolio construction, not simply fee reduction.

When Bad Things Happen to Good Investments

As with any investment, ETF performance is inevitably influenced by the quality of the decision-making process. Canadians face many challenges when making such investment decisions. Three areas are of particular cause for concern:

- Uncertainty: The market volatility created during the COVID-19 pandemic reinforces the importance of integrating the management of uncertainty into every step of the investment process if investors are to have confidence in their decisions. During periods of rapid market fluctuations, inexperienced investors risk being trapped holding losses in certain less liquid asset classes, with no buyer in sight. This is known as liquidity risk.

- Behavioural biases: Money is an emotional subject, as we have seen during the 2020 market downturn. Our biases are ingrained and involuntary, and if we listen to them, they can lead to poor financial decisions. Unfortunately, the same bad habits that derail traditional investments—buying high and selling low, chasing past performance, trying to time the market—can just as easily impede ETF performance and may even be amplified by the ease of trading ETFs.

- A multitude of choices: The number and variety of ETFs seems head-spinning; even investment professionals sometimes struggle to stay on top of developments. Selecting the right ETF for the right purpose requires a well-developed selection and monitoring process to ensure proper portfolio construction, especially during times of significant market volatility and economic stress.

These risks can be managed by investment options that offer expertise for actively managing asset-allocation, mitigating risk, buying and selling ETFs and monitoring investments.

5. The Review of Finance, *Abusing ETFs*, Utpal Bhattacharya, Benjamin Loos, Steffen Meyer, Andreas Hackethal, July 11, 2016. (link)

Misconceptions Are Common

ETFs are more than just the financial equivalent of “plug and play”. One cannot simply throw a few asset classes, regions or investment strategies into a portfolio and wait for the mix to perform. Whether using active mutual funds, individual stocks or ETFs, portfolio construction can be a complex undertaking. That complexity usually increases during periods of heightened anxiety in the markets.

One of the most common areas of weakness is a lack of knowledge about index construction and composition. As some ETFs are designed to mimic the performance of an index, understanding the composition of an ETF’s tracked index (or indices) is critical to evaluating its usefulness in a portfolio.

For example, an investor seeking diversification may allocate to both a FTSE developed markets ETF and an MSCI emerging markets ETF in their portfolio (FTSE and MSCI are providers of stock market indices used by ETFs and other products). Unknowingly, they would be overweighting South Korea exposure, since FTSE classifies South Korea as a developed market while MSCI classifies it as an emerging market.

There are more than twice as many ETFs listed on the TSX than stocks in the S&P/TSX Composite Index. Also, there are almost as many ETFs available in the Canadian and U.S. markets as the number of companies listed on the New York Stock Exchange[6]. Given this universe of ETFs, a strong research process that helps identify the most appropriate ETFs from all available options is crucial to prevent unintended exposures.

Cost is another sore point. There is a widespread misunderstanding among investors that the management expense ratio (MER) represents the total cost of ETF ownership. This is not true. Investors need to evaluate the total costs for holding ETFs, which include transaction costs related to rebalancing as well as costs associated with purchasing and exiting an ETF.

Speaking of Fees…

Fees tend to dominate the minds of many investors. Low fees are undoubtedly a powerful attraction and probably one of the main reasons why ETFs have become so popular; yet they should not be the only factor in the decision-making process. It is important to analyze every aspect of the investment and how it fits into the portfolio.

Overlooking investment basics like asset allocation, portfolio construction and risk management can easily overwhelm any potential fee savings between active and passive strategies. The institutional investor experience shows that maximizing value—paying higher fees where warranted by a thorough analysis—produces better results than pure “bottom-fishing” on fees.

Then There Are the Risks

While many of the risks listed below are common to other capital market investments, ETFs have some special considerations:

- Market risk: Passive ETFs move up and down with the markets they track. While smart beta and active management strategies can help manage an element of market risk, they do not eliminate its effects.
- Composition risk: Within the same asset class, ETFs can track different indices. Even within an index, market capitalization, sectors and other factors can be skewed in ways that can contribute to exposure risk.
- Methodology risk: Not all ETFs are created equal, even if they track the same market or sector. Understanding the methodology helps to identify some of the potential risks of using certain ETFs. Methodology can include items such as rebalancing frequency and the amount of leverage used.
- Trading risk: Commissions, sales charges, market impact costs and direct trading costs can all affect returns.

6. Source: Strategic Insights. (link)

- Tracking error risk: Tracking error occurs when an ETF does not track to its index because of variables like management fees, tax treatment and dividend timing. ETFs with holdings of physical securities can have higher tracking error than synthetic ETFs.
- Counterparty risk: Securities lending and synthetic replication can result in increased risk when dealing with various counterparties.
- Tax risk: ETFs typically use in kind transfers to prevent the need to pay capital gains distributions. Actively managed ETFs, however, sell only a portion of assets in kind, which can leave investors exposed to capital gains taxes.

A professionally constructed and managed portfolio of carefully selected passive, smart beta and active ETFs can manage these risks with the flexibility to respond quickly to emerging events. A market shock like the COVID-19 pandemic can lead to investor decisions that are driven by emotion, news headlines and social media.

The Challenge: Build a Better Mousetrap

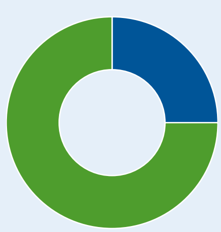
With investor needs in mind, the Franklin Templeton Multi-Asset Solutions team developed a suite of risk profile-based, multi-asset portfolios comprised of diverse ETF investments in a mutual fund structure. Our reasoning was simple. Mutual funds are familiar and accessible to all investors. For a number of reasons, including the regulatory oversight and the ease of making regular contributions and withdrawals, they continue to be the preferred way for many Canadians to invest.

We view the development of multi-asset mutual funds of ETFs as the next logical step in the ongoing evolution of the use of ETFs and their advancement in the investment management industry. Our design for this suite of portfolios is built around three premises:

1. We believe investors can benefit from different types of ETF strategies—passive, smart beta and active—in the same portfolio.
2. Mutual funds of ETFs combine the deep diversification of multi-asset investing with the cost efficiencies, flexibility and transparency that define ETF investments.
3. Professional portfolio management increases the probability of better investment outcomes given skilled ETF selection, portfolio construction and risk management.

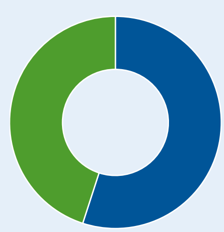
Franklin Multi-Asset ETF Portfolios

Franklin Conservative Income ETF Portfolio



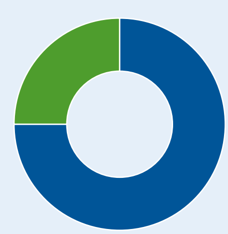
Equity: 25% (±15%)
Fixed Income: 75% (±15%)

Franklin Core ETF Portfolio



Equity: 55% (±15%)
Fixed Income: 45% (±15%)

Franklin Growth ETF Portfolio



Equity: 75% (+25/-20%)
Fixed Income: 25% (+20/-25%)

Asset Allocation Drives Alpha Capture

It is generally accepted that asset allocation plays a significant role in determining portfolio performance in terms of both risk and return. We expect asset allocation will contribute the most to capturing excess risk-adjusted returns (alpha) in our portfolios, with ETF selection also adding some value.

Much of the added value in actively managed portfolios of ETFs comes from dynamic asset allocation decisions. Dynamic investing lets us take advantage of market dislocations and other near-term opportunities. We believe that actively managing the asset allocation within tactical bounds is fundamental to managing the risk and return potential of the ETF portfolios.

A Tisket, A Tasket, What's in Your ETF Basket?

In the Franklin Multi-Asset ETF Portfolios, each type of ETF—passive, smart beta and active—plays a valuable role in achieving an investor's desired outcome:

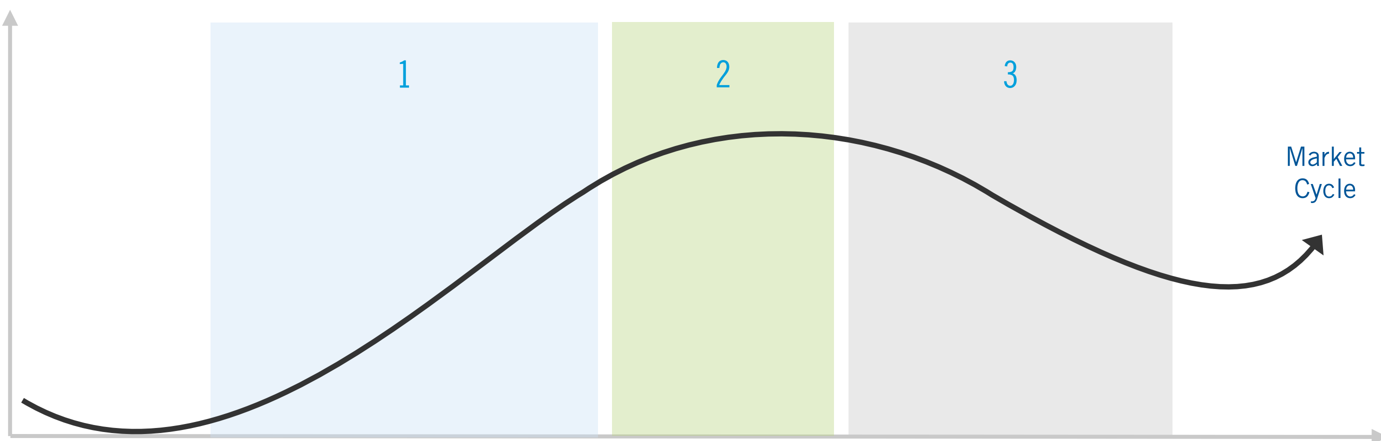
Passive	Smart Beta	Active
• Proxy for the market • Provides market returns • Transparent, low-cost, beta exposure • No discretion	• Targets specific investment outcomes • Invests in pre-defined subset of market to tilt toward desired factors • Active insights, with transparent investment discipline of a rules-based approach • Quantitative Model Driven—No discretion	• Designed to outperform benchmark • Active insights • Can invest outside index constraints • Potential for outperformance in inefficient markets • Fundamental research and expertise • Discretionary
Pros		
• Low cost	• Aims to provide a particular outcome within an asset class	• Provides opportunity to outperform a selected market
Cons		
• No opportunity for relative outperformance	• More costly than passive (but less than active) • Potential to generate excess return is limited by smart beta constraints	• More costly • Can have periods of relative underperformance

Creating a Synthesis of Strategies

From an implementation standpoint, appropriate ETF selection is key to an efficient portfolio in which all investments work together. The use of passive ETFs alone can leave the portfolio exposed to full market risk, with no ability to provide downside protection or capture upside alpha at the asset class level.

Complementing passive ETFs with smart-beta and active vehicles adds an important element of diversification that, guided by dynamic asset allocation, can help us navigate shorter-term risk and return opportunities, as illustrated in Figure 4.

Figure 4. Dynamic ETF Asset Allocation: A Case Study



1. Market Environment: Recovery Stage of the Market Cycle
   - Tilt portfolio to a risk on position – overweight equity
   - Use smart beta ETFs with value bias
   - Use passive ETFs to capture the full market momentum
   - Use active fixed income ETFs tilted towards spread sectors (high yield, investment grade and emerging markets)
2. Market Environment: Late Cycle/Peak Market
   - De-risk portfolio to reduce overweight to equity
   - Use smart beta ETFs with quality bias for some protection
   - Reduce higher risk fixed income allocations like high yield bonds
3. Market Environment: Bear Market/High Volatility
   - Risk off portfolios – overweight fixed income and underweight equity
   - Use smart beta / low beta ETFs for some protection
   - Use passive government bond ETFs for duration exposure

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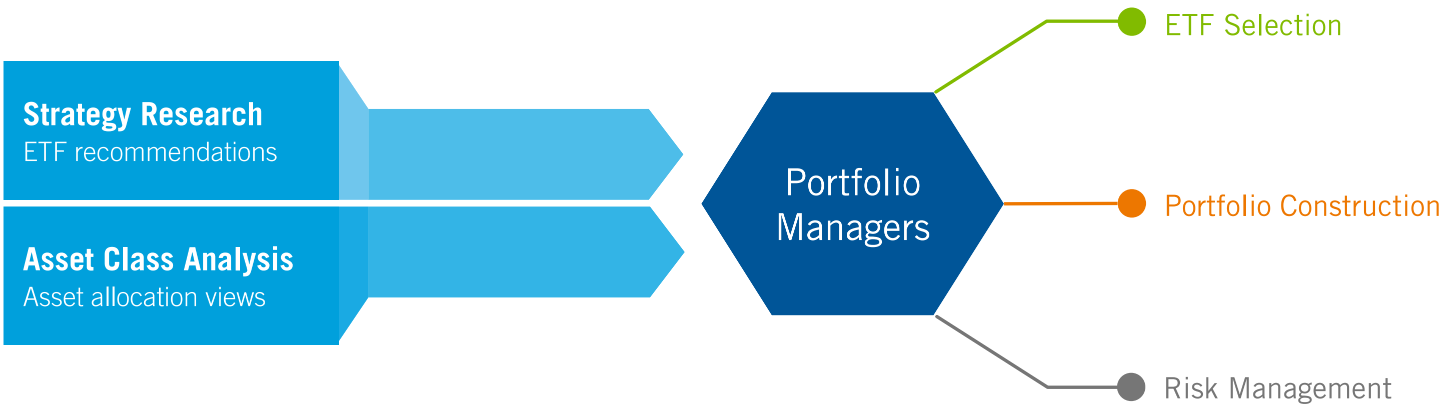
Research Is the Foundation

Franklin Multi-Asset ETF Portfolios are supported by Franklin Templeton Multi-Asset Solutions, a global team of more than 50 dedicated investment professionals including specialists in passive and active ETFs. When evaluating ETFs, this team uses the same five-step process as for active investment strategies—Source. Assess. Validate. Approve. Monitor. The portfolio managers work closely with an independent team of research analysts, who apply a consistent deep-dive due diligence process when reviewing ETFs. A separate dedicated team conducts macro market analysis and asset class analysis and provides the investment team with asset allocation views. The portfolio managers then use these inputs to form their ETF selection, portfolio construction and risk management decisions. (Figure 5).

Figure 5. A Unified Investment Process



Areas of focus in our ETF research include:

- Strategy design: Assessment of the ETF structure and index design
- Strategy implementation: Assessment of tracking error, replication method, counterparty risk and securities lending
- Liquidity: Assessment of the liquidity of the primary (creation/redemption), secondary and underlying securities
- Fees: Comparison with peers and other actively managed products including transaction costs which may include brokerage fees, and creation and redemption costs
- Organization and operations: Quality of the sponsor, including size, history, and experience

The investment team actively manages the asset allocation, ETF selection, currency and risk in each portfolio. The managers have the flexibility to tilt the portfolios, depending on the opportunities and risks they see in the markets

Selection Views Guide Portfolio Construction

Our focus is on risk/return optimization: delivering solutions that seek to provide optimal value for the level of risk taken, while remaining cognizant of fees. This is consistent with our belief that investors can benefit from both passive, active, and smart beta ETF strategies within the same portfolio.

Passive ETFs provide market beta exposures that function as the core, or anchor, of the portfolio. We achieve additional tracking error against the benchmark by using smart beta and active strategies, and dynamic asset allocation. Smart beta strategies, which are typically outcome oriented, help refine our dynamic allocation views or allow adjustment of the beta of each asset class, as necessary. Active ETFs help provide higher alpha potential and opportunistic exposures in the portfolio that can differ from the index.

In the implementation of active ETFs, our manager research process is critical to understanding the active strategy and developing views on when the strategy will benefit the portfolio.

Currency Hedges help Reduce Risk, Add Diversification

Portfolio diversification can be enhanced by investing in securities that provide exposure to markets beyond our borders. For investments denominated in different currencies, exchange rate fluctuations can cause significant gains or losses when their values are translated to Canadian dollars.

Active currency management (e.g. hedging) is another tool used in the Franklin Multi-Asset ETF Portfolios to help mitigate risk and take advantage of opportunities.

Managing the currency exposure (e.g., hedging) in a retail portfolio can help mitigate currency risks and capitalize on opportunities. Overall, the result of our investment process is a dynamic and diverse portfolios managed from a Canadian perspective. The expertise and depth of the asset allocation team should be of primary concern to anyone planning to invest in multi-asset portfolios of ETFs.

Conclusion

Franklin Multi-Asset ETF Portfolios brings the benefits of ETF investing to more Canadians. With this option, investors do not have to research ETFs, make asset-allocation decisions, monitor investments, or handle ETF trades—an investment team does all of that for them.

The asset allocation process for Franklin Multi-Asset ETF Portfolios is top-down and actively managed, while supported by bottom-up research to select the most suitable ETFs for the portfolios. Positions are informed using long-term expectations for market returns and risks. The portfolios are then optimized toward the goal of maximizing returns for a given risk profile of the investor.

Periods of volatility can often reinforce the importance of research-driven asset allocation, portfolio diversification and risk management. When faced with market and economic uncertainty, investors are more susceptible to making emotional decisions that could jeopardize their long-term goals.

Franklin Multi-Asset ETF Portfolios offer a simple (yet sophisticated) and cost-effective way for Canadians to get diversification in their portfolios. And with a proven, professional management team at the helm, portfolios can be better protected from the risks associated with investor biases and emotion.

Learn more about Franklin Multi-Asset ETF Portfolios at franklintempleton.ca or by contacting your Franklin Templeton representative.

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FRANKLIN TEMPLETON

Franklin Templeton Canada
200 King Street West, Suite 1500
Toronto, Ontario, M5H 3T4

(800) 387-0830
franklintempleton.ca