

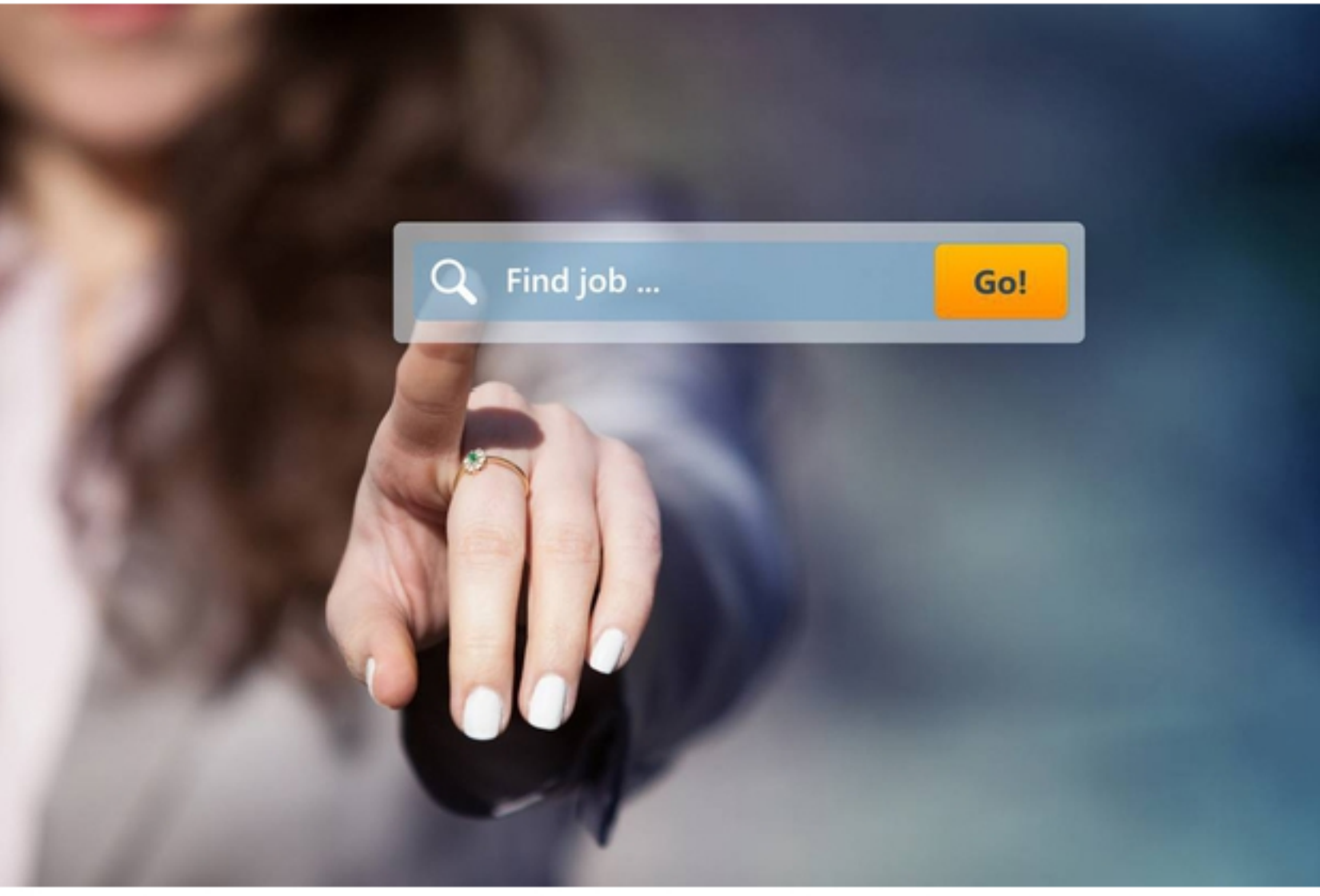
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EXCHANGE-TRADED FUNDS

Themed ETFs – solid strategy or gimmick?



Evolve Funds Inc. in Toronto recently launched the Evolve North American Gender Diversity Index ETF. The gender practices of thousands of blue-chip North American corporations were closely scrutinized to determine the 150 companies chosen for the fund.

ISTOCK

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While exchange-traded funds have traditionally been utilized as a conservative way to invest in securities that belong to a widely diversified stock exchange, more investors are now using ETFs to zero in on a particular segment of the market that catches their fancy.

"There is an ETF for just about any trend at this point – online retail, gender diversity, video gaming, health and wellness, robotics. The list just goes on and on," says Prerna Chandak, assistant vice-president of exchange-traded funds at Mackenzie Financial Corp. in Toronto.

But do these funds represent smart strategic plays in an investor's portfolio? Or is the whole concept of a thematic ETF more of a gimmicky nature?

Graeme Egan, head of CastleBay Wealth Management Inc., a portfolio manager and fee-only financial planning company in Vancouver, has mixed feelings about the merits of thematic ETFs in an investment portfolio.

Mr. Egan believes there can be a sort of gimmicky rationale behind the decision of some investors to hold thematic ETFs, akin to jumping on a trending bandwagon. "There's probably some flavour of the month stuff that is so trendy that it will be out of fashion next year. I'm concerned about that," he says.

However, Mr. Egan also believes that, if carefully chosen and researched, there may be a limited place for thematic ETFs in some investors' portfolios. "I wouldn't necessarily call them strategic. I'd call them more tactical. But you've got to be nimble and know what you're doing," he advises.

Raj Lala, president and chief executive officer of Evolve Funds Inc. in Toronto, a 2017 startup ETF firm that offers themed ETFs, says thematic funds are strong investments to add to a portfolio because they reflect long-term trends taking place.

"I would absolutely disagree that themed ETFs are gimmicky in any way, because gimmick to me is more like a fad without a long-term investment thesis. There's a very solid investment thesis behind the themed ETFs in our name," Mr. Lala says.

Evolve recently launched three funds that trade on the TSX – the Evolve North American Gender Diversity Index ETF consisting of about 150 firms, the Evolve Cyber Security Index ETF, consisting of about 30 companies, and the Evolve Automobile Innovation Index ETF, also consisting of about 30 firms.

Mr. Lala explains why each of those ETFs were viewed as valuable investment themes. Gender diversity, he says, has been in the spotlight for many years. But it got more attention a couple of years ago when incoming Prime Minister Justin Trudeau famously responded, when asked why he had a fully gender-diversified cabinet, "because it's 2015."

"I think that really sparked a lot of the corporate CEOs north of the border to at least focus a little bit more on increasing gender diversity within their firms," says Mr. Lala, who explains that the gender practices of thousands of blue-chip North American corporations were closely scrutinized to determine the 150 companies chosen for Evolve's fund.

Evolve's Cyber Security Index ETF includes well-known industry giants such as Symantec Corp., FireEye Inc. and Check Point Software Technologies Ltd., among others.

"When you get a cyber breach of client data or information, stocks tend to fall dramatically, and consumers start to lose confidence, and it's tough to recover. So one of the drivers for a lot of corporate CEOs is to make sure that they preserve their stock price, and part of that is making sure they're insulated from cyber theft or cyber crime," says Mr. Lala.

Evolve's CARS ETF fund covers organizations throughout the automotive supply chain that are contributing to technological changes. Many experts predict there will be an unprecedented transformation in the automotive industry over the next 10 years.

"For example, we've got organizations that create semi-conductors that help with connectivity for self-driving vehicles, camera manufacturers for self-driving, and battery manufacturers for the electric vehicles," Mr. Lala says.

Tim Morton, the senior vice-president and portfolio manager with TD Wealth in Toronto, says investors in themed ETFs need to be careful.

"You've got to have a very strong conviction to want to go down into a specific sector. One of the difficulties [is] you have to get the timing really right. Maybe it's not an asset that you want to hold throughout the entire investment cycle, so your timing, both on your purchase and your sale have to be good," he says.

How much to purchase is another important consideration, taking into account various individual risk and other factors. With an ETF, "you have to look and say, 'Maybe it's not as volatile as an individual stock. But maybe there's 20 per cent or 30 per cent volatility in it and maybe that volatility rate is two or three times that of the market. Therefore I've got to make sure I'm very careful of my sizing,' " Mr. Morton says.

The potential liquidity of the underlying stocks that make up the themed or micro-focused ETF must also be studied.

"You need to consider, 'Is that asset going to go in and out of vogue?' There might be good liquidity in it today. But you have to be concerned about what the liquidity might look like when you want to get out of it," says Mr. Morton.

Thematic ETFs are a strong component of an overall investor portfolio because they can meet an investor's specific desires and strategies, says Steve Hawkins, president and co-chief executive officer of Horizons ETFs Management (Canada) Inc. in Toronto. That firm recently launched its proprietary Horizons Marijuana Life Sciences Index ETF, which seeks to replicate the performance of the North American Marijuana Index, net of expenses. This involves a basket of North American publicly listed life-sciences companies with significant marijuana-related business.

"We started working on it last year. The market had matured enough to a point where we thought it could support the sustained liquidity of an ETF that was needed to bring a niche, or thematic product like that to market," says Mr. Hawkins. For example, medical marijuana has been approved for many years in Canada, and "we've seen marijuana sales on the medical side grow significantly as it becomes more mainstream," he notes.

Companies within Horizon's ETF marijuana fund include Canopy Growth Corp., Aphria Inc., and Aurora Cannabis Inc., among others.

The company currently has two other themed ETFs – the Horizons Cdn Insider Index ETF and the Horizons Canadian Midstream Oil & Gas Index ETF.

The concept of having an insider index as a thematic product is based on the insider trading sentiments of management and directors of corporations. It involves tracking the insider trading reports and the buying and selling of their senior management.

Horizon's ETF inside trading fund includes HudBay Minerals Inc., Canfor Corp., and West Fraser Timber Co. Ltd., among other companies, explains Mr. Hawkins.

Horizon's oil and gas ETF is designed to "allow investors to access the market between when oil comes out of the ground to when it goes into the gas tank of your car. There are a lot of steps in between for that, with respect to post-refinement, delivery, pipelines – all of those pieces to the energy transition process. So we created an ETF that directly accesses that market," he says.

Components of that fund include Pembina Pipeline Corp., Shawcor Ltd., and Enbridge Inc., among others.

Ms. Chandak warns that certain thematic ETFs might not be giving investors as pure an exposure to an economic sector or industry as they might be expecting, and therefore they need to do their homework before investing.

For example, "if we look at something like robotics, there are a number of robotics may also have exposure to companies that aren't specifically in the robotics industry. You might be buying into a more diversified portfolio than you are aware of," she cautions.

Moreover, an investor has to look across their total portfolio exposure to avoid unwittingly going overweight in certain themes, says Ms. Chandak, who notes how, for instance, many Canadian portfolios already have oil and gas exposure.

"That's a critical aspect of ensuring that you're not just looking at what's trending, but also assessing what's right in strategy and allocation size in your investment portfolio," she stresses.

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