EPISODE 31

Single Decision ETFs: Unpacking XGRO and XBAL from BlackRock

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix, and Cameron Passmore.

We reached out to BlackRock, or iShares as I guess, to see about having somebody on to talk about the new XGRO and XBAL products, which are I guess iShare's answer to Vanguard's asset allocation ETFs.

[0:00:30.6] Cameron Passmore: The one decision ETFs, yeah.

[0:00:32.2] BF: Yeah. It's one single ETF that gives you exposure to a globally diversified portfolio. So you buy one thing and you get everything that you need.

Anyway, Vanguard came up with one early last year and iShares answered late last year or early this year?

[0:00:47.2] CP: Late last year.

[0:00:48.2] BF: Yeah, anyway, we reached out to them and they were gracious enough to offer us Steven Leong who is the Director, a Director and the Head of Canada iShares Product at BlackRock.

I mean, that's the guy to talk to, to get more information on this type of thing.

[0:01:05.7] CP: He was very interesting. He gives perspective and the company's perspective and lots of different things from financial planning to the future of advice to what's worth paying for, to how to structure portfolios, he was very good.

[0:01:16.8] BF: Yeah, it was insightful. I was going to say that I was surprised but that's not what I mean. He gave insight that I wasn't necessarily expecting based on the types of questions that we were asking.

[0:01:26.8] CP: Yeah.

[0:01:27.0] BF: It's definitely a good interview. I think that these types of products, they asset allocation ETFs as Steven talks about in the episode, they're going to change the landscape for investors over the long term.

[0:01:38.9] CP: Also the advice delivery too.

[0:01:41.3] BF: For sure.

[0:01:42.2] CP: How you structure your relationship with clients is definitely changing due to products like this.

[0:01:46.8] BF: Yeah. I mean, we've made that transition ourselves, right? It was only when I started is when we started going more towards asset allocation funds as opposed to building our own portfolio using ETFs and other indexed mutual funds.

My opinion is that's the future, the advisor can't really compete with BlackRock or say, Dimensional Fund Advisors on portfolio construction and management but the financial adviser can compete on advice.

That's where I think the business is going and that's based on our conversation, BlackRock seems to have a similar view.

[0:02:18.1] CP: Yup, it's a good interview, have a listen.

[0:02:19.2] BF: Yup, we'll go ahead to the episode.

[INTERVIEW]

[0:02:27.9] BF: Steven, welcome to the Rational Reminder Podcast, thanks a lot for joining us.

[0:02:31.2] Steven Leong: Thanks very much for having me.

[0:02:33.5] BF: I'm sure our listeners have heard of BlackRock and probably iShares as well but I don't know if they would understand the scope of the company and the size of the company. Can you give us a quick overview of BlackRock's scope and size?

[0:02:44.0] SL: Sure, I'd be happy to do that. BlackRock is a large investment management and risk management firm. We operate a global diversified platform, the company has roughly six trillion dollars in asset under management worldwide.

[0:02:58.8] BF: Six trillion?

[0:03:00.6] SL: Yeah, I know. Sometimes it's distracting even to say it out loud. That six trillion is diversified across a range of investment strategies and asset classes. Whether that's equities, fixed state multi-asset commodities, alternatives, hedge funds and then also across index, factor, traditional active, quantitative, very broad range of both strategy than asset classes.

In terms of ETFs, BlackRock is very well known globally for iShares business of ETFs. We are the world's largest family of ETFs with large platforms in the US, Europe, as well as Canada, Latin America and Asia.

There's about 1.8 trillion dollars in iShares ETFs globally. If we sort of shrink that down and look at it at the Canadian business, about 57 billion in an ETF [inaudible] here in Canada. In addition to the investment management business, BlackRock also operates the Aladdin platform, which is a portfolio management and risk platform that is used to manage all of BlackRock's in house strategies.

So that's $6 trillion and also used by other asset and risk managers around the world. So there's over $10 trillion dollars, which is managed via Aladdin and if you will, not all of that by BlackRock.

[0:04:19.9] BF: Interesting, I never heard of that. Okay, now, specific to Canada, in terms of BlackRock's scope and size, there was a recent announcement that there's going to be a partnership with RBC for the ETF business. Can you talk a little bit about that and what that means?

[0:04:35.8] SL: Yeah, in early January of 2019, BlackRock in Canada, the Azure's ETF business in Canada announced that it was entering into a strategic alliance with RBC Global Asset Management. What that means is that the two organizations, BlackRock and RBC GAM are really going to pool together their efforts and resources in the ETF space with respect to the Canadian market. The alliance is going to operate under the combined brand, RBC iShares and the combined product family will be supported by both organizations.

Now, it's important to bear in mind that both RBC and BlackRock will continue to operate different families of ETFs within the scope of the alliance. So iShares' branded ETFs will continue to be iShares' branded ETFs and those are predominantly index tracking strategies.

RBC GAM will continue to operate RBC branded ETFs and those are predominantly a factor in active strategies. The product families are not necessarily being combined under a single brand but the services support is going to be combined by between BlackRock and RBC, to really depend the amount of support available on the combined product family and also expand the reach of both firms as the Canadian market.

[0:05:58.7] BF: That's really fascinating. I mean, I think everyone kind of knows that the ETF game and the passive index game anyway is a scale play and obviously, this gives both RBC and iShares a huge amount of scale, more scale than they already had, which was already huge.

[0:06:16.5] CP: In terms of scale Steven, in candidate, you know, BlackRock launched a couple of one decision portfolios, the XGRO, the XBAL. These are one decision portfolios that have you know, prebuilt, diversified, auto rebalanced portfolios. Can you talk about those portfolios?

[0:06:32.3] SL: Yes, thanks for bringing that up. The origin of these products is actually a little bit of a remolding of some older multi asset class ETFs that had actually been launched by Claymore several years ago and then joined the iShares family in 2012.

These products were frankly kind of due for a facelift or a significant renovation. In the late 2018, these portfolios actually were changed to invest in a much more foundational asset allocation with the idea that these could become, this could really set a new standard for single ticket or you know, all in one foundational portfolio tools.

Where you're getting and diversified portfolio of both equities and fixed income, diversified internationally. If we look at the way that these products are constructed, they each invest in eight other iShares ETFs, some Canadian listed, some US listed.

They provide exposure to Canadian equities, US equities, international developed markets, emerging markets and then both Canadian and US fixed income and between them, they each have exposure to more than 16,000 individual securities.

[0:07:51.7] BF: Wow, sounds like a neat product. Was this – I don't know, to what extent you can answer the question but was this in a way a response to the similar product that Vanguard rolled out?

[0:08:01.1] SL: You know, I think it's fair to say that the market clearly demonstrated that there was a significant appetite for products in the space. We had been looking at making improvements to the legacy strategies that I mentioned for some time and it felt like the time was right.

[0:08:01.1] BF: Cool. Now, one of the decisions that you guys made in portfolio construction for these asset allocation ETFs that was different from Vanguard's product, Vanguard's comparable product but also different from, I mean, if we survey all of the different model ETF portfolios that are around the internet in Canada like the Canadian Couch Potato, PWL's modern portfolios, Wealth Simple, you know, all the big name ETF portfolio model portfolio providers.

Everyone's overweight in Canada and the new iShares products are still overweight in Canada but less so than the common model portfolios, can you talk a little bit about that?

[0:08:52.1] SL: Yeah, I actually think it's important to kind of separate that out between equities and fixed income. If you look in the equity portfolio and one of the things that we think is really neat by the way about these is the relative proportion of Canadian US, international and emerging markets and the equity lead is the same for both XBAL and XGRO. Just scaled whether the overall equity allocation is either 60% in the case of XBAL or 80% in the case of XGRO.

You know, if you were to look at just this kind of market cap weighted basis, you know, the Canadian equity market would only be around four or 5% of equity holding. You know, our experience has been the Canadians simplly want to have more of that home country in their portfolio.

It's where their accustomed to, it's what they're used to but we also wanted to sort of nudge things a little bit and so this in a way is — it's a middle ground between where you might get to on a sort of pure market cap basis and as you described, where the average is. We want these portfolios, these solutions to fit well into existing Canadian portfolios themselves. Having that higher than market cap weighting, we think makes sense but at the same time, there is a ton of value that you get from international diversification. Particularly in equities.

As you point out, we have sort of tome a home bias down a little bit compared to what you might find and typically. If we look at the fixed income allocation, we find actually that there's a very large number of portfolios in Canada, which will only Canadian fixed income.

We've included leave of US fixed income here, it's about 20% of the fixed income allocation of each of XBAL and XGRO. Where again we think there's really valuable diversification that we get from that. You know, although, the majority of the exposure is still too familiar to the fixed income.

[0:10:52.3] CP: Yeah, one of the big advantages of these portfolios is the fact that it's a one decision, all rebalanced automatically for the investor. I presume BlackRock, you must see this would be the huge behavioral advantage to your clients.

[0:11:06.3] SL: Yeah, I think, you know, we're strong believers in, not having complexity where complexity is not required and so I think that you know, being able to buy this diversified asset allocation, being able to simply buy a single ticker to gain access to it.

And then to be able to simply rely on effectively rules driven rebalancing, you know, not have to decide, is it right for me to rebalance at this time or not. You know, my strategy may tell me that it should be time but there's lots of noise and reasons why a person might not stick to the original plan.

So yes, I definitely think that the discipline that you get with a strategy such as XBAL or XGRO is definitely really valuable. Again, we're talking about something that's really intended to be the foundation of a broader portfolio and again, just that trusted reliable, not having to worry about foundational tool we think is really valuable.

[0:12:01.2] BF: We've now got between iShares, Vanguard, and Horizons three different options for Canadian investors to get access to – I mean, really good well diversified auto rebalanced portfolios.

That kind of makes me wonder, where's the role of the traditional portfolio manager that's doing asset allocation and stock pick and all that kind of stuff. Does BlackRock have a view or do you have an opinion on where the traditional portfolio manager's going in the future?

[0:12:27.4] SL: Absolutely. What I would say is that, BlackRock is a strong believer in the value of investment advice and strong believer that investors are well served by having financial plans and using high quality advice. At the same time, we think that it is important to really separate out where our fees being paid and what are those fees being paid for and these portfolios are another representation or another way of doing that.

The way that I would characterize them is that these are a really high quality canvas for portfolio managers to really build the customized client portfolios that are really exactly tailored to each individual client's needs where the portfolio manager is really empowered to spend more time on what are the higher value added complementary exposures and tools that can be layered over top of strategies such as these, rather than needing to rebuild the asset allocation from individual components.

We also see a lot of value here for complementary smaller accounts. You know, many clients have more than one account with their portfolio manager or advisor and so this is a way of having a consistent experience across both the larger and smaller accounts that a client may have.

[0:13:52.2] CP: As you know, in the US, Vanguard offers, I think it's called a personal adviser service where investors get access to a human financial planning advisor for pretty low fee and we've heard some rumbling that Vanguard maybe bringing that to Canada.

Do you foresee a time when BlackRock will get into the advice business?

[0:14:11.0] SL: No, it's not a business that we're in, in other markets. We are – when it comes to investment advisors, we are very much focused on servicing the adviser directly or the portfolio manager and directly. It's not something that we do elsewhere or we're planning to do again.

[0:14:29.8] BF: All right, now here's a question that BlackRock is better positioned than anyone to answer I think. Fund fees have been racing downward, BlackRock and Vanguard kind of the leading on the Fidelity in the states last year did release the first as far as I know, zero fee, zero MER anyway, index fund.

The question that I have is do you think that fees on market cap weighted index funds like the ones used in XGRO and X spell, do you think those fees are the MER's anyway are going to zero?

[0:15:01.8] SL: Yeah, it's a really interesting question and you know, the announcement for Fidelity I think is really kind of kicked off a lot of curiosity almost, whether this is sort of the direction we're going. I think if you sort of peel the onion a little bit and look at the details of what was announced by Fidelity in the US, you know, I think you'll see that this is not likely to be a widespread phenomenon or sort of the prevailing approach going forward.

I think there's a couple of things to unpack there. You know, we don't see the clearing fee for market cap exposure going to zero in a sort of universal way, these products, they cost money and resources and investment in technology and platform when we manage them well and efficiently and for the most part, you have to charge some kind of a fee in order to make those investments to deliver a high quality experience to clients.

You know, if you look at the details of what Fidelity did in the US, they specifically introduced zero fee index funds but not ETFs. Index funds where they could control the availability of that product, control who was able to access it or not access it and the access to those fees is actually limited to a few Fidelity account windows or brokerage windows and so these are customer acquisition tools. These are a way of bringing new customers Fidelity and then the strategies to find ways, sell them, you know, additional products or services where that would be fee charging.

In the ETF context, that really doesn't work because neither Fidelity nor BlackRock, Vanguard could really prevent an ETF sold in one channel or another or in one platform or another, they're completely open architecture.

Again, we don't really see a world where fees on those types of products could go to zero, it would be a really irrational calculus on the part of the manager. You know, the head of our Canadian US iShares business likes to say that banks give away toasters for many years to bring customers in the door but it didn't cause the prices of toasters to go to zero.

I think that that is a very similar situation in here.

[0:17:19.3] CP: That's so interesting. I guess if fees did go to zero, the due diligence that investors would have to do to choose between two comparable, arguably with the products because it's much more difficult like looking into securities lending revenue and other sources revenue that the investment company receives, correct?

[0:17:36.9] SL: Yeah, you know I think in a high fee context, the low fee context, a single digit basis point context, which both iShares and others, we have products in that sort of range in Canada. I think it is always when evaluating those products it is always a fee and quality question and so you are always trying to understand what is the fee I am paying and to your point, perhaps you have to fully understand all of the sources of these or drag on the portfolio.

As well as the normal criteria that you'd use to evaluate quality particularly, guess on how well does the track to the next that fits my portfolio and what is the liquidity, what is the reputability of the manufactures of high quality manufacturer, are they committed. Are they committed to the space?

And to the point about free or close to free, there is definitely the temptation I suppose for people to play little games in marketing base here and so definitely need to make sure that something is actually free, if it is being promoted that was because as I just mentioned, it tends to be not really economically sensible to deliver something for truly zero.

Even if it is an index replicating product there's still costs associated with operating soundly, complying with all applicable regulations things of that nature.

[0:19:03.9] BF: I'm going to question that dovetails in within this one and it is about product structure. So one the things that fund companies have done ETF providers as well as mutual fund companies like Dimensional Fund Advisors is they've instead of tracking traditional market cap way within industries they have started to try and target specific factors.

Now iShares did launch some factor ETF's in Canada with higher fees, which you'd expect is okay, assuming they are getting factor exposure but one of the things that I have noticed is that those products have gotten very little traction in the Canadian space anyway. I think they are getting a little bit more attention from individual investors.

But I am just wondering what your thoughts are on why the uptake to the iShares factor products has been relatively slow.

[0:19:46.9] SL: Yeah, you know that I think that we have started to hit — if you look at the evolution of this conversation, in Canada we say we started to reach the inflection point or maybe we are just passing the infection point on indexing as an effective tool to be deployed in portfolios.

It was not that long ago that portfolios in Canada, a significant, a majority of portfolios in Canada would only hold either individual securities or actively managed funds and we have now reached the point where indexing had become a lot more mainstream.

Primarily ETFs, we sort of leap frogged the index mutual fund then went straight to the ETF in Canada. But the adoption of index products is really just hitting its stride in Canada and I think that factors in a way sort of bears out the index conversation where one you recognized or started to incorporate index, factor is a really logical next place to go. It is somewhere that sits in between the more traditional stock picking and index strategies where you're tapping into systematic factors of return that are beyond the market and beyond just the pure market risk factor.

And so we do have a number of products in the space, we have a family of minimum volatility ETFs, which have been reasonably popular but I think to your point still early days in adoption. As well as multi-factor strategy, which incorporates value, momentum, quality and low size.

And we think that this will be an increasingly important part - that factors will be an increasingly important part of investor portfolio in the same way that indexing has become an increasingly important part of portfolios.

But we are very early in the adoption curve as it points out and so we build these funds with forever in mind and so I think that there is a really bright future for them but you are right, we're still in the early days.

[0:21:47.9] CP: Speaking of early adoption, Canada has been quite slow at adopting index strategies in portfolio certainly compared to the US and BlackRock being a massive global firm do you an opinion as to why Canada seems to be lagging the acceptance of index funds?

[0:22:04.9] SL: So we see very, very similar trends in the wealth management space all around the world and the underlying drivers that are leading to the greater adoption of indexing are the same in Canada as elsewhere. So that's things like the significant pivot towards fee based advice and the increasing amount of regulation of both the disclosure of feed and the nature of feed that can or cannot be charged as well as the transparency into both product and advice fees.

And so where whether it's Canada or the US or Europe, where exactly we are at the curve varies and so to you point I would say that yes, where we sit it looks as though Canada is a little bit further behind than say a market like the US but the threads are very similar and the adoption is very similar. We seem really significant growth in the use of index ETFs in Canada in what call full service brokerage or wealth advisory and so we are very optimistic about the increasing use of these low cost tools portfolios in Canada.

The need is the same you know, to really efficiently figure out where should you be paying higher management fees, what sort of benefit should that be adding to the portfolio whereas where can you get really low cost exposure to the market risk factor in a diversified way and what should the fee for that be.

[0:23:36.3] BF: I think it is going to be fascinating to see where obviously RBC Global Asset Management is a huge asset manager and they do have a ton of actively managed funds with relatively high fees.

It will be interesting to see where product with RBC goes moving forward with this new – I know it is not a partnership but the new relationship with iShares. That will be interesting to watch.

[0:23:59.0] SL: Yes, I mean I think both RBC GAM and BlackRock recognize that portfolio in the diversification of asset classes you also benefit from having diversification of investment strategy. So index factor active and as an alliance, we want to be able to address every part of that portfolio and when the two firms looked at that aspiration, looked at our respective strengths and product line ups, you know it was clear that by bringing the two organizations together we could really accelerate the adoption of ETFs in Canada and really accelerate the growth of the use of this strategies and really become the defacto go-to place for ETFs in Canada.

So we’re really excited about that.

[0:24:50.8] BF: So we here at PWL were extremely heavily entrenched in the passive side or at least the factor side of investing and portfolio management and obviously that is not the only way to do it.

With the growth of index funds and ETFs and BlackRock being at the forefront of that, where do you guys see the future of a traditional active like security selection and market timing versus market cap weighted index passive.

Where do you see the future of that competition if it is a competition going?

[0:25:21.2] SL: Yeah, you know we don't think of it as a competition and you know one thing that we try to express is that regardless of the types of building blocks used all portfolios are active portfolios. Every portfolio involves an investor or their advisor or portfolio manager, you know really deciding what goes in, what doesn't go in and in what proportion. So we think of investing and portfolio expression as an inherently active process.

In terms of the building blocks that are selected, you know I think it is really valuable to have choice and it is really valuable to be able to understand what are the ways in which a portfolio can deliver returns and what are the fees being paid for access to that strategy and so we do think that the more traditional forms of active management will increasingly be required to separate out where have returns come from.

Where has return come from, how much of the return has come from exposure to factors or exposure to the market risk as a whole versus security selection or market timing things of that nature.

And we think that it is really valuable to pay for effective active management in the sense that you are delivering risk adjusted returns in excess of the benchmark. But we also think that if you are primarily getting market exposure that there are most cost effective ways of doing that.

And so we are in our minds still very early in the days of adoption of these index building blocks as investors become increasingly knowledgeable about how to evaluate individual investment strategy.

[0:27:05.2] BF: So given your role and your experience, I am curious what would be your most valuable piece of investment or knowledge or advice that you leave our listeners with?

[0:27:14.7] SL: So I am going to go with two if you don't mind. You know, the first is that investors should know that no amount is too small to get started. You know particularly now that there are products available. They could really deliver a very diversified foundational portfolio for low cost and for low investment thresholds. You know there should be really no aversions saying this can be for me regardless of how much you may have to invest.

But then what I would add to that is there is incredible value in having a sound financial plan and not focusing completely on product selection decisions or even portfolio construction decisions but making sure that your overall financial plan and your savings and behavior are really set for what you're trying to achieve and you know, working with advisers or portfolio managers is a really valuable way to put that plan together and then to make sure that you're sticking to it.

You know, there's lots of ways to kind of sweat the details of product selection or portfolio construction but you're really kind of missing the most important thing if you're not getting your own financial plan and align with your goals. We definitely encourage everybody to make sure that they've completed that step before launching into the index versus active or you know, Vanguard and BlackRock. Keeping sort of big picture in mind.

[0:28:46.9] BF: That's good advice. Steven, this has been wonderful and we really appreciate you taking the time and it's really great to get your view and also BlackRock's view on all the questions that we asked. Again, we really appreciate it.

[0:28:58.1] SL: Thanks very much. It was great being here.

[0:29:00.9] CP: Thanks, Steven.

[END]