Insights on Exchange-Traded Funds
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Charles Schwab Investment Management

Follow the money: What we learned from 2018 ETF flows

The transparency and daily asset moves shown by ETFs makes them a telling window into the investing tactics that advisors and investors deployed over the past year. Following the money can tell us a lot about what investors are thinking. While we caution against watching ETF flows on an intraday basis, they can be incredibly informative over a longer time span.

We took a close look at flows to see how investors are reacting, both to the state of the world around them and to the slate of ETF offerings. As we expected, 2018 flows reflect the use of ETFs as tools to diversify portfolios and implement market views.

Key takeaways

- ETFs continued their streak of net inflows dating to 1996. 2018 saw $313B in inflows, down from a record $466B in 2017 but in line with recent years.
- Investors allocated toward more conservative choices in 2018. International Equity inflows were down markedly, while short duration and Treasury strategy flows surged.
- Low-cost ETFs maintained their edge, garnering nearly all net inflows for the year.
- Our chief investment officers (CIOs) anticipate continued volatility in 2019, and 2015–2016 flow trends may repeat. We highlight strategies that may help buffer volatile markets.

Another year of net inflows

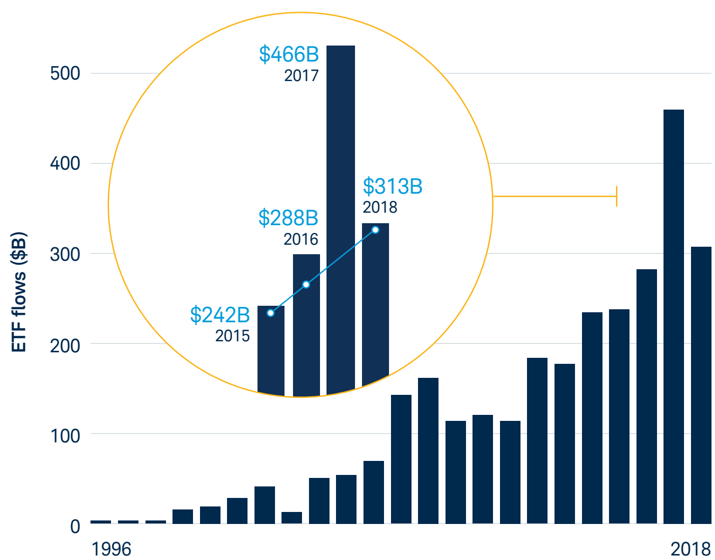
2018 was another year of strong net inflows for ETFs, continuing the uninterrupted streak of demand going back to 1996. Inflows retreated from the record levels of 2017, down by about one-third on a year-over-year basis, but 2018 was the second-largest inflow year for ETFs on record.[1]

We see two ways to view this: First, there was a significant drop between 2017 and 2018. But if we expand our view back to 2015, 2018's inflows were in line with the longer-term growth trend, while 2017 stands out as the outlier (see Exhibit 1). Indeed, 2017 was something of a Goldilocks market environment. Global economic growth was uniformly strong, boosting outlooks and sentiment, while global interest rates and inflation expectations remained low. As such, it's of little surprise that inflows surged in 2017 as much as they did before retreating to the trend line in 2018, a year when volatility returned to markets.

2018 was the first year that ETF assets under management saw single-digit growth, rather than double-digit growth, as a percentage of invested assets.[1] As the market matures

Exhibit 1: ETF flows returned to the trend line in 2018

2018 inflows were in line with recent years' growth. 2017 appears as an outlier, driven by synchronous investor enthusiasm and growth across the asset spectrum.



Source: Bloomberg Intelligence as of December 31, 2018.

[1] Bloomberg Intelligence as of December 31, 2018.

and the asset base expands, it follows that inflows as a percentage of the market could settle at a lower rate. Still, recent data suggests that ETF demand persists. In a recent study, 69% of advisors said they expected to increase their allocations to ETFs in the next five years (compared with 53% to mutual funds, 52% to individual stocks, and 46% to individual bonds).[2]

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Allocations in real time

Flows also tell us a lot about what investors are thinking. 2018 was a more conservative year than 2017 in terms of allocation decisions (see Exhibit 2). The first takeaway is the steep drop in international categories over the course of 2018. In 2017, International Equity ETFs garnered about $151B in net inflows, just ahead of U.S. Equity ETFs, at $143B. For 2018, net flows to International Equity ETFs dropped by about two-thirds, to $62B (see Exhibit 3). Interestingly, Emerging Markets' ETFs net flows were negative only in the second quarter. They rebounded toward the end of 2018, suggesting that investors were attracted to valuations.[3]

In a year when volatility returned to markets, it's a bit surprising to see that net flows to taxable fixed income categories were down 24% compared with 2017 levels. But when we look more closely, it's clear that investors directed money toward noticeably more conservative bond categories than the year before. In 2018, dollars flowed toward ultrashort bond ETFs and short and intermediate government ETFs, while corporate bond and high-yield ETFs suffered net outflows. In 2017, investors heavily favored investment-grade corporate strategies.[3]

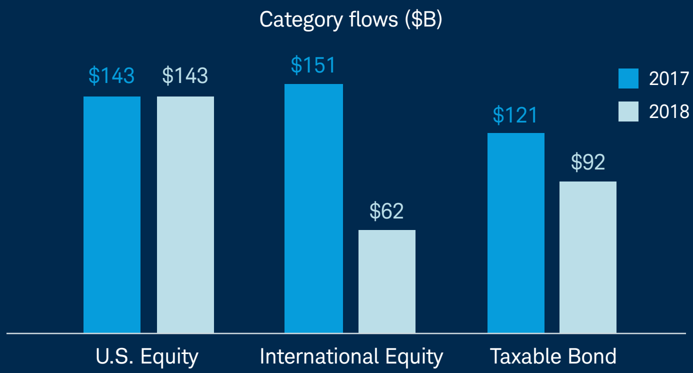
Low-cost ETFs maintain their edge

Two other trends stand out in the 2018 data: continued demand for low-cost ETFs, and continued demand for strategic beta. When we group ETFs by cost, it's clear that nearly all the flows have gone to the lowest-cost tier of tickers (see Exhibit 4). More than 95% of net flows went to funds with operating expense ratios (OERs) of 0.2% or less. More than 60% went to products with OERs of 0.09% or less, further illustrating that investors continued to be cost focused. In a recent advisor study, 66% of advisors said total cost was extremely important.[2] In fact, the number one input on investment choice was total cost.

[2] Charles Schwab study—At the Core: Advisor Views on Investment Trends, October 2018.
[3] Morningstar as of December 31, 2018.

Exhibit 2: 2018 vs. 2017: ETF flows by category*

2018 flows were lower than 2017's primarily because of a reduction in International Equity flows and, to a lesser extent, Taxable Bond flows.



*U.S. ETFs (excluding obsolete funds).
Source: Morningstar as of December 31, 2018.

Exhibit 3: Top flow categories highlight tactical moves*

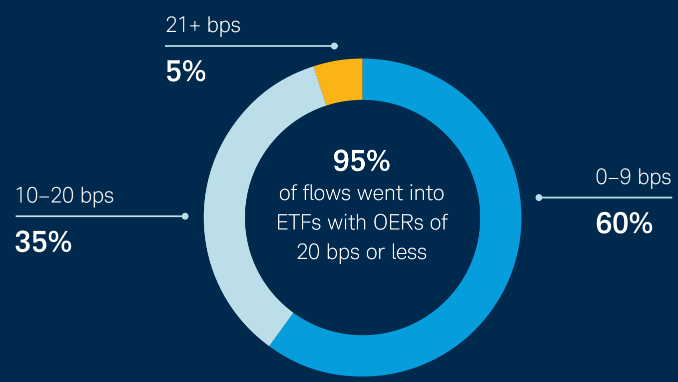
International Equity fell out of favor in 2018 as returns turned markedly negative and volatility jumped.

2015	2016	2017	2018
International Equity $105B	U.S. Equity $140B	International Equity $151B	U.S. Equity $143B
Taxable Bond $57B	Taxable Bond $86B	U.S. Equity $143B	Taxable Bond $92B
U.S. Equity $52B	International Equity $12B	Taxable Bond $121B	International Equity $62B

*U.S. ETFs (excluding obsolete funds).
Source: Morningstar as of December 31, 2018.

Exhibit 4: 2018 flows by cost percentile

Low-cost ETFs continue to earn a vast majority of ETF inflows.



Source: Bloomberg as of December 31, 2018.

Strategic beta is another clear winner for the year.

While ETF flows in aggregate were down about 32% from 2017, flows to strategic beta ETFs were up 17% on the year (see Exhibit 5). The continued interest in strategic beta was another theme found in an advisor survey. For example, 74% of advisors already invested in strategic beta planned to increase client investments in the category in the next year.[2] This consistent demand could be partially fueled by the continued exodus from active mutual funds as roughly $300B exited in 2018.[1]

Preparing for 2019

Our equity and fixed income CIOs anticipate continued volatility in 2019 (see Exhibit 6). Indeed, in 2018 we saw market pressures gathering steam from several directions. Ongoing tariff fights, policy uncertainty from central banks, deterioration in the Brexit process, signs of slowing growth in China, struggling oil prices—the trends that took hold in 2018 are likely to have staying power.

To see what that might mean for ETF flows, we point to 2015 and 2016 as a relevant example. Oil prices fell by nearly 70% from mid-2014 to early 2016, and slowing growth in China dominated outlooks. U.S. Equities were barely positive in 2015, just as in 2018. Against that backdrop, ETF flows remained robust and positive. In a recent investor study, 40% of investors said that market volatility led them to put more money in ETFs.[4]

Advisor homework: Preparing for opportunities

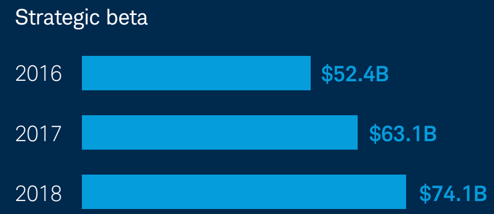
Ultimately, the best action you can take with these outlooks in mind is to prepare for possible tactical allocation moves. If you anticipate volatility, do your product research and valuation analysis homework now so you are ready to address investor concerns and market opportunities. We see four key considerations for 2019.

1. Check for diversification and stay invested.
First and foremost, check that your portfolios pass the test for diversification. The split of asset classes will likely have the greatest effect on performance in a volatile environment, helping to buffer swings among risk assets. Rely on periodic rebalancing to help keep portfolios invested. Sometimes the push for tactical opportunities overwhelms basic portfolio design. The first priority is to ensure you have a comprehensive mix of asset classes in line with individual investor profiles.

[1] Bloomberg Intelligence as of December 31, 2018.
[2] Charles Schwab study—At the Core: Advisor Views on Investment Trends, October 2018.
[4] 2018 ETF Investor Study by Charles Schwab, June 2018.

Exhibit 5: ETF asset growth matures, but strategic beta is still growing*

Overall, ETF flows contracted year-over-year, but strategic beta grew 17% from 2017.



*U.S. ETFs (excluding obsolete funds).
Source: Morningstar as of December 31, 2018.

Exhibit 6: 2019 outlook

Views from CSIM CIOs provide a tactical guide for advisors to consider.

From CSIM's Equity and Multi-Asset CIO Omar Aguilar

- ✓ Defensive growth rotation is on the horizon
- ✓ Large-cap multinationals may outperform small-caps amid volatility
- ✓ Emerging markets face a troubled outlook

From CSIM's Fixed Income CIO Brett Wander

- ✓ A limited horizon for rate hikes
- ✓ A flat yield curve conveys that inflation is contained
- ✓ Pressure building for spread sectors

2. Have conservative bond choices at the ready.
Fixed Income CIO Brett Wander argues for short duration and Treasuries in 2019, thanks to a confluence of events: the uncertain timeline for rate hikes, the flat yield curve, and the building pressure in spread sectors. With yields now much higher than the record lows, there is also more appeal to conservative bond categories than there has been in recent years. Credit segments, on the other hand, could be at risk for the same strains of volatility as equities.

3. Within equities, prepare for defensive tilt.
Fundamental Index® and other quality-focused strategies can serve as a buffer against market volatility if the strong trend of momentum reverses. Equity CIO Omar Aguilar also sees possible outperformance among large-cap multinationals.

4. Monitor international and small-cap valuations for an attractive entry point.
International stocks have been the first to pull back amid the current volatility, especially emerging markets, and they are trading at lower valuations than domestic equities. We think investors may face opportunistic valuations in 2019. Further, as Aguilar notes, small-cap stocks often struggle most in volatile environments. As such, the category could be another opportunity for attractive valuations. In both categories, define what valuation you would consider the right entry point for a tactical increase in exposure, so you'll be ready to act if the window opens.

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Ready for the year

The value proposition of ETFs remains compelling: These low-cost, liquid, and easy-to-use tools help create comprehensive, diversified portfolio allocations. 2018, a year when volatility came back to markets, is a good example of how investors use ETFs to make tactical adjustments. Even when other higher-cost investment vehicles were witnessing net outflows, ETF growth among investors led to an unbroken 22-year streak of net inflows. We expect to see that trend continue in the year ahead.

We encourage advisors to consider whether their existing portfolios are diverse enough to withstand a volatile environment. In line with our CIO recommendations, we would urge ETF investors to be ready for tactical allocation changes in 2019. Do your homework now: Consider increasing exposure to Treasuries, shoring up allocation to more defensive equity strategies, and look for entry points in international and small-cap strategies.

About the author

D.J. Tierney is a Managing Director and Client Portfolio Strategist at Charles Schwab and Co., Inc. supporting Charles Schwab Investment Management, Inc. In this role, he represents Schwab ETFs™ to sales channels, clients, and the media. He also works with CSIM's product team to optimize Schwab's ETF offerings. Mr. Tierney assists in managing relationships and communications for Schwab ETFs with authorized participants, broker-dealers, and regulatory agencies. Prior to joining Schwab in December 2016, Mr. Tierney spent 16 years with Morgan Stanley as a senior institutional sales, trading, and relationship management professional. Mr. Tierney earned a BA in economics from the University of California, Los Angeles, and an MBA from the University of California, Berkeley, Haas School of Business.