"We know equity investors, especially retail investors, have the tendency to chase returns," Zhu told US-based magazine *Financial Advisor*. That herd behaviour, she speculated, tends to inflate valuations of the underlying assets in the ETFs; as the valuations revert back to normal, the asset will eventually underperform.

> "We know equity investors, especially retail investors, have the tendency to chase returns"

But there's a caveat to Zhu's research. While that tendency to perform poorly after strong inflows was consistent in equity ETFs, fixed-income funds didn't show the same behaviour. In fact, inflows and performance in fixed-income funds across the categories Zhu studied have been flat since 2009.

"Fixed-income investors are more risk-averse," Zhu noted. "They want to protect their principal or protect their investment. So instead of return-chasing, when things are not going well, they may overreact [and sell]."

While Zhu added that a closer look would be necessary to explain for certain why equity ETFs with high inflows underperformed, the research sounds a useful note of caution. "It's just something that you want to keep in mind when you are trying to build your portfolio – to probably avoid certain ETFs that are really hot," she said.

Rob Wessel
Managing partner
HAMILTON CAPITAL

Years in the industry
20+

Fast fact
The Hamilton Capital Canadian Bank Variable-Weight ETF (HCB) invests in the Big Six banks via a unique monthly rebalancing strategy based on mean reversion

Q&A

A new strategy for bank investors

Can you talk about the possible reasons behind the mean-reversion trend in Canadian banks?
Over the years, mean reversion has been one of the most popular themes in Canadian bank investing. Many analysts have published work to show that Canadian banks have exhibited powerful mean-reversion tendencies over the past two decades. The individual Canadian banks tend to perform similarly over time, meaning a strategy of selling the winners and buying the laggards has generated higher returns over time.

Mean reversion is a powerful theme because the Canadian banks are very similar companies. Their business mix and geographic footprints have substantial overlap. They have relatively equal brands, virtually identical product offerings, similar size and scale, and operate under the same regulatory regime.

How does that play into the strategy behind the Hamilton Capital Canadian Bank Variable-Weight ETF?
Given that the Canadian banks have well established mean-reversion tendencies, we rebalance HCB monthly and make large distinctions in weighting between the laggards and outperformers from the prior month by overweighting the three most oversold banks to 80% and underweighting the three most overbought to 20%.

An individual investor attempting to execute this strategy would have to take time each month to try to rebalance while paying retail trading costs. We can effect this rebalancing each month for the investor at institutional trading costs, which are substantially lower. HCB also pays monthly dividends, which investors find valuable. And the strategy is executed using a formula that eliminates discretion and emotion.

How might market turbulence affect HCB's performance?
The sector has demonstrated mean-reversion tendencies in both up and down markets, with the greatest impacts during the most volatile periods. In fact, the benefits from mean reversion have been greatest in periods of market turbulence relative to an equal-weighted portfolio of Canadian banks. That means such a strategy, based on past performance, theoretically creates lower risk of declines in large market corrections.

How has HCB been received by investors and advisors?
The interest we have received so far has been very positive, and we are excited to provide investors with a low-cost, efficient vehicle to potentially achieve higher returns, increased diversification and, if history is a guide, reduced risk.