PROSHARES: DISRUPTING THE RETAIL ETF SPACE

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Simeon Hyman, CFA, joined ProShares in 2013, and is the firm's global investment strategist. He leads ProShares' team of investment professionals engaged in portfolio analysis, product research and development, education and the delivery of investment strategies using the company's ETFs. Here, he discusses the disruption that the rapid growth of e-commerce is causing in the retail industry, and how investors might take advantage of it. He spotlights the investment opportunity provided by the ProShares Online Retail ETF (ONLN), which is part of ProShares' larger Retail Disruption suite.

What's going on in retail today, and how is it being disrupted?

Simeon Hyman: E-commerce—specifically online retail—has rapidly become part of our lives, and the traditional "bricks and mortar" retailers that aren't adjusting to this change are paying the price. Think about how many empty stores you see in malls, and how many major retailers have filed for bankruptcy in recent years. Much of that is because of the rise of online retail. We call it "the new retail reality," and it's why we created the ProShares Retail Disruption suite of ETFs.

One of those funds is the ProShares Online Retail ETF (ONLN). Would you provide an overview?

Hyman: As its name implies, ONLN is an ETF that invests in online retail. ONLN's strategy pinpoints online retailers—stores that principally sell online or through other nonstore channels such as mobile—and separates them from those that rely on bricks-and-mortar stores.

There's no doubt online retail is here to stay, but how much is it growing?

Hyman: Online retail sales are soaring. But we're still early in the game, which is something investors may not appreciate. Online sales make up only about 12% of total global retail sales. In the U.S. alone, that number is expected to grow to more than 17% by 2021, and there are plenty of indicators to support growth predictions like that.

Online retail has been growing steadily for years. Global e-commerce sales doubled between 2014 and 2018, up from $1.3 trillion to about $2.8 trillion annually. By 2020, over 2 billion people are expected to be digital buyers (a 19% increase from 2018) as more and more people—particularly in developing nations where barely half the population is online—become internet users.

And with online retail's ease and convenience, almost one-third of consumers are already buying products online at least weekly, and 75% at least once a month. I think those kinds of numbers surprise some folks.

KEY FACTS

- 200 million people got their first mobile device in 2017
- ¼ billion people went online for the first time in 2017
- Double-digit online sales growth continues in emerging markets

What do you think the future looks like for online retail? Will this trend continue over the longer term?

Hyman: When you think about that 12% figure, there is a huge amount of growth potential that just about everybody expects as the penetration of online retail continues to take share from bricks-and-mortar retailers.

If you look at recent polls about shopping preferences, even in the lowest-ranked category like groceries, well over 20% of folks would prefer to shop online. Forecasts predict about $4 trillion annually in online sales by 2020, which is a 45% increase from last year.

So, back to that 12% figure. By 2021, that number will probably be projected to go somewhere in the 17-18% range. This is just the early innings, as I said. We should expect steady and substantial continued penetration as more and more retail goes online at the expense of traditional bricks-and-mortar stores.

In addition, it's important to remember that this growth potential is global. As sizable emerging market populations get access to mobile devices, often for the first time, online retail is likely to grow significantly.

ONLINE SALES AS A PERCENTAGE OF RETAIL SALES

2018	2021 (est.)
12%	17.5%

The top holdings for ONLN are names like Amazon, Alibaba, Netflix and Groupon. It seems the fund focuses on the largest names in the space. Why is that?

Hyman: We believe that's the most effective way to construct a strategy that invests in online retailers. Company size really matters. ONLN uses a modified market-cap weighting approach that emphasizes the largest players in the space—leaders like Amazon and Alibaba. By 2023, Amazon is projected to account for half of all online sales; Alibaba holds the single-day record of $30.8 billion in sales.

That scale is important, as is having that reflected in the structure of the portfolio. We think ONLN's strategy of zeroing in on the largest players is the right answer for taking advantage of the growth of online retail.

Of course, the global nature of these companies is also key in this space. One reason the portfolio invests in online retailers from around the world is that online success, especially in today's global economy, bears little relation to location or to the nation in which a company was founded.

Would you talk about the increasing online presence of the more traditional bricks-and-mortar retailers? Is the line between online retailers and traditional retailers blurring in that area?

Hyman: This is an important question, and a lot of folks don't quite understand the nuances of it. When they think about the investment opportunity that ONLN is pursuing, a lot of people might say, "Does it really matter anymore? Because Walmart and Target keep building their online business too."

It is true that some of the traditional bricks-and-mortar players are doing a reasonable job of growing their online presence in today's retail landscape. But when a traditional bricks-and-mortar retailer moves more into the online space, they are facing some significant challenges: No. 1, margins are typically lower online, and No. 2, they often have, in a sense, duplicate distribution organizations. Traditional retailers have their existing bricks-and-mortar business, and layered on top of that, they have had to create a second infrastructure to execute online sales.

Those kinds of issues are big handicaps to the traditional players. While yes, they may be growing their online business, it could be difficult for them to thrive. Existing and emerging important online players, on the other hand, are probably just a little bit better at efficient online execution, because that's how they founded their firms. The dominant online players are more likely to continue to grow, thrive and outperform the traditional bricks-and-mortar retailers who are still growing their online businesses.

How would a fund like ONLN fit into an investor's portfolio?

Hyman: We believe that it fits most effectively into a core and satellite approach to portfolio construction. Core equity holdings would likely cover diversified allocations to U.S. large cap, midcap and small cap stocks, and some international. ONLN could then form an important satellite allocation that would take potential advantage of the growing global trends in retail as an enhancement to core equity holdings. And it's a compelling alternative to picking the stocks yourself.

To provide a little more color into that last statement, Amazon currently holds the largest weighting in the fund, about 24%. That's quite high, but obviously not 100%. Some investors may say, "Oh, I'm just going to buy some Amazon stock to take advantage of this trend." Even with its appropriately large positions in Amazon and Alibaba, ONLN is certainly much better diversified than just picking one or two of the dominant securities. We think ONLN is an appropriately concentrated, appropriately diversified and well-constructed fund for taking advantage of the growth of companies that principally sell online.

Do you offer other funds that take advantage of retail disruption trends?

Hyman: There are two more retail disruption ETFs in our suite, in addition to ONLN. The ProShares Long Online/Short Stores ETF (CLIX) is a long/short retail ETF to take advantage of this trend. It's 100% long online players, using the same construction as ONLN. However, it also has a component that is 50% short legacy bricks-and-mortar retailers.

This approach provides an opportunity for investors looking to take advantage of both sides of retail's transformation—toward online shopping and away from bricks-and-mortar stores. It seeks returns from both the growth opportunity of online retail and the potential for underperformance among legacy bricks-and-mortar players, in a single ETF package.

So, ONLN is for straight, long exposure to dominant online retailers. CLIX is a long/short strategy taking advantage of both online and bricks-and-mortar retailers. And the third member of our retail disruption suite is the ProShares Decline of the Retail Store ETF (EMTY), which is a dedicated short fund designed to benefit from the decline of traditional bricks-and-mortar retailers.

Together, these funds provide investors with multiple investment strategies for taking advantage of the investment potential of the new retail reality.

ProShares

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Sources: ProShares; eMarketer (global retail sales data); ITU (developing nations internet use); IPC and Survey Sampling International (online purchasing frequency); PwC (online penetration and shopping preferences); FTI Consulting (Amazon sales projection); CNBC (Alibaba sales record); FactSet (online margins).

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