

What You Need to Know About Active ETFs

by Shishir Nigam

There's a new kid on the block. That's "new" relative to incumbents that have been around for ages in the investment world and are well understood. Actively managed ETFs made their debut in the United States in early 2008 when Bear Stearns brought the first active fixed-income ETF to the market. However, the launch was ill-timed and the fund went down with the firm.

The oldest active ETFs in the market today are four funds launched by PowerShares in April 2008. At the end of March 2011, there were 36 actively managed ETFs by six different issuers in the United States. The real growth has yet to be experienced, though, as many large-fund managers have filed applications with the SEC to launch their own active ETFs, including BlackRock iShares, Eaton Vance, J. P. Morgan, Legg Mason, PIMCO, T. Rowe Price, and others.

Most financial planners are now familiar with ETFs because the funds have been around for more than a decade. Before the advent of active ETFs, all ETFs were index ETFs, which generally provide passive exposure to the overall market or a niche market segment by following an index that represents that sector or market. In that sense, they are directly comparable to index mutual funds that "own the index" and follow it passively.

Active ETFs, on the other hand, are more comparable to active mutual funds. Active ETFs are funds that have

portfolio managers behind them making active security selection decisions about what they hold in the portfolio. These managers may have their performance measured against an index benchmark, but they have no obligation to hold all the components that make up the index. This allows investors to benefit from the

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value-add the portfolio manager brings to the table to potentially outperform a passive investment. Of course, whether planners have a preference for active management or passive management is another discussion altogether.

The Benefits

As mentioned, actively managed ETFs are directly comparable to active mutual

funds because both vehicles provide access to active management. However, investors benefit from several key differentiating factors as a result of the strategy being packaged as an ETF.

Greater Liquidity. Active ETFs are more liquid than active mutual funds because they are exchange traded. Active mutual funds can only be traded at the end of each day, and investors who buy or sell them do not know at what price they have transacted until the fund's net asset value (NAV) is struck upon market close. In contrast, active ETFs can be traded at an indicative value of the fund available throughout the trading day. Active ETFs can be bought and sold just like stocks, with margin, with limit orders, and even shorted. With the volatility of today's markets, the ability to exit a fund at any time during the day as opposed to waiting until market close can be a significant benefit.

Greater Transparency. Actively managed mutual funds are only required to disclose their holdings once every quarter, and that, too, with a 60-day lag. Conversely, active ETFs are required by the SEC to provide daily disclosure of their holdings with a one-day lag. In other words, every morning investors can see what the portfolio manager held in the fund as of the previous day's close.

Higher Tax Efficiency. One not very investor-friendly feature of active mutual funds is that investors may have to bear capital gains tax even

though they have not sold any of their own shares. The full brunt of this was felt by mutual fund investors in late 2008 when they not only experienced falling portfolio values but also ended up paying capital gains taxes resulting from large redemptions. In active ETFs, the fund's shares trade on the secondary market and transactions are done through a market maker for the fund. If market makers need to create or redeem more shares, they can do so through an "in-kind" creation/redemption process unique to ETFs. This means that when redemptions occur, the portfolio manager does not have to sell securities and can instead transfer them "in-kind" to the market maker, thereby avoiding any realized capital gains. Hence, the active ETF structure ends up being more tax efficient compared to active mutual funds because investors only incur capital gains tax when they sell their own shares.

Lower Costs. The average expense for an active mutual fund in the United States is 1.21 percent, according to Strategic Insight, while the average expense ratio for existing active ETFs is 0.73 percent, according to ActiveETFs | InFocus. Investors and advisers know how important cost differentials can be to overall portfolio performance over the long run. This difference alone can result in huge costs savings when compounded over the years.

The Drawbacks

Of course, no product is perfect.

Short Track Records. As with any actively managed product, the portfolio manager's performance track record is of paramount importance in helping investors and planners gain comfort with the fund. Active ETFs still have relatively short track records, with the oldest active ETFs being fewer than three years old. Active funds typically start receiving star ratings from Morningstar once they have a three-year track

record. As a result, some planners may not be comfortable with these funds yet. To alleviate this concern, issuers often disclose past performance records in the fund prospectus from other funds managed by the investment manager that had similar investment mandates.

Too Much Transparency? Another feature of active ETFs that has raised some concern is their high level of transparency. Not all market participants have welcomed the amount of transparency active ETFs are required to provide. Most concerned are the portfolio managers themselves, who feel that by disclosing all their holdings every day, they may be opening themselves up to potential front-runners as well as giving away their intellectual capital and alpha-generating strategies. There is considerable discussion on this topic among the issuers, regulators, and market experts, and the eventual conclusion could determine how quickly or slowly the number of active ETFs grows.

The Future

ETFs should no longer be synonymous with a passive management strategy because ETFs now provide investors access to both passively managed and actively managed portfolios. There is undisputed interest from fund managers in active ETFs, but the eventual success of this new kid on the block will really be determined by how well investors and the advisers who serve them warm up to this innovation.



Shishir Nigam is the founder of ActiveETFs | InFocus (www.etfshub.com), the first website dedicated to focused coverage and in-depth analysis of actively managed ETFs.

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Post-Crash Investing

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capitalization weighted index that includes all tax-qualified REITs listed on the NYSE, AMEX, and NASDAQ, had a total return of 27.95 percent for 2010, compared with the 2010 returns of equity markets of 26.85 percent for the Russell 2000 Index, 16.91 percent for the NASDAQ Composite, 15.06 percent for the S&P 500, and 11.02 percent for the Dow Jones Industrial Average.

For Q1 2011, the total return of the FTSE NAREIT All Equity REITs Index was up 7.5 percent compared to 5.9 percent for the S&P 500.

From 2008 through 2010, both REITs and alternative investments (whether held outside mutual funds and ETFs or not) demonstrated consistent growth in adviser usage according to previous FPA *Trends in Investing* study data (see Figure 2 on page 31).

Economic Outlook: Bullish

Although advisers are not willing to return to their pre-crash investing philosophies of more risk/more potential return, they are regaining confidence in the economy. Sixty-eight percent of 2011 respondents are bullish on the short-term (six months) economic outlook, 58 percent are bullish on the next two years, and 52 percent have an optimistic outlook for the next five years. We're looking forward to seeing how their outlook may affect their investment practices in the year ahead.



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Endnote

1. Statistically valid at a 95 percent confidence level with a 3 percent margin of error, and is representative of the FPA membership.