

ETF Trends: Actively Managed Funds Gaining Ground

by Amy E. Buttell

Exchange-traded fund (ETF) sponsors are generally not short on creativity and innovation. Following the introduction of specialty indices, the latest trend in the ETF market is actively managed products that employ portfolio managers and seek to outperform passive investments; in other words, products that look and feel a lot like active mutual

funds. Although the actively managed ETF will not spell the decline of the mutual fund anytime soon, actively managed ETFs represent an intriguing option for financial planners looking to keep expenses down, improve tax efficiency, trade intra-day, and operate with more transparency.

“It’s true that ETFs have been growing faster than mutual funds,”

says Russell Wild, a financial adviser and author of *Exchange-Traded Funds for Dummies*. “However, despite all the growth in ETFs, they have a long way to go before they hold anywhere near the assets as mutual funds.”

Consider these numbers: As of February, there were 956 ETFs with \$1.035 trillion in assets, a 3.1 percent increase from January (but a 38 percent increase from February 2010) according to the Investment Company Institute (ICI). Comparatively, as of February, there were 7,601 mutual funds with \$12.122 trillion in assets, a 2.1 percent increase from January, according to ICI.

What Distinguishes ETF Owners?

It’s no surprise that ETF owners share some characteristics with retail stock owners, considering ETFs trade on an exchange just like stocks, and households that own ETFs generally also own stocks, according to the Investment Company Institute (ICI). What may be a surprise is that ETF owners tend to have greater household assets, higher incomes, and a higher tendency to own IRAs than retail stock investors.

Characteristics of ETF-Owning Households

| | All U.S. Households | Households Owning ETFs | Households Owning Individual Stocks |
|--|---------------------|------------------------|-------------------------------------|
| Median | | | |
| Age of head of household | 49 | 51 | 50 |
| Household income* | \$50,000 | \$120,000 | \$86,500 |
| Household financial assets** | \$64,000 | \$350,000 | \$200,000 |
| Percentage of households | | | |
| Household primary or co-decision maker for saving and investing: | | | |
| Married or living with a partner | 63% | 79% | 77% |
| Widowed | 10% | 5% | 7% |
| Four-year college degree or more | 30% | 65% | 49% |
| Employed (full- or part-time) | 60% | 74% | 69% |
| Retired from lifetime occupation | 27% | 27% | 26% |
| Household owns: | | | |
| IRA(s) | 39% | 76% | 62% |
| DC retirement plan account(s) | 51% | 69% | 71% |

*Household income before taxes in 2008.

**Includes assets in employer-sponsored retirement plans; excludes primary residence.

Source: 2010 Investment Company Fact Book (www.icifactbook.org)

Growth Outlook

According to Wild, much of the growth experienced by ETFs has been because of their transparency, tax efficiency, and low costs, which are part and parcel of them being index funds, he says.

“My guess is that actively managed ETFs are going to move more slowly—particularly if they move beyond the traditional full transparency, low cost, and tax efficiency—because there won’t be as much of a differential between actively managed ETFs and actively managed funds, in that case.”

As of March 31, 36 actively managed ETFs held a market cap of \$4.2 billion, according to data compiled by ActiveETFs | InFocus (www.etfshub.com), a \$725 million increase from February 28.

According to a recent survey of FPA members on their use of various investment products, 77 percent currently use ETFs in client portfolios (86 percent use non-wrap mutual funds). Among advisers who use ETFs, 76 percent use traditional, index ETFs and 24 percent use actively managed ETFs.

Tom Lydon, president of Global Trends Investments and editor of ETFtrends.com, says some of the most popular actively managed ETFs include PIMCO Enhanced Short Maturity (MINT), WisdomTree Dreyfus Chinese Yuan (CYB), and WisdomTree Emerging Markets Local Debt (ELD).

Meanwhile, some fund advisers are considering converting actively managed mutual funds to actively managed ETFs, says Robert Goldsborough, an ETF analyst with Morningstar. There's little doubt that many mutual fund managers would be interested in at least extending their strategies into active ETFs to capture more market share, even if they weren't interested in converting a fund to an ETF.

The Role of Actively Managed ETFs in a Portfolio

Active ETFs can play the same role in a portfolio as actively managed funds. However, because of the limited number of actively managed ETFs, there currently isn't enough coverage of the market and market sectors to entirely abandon actively managed mutual funds in favor of their ETF counterparts. That said, as more actively managed ETFs obtain three-year track records that are competitive with actively managed mutual funds, there is no reason not to consider adding these products to client portfolios, according to Lydon.

"If you, as an adviser, are accustomed to using actively managed funds and a sponsor introduces an actively managed ETF with the same brand, same discipline, same focus, and same

ETFs vs. Mutual Funds

Why do you prefer mutual funds?
(Among survey respondents who use/recommend mutual funds, but do not use/recommend ETFs)

| | |
|--|-------|
| I prefer the management style typically found in mutual funds. | 74.7% |
| They are easier for my clients to understand. | 31.3% |
| Other* | 19.3% |
| My clients prefer mutual funds. | 9.6% |
| *Other includes: "Because ETFs are still relatively new," "Because I have more experience using mutual funds," "No need for intra-day trading," and "Liquidity." | |

When using both mutual funds and ETFs, what prompts you to use one over the other?
(Among survey respondents who use both products)

| | |
|---|-------|
| I don't choose one vehicle over another. I evaluate specific investments from both categories and simply choose the product that best fits my clients' needs. | 66.3% |
| I use the most tax-efficient vehicle that suits my clients' needs. | 36.6% |
| I use the least expensive vehicle that suits my clients' needs. | 31.9% |
| I usually recommend specific products from both vehicle classes. | 30.8% |
| I use ETFs with one type of client and mutual funds with a different type of client. | 14.7% |
| It is based on client request. | 8.4% |
| Other* | 4.3% |
| *Other includes: "I use ETFs for specific sectors not available with mutual funds," "I use ETFs mostly for tax-loss harvesting," and "Depends on client's investment policy." | |

Source: FPA's 2011 *Trends in Investing* study (February 2011)

manager but you can get it for less, there's no reason not to move from the fund to the ETF," says Lydon.

Goldsborough believes waiting for a three-year track record before investing in an actively managed ETF is an important consideration. "There will be a whole lot more options eventually with a host of different active strategies," he says. "It's a developing story. Getting to the point where there is a three-year track record is a compelling reason to wait."

Lydon sees more advisers adding ETFs to client portfolios to diversify into asset classes they didn't have access to before, such as commodities, currencies, and certain emerging markets. And the growth of actively managed ETFs will offer advisers further opportunities to diversify—something many will welcome.

For Lydon, a surge in actively

managed ETFs may help bring active management back into favor with some advisers and their clients. "We might get back to the point where we used to be with actively managed funds, where it's basically a beauty contest," he says. "I, as the adviser, am going to pick out the prettiest models for you and put them in your portfolio. If one starts to get warts and age spots, and doesn't look good, we'll swap that out for something else."



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