# ETF Custom Baskets A Game Changer

One of the modifications in the ETF Rule is altering the shape of the ETF industry.

Gerrard Cowan | Jul 23, 2021

*Reviewed by: Gerrard Cowan, Edited by: Gerrard Cowan*

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The SEC's ETF Rule, which was passed in September 2019, brought significant change to the ETF industry, not least through widening access to custom baskets. This levels the playing field for newer issuers, according to industry experts, and is already reshaping the sector.

Custom baskets are a crucial—though complex—tool for ETF managers. The concept is tied to the "creation/redemption" mechanism, which ETFs use to create new shares in the fund (to meet increasing market demand or to launch a new product) or to remove shares from the market.

How Custom Baskets Work
This process relies on authorized participants (APs), that are usually large financial institutions with plenty of buying power. When new ETF shares are required, the APs buy a "creation basket," usually containing a pro rata slice of all the ETF's underlying securities.

They deliver this to the ETF and receive new ETF shares in return, with the exchange taking place on a like-for-like basis in terms of NAV. The APs can then sell at a profit on the stock market.

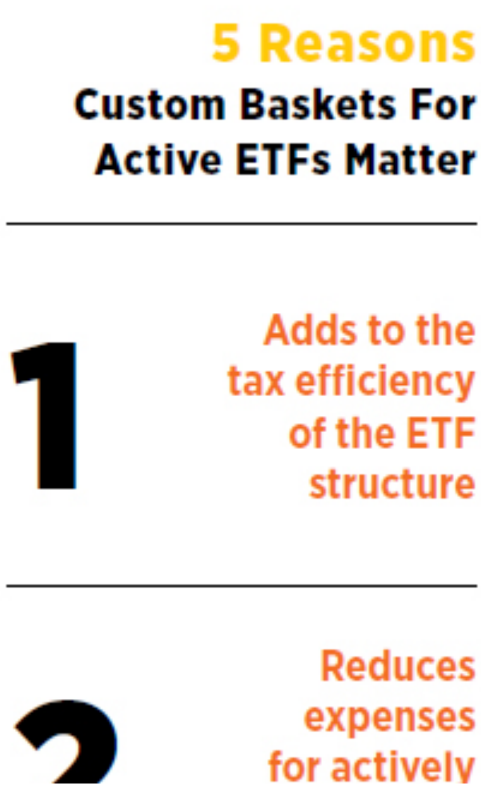
APs are also key to redeeming ETFs. They'll buy ETF shares, deliver these to the fund in exchange for a portfolio of the underlying securities, and then sell these on the market. To know which securities they should buy (or which they'll receive), APs use a portfolio composition file, a list of securities that's updated daily.

The process benefits everyone. Because ETFs trade like a stock, the APs can exploit any price differences between the ETF and its holdings. The AP takes care of all the trading costs—which benefits the ETF—and in turn, benefits investors. Perhaps most importantly, these "in kind" transactions make ETFs highly tax efficient.

APs have always managed the creation/redemption process through two types of trading baskets: standard and custom. Standard baskets simply contain a proportional slice of all the securities in the ETF's index. Custom baskets, by contrast, could include cash or a collection of securities in nonrepresentative amounts.

This creates flexibility for both the AP and the ETF. For example, it means the ETF managers can dispose of securities they no longer want to hold in the fund, or acquire new securities, while still benefiting from the tax-efficient ETF wrapper.

Previously, a range of established funds were able to use custom baskets. The ETF Rule opens custom baskets up to everyone, including new funds.




The Rule That Changed Everything
Chris Hempstead, director of international business development at IndexIQ, says it's like ordering a meal at a restaurant and asking for a slight change to the recipe: "They're still going to charge you $25 a plate, but maybe they'll make it without peanuts."

However, for most ETFs, there won't be enough daily turnover to make a difference, Hempstead says, with most passive funds likely to use custom baskets only during index rebalancing events, a long-established process.


Still, there are a few hundred index-based ETFs that could find it useful on a more regular basis. In particular, Hempstead points to the fixed income space, where the passive ETFs tend to be heavily optimized. It could be difficult finding bids for certain types of bonds in which the fund might want to cut back, for example, so the fund manager could place these bonds in the redemption basket, adding in-demand bonds to the creation basket.

There are particular advantages for active ETF managers, says Todd Rosenbluth, head of ETF and mutual fund research at CFRA. Their portfolios could include less liquid stocks, he notes.

For example, they might hold meaningful stakes in relatively small companies in niche areas. Additionally, they're more likely to see higher turnover, paring or increasing individual holdings through the day, as custom baskets give them greater leeway for changing their portfolio. "The plumbing works better for them," Rosenbluth said.

When The Plumbing Is Better
Due to when it first entered the market, the entirely actively managed AdvisorShares family has long had the ability to offer custom baskets in its ETFs, which are fully transparent, said CEO Noah Hamman.

However, custom baskets' inclusion in the ETF Rule "helps normalize the process, and makes it much easier to work with service providers with similar procedures and guidelines to support custom baskets," he explained.

Thanks to the "in-kind" nature of flows and the custom basket process, it's estimated that an ETF can potentially operate with 75 basis points of cost improvement over the mutual fund structure, said Hamman. Expanding custom baskets "will result in much better performance for both the portfolio managers and shareholders."

The ETF Rule is having a significant impact on the industry. In June, Dimensional Fund Advisors announced it would convert four of its mutual funds into active transparent ETFs listed on the NYSE, the largest such conversion in the sector's history.

The conversion followed the launch of Dimensional's first three ETFs in 2020. The firm has quickly turned itself into one of the largest active ETF issuers, ranking in the top 15, with over $30 billion in AUM.

The ability to use custom baskets within the ETF wrapper was key to Dimensional's entrance to the market, said Nicole Hunter, DFA's head of capital markets. The firm's approach to implementation goes beyond standardized indexing, she notes, as "custom baskets allow us to implement our flexible approach," which emphasizes risk management and tax efficiency.

Hunter says she applauds the SEC for harmonizing the rules across issuers: "I think we're in a really great place now to think about the next evolution of ETFs."

Custom Baskets & Semitransparency

While ETFs are associated with transparency, a number of semitransparent structures have been launched in recent years, which don't have the same daily disclosure demands as more traditional funds, a significant benefit to active managers. Some of these have received approval to use custom baskets.

Earlier this year, Stance Capital launched the Stance Equity ESG Large Cap Core ETF (STNC), in partnership with portfolio trading subadvisory firm Vident Investment Advisory. STNC is delivered through the Blue Tractor semitransparent wrapper.

Custom baskets have delivered significant tax advantages, says Bill Davis, portfolio manager at Stance Capital. For example, portfolio rebalancing doesn't typically create taxable events. There's also a one-time potential at the launch of an ETF to transition separate accounts into the fund without triggering a taxable event, "even though the underlying securities might have embedded gains," Davis said.

Ryan Dofflemeyer, senior portfolio manager at Vident, notes that the ability for active managers to rebalance tactically using in-kind custom baskets, while reducing capital gains tax, is likely to further fuel the growth of active ETFs in the coming years: "Custom baskets are the secret weapon of ETFs."

Indeed, the allowance of custom baskets for all actively managed ETFs seems to have opened the floodgates. In 2020, actively managed ETFs accounted for 122 of the nearly 320 launches that took place during the year.

That number doesn't even include defined outcome ETFs, which are excluded because they largely look to replicate the returns of an index or ETF within certain buffered parameters, but are required to be actively managed. At least 125 defined outcome ETFs have been launched since 2018.

In the first six months of 2021, we've seen 88 actively managed ETFs that don't use defined outcome strategies make their debut out of total launches of roughly 200. Consider the big picture: Actively managed ETFs (excluding defined outcome ETFs) overall represent less than 20% of all ETFs (and a much smaller percentage of assets). The industry has clearly hit a turning point.

**Gerrard Cowan**

Gerrard Cowan is a freelance journalist who writes on finance and technology. He previously worked at The Wall Street Journal, where he edited the Business & Finance section of the European edition, and at Jane's Defence Weekly. Gerrard is the author of "The Machinery" fantasy novels, published by HarperCollins.

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