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Cut to the Chase

Active management is shaking up the ETF Industry

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What are actively managed ETFs?

An actively managed ETF is a form of Exchange Traded Fund (ETF) that has a fund manager making decisions on the underlying portfolio allocation and not adhering to a passive investment strategy of mimicking a benchmark index.

How are they different from index ETFs?

Index or passive ETFs strictly follow a benchmark index like S&P 500 or Dow Jones Industrial Average which results in reduced expenses for fund management and hence lower fees. Active-ETFs on the other hand have higher fees than passive ETFs due to the fund management expenses as the fund manager picks the underlying stocks based on his/her strategy. Both passive and active ETFs share similarities like being traded on exchanges. This tradability makes them different from mutual funds which are not traded on exchanges but like ETFs invest in a variety of companies.

How are Active-ETFs different from other actively managed mutual funds?

Fund managers who pick stocks based on their own research just like actively managed mutual funds manage active-ETFs. However, they are also listed on exchanges and subject to other regulations like having to disclosure their portfolio and are thus more transparent than actively managed mutual funds. Recently the Securities and Exchange Commission (SEC) has approved "models" that allow active managers to list ETFs that shield their portfolios, or are "non-transparent". Historically, U.S. ETFs have been required to publish their holdings every day. Many active managers dislike this transparency requirement because, they claim, their stock picks are intellectual property. This new regulation is another positive for active fund managers many of whom are now looking to list more Active ETFs and convert active mutual funds, which are seeing massive outflows into ETFs.

What has changed in 2020 since the start of the Covid-19 crisis?

In 2020, for the first time ever, more actively managed ETFs were launched in the U.S. than passive ones. According to FactSet and Ultumus, there were 42 active ETFs listed as of June 4. This compares to just 35 index funds[1]. Fidelity and JPMorgan were among the better-known active ETF issuers. In the first five months of 2020, more ETFs were closed than new ETF launches. Most of the liquidations were index-tracking funds and notes. Actively managed ETFs are growing fast, albeit from a low base.

What are the reasons for this shift?

The proliferation of low fee Passive funds has resulted in margin erosion across the asset management industry. Asset managers' profit margins have fallen from an industry median of 34 per cent in 2015 to 27 per cent in 2019, according to consultancy Casey Quirk. Margins are weak despite the market rising sharply during the time. Rising markets typically support profits as fees are charged on the total value of assets managed. This has resulted in asset management companies exploring margin-improving ideas like Active ETFs.

Are there any disadvantages particular to Active ETFs?

Actively managed ETFs may develop large premiums or discounts to the underlying Net Asset Value (NAV) on volatile trading days. With index ETFs, authorized participants (APs) can minimize the possibility of arbitrage by releasing or redeeming shares. Any time a price disparity becomes apparent in an index ETF, it immediately gets traded away. In the case of actively managed ETFs, APs may not be able to maintain the same kind of control. It is difficult to hedge positions without the details about the underlying securities in an actively managed ETF and that may lead to wide price disparities.

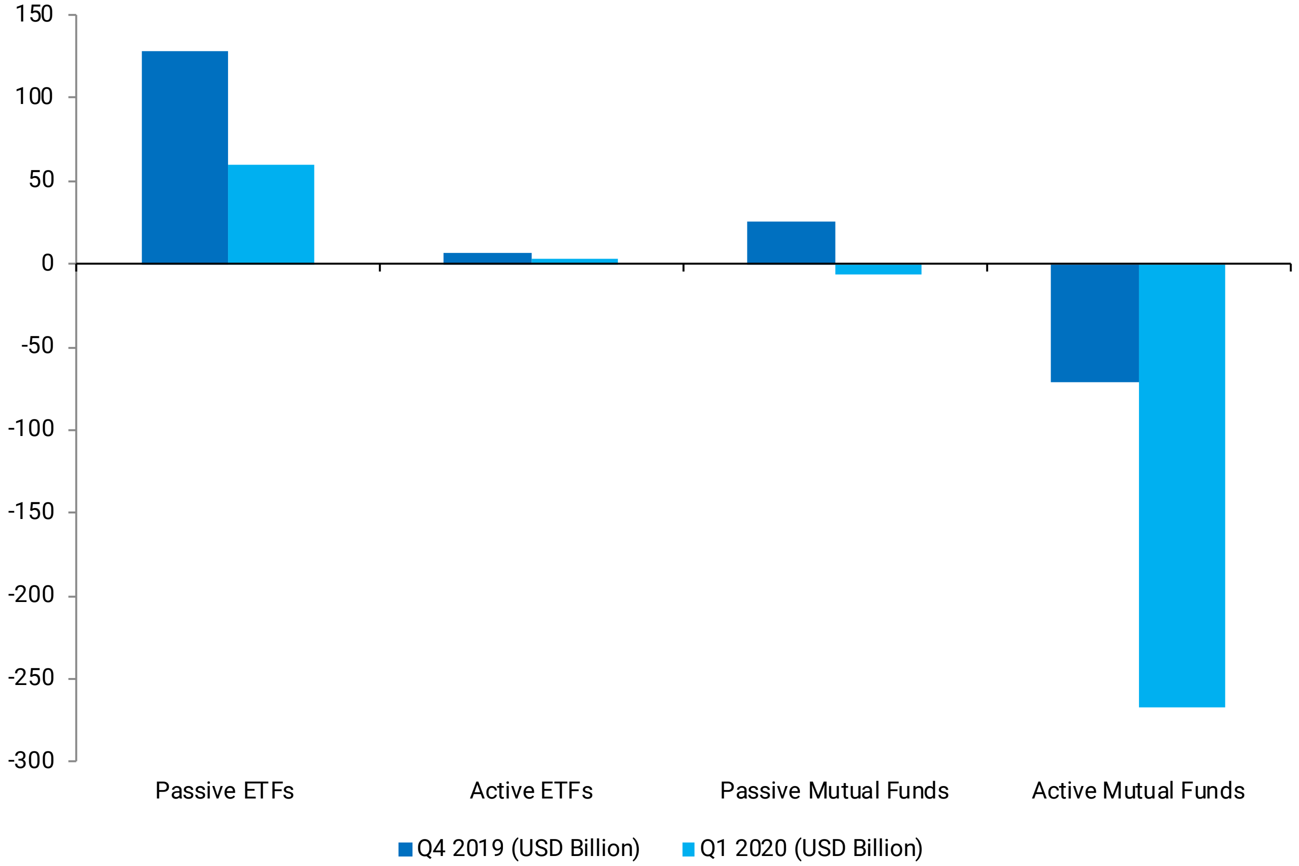
[1] https://www.ft.com/content/541b1acc-c521-4cfe-89a3-132f02df497b

Also, huge price disparities can happen if an ETF's last trade occurs well before the market close. At that time, the underlying securities in the ETF might have already moved the fund's intraday value away from its last traded price. This can be a problem if investors suffer losses due to these price disparities.

How do Active-ETFs stack up against other funds after this increase and what is the way forward?

In Q1 2020, Passive ETFs saw net inflows of USD 60 billion as against USD 3.7 billion for Active ETFs. But Active ETFs compare favourably with the net outflows of USD 267 billion for Active Mutual Funds[2]. Also, inflows seen during a period of market mayhem augurs well for the relatively new product as the markets have since recovered and likely to have seen more inflows in Q2.

Exhibit 1: Net Fund Flows for different types of funds in Q4 2019 and Q1 2020



Source: Betashares

[2] https://www.betashares.com.au/insights/global-etf-review-q1-2020/

Exhibit 2: Information about some actively managed ETFs currently traded on exchanges

Fund	Firm	AuM (USD mn)	YTD Returns (%)	Expense Ratio (%)	Benchmark Index
ARK Innovation ETF	ARK	2,000	41.2	0.75	S&P 500
International Shares Active ETF	Morningstar	91	-6.84	0.39	MSCI World
Dorsey Wright ADR ETF	AdvisorShares	76	-9.39	1.1	MSCI EAFE
Dorsey Wright FSM U.S. Core ETF	AdvisorShares	46	4.01	1.14	Nasdaq 100
Real Asset Allocation ETF	Van Eck	14	-24.2	0.75	Bloomberg Commmodity

Source: Marmore Research

Active managers such as JPMorgan, Gabelli, Columbia Threadneedle and Nationwide Fund Advisors have signed licence agreements with an eye to listing active ETFs. Non-transparent active ETFs from American Century and Legg Mason have already listed[3]. They and other fund managers are looking to utilize the popularity of ETFs and increase fees at the same time through Active ETFs. How far they are successful will ultimately depend on the performance of the funds, which is what investors are looking for. Otherwise, this could simply be another instance of an 'old wine in a new bottle'.

[3] https://www.ft.com/content/541b1acc-c521-4cfe-89a3-132f02df497b

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