



## ETF STRATEGY BRIEF #2: ACTIVELY MANAGED EXCHANGE TRADED FUNDS

# Actively Managed Exchange Traded Funds

ETF assets have steadily grown worldwide from \$310 billion in assets in 2004 to \$750 billion in 2008 representing a compound annual growth rate of 25%, and in spite of a plummeting stock market, ETF assets dipped less than 10% in 2008.<sup>1</sup> This growth rate has attracted start-up managers launching niche ETFs to established managers with significant assets under management incorporating ETFs into their diverse product lineups. The growth rate also attracted BlackRock to Barclays Global Investors (BGI).

ETFs also have a history of product innovation, and this Strategy Brief explores the latest innovation – actively managed ETFs. This brief outlines the key features of ETFs, describes the current classifications, addresses whether a mutual fund can convert to an ETF, discusses the active ETFs currently available, and analyzes the impediments to widespread adoption of active ETFs. The first brief in this series provides an overview of the ETF landscape, compares ETFs to index mutual funds and addresses current and future product usage.

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### TOPICS EXAMINED

#### KEY FEATURES OF ETFS

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#### CHALLENGES TO ADOPTION AND GROWTH OF ACTIVE ETFS

#### CAN A MUTUAL FUND CONVERT TO AN ETF?

### KEY FEATURES OF ETFS

ETFs generally have four key features that have attracted financial advisors and institutional investors: (i) intraday trading; (ii) portfolio transparency; (iii) tax efficiency; and (iv) low cost. ETFs trade on exchanges so they can be bought and sold throughout the trading day while mutual funds are bought and sold once per day as of the close of trading. Currently, ETFs, including active ETFs, are required to disclose their portfolio holdings on a daily basis to prevent premium/discounts to net asset value, so they are highly transparent products.

From a tax perspective, because most ETFs track an index, their portfolio turnover is low. They only buy and sell positions when the relevant index is rebalanced usually quarterly or annually. In addition, because most ETFs satisfy redemptions in-kind, they do not have to sell portfolio positions to raise cash to satisfy redemptions – thereby significantly limiting the potential for capital

gains distributions. In the case of ETFs in less liquid asset classes such as emerging markets, cash instead of in-kind baskets may be used in the purchase and redemption process, which may result in less tax efficiency and higher tracking error.

Finally, because nearly all ETFs currently track indices and are passively managed, they tend to have low management fees. Unlike mutual funds, ETFs do not have transfer agency expenses because shares are held in street name at various broker-dealers. In light of these factors, ETFs generally have low expense ratios compared to actively managed mutual funds.<sup>2</sup>

## ETF CLASSIFICATION

ETFs can be classified into three main categories: traditional, passive ETFs; fundamental ETFs; and actively managed ETFs.

**Traditional, passively managed ETFs** are designed to track established indices. Some examples of these types of ETFs are the iShares S&P, Russell, and MSCI series of ETFs. More than 80% of ETF assets fall into this category, which is dominated in the US by BGI (approximately 53% market share), State Street Global Advisors (22%) and Vanguard (10%).<sup>3</sup> Inverse and leveraged ETFs based upon traditional indexes also fall into this category.<sup>4</sup>

**Fundamental ETFs** limit their investment universe to the holdings within an index but the weightings of those holdings within the ETF do not correspond to the traditional index weightings of such holdings. Rather, ETF managers weight the index holdings based on their dividend yields, cash flows, P/E ratios, earnings expectations, etc. PowerShares and Wisdom Tree currently are the two main providers of fundamental ETFs, and offer ETFs covering a broad range of asset classes.<sup>5</sup>

**Actively managed ETFs** do not passively track an index. Rather, actively managed ETFs have a portfolio manager or team of investment professionals proactively trading the ETF portfolio. They typically seek to outperform a benchmark on a relative basis.

## ACTIVE ETFS LAUNCHED TO DATE

While some may consider fundamental ETFs active ETFs, their investment strategies generally prohibit trading the portfolio on a daily basis and limit investment discretion – limitations not typically associated with active management.<sup>6</sup> Rather, these ETFs generally restrict trading to a less frequent basis in order to prevent front running, and typically utilize a quantitative, rules-based investment selection process. Moreover, as noted, a fundamental ETF limits its investment universe to holdings within a particular index. Consequently, fundamental ETFs are not considered active ETFs for the purposes of this Strategy Brief.

As a result, Grail Advisors has the distinction of being the first sponsor to offer an active ETF.<sup>7</sup> Grail Advisors has launched one actively managed ETF to date and has others in registration with the SEC. In addition to the Grail Advisors ETFs, BGI, State Street and Vanguard have filed for active ETFs and Pacific Investment Management Co. (PIMCO) has filed to launch actively managed stock, bond, commodity and/or asset allocation ETFs as well as passively managed ETFs. PIMCO's active ETF launch is potentially significant and could draw additional established, active managers to the space.<sup>8</sup>

## CHALLENGES TO ADOPTION & GROWTH OF ACTIVE ETFS

### Front Running Risk and Premiums/Discounts to NAV

While active ETFs may hold promise for investment managers, there are significant impediments to widespread adoption – in particular, the requirement to disclose ETF holdings on a daily basis. As noted, ETFs, including active ETFs, are required to dis-

close their portfolio holdings on a daily basis. The disclosure of holdings is intended to prevent premiums or discounts to an ETF's net asset value (NAV), which could negatively impact investors.

With index-based ETFs this requirement is not problematic because (i) all indices have a published methodology and index positions are already disclosed, and (ii) they rebalance infrequently, usually on a quarterly or semi-annual basis. Fundamental ETFs, although constructed differently, track indices and only rebalance two to four times a year as well. In contrast, actively managed ETFs have portfolio managers who may actively trade positions each trading day and publishing holdings at the end of each day could lead to front running.

An active ETF manager may be at risk of revealing trading strategies, research and best ideas, which form the basis for seeking to deliver excess returns and distinguish the manager from peers. This risk is magnified for funds that hold mid- to small-cap names, which may have limited liquidity. It may take longer than a day to build or divest a position in the portfolio, creating a front running opportunity for competitors to the disadvantage of the ETF investors.

To satisfy the daily disclosure requirement, some ETF sponsors are advocating the use of tracking portfolios that would serve as a proxy for the ETF's holdings. However, it is unlikely the SEC will anytime soon waive the daily disclosure requirement of actual portfolio holdings because insufficient disclosure could lead to premiums or discounts to the ETF's NAV to the detriment of an ETF's investors.<sup>9</sup>

While Grail Advisors has launched an actively managed fund that discloses the fund's holdings daily, there are two aspects of the Grail ETFs that must be considered. First, the Grail American Beacon Large-Cap Value, is subadvised by multiple managers so the disclosure of the aggregate fund holdings, as opposed to holdings selected by individual managers, will shield to a greater degree the stock-picking strategies of individual managers. Second, the fund is in the large cap category, generally considered a liquid asset class. As noted, for less efficient asset classes such as small cap and emerging markets, disclosure of holdings may pose a more significant risk of front running.<sup>10</sup>

As a result, while transparency is one of the key features of ETFs, in the case of actively managed ETFs, transparency may be a detriment.

### **Limited Track Record**

Another impediment to the success of active ETFs is the lack of track records. Track record is typically not an issue with traditional ETFs as the index may be well recognized and generally has a previous history. A new active ETF faces similar challenges as a new mutual fund in that potential investors cannot see the results of the manager's investment process. Investors and financial advisers typically look for at least a 3-year track record before investing. This challenge could be mitigated to some extent if the ETF sponsor is a well-respected investment manager with a strong brand, the ETF represents a high-demand, unique product, or there is a track record for the strategy in another product package, such as a mutual fund or separate account.

### **Potentially Lower Fees**

To date, one of the main advantages of ETFs is their generally lower costs relative to mutual funds. As previously noted, nearly all ETFs are passively managed to track indices so they tend to have low management fees. Additionally, the lack of transfer agency expenses further reduces the ETF cost compared to mutual funds.



However, while recent active ETFs are priced below their mutual funds counterparts, their expenses are notably higher than passive ETF strategies. As of year-end 2008, the median large cap value mutual fund had an expense ratio of .90% and Grail American Beacon Large Cap Value ETF has an expense ratio of .79%.<sup>11</sup> By comparison, the iShare Russell 1000 Value Index Fund, a passive index-based ETF, has an expense ratio of .20%.

Furthermore, if intermediaries begin to charge sub-transfer agency fees or revenue sharing, as is common practice for mutual funds, there could be additional fees levied on ETFs and ETF investors, further reducing cost benefit associated with ETFs in general.

### **Tax Consequences**

Depending on their investment strategy and process, active ETFs may trade frequently and possibly generate capital gains. Accordingly, one of the main benefits of ETFs (tax efficiency) may not be realized to the same degree as expected with passive, index-based ETFs. Historically, ETFs have distributed nominal capital gains because most track indices and therefore have low portfolio turnover. In the case of actively managed funds, including actively managed ETFs, investors would expect a higher turnover rate, which could result in lower tax efficiency.<sup>12</sup> Nonetheless, ETFs, including active ETFs, generally have a structural advantage when it comes to tax efficiency, because ETFs generally satisfy redemptions-in-kind as opposed to in cash.

With respect to specific active ETFs, the question will be whether the ETF's investment strategy and asset class has sufficient liquidity to rely upon the redemption-in-kind process. As noted, in the case of ETFs in less liquid asset classes, cash instead of in-kind baskets may be used in the purchase and redemption process, which may result in less tax efficiency and higher tracking error. To the extent the active ETF is not highly tax efficient, another benefit generally associated with ETFs would not be realized.

### **Distribution of Active ETFs**

The first traditional ETF launched in February 1993. However, asset flows into ETFs did not take off until 2000 when BGI introduced a complete line of ETFs – making it possible for investors to build an entire asset allocation using ETFs. Moreover, wide adoption of ETFs required significant investor and intermediary education. Both BGI and State Street Global Advisors, the two largest ETF sponsors, concentrated their sales efforts on educating advisors on ETFs, the benefits of their structure, how the indices were constructed and strategies to use them in a diversified portfolio.

Many advisors today still do not fully understand the complexity of the creation/redemption arbitrage process, which helps maintain narrow premiums/discounts to NAV. The introduction of actively managed ETFs adds another dimension of complexity, and advisors, especially in the current market environment, must be educated on how they are different from passive, index-based ETFs as well as actively managed mutual funds.

Additionally, to date ETFs do not employ 12b-1 fees to compensate intermediaries for distribution and shareholder servicing activities. Anecdotally, at least one significant intermediary is investigating how revenue sharing might be charged to ETF sponsors for distribution within its financial advisor network. In this regard, actively managed mutual funds would appear to have an ad-



vantage in light of the widespread adoption of 12b-1 fees by mutual funds and the revenue sharing and shareholder servicing arrangements prevalent in the mutual fund distribution infrastructure.<sup>13</sup>

### Importance of Trading Volume

In order to attract investors and maintain market maker commitment to an ETF, trading volume is critical as adequate trading volume ensures reasonable bid-ask spreads and minimizes the cost of trading ETFs. Currently, ETF investors and market makers expect trading volume of at least 100,000 shares daily. To monitor for early indications of the likely success of active ETFs, a key metric to follow will be whether they generate sufficient trading volume. To date, the Grail Advisors active ETF has suffered from low trading volume.

### CAN A MUTUAL FUND CONVERT TO AN ETF?

Some mutual fund sponsors are considering converting their mutual funds to ETFs as a means to enter the ETF space - particularly those investing in highly liquid asset classes with low portfolio turnover in light of the daily portfolio holding disclosure requirement. To accomplish this objective, a fund sponsor would have to file for exemptive relief on behalf of newly created ETFs and reorganize their existing mutual funds into the newly created ETFs – after approval by both the fund's board of directors and its shareholders.<sup>14</sup> The fund sponsor would have to assure the board and shareholders daily disclosure of holdings will not harm shareholders as well as address operational considerations. For example, industry-wide, mutual fund shareholders hold approximately 15% of fund shares directly with mutual fund transfer agents (i.e., in the shareholders' names) while the balance of shares are beneficially owned by shareholders through a myriad of financial intermediaries. In the case of ETFs, only a handful of intermediaries hold shares directly with the ETF. These two different holding scenarios would need to be reconciled as part of any conversion to an ETF format.<sup>15</sup>

Moreover, unlike mutual funds, most ETF investors cannot purchase or redeem ETF shares directly with the ETF but must transact in the secondary market (i.e., purchase on an exchange). This difference is one of the key reasons ETFs need exemptive relief from the requirements of the Investment Company Act.<sup>16</sup> Because the right to redeem directly from a mutual fund on a daily basis is one of the most fundamental rights of a mutual fund shareholder, it's possible the Securities and Exchange Commission (SEC) would object to a mutual fund converting to an ETF format and eliminating this right in the process. However, it's not clear whether the SEC could or would prevent a conversion or delay the process due to public policy concerns. In either case, the fact a conversion to an ETF format requires both board and shareholder approval should address any public policy concerns.<sup>17</sup>

An alternative would be the Vanguard approach where Vanguard's ETFs are issued as a separate share class of some of their index mutual funds, as opposed to separate legal entities as is the case with all other ETF providers. However, Vanguard has patented this structure. While Vanguard apparently is willing to license the patent, no ETF sponsor has done so to date. Neither has any firm challenged the patent.

So, can a mutual fund convert to an ETF? The short answer is yes, in theory. However, as noted, there are several practical considerations that must be addressed and the SEC's perspective is unknown at this time. While a fund sponsor will blaze the trail sooner or later, as previously noted there are nevertheless impediments to widespread adoption and growth of active ETFs.



## CONCLUSION

While actively managed ETFs are an important innovation, they do not necessarily deliver all of the key features investors and intermediaries have come to expect from ETFs. As a result, actively managed ETFs do not pose an immediate threat to actively managed mutual funds. Nevertheless, the following developments should be monitored, which could alter this conclusion and possibly accelerate the adoption and growth of active ETFs:

**Elimination of 12b-1 fees.** While unlikely in the near future, if the SEC eliminates 12b-1 fees, the distribution landscape for ETFs, including active ETFs, would be much closer to the mutual fund distribution landscape. In the meantime, look for intermediaries to seek compensation from ETF sponsors for distribution and shareholder servicing activities – particularly, sub-transfer agency fees.

**PIMCO gathering significant assets.** If an established manager such as PIMCO gathers significant assets in active ETFs, mutual fund sponsors will have to respond. Similarly, if BlackRock leverages the iShares brand to successfully launch active ETFs, fund sponsors would have to respond.

**Insufficient trading volumes.** On the other hand, generating sufficient trading volumes is critical to the success of any ETF as noted. If active ETFs fail to generate sufficient trading volumes, they will have limited success.

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For ETF sponsors, SEI offers a flexible and scalable solution that provides managers the ability to focus on revenue and growth while SEI manages key outsourced functions. SEI's integrated, one-stop solution includes:

- Fund accounting and administration
- Authorized Participant (AP) processing
- Custody and transfer agent
- Distribution services
- Compliance support



<sup>1</sup> Cerulli: The Global Edge ETF Issue June 2009. SEI calculates a 29.6% CAGR for US-based ETFs from 2000, when BGI began actively promoted iShares, through June 2009 compared to a growth rate of 2.6 % for mutual funds over the same period.

<sup>2</sup> According to Lipper, actively managed mutual funds had an average expense ratio of .712% in 2008 while index funds, including ETFs, had an expense ratio of .262%.

<sup>3</sup> ProShares and PowerShares each control approximately 5% of the US ETF assets WisdomTree, Van Eck, Bank of New York and others split the remainder. In Europe, the market is dominated by three players: BGI (approx. 40%), Lyxor Asset Mgmt (22%) and Deutsche Bank (18%). Source: BGI.

<sup>4</sup> Inversed and leveraged ETF sponsors provide prospectus disclosure regarding holding periods and related tracking issues. Recently, a few influential intermediaries ceased selling these specific types of ETFs to their retail customers related to tracking issues.

<sup>5</sup> Fundamental ETFs were launched in December of 2005 to great anticipation. Even with the backing of well-regarded financial professionals such as Jeremy Siegel and Rob Arnott, fundamental ETFs have experienced limited flows with the exception of a few funds. The limited success of fundamental ETFs is due in part to their short track record when compared with actively managed mutual funds, passively managed ETFs and index mutual funds. Also a factor is the lack of recognizable brands at the firm and index levels.

<sup>6</sup> For example, of the five “actively” managed PowerShares ETFs, two have approval to trade throughout the day because they both invest in large, liquid holdings. In addition, these PowerShares ETFs use quantitative, rules-based investment strategies as opposed to qualitative strategies. The other three PowerShares ETFs have trading restrictions in place to discourage front running

<sup>7</sup> Bear Stearns launched the first actively managed bond ETF in May 2008 but it was liquidated in October 2008.

<sup>8</sup> Russell Investments, a recognized index provider, has filed to launch a series of ETFs however they have not provided details on the strategies. There is speculation they may be active ETFs.

<sup>9</sup> With an ETF trading throughout the day and market makers not made aware of changes to the portfolio, the ETF could experience significant premiums and discounts to NAV. Additionally, in light of heightened scrutiny of leveraged and inverse ETFs from a suitability perspective and questions regarding potential impact to market volatility, the SEC is likely to proceed with caution before agreeing to anything other than daily holding disclosure

<sup>10</sup> Grail Advisors has filed for four additional ETFs that will be actively managed by a single investment manager.

<sup>11</sup> Strategic Insights, 2008 Annual Mutual Fund Industry Fee and Expense Benchmark.

<sup>12</sup> While some fundamental ETFs have turned over more than 100% of their portfolios, they have used tax loss harvesting to prevent the distribution of capital gains.

<sup>13</sup> 12b-1 reform is an on-again, off-again SEC priority. Currently, fundamental 12b-1 reform is unlikely. Additional guidance for fund boards to consider when adopting and renewing 12b-1 plans is the likely extent of any SEC action in the near future.

<sup>14</sup> If appropriately structured, the reorganization should qualify as tax-free reorganization and not result in capital gains or changes to holding periods.

<sup>15</sup> In summary, shareholders who own shares of the mutual fund directly would need to open a brokerage account into which their new ETF shares would be transferred as part of the conversion process. To the extent a shareholder did not open a brokerage account, their interest would be liquidated and cash proceeds provided to them – all of which would be described in the proxy statement. Of course, it would be in the interest of the fund sponsor to proactively facilitate this process by partnering with a broker-dealer or otherwise.

<sup>16</sup> Conversely, broker-dealers, market makers and some large institutional investors may trade large blocks (i.e., creation units) of the ETFs' shares directly with the ETF. For index-based ETFs, these investors may deliver the basket of securities representing the index being tracked by the ETF when they purchase ETF shares. When selling a large block of ETF shares, these investors will accept the basket of securities in exchange for their ETF shares. It is this redemption-in-kind process in particular, that results in index-based ETFs being highly tax efficient. The ability of institutional investors and dealers to transact directly with the ETF also is key to minimizing the premium-discount between the ETFs NAV and market price.

<sup>17</sup> It is possible a shareholder voting against the conversion could file a lawsuit, a shareholder generally would not prevail if the conversion is consistent with the fund's organizational documents and applicable state and federal law (in particular, board and shareholder approval and proxy disclosure requirements).