

## Active ETFs and the Opportunities for Investment Managers

Media coverage about active ETFs has seemingly been non-stop over the past several months. In this *Issue Brief*, we strip out the hype and impartially consider the pros and cons of active ETFs and the opportunities for investment managers.

Both ETFs<sup>1</sup> and active ETFs are designed to offer liquidity, lower expenses, transparency, trading flexibility, and significant tax advantages over mutual funds. Active ETFs offer the features of ETFs combined with an investment process that provides the opportunity for above-average returns (where average is defined as matching the performance of the index/benchmark).

Active ETFs are an evolution in the distribution of an investment manager's acumen. Nevertheless, our evaluation suggests that active ETFs are generally a packaging story. Absent a distinguishing strategy combined with effective distribution, there is no compelling urgency for investment managers to build active ETFs in the near term.

### The Pros and Cons: Active ETFs and Mutual Funds

**Taxes** – Undeniably, active ETFs provide more favorable tax treatment for investors than mutual funds. Mutual funds employ a highest-in, first-out tax treatment that frequently creates unrealized gains in the portfolio that may result in taxable distributions to shareholders. In contrast, active ETFs employ a lowest-in, first-out strategy that can minimize or eliminate capital gains distributions through the creation and redemption process whereby the portfolio manager may be able to eliminate the lowest-basis holdings.

Congressional interest in more favorable tax treatment for mutual funds seems to be gaining momentum. Most often discussed is the elimination of taxes on capital gains distributions until the investor sells his shares. While active ETFs would still have an advantage, that differential would be tempered.

It has been suggested that active ETFs might not be as tax efficient as index-tracking ETFs due to increased turnover. Since active ETFs have been operating for only 1.5 years, no conclusion can yet

be drawn. That being said, from a tax viewpoint, active ETFs still offer a more favorable tax structure than mutual funds.

**Transparency** – Active ETFs must report their holdings daily to facilitate the creation and redemption process. Generally, mutual funds only report their ten largest holdings monthly. On its face, score another point for active ETFs.

It is precisely the frequency of that transparency that gives pause to active investment managers. Fear of revealing a manager's investment strategies and front-running – the ability of others to purchase or sell shares before the manager is able to establish or liquidate a particular position (and presumably at more favorable prices) – cannot be downplayed. This is a more significant concern for investment managers running niche strategies and/or where there is limited trading liquidity than for a highly liquid, large-cap strategy.

An initial response by some active ETFs was the multi-manager route, which precluded the ability to link an underlying manager with a specific exposure. However, a speedy evolution to single-manager offerings is underway. This takes us full circle to the transparency and front-running issues. For investment managers concerned about transparency, it is advantage: mutual funds.

**Arbitrage** – Arbitraging occurs when there is a differential between the share price of the offering and the NAV of its underlying holdings. Through the creation/redemption process (and the transparency of holdings), arbitraging opportunities are designed to be reduced. Such opportunities do not even exist for open-end mutual funds (the same does not hold true for closed-end funds).

Arbitrage is closely aligned with AUM and liquidity. Active ETFs with low AUM or small volumes of creation/redemption activity are at a disadvantage because the opportunity for arbitrage is much greater.

**Liquidity** – Liquidity in an active ETF requires demand, as defined by an active pool of buyers and sellers. As shown in the chart below, the 20-day average share and dollar volumes for these offerings remain low.

Investment Manager	Fund Name	Investment Style	Net Assets	20-Day Average Share Volume	20-Day Average \$ Volume	Inception Date	Expense Ratio (%)
PowerShares	PowerShares Active Mega-Cap	US Size Large Cap	\$ 2,000,000	1,718	\$ 32,865	4/11/2008	0.60
Grail Advisors	Grail American Beacon Large Cap Value	US Style Large Value	\$ 3,000,000	200	\$ 5,110	5/4/2009	0.79
PowerShares	PowerShares Active US Real Estate	US Sector REIT	\$ 3,000,000	1,205	\$ 31,041	11/19/2008	0.80
PowerShares	PowerShares Active Alpha Multi-Cap	Dividend/Fundamental	\$ 4,000,000	3,917	\$ 56,640	4/11/2008	0.75
PowerShares	PowerShares Active AlphaQ	Dividend/Fundamental	\$ 4,000,000	1,292	\$ 23,464	4/11/2008	0.75
PowerShares	PowerShares Active Low Duration	Fixed Income-Corporate	\$ 5,000,000	11,606	\$ 292,239	4/11/2008	0.29
WisdomTree	WisdomTree U.S. Short-Term Government Income*	Fixed Income-Treasury	\$ 20,000,000	11,849	\$ 296,817	5/20/2008	0.25
WisdomTree	WisdomTree Dreyfus China Yuan	Currency	\$ 127,000,000	56,257	\$ 1,428,258	5/14/2008	0.45
WisdomTree	WisdomTree Dreyfus Brazilian Real	Currency	\$ 97,000,000	76,036	\$ 1,761,754	5/14/2008	0.45
WisdomTree	WisdomTree Dreyfus Emerging Currency	Currency	\$ 27,000,000	33,986	\$ 709,968	5/6/2009	0.55
WisdomTree	WisdomTree Dreyfus New Zealand Dollar	Currency	\$ 13,000,000	14,950	\$ 332,937	6/25/2008	0.45
WisdomTree	WisdomTree Dreyfus Japanese Yen	Currency	\$ 11,000,000	1,465	\$ 39,808	5/16/2008	0.35
WisdomTree	WisdomTree Dreyfus Indian Rupee	Currency	\$ 10,000,000	4,691	\$ 114,226	5/14/2008	0.45
WisdomTree	WisdomTree Dreyfus Euro	Currency	\$ 9,000,000	6,779	\$ 154,358	5/14/2008	0.35
WisdomTree	WisdomTree Dreyfus South African Rand	Currency	\$ 5,000,000	3,401	\$ 90,827	6/25/2008	0.45

Total \$ 340,000,000 229,352 \$ 5,370,312

Average - All Active ETFs \$ 22,666,667 15,290 \$ 358,021

Average Less China Yuan and Brazilian Real \$ 8,923,077 7,466.1 \$ 167,715

Source: *ETF Industry Guide*, SPDR State Street Global Advisors, data as of June 30, 2009

\* Formerly, U.S. Current Income

Net assets for the 15 active ETFs in operation as of June 30 were \$340 million. If we eliminate the two that have arguably reached or are approaching breakeven, assets in the other 13 offerings, on average, were a meager \$9 million. The average share and dollar volumes are similarly low, and underscore the limited liquidity currently in most active ETFs.

**Expenses** – The media touts the lower expenses of active ETFs as compared to the average actively managed mutual fund, but does not focus on investment style and ability to deliver alpha, nor the deployment of 12b-1 fees, in reaching its conclusions. The investment style employed directly correlates with the expense ratio. As shown in the chart, the large-value active ETF, Grail American Beacon Large Cap Value, has an expense ratio of 79 basis points, which is 11 basis points lower than the average large-cap value fund and equal to the asset-weighted average for the category. In strategies such as large cap, there are fewer opportunities for active management to *consistently* deliver alpha over the benchmark. Is

the active ETF competing with the active mutual fund or the meaningfully lower cost of an ETF or passive mutual fund? We would argue that the real competition is the cost-effective passive vehicles.

#### Other Considerations

**Costs of Distribution** – Major distributors, such as the wirehouses and large regional brokerage firms, will continue to act as gatekeepers and limit the array of ETFs on their platforms. This means that an active ETF will need to satisfy all the distributor's due-diligence tests.

A major benefit of platform distribution is active selling, but it comes at a price. While an investor can buy any ETF through their broker, investor interest must be sparked by the fund's marketing efforts. These differences amount to a push or pull strategy – pay the platform or be faced with higher direct marketing costs.

**The Game Changer** – Vanguard, which is in registration for active ETFs, holds the game-changing hand. By offering ETFs as classes of its existing mutual funds, there is less risk to, and easier execution of, the strategy. Managers are able to divest unfavorable tax lots as a part of the creation/redemption process, which benefits all fund investors. Vanguard also offers its brand name, low-cost mantra, and performance record as added incentives. Most importantly, its patent constrains the ability of others to copy this approach – absent the payment of licensing fees.

**Investors** – Active investment managers use ETFs for cost-efficient, short-term exposure to a particular market segment, particularly when a flurry of cash needs to be deployed prior to implementation of the manager's strategy. Critically, the manager provides the alpha at all times. Unless an active ETF fills a distinct niche, purchasing that offering defuses the manager's *raison d'être*. The same argument may also hold true for institutional investors.

Retail investors are developing a greater appreciation for passive core investment strategies, their lower costs and their performance. As a result, the migration toward ETFs and index funds continues. We expect that the touted benefits of active ETFs may be a more challenging sale to this constituency.

**Performance** – The media cites intermediary interest in active ETFs, immediately followed by cautions about extensive performance monitoring prior to investment. No prospective investor should presume that a mutual fund manager will be able to deliver similar performance in an active ETF.

#### Wisdom Tree/Dreyfus

Dreyfus, one of the foremost institutional money market fund managers, joined forces with WisdomTree to create eight currency-styled active ETFs. These are not money market funds, but follow the tenets of Section 2a-7. In particular, these active ETFs are likely to appeal to institutional managers looking to hedge currency risks in their portfolios. Even with strong branding, a distinct investment acumen, and distribution, only the China Yuan and Brazilian Real active ETFs can be labeled "successful;" the Emerging Currency Fund is a distant third with only \$27 million in AUM.

Barriers to success may be lowered with household brands like PIMCO that have demonstrable performance records, distribution,

and comfort with transparency. Of the five active ETF offerings that PIMCO currently has in registration, most are designed for investors seeking short-duration fixed-income products, and all will follow actively managed investment strategies that are the hallmark of this firm.

Active ETFs provide another vehicle for an investment manager to package its capabilities. Because this is a nascent market, it will take time for most active ETFs to demonstrate consistency of performance, build liquidity, prove their lower cost, and confirm their lower risk. Sitting on the sidelines over the near term may be the appropriate decision for most investment managers.

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<sup>1</sup> In this article, we use the term 'ETFs' to describe the traditional index-based vehicles. Many of the arguments set forth herein are equally applicable to ETFs and active ETFs.