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Time Will Tell Worth of Actively Managed ETFs

By Tom Steinert-Threlkeld
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This is the week that actively managed exchange-traded funds get their biggest booster shot since they first arrived, less than five years ago.

Pacific Investment Management Co., aka PIMCO, launches the Total Return Exchange-Traded Fund (TRXT) on Thursday, which is March 1. Its manager: Bill Gross, who built the Total Return Fund into the world's largest mutual fund over the past 25 years. Its total assets exceed $250 billion by Morningstar's count, even after a down year in 2011.

"That will draw attention," said Noah Hamman, chief executive officer of AdvisorShares, a Bethesda, Md., marketer of actively managed ETFs. "But, mostly, it will take time," for actively managed ETFs to prove that they outperform passively managed funds. That is to say, index-based funds.

The $250 billion in the actively managed Total Return mutual fund dwarfs all the money held in actively managed exchange-traded funds. At the end of 2011, the 39 such ETFs held $5.2 billion in assets, all told, according to AdvisorShares.

By contrast, roughly $1.05 trillion was held in 1,030 index-based exchange-traded products at the end of 2011, according to statistics kept by the Exchange-Traded Fund Association.

Which makes the actively managed ETF almost a rounding error, in the overall scheme of these funds. ETFs now account for roughly 35% of daily volume on the New York Stock Exchange, notes James P. Palermo, vice chairman of asset servicer BNY Mellon.

But the takeoff is dramatic, by Hamman's count.

Compare their start, he says, to the start of index-based exchange-traded funds. These are funds which are passively managed. Their assets are placed in a carefully constructed marketbasket of shares in stocks or bonds that fit a benchmark index that is created by an index creator such as Russell Investments and is designed to stick closely to those components.

No "active" management required, where a human being tries to select stocks that outperform the market or its embodiment in a benchmark.

After the first three years, two index-based ETFs existed in 1995, according to Hamman. They counted $1.2 billion in assets.

After the first three years, 30 actively managed ETFs existed, he noted. By the end of that third year, which was 2010, they counted $3.1 billion in assets under management.

In the AdvisorShares construct, there are two ways to apply active management to exchange-traded funds.

One is to use rules to identify stocks or bonds that outperform their markets. The other is to use...human beings.

Take the rules-based approach, first.

The AdvisorShares TrimTabs Float Shrink ETF (TTFS) aims to beat the total return of the Russell 3000 Index, with less volatility.

Stock selection for TTFS is based on research by TrimTabs, an institutional research firm that looks at stock prices as a function of supply and demand rather than value.

That exchange-traded fund identifies companies which are buying back their shares (i.e., shrinking the float) and, at the same time, creating significant cash flow.

This becomes a way of identifying, in effect, a distribution to shareholders, Hamman said. And can be quantified by applying rules.

Then there is the Cambria Global Tactical ETF (GTAA), which invests in a variety of ETFs based on stocks, bonds, real estate, commodities and currencies. If a particular asset is moving above its average price for the past 250 days, then the fund buys into it. If it falls below, it moves out.

Again, quantifiable. But not based on an index, per se. Instead, designed to produce above-average returns.

Also pursuing the quantified approach is First Trust, marketer of the AlphaDex family of ETFs.

These take existing indices and tweak them to try to create greater performance.

Every stock is scored on the basis of five growth metrics and three value metrics. If a fund is looking for growth stocks, the growth scores are used; if value is the overriding measure, the value scores are used.

The growth stocks are measured on:

Three-, six- and 12-month price appreciation (i.e., momentum); One-year sales growth; and sales-to-price ratio.

The value stocks are scored on:

* Book value to price

* Cash flow to price

* Return on assets.

The funds charge 70 basis points in expenses, among the highest fee for any non-leveraged equity ETF. First Trust said that the upside performance will more than compensate for the higher fees.

The idea is to quantify what makes for a better fund and run that by repeatable rules.

In growth or value stocks, for instance, one principle is to avoid putting too much stock in stocks with large capitalizations, said Ryan Issakainen, senior vice president and ETF strategist for First Trust.

Using the Standard & Poor's 500, the bottom 125 stocks-those with the lowest scores for "investment merit"-are tossed out. Then, a weighting system sets in.

The 75 stocks that score the best in the model become 33.3% of the overall holdings in the fund.

Then, the next highest-scoring 75 for the next 26.7% and each 75 thereafter count for a progressively smaller slice.

The approach has worked well enough that assets in AlphaDex funds have increased from $150 million in 2007 to $3.5 billion last year.

Then, there is the human approach.

The WCM/BNY Mellon Focused Growth ADR ETF (AADR) from AdvisorShares invests in high-quality, large-cap growth stocks outside the United States.

These are firms with at least $3.5 billion in capitalization and consistent records for 10 years or more in delivering strong return on invested capital as well as earnings growth.

Out of 35,000 stocks outside the United States, only 200 to 250 may even meet the basic criteria. And the fund's manager, a human being named Duff Daniels, may only deem 35 to 40 worthy of being part of the fund's holdings.

But it's not clear that all this active management makes a difference.

Sharath Sury, executive director of the Institute for Financial Innovation & Risk Management research think-tank, this month presented data that said the result of stock and bond fund managers can be produced more cost-effectively with index funds.

Indexed investment fees range from one tenth of one percent 10 bps to one half of one percent 50 bps of a fund's assets. In comparison, hedge funds, for instance, can charge as much as 300 bps the assets under management plus an additional 2000 bps of any gain.

"In our study, some managers did indeed exhibit high, consistent skill and value," Sury said. "The trick is to weed out those who do not."

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