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The evolution of asset management through exchange-traded products.

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Real Potential or Active ETF Imagination?

Active exchange-traded funds turn four years old in April, but the kids are barely walking and talking.

Several early active funds have faded away, while most stand by watching money cascade into passive index ETFs. Still, asset managers are determined to power forward, planning more active equity and fixed income exchange-traded products.

Thus, the plight of active products provides fertile ground for the primordial ETF debate: Is the long-term success of the fund structure more dependent upon cost-effective indexing or cost-effective technology?

That question will not be answered for several years.

According to ETF issuer AdvisorShares, forty-one active ETFs traded on U.S. exchanges at the end of February, holding just $5.2 billion in assets. Moreover, half of the assets are split between two funds, the $1.4 billion Pimco Enhanced Short Duration (MINT) and the $1.2 billion WisdomTree Emerging Markets Local Debt (ELD).

Only 11 active ETFs specifically targeted equity returns, attracting just $102 million in assets. Compare this to the $939 billion invested in all equity ETFs or the $5.6 trillion held by stock funds, according to January data from The Investment Company Institute.

Active ETFs – particularly equity funds – aren't keeping pace. Should investors even care?

Portfolio Solutions Rick Ferri says no. Writing here as "The Indexer," he argues that outperformance is a myth propagated by the industrial fund complex and that actual outperformance is more about luck than skill. To celebrate the March 1 launch of the Pimco Total Return ETF (TRXT), Ferri questioned the utility of actively-managed ETFs .

Still, citing a 2006 Fama/French working paper, Ferri duly notes that a handful of active managers outperform, even when adjusting for cost and risk. He writes:

> "These so-called outliers may possess skill, if only they could be identified. Unfortunately, knowing that a manager had skill *ex post* doesn't help investors much, because we need to

> place our bets *ex ante*, and it's not possible to determine which managers will possess skill in the future. We only know that some will.

The semi-annual S&P Indices versus Active Funds Scorecard comes down, naturally, on the side of indexing. (Read the latest survey PDF.) But peruse the report and any betting person could be convinced that the odds for relative outperformance over an entire market cycle, adjusting for survivorship, are not so wide that they're not worth a punt.

Still any investor taking that chance on active-management must ask what price they are willing to pay for the *potential* of outperformance or even uncorrelated, market-neutral returns?

The $10 million, 75 basis point PowerShares MegaCap Fund (PMA), launched in early April 2008, has barely any investors, despite outperforming the 15 basis point iShares Russell Top 200 Index Fund (IWL) since that fund launched in late September 2009.

Some argue that the regulatory requirements of daily portfolio disclosure are too restrictive for active managers, marginalizing their alpha by broadcasting their moves. Both the iShares unit of BlackRock (BLK) and Eaton Vance (EV) are attempting to sway the U.S. Securities and Exchange Commission to permit more latent disclosure.

Other issuers have chosen to launch ETFs based on so-called "smart beta" indexing that effectively removes human discretion from otherwise active decisions. The PowerShares S&P 500 Low Volatility ETF (SPLV) is such a fund, attracting $1.4 billion in assets in less than a year after being launched by Invesco (IVZ).

To date, no company has more riding on the success of active ETFs than Bethesda, Maryland-based AdvisorShares, which sponsors 14 active ETFs, managed by a variety of sub-advisors from Accuvest to Trimtabs. Assets under management totaled $420 million at the end of February and the largest funds are the Active Bear ETF (HDGE) and the Cambria Global Tactical ETF (GTAA), each over $100 million.

For more on the challenges facings active ETFs, I asked Noah Hamman, CEO of AdvisorShares, to weigh in.

Who is buying active ETFs? Are active bond buyers different than active equity buyers?

> “ We mostly see financial advisers using active ETFs for their clients, but we have seen a few self-directed investors. I don't think the investors in active bond ETFs are much different, but considering the asset size of MINT and ELD, I expect there are some institutional investors. We have also seen institutional investors start to utilize some equity-based active ETFs.

How should an investor judge an active ETF? Over what time period and what risk level?

> “ That answer depends on the investment objective of the active ETF. If the active ETF is designed to provide relative returns against an index, then you are looking for outperformance over its benchmark. Active ETFs are fully transparent, so you can always see what the portfolio manager is doing, such as adhering to the investment strategy or chasing beta. Window dressing doesn't happen in these products.
>
> Some active ETFs are designed to provide better risk adjusted returns, which is often an important measurement overlooked when assessing the quality of an active ETF. Other

active ETFs are designed to be non-correlating to the other investment strategies in your portfolio to provide added diversification and lower overall portfolio volatility.

How do you explain your ETFs to investors who make decisions based only on recent results?

“ To keep the message strong, you have to start with the right message, which is that the benefits of active management occurs over multiple market cycles, not in a week or in a year. Most advisers who are invested in active managers look for philosophical changes in the manager's investment approach to make the decision to change their allocation. As an investment adviser, if you disagree with the direction your active manager is heading, that is the time to make a change, assuming the client's investment goal hasn't changed.

Are active ETFs handled differently than index ETFs by market makers and authorized participants?

“ It's very much the same. We notice some differences in that active ETFs don't have the type of trading volume that passive index ETFs have. Most investors in active ETFs are not trading the position, but are taking more of a dollar cost averaging approach to investing.

So, while market markers may not be constantly trading active ETFs shares, then they can make very tight markets when the underlying holdings in the active ETF are liquid. We always recommend putting in limit orders and utilizing either the sponsor or your trading desk to ensure best execution.

Where are active ETFs headed?

“ We see more mutual fund sponsors applying for active ETF exemptive relief. According to the ICI, 80% of equity mutual fund assets are in actively managed mutual funds. As more investors get educated on the benefits of active ETFs, we believe a significant portion of those assets will convert to the active ETF structure. No differently than how iTunes changed the way people access music and how it allowed all types of musician to access all types of listeners, professional money management, both transparent and liquid on universally accessible exchanges will have a similar impact.

Interview has been edited and abridged.
