The Future of Active ETFs

J.P. Morgan

Over the past few years, actively managed ETFs have begun to emerge as a quiet success story. What’s more, there’s good reason to think this trend is just getting started.

There are currently 55 actively managed ETFs listed in the U.S., with $9.6 billion in assets under management. More than half of those assets are housed in two PIMCO funds: the Total Return ETF (NYSE Arca: BOND, with $3.2 billion in assets) and the Enhanced Short Maturity ETF (NYSE Arca: MINT, with $2.1 billion in assets). There have been, however, other success stories: The AdvisorShares Ranger Equity Bear ETF (NYSE Arca: HDGE), for instance, has quietly amassed $326 million in assets, while providing short exposure to the market.

Compared with the potential of this market, however, the numbers so far are small. The U.S. ETF industry has $1.3 trillion in assets under management, 99% of which is invested in index products. In contrast, the broader mutual fund market has shifted decidedly toward actively managed funds: Of the $11.6 trillion in mutual fund assets, roughly $8.5 trillion is in actively managed funds (73%).

This discrepancy has issuers lining up at the SEC to issue actively managed ETFs. And while a few key impediments must be removed before the category can truly take off, there’s significant room for growth as things stand today—and reason to believe that those last barriers will be overcome.

The Case For Actively Managed ETFs

The case for actively managed ETFs is clear, and involves four main facets: cost, tax efficiency, intraday liquidity and distribution.

**Cost:** ETFs are well known for being low-cost instruments. Because ETFs cost issuers less to run than traditional mutual funds, they can be offered to investors at a lower fee. For instance, the asset-weighted average expense ratio for actively managed bond mutual funds was 0.66% in 2011, according to the Investment Company Institute. By comparison, the current asset-weighted average expense ratio for actively managed fixed-income ETFs is just 0.49%, despite those ETFs being much smaller, on average, than their mutual fund peers.

A great deal of media attention has been focused on the fact that actively managed ETFs are, on average, more expensive than index-based ETFs. However, this could be a faulty comparison, since actively managed ETFs will largely compete with actively managed mutual funds, and there, ETFs have a decided edge on costs.

**Tax Efficiency:** Thanks to the in-kind creation/redemption process, ETFs have demonstrated a long-term ability to deliver returns with greatly reduced capital gains distributions. For instance, over the past 10 years, the average actively managed small-cap mutual fund has distributed 4.1% of its AUM as capital gains each year, according to iShares. By comparison, long-running ETFs in the same category, like the iShares Russell 2000 Index Fund (NYSE Arca: IWM), have never distributed capital gains. The inherent tax efficiency of the ETF structure will be particularly important in the active space, where higher turnover increases the likelihood of capital gains distributions. Of note is that no actively managed equity ETF has paid out a capital gains distribution to date.

**Intraday Liquidity:** ETFs offer investors the ability to buy and sell on an intraday basis, compared with once-daily liquidity for mutual funds. While investors are less likely to use active ETFs than passive products in trading strategies, in today’s volatile market, the intraday liquidity offered by ETFs is welcome.

**Distribution:** From a fund provider’s perspective, ETFs offer instant distribution. Instead of having to get funds onto individual platforms (and paying associated fees), ETFs are available to anyone with a brokerage window. This alone is encouraging some asset managers to move into the space and offer investors a new way to access their products.

Examining BOND’s Success

The biggest success by far among actively managed ETFs is PIMCO’s BOND. It has been, in fact, the second-most-successful ETF launch of all time, trailing only the PowerShares Nasdaq-100 ETF (Nasdaq GM: QQQ) in terms of gathering assets. BOND’s success provides a number of guideposts to future success in the active space. For one, it suggests that investors will buy active ETFs, given the right circumstances. Second, it shows that actively managed funds benefit from being backed by a solid brand. Third, it
shows that performance matters, both on a historical and real-time basis.

One of the reasons for BOND’s quick success was that PIMCO marketed it as providing the same general performance as the landmark PIMCO Total Return Bond Fund. As such, BOND inherited the long and successful track record of PIMCO’s mutual fund in the eyes of most investors. It helped that BOND itself stormed out of the gates, significantly outperforming the mutual fund (and the broader market) over its first six months.

The track record issue is critical, however. Those who question the ability of actively managed ETFs to attract assets inevitably point to the fact that 39 of the 55 active ETFs on the market today have less than $50 million in AUM. But really, it should not be expected that most actively managed ETFs take off out of the gate. They need time to build a track record. If the traditional mutual fund world is any indication, most funds do not attract significant assets until they have a three-year track record and receive a good “star” rating from Morningstar. Firms getting into the active space should take note of this, and make sure they are in it for the long haul.

State Of The Market
In addition to firms like PIMCO, Northern Trust, WisdomTree and BlackRock—all of which have actively managed ETFs on the market today—a huge number of firms are lining up to enter the space. A large number of major players from the traditional mutual fund world have filed for exemptive relief with the SEC to launch actively managed ETFs, showing they are serious about entering the market: Alliance Bernstein, Dreyfus, Eaton Vance, Franklin Templeton, The Hartford, Janus, John Hancock, J.P. Morgan, Legg Mason and T. Rowe Price, to name a few. Yet, the strategy each firm is developing for entry into the ETF space is still evolving.

Less-Transparent Active
What is holding things up? The primary impediment to widespread adoption is that, currently, actively managed ETFs must disclose their full holdings on a daily basis. A number of large fund managers have expressed concerns about providing this level of transparency, worried that others will front-run their trades.

There are currently a number of proposals at the SEC that would allow for less-transparent active ETFs. Those proposals are under review and offer interesting solutions. Many remain hopeful that one or more proposals will eventually be approved. When that happens, the floodgates could open.

In the end, after all, an ETF is just a wrapper: a very efficient, effective and appealing wrapper for delivering investment returns. If the daily disclosure hurdle can be addressed, active ETFs could boom.

J.P. Morgan: Servicing The Active ETF Space
Actively managed ETFs place special demands on investment managers and service providers. Investment managers require increased flexibility and the ability to tap into assets across the capital markets spectrum. A global, tactical, go-anywhere manager, for instance, will need access to many global asset types. J.P. Morgan’s scope and size allows that manager to leverage J.P. Morgan’s firmwide resources and expertise on these asset categories.

J.P. Morgan’s fully integrated ETF services include subadvisory solutions, basket settlement services, cross listing, prime custody, derivatives collateral management, global custody, securities lending, fund accounting, fund administration and transfer agency services. Additional complementary services are available through J.P. Morgan’s Investment Bank including market making, authorized participant trading and product structuring. With its breadth, strength and market coverage, J.P. Morgan is in a unique position to provide global servicing and support to the actively managed ETF market.

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J.P. Morgan offers a market-leading, comprehensive suite of products for developing, launching and servicing ETFs. Our fully integrated ETF offering includes, basket settlement services, cross listing, prime custody, collateral management, index receipt agent, global custody, securities lending, fund accounting, fund administration, and transfer agency services. We leverage our global, firmwide operations and expertise in over 50 countries to provide assistance in launching new and innovative fund structures while engaging our ETF clients in a consultative process.

Our ability to bring together resources from the entire global franchise - including our Investment Bank, collateral management, prime custody, and futures and options groups - differentiates us from our competitors.

- Our Investment Bank is an authorized participant for all major ETFs and a market maker in all ETFs. It also provides additional complementary services around primary and secondary market trading as well as specialized ETF research.

- Our OTC Derivatives Collateral Management solution leverages our expertise in managing risk and exposure. We provide clients with a robust, scalable and cost-effective means of managing collateral and credit risk.

- For prime custody services, we offer comprehensive solutions that enable Prime Brokerage clients to use our core custody platform to hold long positions. Clients who participate in this integrated offering benefit from consolidated reporting, automated collateral movements and a single point of contact.

- J.P. Morgan has been consistently ranked as a top-tier futures and options broker with the number of futures and options contracts executed or cleared with J.P. Morgan outperforming the market across many exchanges.

We also work closely with external counsel, stock exchanges, registrars, brokers, subadvisors and depositories to oversee the business analysis, design, development, testing, procedures and control of new ETF products. In addition, our continued investment in technology has enabled us to expand our ETF offering, providing several industry “firsts.” Specifically, we have assisted our clients in offering the first ‘class of share’ ETF, the first enhanced index, inverse index and enhanced inverse index ETFs, and the first series of foreign currency based ETFs. We also developed the infrastructure to support long-short ETFs leveraging our integrated prime custody solution. Additionally, we have assisted with the compilation and dissemination of complex intraday indicative valuation files and the creation of an ETF dividend reinvestment program.

J.P. Morgan has placed significant strategic importance on the ETF marketplace and we have the experience and full range of capabilities to serve the needs of investment managers.