

P>CIFIC|AM

Active, Passive and In-between.

# EXAMINING THE ETF LANDSCAPE

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Historically, most exchange traded funds (ETFs) have been passive. But that's starting to change, with more and more active ETFs coming to market. The growth in active ETFs is largely the result of traditional fund managers realizing that the ETF is a great wrapper and investment vehicle for a broad range of strategies. The result is that investors have more choice than ever before.

## > ACTIVE VS. PASSIVE ETFS DEFINED

Passive ETFs are designed to track a particular index or sector — and, hence, do not aim to “beat the market.” Rather, they tend to own a basket of securities (based, for example, on market capitalization). The buying, selling and rebalancing process for these strategies is based on a specific set of rules outlined in the product’s methodology.

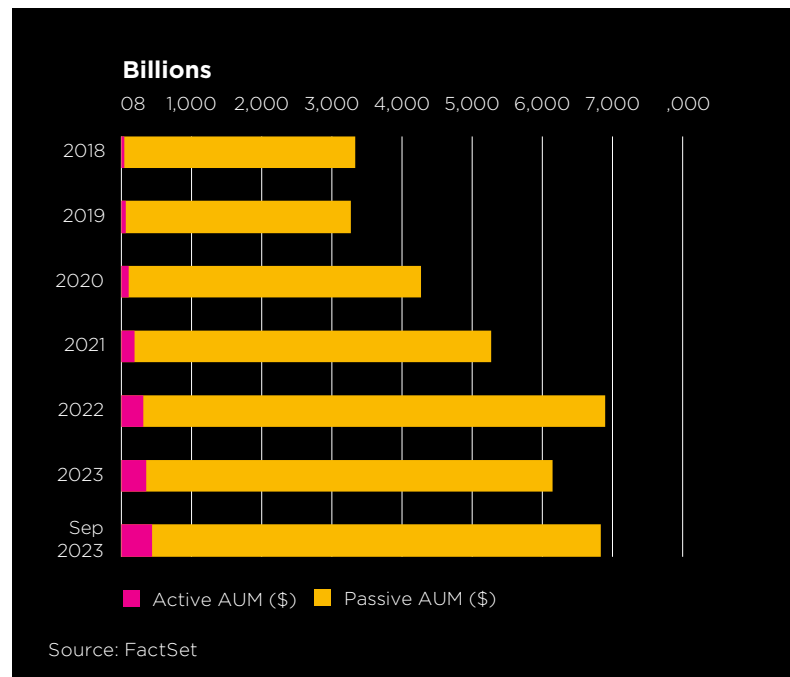
While they can be rebalanced occasionally if, say, an index is altered, they don’t engage in buying or selling for the

purpose of generating excess returns.

Active ETFs, by contrast, are designed with the goal of outperforming a benchmark index or sector. Helmed by professional fund managers, these ETFs may employ a proprietary mix of quantitative and qualitative investment strategies to inform buy and sell decisions. Ideally, an active ETF will deliver ‘alpha’ to investors, that is, a risk-adjusted return that beats a given benchmark.

## > WHY INVESTORS MIGHT CHOOSE EITHER AN ACTIVE OR PASSIVE ETF

Both styles of ETFs have merits. Passive ETFs might be the right choice for investors who seek index-like returns and prioritizes very low fees. Meanwhile, investors may gravitate toward active ETFs due to a desire to outperform the market — and a belief that their ETF is led by professional managers with the ability to do so.



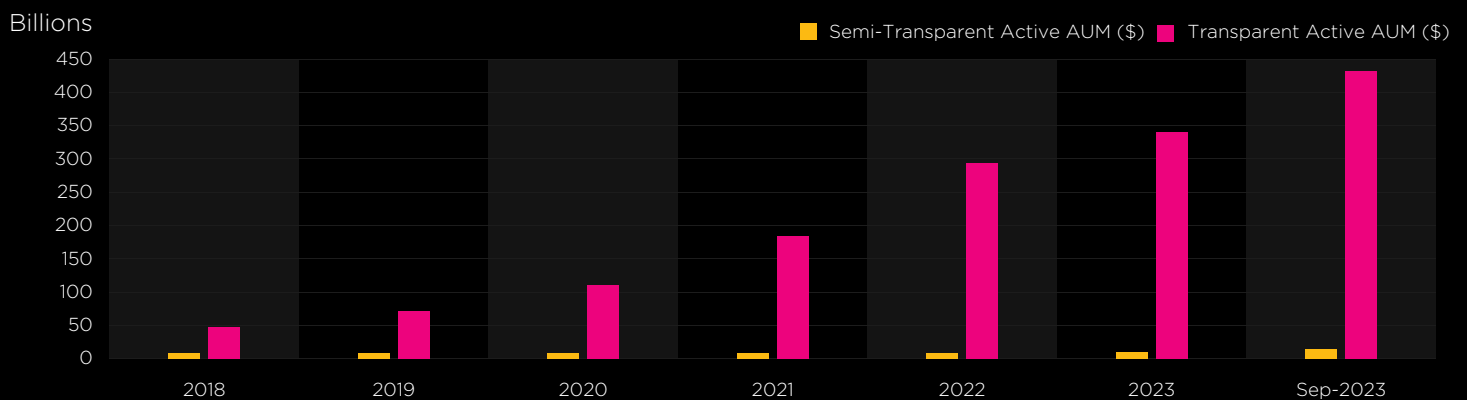
# > ACTIVE FULLY TRANSPARENT ETFS VS. SEMI-TRANSPARENT ETFS

As with passive ETFs, active ETFs have traditionally been fully transparent — offering investors daily insight into their full list of holdings, in addition to indicative net asset values (NAVs) throughout the trading day. This transparency has its advantages, as many investors want to know what exactly they own (or will own, if they go ahead and purchase an ETF).

Some managers, however, are concerned about revealing their proprietary trading strategy. Additionally, managers may be worried about the potential for “front running” — the risk that other market participants, seeing exactly what an ETF is buying or selling, can anticipate their trades — buying before an ETF is likely to buy, and selling before an ETF is likely to sell.

Managers concerned about front-running and exposing their security selection and trading secrets use semi-transparent wrappers and managers that are not worried about these things have used the transparent active wrapper. Many managers became comfortable with the transparent wrapper when it was the only option for active ETFs and have continued incorporating them within their investment strategies.

To combat the potential for front-running, there are a growing number of active, semi-transparent ETFs (approved by the SEC as of May 2019). These ETFs still publish an indicative NAV throughout the trading day, but they don't publish an exact list of their full holdings daily.



Source: FactSet

Instead, they may publish a so-called “proxy basket” of securities that roughly track the actual underlying portfolio. This proxy basket helps inform ETF investors and also helps Authorized Participants (APs) efficiently engage in the creation/redemption process by giving them a good sense of when arbitrage opportunities arise.

## > UNDERSTANDING THE DIFFERENT SEMI-TRANSPARENT ETF WRAPPERS

Under the umbrella of active semi-transparent ETFs, there are a variety of structures. What they have in common is an attempt to balance the need for enough transparency with the desire to shield day-to-day trading activity from market participants.

Here's a quick rundown of the different semi-transparent ETF structures — and what sets them apart:

- **ActiveShares (Precidian Model):** The ETF discloses the full underlying portfolio daily to a representative of the Authorized Participant. Full disclosure to the market happens quarterly.
- **Shielded Alpha ETFs (Blue Tractor Model):** The full

list of holdings is disclosed to the market daily, but portfolio weights are withheld. Complete portfolio disclosure (including weights) happens quarterly.

- **Active ETFs (T. Rowe Price Model):** A proxy portfolio is published daily. Full disclosure happens quarterly.
- **Periodically-disclosed Active ETFs (Natixis Model):** A proxy portfolio is published daily. Full disclosure happens quarterly.
- **Fidelity ETF:** Each trading day, the ETF publishes a tracking basket, as well as the percentage overlap with the actual portfolio. Full disclosure happens on a monthly basis.

## > DIFFERENCES IN BENCHMARKING: ACTIVE VS. PASSIVE ETFS

Active ETFs have more flexibility to choose their reference benchmark or even to choose multiple benchmarks. Active ETF managers can then use the securities and financial instruments within their stated strategy to attempt to outperform their benchmark(s). Conversely, passive ETF managers can choose a specific method to track their one benchmark. Their selection methodology can be full replication, optimization or synthetic replication.

- **Full Replication:** The ETF holds every security at the same weight as in the benchmark index.
- **Optimization:** When an index includes more constituents or difficult-to-trade constituents than the ETF can handle in terms of trading costs, the ETF

will hold an optimized sample of the index in terms of costs, correlations and exposure.

- **Synthetic Replication:** The ETF does not buy the underlying securities of its index and instead uses derivatives to swap the performance of the index for a defined fee. Full disclosure happens on a monthly basis.

Almost all fixed income ETFs use an optimization approach because most fixed income indexes hold thousands of bonds that may or may not have traded recently. The fixed income portfolio manager will utilize a more liquid sample of the bonds to replicate the desired performance.

# > SMART BETA ETFs: A HYBRID APPROACH TO INVESTMENT MANAGEMENT

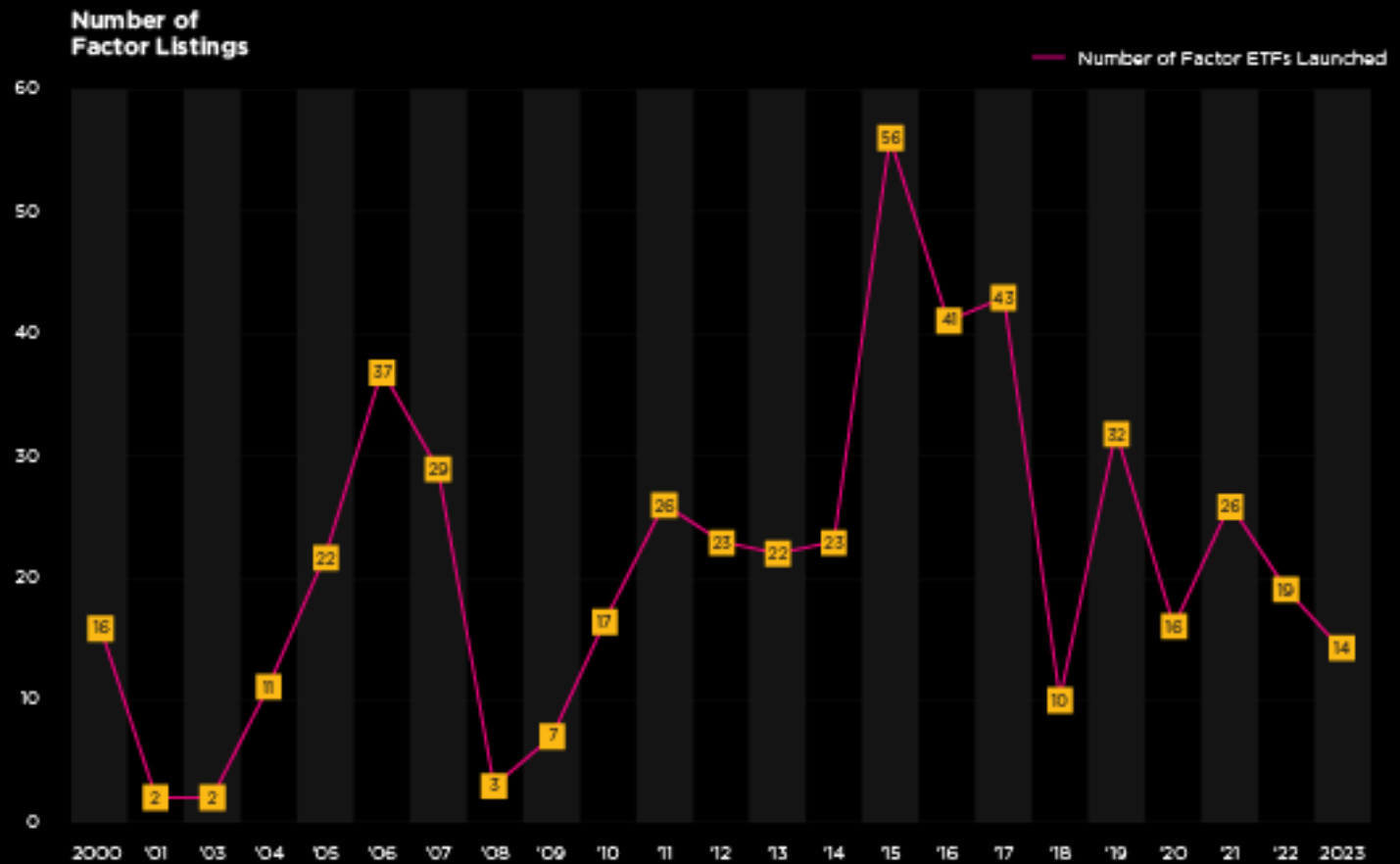
ETFs that combine elements of active and passive approaches employ so-called Smart Beta strategies and do not track a straightforward index like the Nasdaq-100® or S&P 500. Rather, these strategies create a more complex set of screening, filtering, weighting and/or rebalancing rules. This could be interpreted as a hybrid approach because it takes the guidelines an active manager may follow and codifies them into a new Smart Beta index that an ETF can track.

Issuers have expanded into launching ETFs focusing on one or more factors that are meant to be used to outperform different parts of the economic cycle as well.



## Smart Beta, defined:

Using a rules-based approach instead of discretionary stock-picking



Source: FactSet

# > MUTUAL FUND AND SEPARATELY MANAGED ACCOUNT CONVERSIONS TO ETFS

The popularity of ETFs among investors shows no signs of abating. As a result, some mutual funds, as well as separately managed accounts (SMAs), are converting to ETFs. Conversions allow for active management offered in a form that can be more tax-efficient, more liquid, more transparent, more accessible (intraday trading/can be purchased on a simple brokerage app) and potentially with lower fees than mutual funds or SMAs. Converting is not without its hurdles, however. The switch from a mutual fund or SMA to an ETF involves operational challenges, significant communication with investors, and in some cases, shareholder approval.

## Number of Mutual Fund to ETF Conversions



\*Through October 2023

Source: Edgar

## > CONCLUSION

The scope of ETFs has broadened considerably in recent years. Investors can still access a wide range of passive vehicles, but now have the choice of adding active ETFs to their portfolios. To help ensure you own the ETF that best fits your objectives, understanding the nuances behind the different products is a must.

## > DEFINITIONS

**Alpha:** a term used to describe an investment strategy's ability to beat the market. Alpha is also referred to as excess return or the abnormal rate of return in relation to a benchmark, when adjusted for risk.

**Nasdaq-100®:** The Nasdaq-100 is a stock market index made up of equity securities issued by 100 of the largest non-financial companies listed on the Nasdaq stock exchange.

**S&P 500:** The Standard and Poor's 500 (S&P 500) is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.



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Investing involves risk. Principal loss is possible.

ETFs are subject to additional risks that do not apply to conventional mutual funds, including the risks that the market price of an ETF's shares may trade at a premium or discount to its net asset value, an active secondary trading market may not develop or be maintained, or trading may be halted by the exchange in which they trade, which may impact an ETF's ability to sell its shares. Shares of any ETF are bought and sold at market price (not NAV) and are not individually redeemed from the ETF. Brokerage commissions will reduce returns.

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