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Leveling the Playing Field for Active Managers

PREFACE

20 years ago, my article "ETFs Can Benefit Active Managers" appeared in the January 2001 Journal of Indexing. Everything I wrote then still applies. Equity ETFs **are** mutual funds governed by the Securities Act of 1940. ETFs are simply and definitively a more efficient structure. The tax efficiencies of ETFs are mostly understood. What very few seem to recognize are all the other ways the ETF structure benefits fund managers and investors. Industry pundits like to say the only differences between ETFs and mutual funds are the wrappers. In truth, the ETF structure creates many advantages for portfolio management teams and shareholders. Nevertheless, from 1993 through 2019, only about three dozen actively managed equity ETFs were launched on US exchanges. During the past 18 months however, the growth in new entries has been hyperbolic. This increase coincides with newly introduced technology advantages that have made it more beneficial than ever to active managers to adopt the ETF structure with less fear of exposing their alpha generation and portfolio trading strategies.

Actively Managed Funds with the Traditional Structure

The underlying trading and fund accounting system technologies have improved considerably for these funds since 2001. Most fund expense ratios have been lowered and upfront loads have been eliminated. Competition with ETFs is at least partially responsible for that.

In virtually all other ways, actively managed equity funds in mutual fund complexes are still managed using the same way in 2021 as they were in 2001. Here are the key steps:

1. The fund manager and the research staff review the stocks currently in the fund's stock portfolio using screens and pooled market intelligence to determine if there are stocks that need to be sold as a result of recent reports or news.
2. The research staff presents the manager with a list of purchase candidates. Often, they are scored by some internal methodology and compared with the existing portfolio to determine potential purchases and corresponding sales if indeed any are deemed necessary.
3. Typically, on most days, trades are not necessary for investment decision reasons, but due diligence requires they are checked each day.
4. Nevertheless, the fund manager may need to make trades in accordance with cash outflows vs. inflows. The fund generally has a policy-driven cash-equivalent position that may vary from 0.5% to as much as 5% depending on the liquidity of

the holdings. Significant deviations in from that target in either direction due to net flows reported to the manager from fund accounting will result in trades.

5. When trades are needed and generally using some risk management technology, the proper number of shares to be bought or sold are determined. The technology is employed to make sure the risk profile of the fund does not stray too far from its benchmark.
6. The indicated trades are then sent to fund accounting to check if sales will result in significant capital gains beyond a policy-driven limit. If the potentially realized capital gains are too high, the manager will need to override the indicated trades and sell other positions to avoid the larger realized gains. Often those positions are stocks that have been held the longest. Some mutual-funds are categorized as tax-efficient. These funds often restrict trading to selling only the most problematic current positions to minimize triggering capital gains.
7. The trades are sent to the fund's trading desk for execution often with specific instructions and price limits. Frequently, not all the executions take place in one day as the professional traders try to work the market to time the trades.
8. Behind the scenes, the cash management team works actively to sweep net flows together with dividends and interest earned into the cash account. They then manage the cash account liquidating or investing in short-term securities of various types. This often requires some research and technology. The fund accounting team then does reconciliation, informs the team leaders and the entire process resumes the next day.

Actively Managed Funds using ETF Structure

The process is simplified enormously with the ETF structure. However, the first three steps are the same and step five becomes step 4:

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benchmark.

5. The manager sends the trades to the fund’s operations team. Using software, the operations team calculates the new creation and redemption baskets needed for registered market makers to buy and sell new fund shares.
6. The operations team then posts these baskets to Depository Trust Clearing Corporation (DTCC). The DTCC then publishes the lists where its accessible to market makers.

Advantages of the ETF Structure to Fund Management Companies

The ETF structure is more efficient for fund management companies in myriad ways:

1. The contribution and redemption baskets of stocks are considered free receipts and deliveries by the US Internal Revenue Service and therefore, redemptions do not result in capital gains. This rule applies regardless of whether the baskets are standard or customized.
2. Thus, the structure eliminates the need to take capital gains into account for trading decisions.
3. The structure also effectively insulates the fund from needing to make trades on market exchanges, thus avoiding capital gains.
4. Still another advantage of the structure comes in insulating the management team from needing to make trades resulting from net flows.
5. Taken together, all four points combine to ensure that all trading decisions are made purely in the best investment interests of the fund in the perspective of the fund’s management teams.
6. Another advantage over the inefficient mutual fund structure is that the ETF structure eliminates the need for a cash position for daily purchases and sales. Since cash underperforms equities in most market environments, this has the effect of eliminating cash drag on the fund’s returns.
7. The structure greatly simplifies and reduces the costs of the transfer agency system and shareholder recordkeeping.
8. Another major savings in manhours comes from the efficiency in running the fund. There is no need to work trades, no need for cash management and no need for fund accounting to work on minimizing capital gains.

Advantages of the ETF Structure to Investors

1. There are no redemption fees, loads or other administrative fees.

2. Taxable investors have incurred no capital gains in more than 95% of US equity ETFs since the structure was first offered in the 1990's.

3. The collective securities exchanges provide an open and competitive marketplace where expense ratios can be compared in context. This has generally, albeit not always, resulted in lower fees for investors in ETFs, both actively managed and indexed. As mentioned above, lower operational costs to the management company also justify this differential.

4. Empowering fund managers to make trading decisions solely upon their investment acumen gives shareholders the best chance to receive superior returns. It is akin to freeing the management team from having one hand tied behind its back.

5. Buying and selling their shares on exchanges allow investors to fix their risks at the time of the trade rather than not knowing what amount they will receive or will pay for their shares until the fund's NAV is struck at the end of the trading day. This is known as forward pricing and applies to nothing else we buy and sell in real life.

6. The equity market has historically gone up more than it goes down which is a major reason that investors buy equity funds. Therefore, the cash that traditional actively managed mutual funds must keep on hand for daily redemptions is an unnecessary drag that contributed negatively to the funds' rates of return.

7. The final advantage often cited in ETF research is full transparency. Historically, that has been true and works well for fully disclosed rules-based ETFs. However, one of the impediments in active managers using and/or migrating to the ETF structure was that full transparency on positions and trades that need to be made is not always in the best interests of fund shareholders.

SEC Rules Changes to Facilitate Active Management Using the ETF Structure

Beginning in 2019, the United States Securities and Exchange Commission (SEC) liberalized and clarified how customized contribution and redemption baskets could be used to facilitate active trading decisions. A new rule referred to as the "ETF Rule" removed "exemptive relief" regulations, enabling ETF issuers to more easily bring new strategies to market without incurring substantial legal fees. It also makes customized creation/redemption baskets available for all types of ETFs covered under its regulations.

Important Technology-Driven Options Recently Made Available

Until recently, all actively managed ETFs were required to be fully transparent with their daily holdings. Traditional mutual funds are required to disclose their positions only once per quarter and within 45 days of the prior quarter's end. Many active

managers felt that full disclosure would leave them too exposed to being front-run on their trades. They also worried that direct indexers and other so-called “freeloaders” would copy their holdings without needing to pay for their insights.

In 2019, the SEC finally approved a number of semi-transparent basket construction technologies that address these issues. All of the technologies are patented and designed to protect the fund’s trades from being front-run and/or mimicked. Although some of these methodologies bear different names, there are essentially three major methods now adopted and utilized by ETF issuers. Each solution can be grouped into one of the following classifications.

1. Cash-in Lieu Basket

This is what the market sees so that this is the most nontransparent of all such offerings. The large cash component necessitates further deployment to assemble and/or disassemble the desired portfolio. Moreover, a one-second Initial Order Purchase Value (IOPV), in some cases referred to as Verified Intraday Indicative Value (VIIV) is mandated so that Authorized Participants, essentially market makers, can commit to submitting creation and redemption baskets containing the cash. Providing these values as is a further level of administration both these features will incur further costs to the fund.

2. Proxy Portfolio Basket

The creation unit basket comprises a mixture of securities actually in the portfolio and securities that are not in the underlying portfolio as proxies for the securities the manager intends to own. In other words, some securities that are in the portfolio are absent the creation unit basket and are replaced by the so-called proxy securities that can also be thought of as decoys. During an in-kind creation, the manager will be receiving securities that do not fit the design of the ultimate portfolio and therefore will be required to sell those securities to the market. Thus, potential impact costs and potential capital gains are unwanted byproducts.

3. Shielded Alpha® Basket

This technology produces creation units\ baskets comprising all the underlying portfolio securities but with a different weighting scheme to that of the actual portfolio, so a highly transparent structure. Using the system’s cloud-based software available to the manager they can design the creation unit in advance. Therefore, the only stocks they receive are stocks that satisfy their investment strategies and objectives.

From a consultant’s perspective, it is clear is the Shielded Alpha® creation unit maximizes transparency to owners since it contains all the underlying portfolio names. This is the method most likely to be favored by asset owners and their compliance departments. With many of today’s owners concerned with ESG awareness and issuing policies excluding the stocks

of undesired companies, internal compliance demands knowing all the holdings so they can be monitored. Of the three methods this is the only one that end investors will always be assured are in compliance with their principles and exclusionary lists. This is also the method that incurs the fewest non-essential costs and external support.

The Surge in Actively Managed ETF Launches and Filings

The global growth in actively managed ETFs since 2010 has been astounding. By May 31, 2021, the number of actively managed ETFs reached 1168 totaling $363 billion in assets under management. Five years ago, the comparable numbers were 398 ETFs worth $53 billion. Ten years ago, there were just 89 actively managed ETFs worth just $23 billion. That growth continues to accelerate. ETF inflows during the interval from January 1 and May 31, 2001 were $74 billion compared with 19 billion during the first 5 months of 2020. The US has not been left behind in this rush by major fund complexes and investment banks to launch active ETFs with a 25% increase in issuers and listed active ETFs during the first 5 months of 2021. Experts say a major factor in this trend has been the availability and acceptance of semi-transparent baskets for creation and redemption.

The early preference by institutional investors is somewhat surprising. The ever-growing ESG movement increasingly demands institutional investment mandates for best practices and transparency. However, most announcements of new active ETFs made by June 30, 2021 utilized the Proxy Portfolio Basket methodology that effectively hides potentially objectionable corporate holdings from the end investors and their compliance departments. Since the fund management industry tends to follow the leaders until leadership changes, momentum portends that the Proxy Portfolio methodology will increase in popularity in the short run.

However, long-term history in the investment world indicates that this trend will eventually be reversed. In the long run, the market inexorably rewards efficiency and punishes inefficiency. Indeed, this is the primary reason that more than 20 years since my 2001 article in the Journal of Indexes, active managers are finally committing to using the more cost-efficient and flexible ETF structure implicitly being demanded by investors and the marketplace. It follows that in the long-run, the most efficient of the three structures, Shielded Alpha® will prevail over the decades to come.

Impediments to Adoption

The adoption of new technologies that disrupt the status quo usually takes a great deal of time to take root before evolution and acceptance forces change. Certainly, that has been true of most mutual companies. Most have employed the classic “not-on-my-watch” strategy of observing the inevitable but trying to preserve the present structure and higher margins for as long as feasible. Indeed, even though sales loads are now rare and expense ratios have been reduced in most cases, most fund shares sold to individuals with brokerage accounts or Individual Retirement Accounts (IRAs) still

include redemption fees; the standard fee in the US is 0.75%. This is likely to be the last vestige of such "surprise fees." The arguments of resistance thar prevailed for the past two decades have lost credibility. The top argument had always been distribution. Clearly ETFs have shown that the exchanges are more accessible and self-empowering distributions channels for Registered Investment Advisors and their clients than traditional sales platforms. The second most-heard argument was that funds could not migrate because full transparency was required and that would hurt investors. That argument has now been addressed.

Some arguments persist. The longest of these has been that because it is not possible to buy fractional shares of ETFs on the market, they cannot be used for 401K participants and other mutual fund investors who wish to dollar-cost average. Technology and regulatory reform are quickly addressing this issue as well.

Conclusion

The time of reckoning seems near. ETFs in many markets have already surpassed or close to surpassing traditionally structured mutual funds globally in Assets Under Management. All active managers will eventually need to adapt.

The good news for active managers is that many of their structural disadvantages as compared to index ETFs disappear as they adopt the more modern structure. Using the ETF structure in tandem with semi-transparent technologies essentially levels the playing field. The latest technological and regulatory advances to allow for semi-transparent trading, especially using the Shielded Alpha® structure, are the final pieces in leveling structural inequalities.

For years, Standard and Poor's Corporation SPIVA (S&P Index vs. Active) research has detailed the embarrassing numbers of active managers who have failed to deliver better-than-index returns during the past 1-, 3- 5- and 10-years. Over most 10-year periods, that number has exceeded 75%. Mathematically, it is extremely unlikely that such persistent outperformance is because active managers pick stocks poorly. Therefore, the systematic underperformance must be at least in-part due to the structural impediments of the archaic 1940-Act Structure. To paraphrase James Carville, "It's the Structure Stupid."

Twenty years after the original paper, many of the largest mutual fund companies and thought leaders are finally recognizing that they need to co-opt the ETF structure for actively managed offerings. Yet almost none have publicly said that eventually they need to abandon the archaic and traditional form of the 1940 Act structure on which their company was based. That change will come in the fullness of time.

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