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Evaluating active ETFs

J.P. Morgan Asset Management Active ETFs

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Demand for exchange-traded funds (ETFs) has grown rapidly around the globe in recent years. This growth is now being accelerated by the development of more sophisticated smart beta and active strategies. In this paper, we review the key questions raised regarding active ETFs. We also look at potential considerations when evaluating an active ETF.

The active opportunity

While passive strategies continue to dominate flows into ETFs, fund providers are increasingly realising that the ETF wrapper is also suited to actively managed strategies.

Active ETFs are one of the factors driving ETF growth, providing investors with the opportunity to seek alpha on their investments with the features they expect from the ETF vehicle.

The role of active ETFs

Active ETFs allow investors to target specific outcomes. For example, an active equity ETF can provide access to excess returns above a chosen index, driven by fundamental stock selection.

Unlike in passive ETFs, the weighting methodology in active strategies is at the discretion of the portfolio manager (within certain tracking error constraints), allowing some active ETFs to partly mitigate some of the limitations of market-cap indices.

Active fixed income ETFs, for example, have the ability to assess the creditworthiness of individual issuers and deviate from the weighting methodology of traditional fixed income benchmarks, which give larger weightings to issuers with higher outstanding debts.

Active strategies can also be used to gain exposure to certain investment criteria, such as securities with strong environmental, social and governance characteristics.

Active ETFs can also rebalance portfolios outside of the systematic rebalancing dates used in passive indices. This provides active ETF managers with the flexibility to react to market events, for example.

Two tiers of evaluation

As demand for active strategies grows and more active ETFs are launched, it's important for investors to have a full understanding of how they can be employed in portfolios, and the questions to consider when evaluating ETF providers.

Active ETFs can be evaluated at two levels. First, as with a passive ETF, investors may wish to conduct due diligence at the 'wrapper' level.

However, because the benchmark is only a reference for active ETFs, looking under the hood at the investment engine for the chosen strategy can also be beneficial.

Understanding the ETF investment engine

While active strategies strive to deliver alpha, the range of possible outcomes and performance deviations from traditional benchmarks will be much greater than with passive ETFs. Active ETFs can therefore require more upfront and ongoing due diligence at the investment engine level than market-cap weighted index strategies.

In an active ETF, stock selection, investment allocations and risk management are based on a portfolio manager's investment philosophy, conviction and skill. Investors may therefore wish to assess whether the active strategy is based on a proven, repeatable process that aligns with their risk tolerance and overall investment objectives.

Factors to consider could include:

- What is the starting universe of eligible securities?
- How are securities selected and weightings assigned in the portfolio?
- What are the portfolio's diversification and liquidity constraints?
- What biases or exposures can be expected as a result of portfolio construction?
- How experienced is the portfolio management team and do they have a verifiable track record?

Knowing your ETF provider

As with passive investments, when evaluating potential active ETF investments, the capabilities of the ETF provider are important considerations. Investors may wish to choose a provider they value, with a proven history of delivering investment expertise and insights.

Questions to ask could be: Is the ETF provider able to give them the level of client support they need? Does the provider have a capital markets desk that can support with trading questions, and dedicated websites that provide critical fund information? How well aware and aligned is the provider to the regulatory changes impacting the industry?

Assessing the implications of the ETF structure

While the costs and risks associated with physical and synthetic (swap-based) index replication are less relevant for active ETF investors, structural implications are still valid considerations.

For example, active ETFs may participate in security lending schemes to offset costs, similar to many physical replication passive ETFs.

This means it's important to assess and monitor the performance of active ETF providers and understand all the credit exposures that an ETF strategy may have.

Evaluating the total cost of ownership

Low fees are attractive, but the total expense ratio (TER) is just one component of the overall investment cost of an ETF.

As well as the TER, there are other costs incurred for holding an ETF, including such factors as transaction costs related to portfolio rebalancing, and any costs associated with securities lending.

A full picture of the overall cost includes the cost of purchasing and exiting the fund. These charges include brokerage fees, and creation and redemption costs.

Together, the cost of holding and the cost of trading will provide investors with a view of the total cost of ownership of an ETF.

Total investment cost

Internal Costs		Internal Costs		
• Expense ratio • Securities lending • Rebalancing costs-physical replication • Swap spread-synthetic replication	+	• Trading costs • Creation / redemption costs • Brokerage • Taxes	=	**Total Cost of Ownership**

Source: J.P. Morgan Asset Management. For illustrative purposes only.

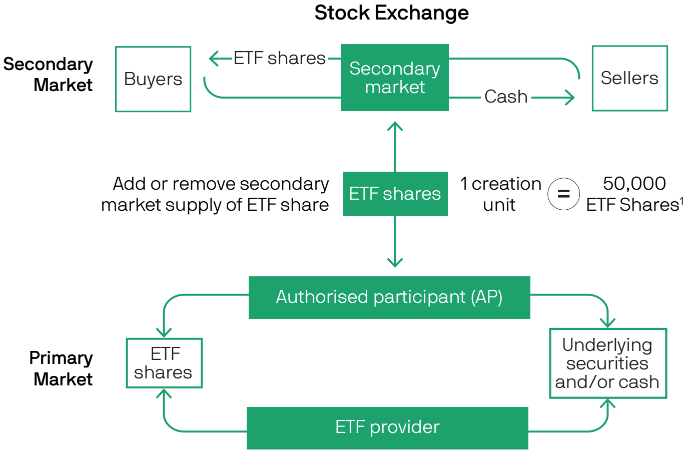
Risk management does not imply elimination of risks. Diversification does not guarantee positive returns or eliminate risks of loss.

Active ETF trading: What makes a good active ETF?

As with passive ETFs, a good active ETF is backed by a dedicated capital markets team with a strong technology platform and strong relationships with a diversified set of authorised participants (APs).

The ETF provider must be able to demonstrate that they can provide APs with all the information they need to deliver efficient pricing of the ETF at all times, while utilising both primary and secondary markets to boost liquidity.

The ETF ecosystem



Source: J.P. Morgan Asset Management. For illustrative purposes only.
[1] Creation unit size will vary by provider, typically of at least 50,000 shares.

Focusing on the underlying securities

Some strategies will not be appropriate for the ETF wrapper, so the ETF strategy should provide ample trading liquidity.

First and foremost, a good active ETF strategy needs to maintain exposure to liquid and tradeable underlying securities, which will allow the cost of creating and redeeming shares to be low, and the ability to provide intra-day pricing to be high.

- **The starting universe** Just like passive strategies, active ETF portfolios are constructed based on a starting universe of liquid underlying securities—taken either from the starting point of a reference benchmark, or from the universe covered by the relevant portfolio management or analyst team.

  Active ETFs will therefore share similar characteristics to the starting universe. An active ETF with a starting universe of US equities, for example, will be more liquid and cheaper to trade than an ETF with a starting universe of emerging market bonds.

- **Portfolio construction** While the starting universe is the main driver of an active ETF's underlying liquidity, the fund's portfolio construction is also a factor in its liquidity profile.

  Liquidity is affected by the investment criteria used to select securities, the risk management tools that the strategy uses, any tracking error considerations that are in place, and any individual security restrictions or other portfolio constraints that will influence the makeup of the portfolio.

Focusing on trading expertise

While many equity indices rebalance on a quarterly basis, active strategies often adjust portfolios on a monthly basis. However, active ETF strategies also have the flexibility to trade outside of their normal rebalancing period, which means portfolio managers can buy or sell securities to reflect a change in market view at any time.

To facilitate intra-day portfolio rebalancing, ETF providers can reissue the daily portfolio composition files (PCFs) that APs use to create or redeem shares throughout the day. This allows the ETF provider to maintain full pricing transparency in real time as the underlying portfolio changes are made.

The ETF provider therefore requires trading expertise and capital markets resources, as well as the technology support, to deliver these extra trading requirements, while also providing best execution and price transparency to investors.

Focusing on secondary market liquidity

As with passive ETFs, secondary market liquidity is an important part of the efficient pricing of active ETFs. If an ETF suffers a redemption, or receives inflows, it may not need to trade its underlying securities if an AP or market maker is able instead to find a willing buyer or seller for the ETF's shares in the secondary market. APs may not therefore need to create or redeem shares—and trigger trading in the underlying securities—every time they receive a buy or sell order for an ETF.

However, the level of visible "on exchange" liquidity may not provide the whole picture. Consolidated trading reports, which show the level of hidden over-the-counter (OTC) trading as well as exchange-based trading, can help give a better view of an ETF's secondary markets access.

Using active ETFs in an investment portfolio: Strategic building blocks

ETFs can be a powerful portfolio construction tool for investors. Today, advanced strategies, such as smart beta fixed income, multi-factor strategic beta, ultra-short income and liquid alternatives are allowing investors to build ETF portfolios with a level of sophistication and diversification that they couldn't have envisaged even just five or 10 years ago.

More efficient asset allocation

The buy-and-hold nature of active ETF strategies (where turnover of underlying assets is relatively low) makes them an option to helping investors build out the strategic core of their portfolios.

At the same time, an active strategy can be used to add alpha to a portfolio with core passive holdings.

For example, if an asset allocator wants to add exposure to a less liquid category, such as emerging market debt, using an ETF within an emerging market sleeve can help them to increase or decrease their exposure without buying or selling individual bonds or managers.

Other examples include using active ETFs to add alpha to a plain vanilla portfolio, or using an actively managed growth-style ETF to reduce a portfolio's value bias at relatively low cost.

Ultimately, active ETFs can offer investors access to long-term alpha potential, while benefiting from the attributes of the ETF wrapper.

Evaluating active ETFs: Key points

The evaluation of active ETFs will differ from passive ETFs given the greater complexity of active strategies. Here are some of the key areas to consider:

- **The investment engine** Is the ETF strategy based on a proven, repeatable process that aligns with your risk tolerance and overall investment objective?
- **The ETF provider** Does the active manager have proven experience of delivering investment expertise and insights over market cycles?
- **The implications of the ETF structure** What are the costs and potential counterparty risks that the active ETF is exposed to?
- **The full cost of investment** What are the costs related to ETF ownership, both internal (such as expenses and rebalancing costs) and external (including trading costs, brokerage and taxes)?
- **The liquidity of the underlying securities** Does the active ETF strategy maintain exposure to liquid and tradeable underlying securities, allowing the cost of creating and redeeming shares to be low, and the ability to provide intra-day pricing to be high?
- **Trading expertise** Does the ETF provider have the resources and technology needed to deliver flexible trading and rebalancing, while also providing best execution and price transparency?

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