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Will active ETFs lure investors?

Perhaps, but not without a strong sales job to overcome the inherent inertia

By **Marvin Appel**
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Exchange traded funds are one of the fastest-growing investment vehicles, but until now, they have been passive investments.

However, a number of providers have been working on bringing actively managed ETFs to the marketplace. The expectation is that with greater flexibility, successful active managers could improve performance relative to passive indexes.

From the ETF sponsors' perspective, it might be possible to charge higher management fees for active funds. But that will require salesmanship, because a large, unmet investor demand for such products does not exist.

The burden of proof, therefore, lies with the companies that want to design and market actively managed ETFs. Their challenge will be to retain the advantages of the most popular ETFs while adding further value.

One very attractive scenario for actively managed ETFs would be if a popular fund manager created an ETF class of shares that paralleled the portfolio of his or her open-ended fund. This strategy would allow popular funds that claimed to be hurt by shareholder trading activity to shield long-term investors from trading. On the other hand, investors who wished to employ such risk control methods as using sell-stop orders would not have to contend with a fund's trading restrictions. A sell-stop order is placed at a price well below the level at which a stock is trading. If the price of the shares drops to that point, the shares are sold — limiting losses in the portfolio.

For example, suppose that an investor desires some exposure to a volatile area such as emerging markets but is concerned about the significant risk that a recession in the United States could severely depress emerging-markets stocks. Rather than waiting for the news headlines to turn negative, that investor could place a sell-stop order 10% to 15% below the price of the ETF.

That would get the investor out of the way of a major bear market, should one occur, but would allow him or her to ride the rising tide of emerging-markets stocks.

This type of investment flexibility has not always increased returns but can be lifesaving during a severe bear market such as the one we experienced from 2000 to 2003.

One might ask whether this investor would be better off with the ETF-class share of an open-ended mutual fund or with established emerging-markets ETFs such as the Vanguard Emerging Markets ETF or the iShares MSCI Emerging Markets Index.

The case for active management of international funds has been stronger than for diversified U.S. equity funds. Many international-equity managers seem to have added enough value to overcome the higher expenses, compared with passive benchmarks such as those of MSCI Inc. of New York.

Moreover, international-equity funds are more likely than domestic-equity funds to place trading restrictions on shareholders because of the higher transaction costs that international funds incur in meeting redemptions or when investing cash inflows. Therefore, if the bid-ask spread were sufficiently low, an actively managed international-equity ETF could be a very useful investment tool.

Nonetheless, I do not expect the launch of actively managed ETFs to be of earth-shaking importance, because the line between actively managed and passively managed ETFs has already been blurred.

Market indexes were originally designed to represent the behavior of entire segments of the market, and the first ETFs from iShares offered by Barclays Global Investors of San Francisco and State Street Global Advisors of Boston were created years after the indexes had been in existence.

In recent years, however, indexes have been developed to serve as benchmarks for ETFs. These indexes were designed with performance history in mind to stimulate investor interest and to maximize liquidity.

Some new indexes, such as the Palisades Water Index (the benchmark for the PowerShares Water Resources Portfolio, offered by PowerShares Capital Management LLC of Wheaton, Ill.) do not even disclose their stock selection methodology.

The only difference between the Palisades Water Index and an actively managed water sector fund is that the "passive" index announces its constituents in a timely manner.

I think competition among ETF providers has resulted in a number of excellent products at reasonable cost.

Adding actively managed ETFs to the menu of selections can only help investors in the future, even if many present and future ETFs are shaken out due to insufficient investor interest.

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