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STRATEGY BRIEF:  
**ACTIVE ETFs**  
REVISITED  
Q1 2014

### **The Rise of Active Management in ETFs**

Many still regard exchange-traded funds (ETFs) as passive, beta-indexing tools for basic market exposure. Thus far, this has generally been true, but the rise of active management in the ETF space may well be the industry's next evolutionary step. To better understand the potential of this ETF segment, SEI collaborated with ETF Trends, looking at the current environment as well as the advantages and the headwinds present.

<sup>1</sup>BlackRock, "ETP Landscape: Industry Highlights," February 28, 2014.

<sup>2</sup>PwC, "The Next Generation of ETFs," November 2013.

<sup>3</sup>*Pensions & Investments*, "McKinsey: Active ETFs on the way to \$500 billion," January 30, 2013.

<sup>4</sup>ETFGI, [www.etfgi.com](http://www.etfgi.com), data as of December 31, 2012.

## Actively Managed ETFs: Here to Stay

ETFs are one of the most used financial products in the world, with over \$2.4 trillion in assets across 5,000 funds globally.<sup>1</sup>

Yet an ETF is not a panacea — it is simply a wrapper, a structure (similar to a mutual fund) around an investment philosophy, process and portfolio of holdings, but with investor demand increasing and regulatory guidance improving, opportunities exist for actively managed ETFs to explode.

Active ETFs did not, and in fact had no reason to, emerge until traditional passively managed ETFs had addressed every basic asset class in fund form.<sup>2</sup> As actively managed ETFs continue to attract greater attention and accumulate more investment dollars, they will start competing with traditional active mutual funds for market share. While actively managed exchange-traded funds may now be in their infancy, McKinsey & Co. expects them to grow faster than their passive brethren over the next several years.<sup>3</sup>

### Key Facts — Actively Managed ETFs

- Are growing in terms of AUM and number of products, but still make up less than 1% of the global market for ETFs today<sup>4</sup>
- Come with an innate creation/redemption process that allows for a potentially more tax-efficient product than mutual funds
- Are required to disclose holdings on a daily basis, yet some providers have petitioned with the SEC to increase the time interval beyond daily disclosures
- May now more broadly utilize derivatives, enabling fund sponsors to expand to other asset classes, such as commodities and currencies
- Are now being developed by more traditional mutual fund-only providers rather than just specialist ETF manufacturers
- Are adding support to the passive indexing providers through tracking “enhanced” indices that screen for specific stocks

Given these facts, active management could well represent the next growth phase for the ETF industry. At least one index-based ETF covers each of the major asset classes and categories, and to date, passively managed ETFs tied to broad industry benchmarks have attracted the lion’s share of ETF assets.

Proponents of ETFs consider the vehicle to be superior to mutual funds due to low costs, ease of purchase, potential tax efficiency, tradability, increased transparency and liquidity. However, it would be a mistake to pigeonhole ETFs solely as index trackers. As discussed in this strategy brief, that does not provide a full picture of the potential opportunity for actively managed portfolios.

## The State of Active ETFs: Where Are They Now?

The actively managed segment of the ETF market is still relatively small, consisting of a mere 85 ETF products and controlling \$15.2 billion in assets under management, as of March 31, 2014. In comparison, the broader all-inclusive exchange-traded product market that includes active and passive ETFs and exchange-traded notes (ETNs) consists of 1,568 U.S.-listed products with \$1.7 trillion in assets under management; globally ETFs account for over \$2.4 trillion.<sup>5</sup> Collectively, U.S.-listed actively managed exchange-traded products (ETPs) and those listed on overseas exchanges together represent less than 1% of the global market by AUM.<sup>6</sup>

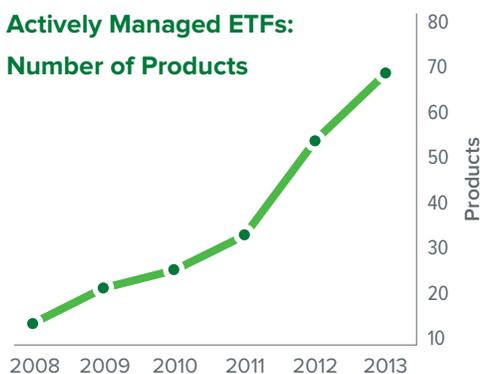
However, when considered in the context of funds introduced during the five years since 2008, active funds have played a larger role, with Strategic Insight finding that their assets comprised 7% of the assets of all ETFs launched in the U.S. during that period.<sup>7</sup>

The actively managed ETF space has been gaining traction and is poised for growth, as the number of active funds and assets under management has slowly increased since the first active ETF was launched in 2008. In that year, there were just 13 actively managed ETFs with \$245 million in AUM. The rising adoption rate of active ETFs and acceleration in new launches indicates that the existing ETF industry is steadily maturing. Currently, there are 1,077 ETFs in registration with the U.S. Securities and Exchange Commission (SEC); of that number, there are over 50 active ETFs that are either in registration<sup>8</sup> or, if having already received approval, have yet to come to market.

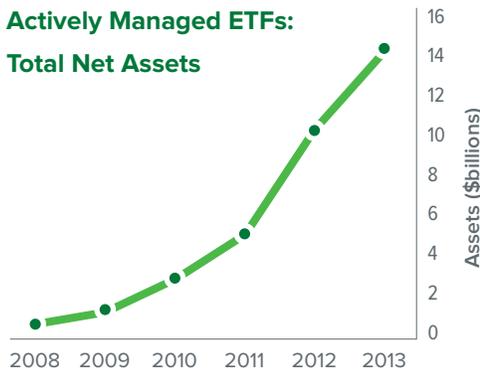
Pooneh Baghai, co-leader of McKinsey's Americas Wealth Management, Asset Management and Retirement Practice, predicts that assets in actively managed exchange-traded funds will explode to \$500 billion by 2020, up from \$15.2 billion today.

"We think active ETFs have major momentum," Baghai said. "It's not a question of if; it's a question of when and how much."<sup>9</sup>

### Actively Managed ETFs: Number of Products



### Actively Managed ETFs: Total Net Assets



Source: Investment Company Institute, XTF, AdvisorShares.

Increased interest from pension funds, endowments and other large institutional investors will fuel the growth of the active ETF space. Two emerging trends could increase institutional participation of actively managed ETFs, specifically: the regulatory scrutiny over the \$2.6 trillion money-market mutual funds space and discussion about a floating-rate net asset value (NAV), and the accelerating pace of exemptive relief approvals for ETFs from the SEC.<sup>10</sup>

The actively managed ETF investment vehicle has garnered greater attention after the successful adaptation of PIMCO's Total Return mutual fund (PTTRX) into the PIMCO Total Return Bond ETF (NYSE Arca: BOND). Having gathered over \$3.4 billion since its launch in 2012, it is by far the world's largest actively managed ETF.

<sup>5</sup> BlackRock, "ETP Landscape: Industry Highlights," February 28, 2014.

<sup>6</sup> ETFGI, [www.etfgi.com](http://www.etfgi.com).

<sup>7</sup> PwC, "The Next Generation of ETFs," November 2013.

<sup>8</sup> ETF.com, [www.ETF.com](http://www.ETF.com).

<sup>9</sup> Pensions & Investments, "McKinsey: Active ETFs on the way to \$500 billion," January 30, 2013.

<sup>10</sup> Pensions & Investments, "Institutions' resistance to active ETFs may ease," March 18, 2013.

<sup>11</sup> Investor.gov, "Investor Bulletin: Exchange-Traded Funds (ETFs)," August 10, 2012.

<sup>12</sup> XTF: The ETF Experts, www.xtf.com.

<sup>13</sup> Invesco PowerShares, "Exchange Traded Funds product sheet;" "Fidelity, ETFs vs. Mutual Funds: Tax efficiency."

## How Are Actively Managed ETFs Different?

While actively managed ETFs may hold a basket of securities as do similar vehicles, they are not based on an underlying index. Instead, they try to achieve an investment objective such as outperforming a given segment of a market, or investing in a focused sector, through actively managing a portfolio of stocks, bonds or other assets.<sup>11</sup>

Actively managed ETF advisors can transact daily, without index constraints, in similar fashion to mutual fund managers. However, this active management comes at a cost: of the 85 actively managed ETFs currently in existence, the average expense ratio is 0.84%, compared to a 0.61% average expense ratio for all ETPs, passive and active.<sup>12</sup>

ETFs share similar traits with open-ended mutual funds, but ETFs, active and passive alike, can also be traded throughout the day on an exchange. Investors are able to buy and sell individual shares at market price throughout a trading day in the secondary market, whereas mutual funds can only be traded at that trading day's ending NAV.

Because of an ETF's unique structure, and the ability of an ETF manager to accommodate investment inflows and outflows by creating or redeeming "creation units," taxable events occur less frequently in a conventional ETF structure than in a mutual fund. This has the effect of potentially benefitting shareholders to substantially decrease capital gains distributions.<sup>13</sup>

## The Unique Creation/Redemption Mechanism

Throughout the normal trading day, the ETF's market price will fluctuate due to the underlying prices of the ETF's holdings and overall market conditions. Since the ETF can be traded throughout the trading day, the ETF's price is free to fluctuate, allowing its supply-and-demand driven market price to trade at a premium or a discount to its underlying NAV.

The inner workings of ETFs are different from mutual funds in that ETFs have a built-in creation and redemption mechanism to produce or destroy ETF shares at NAV. Retail investors, however, while buyers of ETF shares via exchanges, cannot create or redeem individual shares directly from the ETF provider. This can only be done by Authorized Participants (APs) who act as large broker-dealers that purchase and redeem component shares in the primary market directly from the ETF sponsor in large blocks.

In creating new ETF shares, the APs make large aggregations or block orders in amounts of 50,000 or 100,000 ETF shares, commonly known as creation units. Once the AP swaps a basket of securities and cash with the fund in exchange for ETF shares, the AP is free to sell the ETF shares on the secondary market. These are the shares that investors trade.

For the redemption process, an AP has to present a large block of ETF shares to the ETF sponsor in exchange for a predefined basket of individual securities or cash equivalents.

Through supply-and-demand forces on the exchanges, a premium or discount occurs if the market price of the ETF shares deviates from NAV, thus providing the AP with an arbitrage opportunity through the creation/redemption process. As such, APs help to maintain an ETF's price close to its underlying value or NAV per share, reducing any significant discrepancy. This arbitrage mechanism helps keep the share price near "fair value."

## The Active ETF Position Disclosure Conundrum

However, the creation/redemption process requires the ETF to disclose daily the underlying basket of securities. This requirement poses a major challenge for active ETF managers and is generally considered the main difference, and potentially competitive disadvantage vis à vis mutual funds, which are only required to reveal holdings quarterly. With these increased portfolio transparency requirements, managers have been reluctant to launch actively managed ETFs for fear of permitting investors or their competitors to “front-run,” or construct their own portfolios without paying the investment manager (through the ETF). Consequently, the majority of U.S.-listed actively managed ETFs include those that track a basket of fixed-income assets, given the difficulties in replicating the strategies and accessing the bonds held in the ETFs or relevant indices. For instance, the Barclays U.S. Aggregate Bond Index is comprised of over 8,250 securities and the PIMCO Total Return ETF held 772 holdings.<sup>14</sup>

While the active ETFs currently available have provided full transparency, many of those providers seeking to launch new actively managed ETFs are trying to find ways to work around the transparency rules and limit their disclosures of holdings.

In one case, Navigate Fund Solutions, a subsidiary of Eaton Vance, is developing a hybrid product called exchange-traded managed funds, or ETMFs, as a solution to the dilemma. Managers would not publicize positions being initiated or sold until trades are settled, and investors would not know the exact value of shares until the market closes. In another case,

BlackRock filed with the SEC to launch active ETFs that wouldn't follow current daily disclosure practices and would operate from a blind trust. In this situation, market makers would swap cash instead of a basket of underlying securities to create ETF shares, and instead of the normal redemption process, the securities would go to a custodian who would then sell stocks and provide the cash back to the market maker. In other efforts to work around the disclosure requirements, both Guggenheim Investments and Vanguard proposed to create a proxy portfolio that would mimic an ETF's actual movements through the course of a trading day, but specific holdings would likely be different.

More recently, Precidian Investments filed with the SEC for a nontransparent active ETF. The filing shows a two-tiered process that shield trades in which a custodian acts as a middleman dealing through a blind trust on behalf of large investors redeeming shares in-kind—currently, institutional investors directly trade with fund providers. Additionally, the NAVs of each ETF would be revealed every 15 seconds, but the NAV would not include actual components. Instead, individual component weights will be disclosed on a quarterly basis.<sup>15</sup>

While delayed transparency would help the money manager, it could pose a problem for APs and their ability to efficiently facilitate ETFs through arbitrage. However, without accurate holdings disclosures, arbitrage opportunities would be more difficult to identify, and the actively managed ETF may frequently trade at a larger premium or discount to the actual value of the underlying holdings.

<sup>14</sup> As of February 18, 2014.

<sup>15</sup> SEC filing, January 22, 2014; *The Wall Street Journal*, "A Step Forward for New Active ETFs," January 22, 2014.

<sup>16</sup>SEC speech by Norm Champ, "Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services," December 6, 2012.

<sup>17</sup>*The Wall Street Journal*, "Firms Try Varied Designs to Add ETFs," February 3, 2013.

<sup>18</sup>Ignites, "Principal Files to Launch Active ETFs," March 25, 2013.

## SEC Breathes Life into Actively Managed ETFs, Lifts Moratorium on Derivatives

With the growing scrutiny of leveraged and inverse ETF products, the SEC froze the creation of new actively managed and leveraged ETFs that utilized options, futures, swaps and other derivatives as part of their investments. Consequently, most active ETFs now in existence only hold equities or fixed-income assets.

However, on December 6, 2012, Norm Champ, the Director of the Division of Investment Management, announced that the SEC had reversed its position on derivatives and would "no longer defer consideration of exemptive requests under the Investment Company Act relating to actively managed ETFs that make use of derivatives."

"Further," according to W. John McGuire, a partner who specializes in investment company and investment advisor regulatory issues at Washington, D.C.-based Bingham McCutcheon LLP, "the SEC staff gave no-action relief to all of the ETF sponsors that had received actively managed ETF exemptive orders during the moratorium, permitting them to use derivatives in their actively managed ETF."

Consequently, new actively managed ETFs that file for exemptive relief will be

required to represent that: "(i) the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives, and (ii) the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant Commission and staff guidance."<sup>16</sup>

The SEC's lifting of its ban on derivatives allows portfolio managers to use futures, options and swaps in strategies designed to exploit perceived market inefficiencies and for hedging purposes, likely resulting in an increase in the number of active ETF launches. With the moratorium lifted, we expect more competition between actively managed ETFs and other products utilizing various alternative investment strategies and asset classes, such as commodities or foreign currencies. In one example, while the PIMCO Total Return Bond ETF did not hold derivatives as of the end of 2013, portfolio manager Bill Gross expressed his desire to include them if the ban was lifted, as the competing PIMCO Total Return Bond mutual fund utilized derivatives, including Greek swaps, during the eurozone financial crisis in 2012.

## Mutual Funds Eye ETF Industry: A New Wave of Actively Managed ETF Sponsors

The SEC's actions also make it more appealing for traditional mutual fund companies to enter the ETF space through active offerings. For example, T. Rowe Price, Fidelity Investments, Franklin Resources, Janus Capital Group and Columbia Management Investment Advisers are among the firms that are working through exemptive relief with the SEC to launch actively managed ETF products within their stable of products.<sup>17</sup>

More recently, Principal Financial Group has filed with the SEC to offer its own line of active ETF investments.<sup>18</sup>

More traditional mutual fund-only firms are realizing they can no longer ignore the potential threat that ETFs pose to their businesses; indeed, even index-fund giants have seen ETFs coexist and blossom alongside their traditional mutual fund products. PIMCO, the trillion-dollar asset management firm most well-known

for its bond mutual funds, has launched its own series of actively managed and indexed ETFs and recently announced plans to expand its Active ETF lineup by an additional 19 offerings this year.<sup>19</sup> There are also some “pure-play” ETF managers such as Global X and WisdomTree Investments, but some of the largest ETF providers also manage mutual funds, institutional accounts and other financial products.

BlackRock, which owns the iShares ETF business, is one of the largest managers for institutional investors, as is State Street, which manages the SPDR ETFs. Fidelity Investments, a pioneer in actively managed sector mutual funds, has also signaled the firm’s intention to expand into the active ETF space after announcing its partnership with BlackRock in early 2013.<sup>20</sup> J.P. Morgan<sup>21</sup> indicated that not only would the firm be entering the ETF businesses in the first half of 2014, but Bob Deutsch,<sup>22</sup> head of the bank’s ETF business, also stated that the company is interested in launching actively managed ETFs. Additionally, some mutual fund managers have sought SEC approval to convert their mutual funds into ETFs, but the SEC has yet to make a definitive answer on the conversion process.<sup>23</sup> Consequently, some mutual fund providers are opting to clone their existing fund strategies into ETFs.

In attempting to convert the mutual fund to an ETF, the mutual fund sponsor, in addition to having to file for exemptive relief for the newly created ETFs and then reorganize the fund into an ETF product, would also have to gain the approval of both its shareholders and board of directors. To garner approval, the sponsor would have to assure both partners that the daily disclosures in the actively managed ETF clone would not harm the mutual fund.

While PIMCO opted for the aforementioned process, other firms, such as Vanguard, have chosen different routes. Rather than creating a separate legal entity,

Vanguard holds the patent on differentiating ETFs as a separate share class of existing mutual funds.<sup>24</sup>

While Vanguard is most known for its passive indexing strategies, the money manager also recently filed with the SEC<sup>25</sup> to launch actively managed ETFs as a separate share class of existing active mutual funds. Vanguard has not stated which of its mutual funds will be given the ETF makeover. The move can potentially shake up the actively managed ETF landscape as Vanguard brings its low-cost business model over to the active ETF side in response to the shift toward fee-based platforms.

Van Eck Global also proposed to launch ETF share classes on some of its existing funds, but it is unclear whether the proposal would use Vanguard’s patent or challenge it. State Street Global Advisors is taking yet a different track, and is working on a type of master-feeder structure in which the active ETF would strive to achieve its investment objective by investing in a corresponding master fund. This fund would act as a separate mutual fund with an investment objective, investment policy and have risks identical to the active ETF.

Additionally, small hedge fund managers can find that the actively managed ETF space is a better setting to accumulate investment assets. ETFs, unlike hedge funds, come with lower expense ratios, do not have minimum investment requirements and can be accessed by anyone with a brokerage account. The lower fees may be a deterrent, but the cut may make sense for smaller hedge funds as the ETF structure would open up investment avenues to the public at large.

While there are still some structural challenges, success in the actively managed ETF space could eventually attract more asset managers, including well-known names.

<sup>19</sup> Bloomberg, "PIMCO to Start 19 Actively Run ETFs as Gross Diversifiers," January 27, 2014.

<sup>20</sup> Fidelity Investments, "Fidelity and BlackRock Announce Groundbreaking ETF Strategic Alliance," March 13, 2013.

<sup>21</sup> J.P. Morgan Exchange-Traded Fund Trust, et al.; "Notice of Application to the SEC," January 30, 2014.

<sup>22</sup> *Financial Times*, "Active ETFs reach critical mass in the US," November 8, 2013.

<sup>23</sup> Reuters, "SEC rejects Huntington's request to convert fund to ETF," June 20, 2012.

<sup>24</sup> *The Wall Street Journal*, "Firms Try Varied Designs to Add ETFs," February 3, 2013.

<sup>25</sup> SEC filing, March 7, 2014.

<sup>26</sup>Risk.net, "SEC scrutiny blamed for stifling active ETF market," February 14, 2013.

## Headwinds Present: All Dressed Up and Nowhere to Go?

While more money managers are taking a look at opportunities in the active ETF space, actively managed ETFs nonetheless face headwinds in challenging mutual funds and index-based ETFs for supremacy.

Due to the long SEC approval process, new actively managed ETFs have been slow coming to market. The SEC's Division of Trading and Markets has made sponsors wait between 6 and 18 months to approve their 19b-4 applications, which is required for an actively managed ETF to be listed on the NYSE Arca or NASDAQ. In comparison, plain-vanilla, beta-indexing applications entail 9 to 12 months of SEC review. Even though the derivatives moratorium has been lifted, if an applicant were to utilize over-the-counter derivatives, it should expect an even longer waiting period due to the fact that such OTC derivatives are harder to monitor "... because there is no centralized exchange to get the information from," said Richard Keary, principal and founder of Global ETF

Advisors and former head of global ETF/ETN listings at NASDAQ.<sup>26</sup>

Moreover, as active ETFs have only recently been launched and offered to the public, most active strategies do not have long track records. Similar to '40 Act mutual funds, actively managed ETFs require a three-year-performance track record to be eligible for Morningstar ratings. Not only do active ETFs face this common headwind, but they must also address low trading volume perceptions and other home-office due diligence requirements in order to receive trading approval on the platforms.

Marketing and distribution executives also face the added complexity of the ETF wrapper in their discussions with financial advisors and home-office research personnel. While ETFs are popular with fee-only advisors because of their low expenses, advisors who depend on 12b-1 fee revenue (from mutual funds) may be unsupportive and not utilize ETFs in their solution set.

## Education and Marketing

As a relatively new investment vehicle, ETFs face misconceptions regarding technical aspects of the ETF structure. To encourage continued investment, the industry and the managers themselves need to educate investors on ETFs.

For example, liquidity and trading volume are big considerations among investors, and most investors new to ETFs will often equate trading volume to the fund's actual liquidity. Consequently, many investors have gravitated toward the largest funds with the largest daily volumes. ETFs, in reality, are only as liquid as their underlying component holdings.

Given the transparent nature of ETFs, more fund providers are using content marketing and thought leadership as a way to share best trading practices for using newer ETF offerings. Most advisors and investors may have a basic understanding of how ETFs work, but they may not fully understand how to put the various ETF strategies to work in their investment portfolios. Consequently, ETF providers could generate interest for their products by simply outlining how the ETFs work given current market conditions and how advisors can best incorporate the strategies into their portfolios.

## Outsourcing ETF Operations to Streamline New Launches

As money managers prepare to launch actively managed ETFs, many are finding their back-office operations for mutual funds are inadequate for accommodating the newer ETF structure.

For instance, Fidelity Investments is working with State Street, and Franklin Templeton has contracted with BNY Mellon for custody, sub-administration and transfer agency services, despite running large mutual fund operations in-house. These types of partnerships, as well as turnkey solutions such as that offered by SEI, help large mutual funds to enter the ETF space without having to accommodate the high upfront technology and skill costs.

Mutual fund providers have found that their technologies and service providers are not efficiently set up to meet their ETF needs. As more managers enter the active ETF business and establish long-term plans, they will have to acquire the necessary resources to ensure that

their market strategies are adapted to the ETF investment vehicle.

The expanding ETF industry has instigated significant changes to middle- and back-office investment operations. As barriers to entry ease, operations teams are discovering the increasingly difficult nature of developing internal skill sets and acquiring adequate technologies to meet the rate at which front-office management teams file and launch ETF products.<sup>27</sup> For example, newer entrants into the ETF space will have to undertake a crash course in the creation and redemption process as well as the order process from Authorized Participants. Moreover, many firms are not prepared for the accounting, basket creation processes and tax reporting associated with ETFs.

Consequently, many mutual fund providers would outsource at least part of their ETF operations to shore up any weaknesses.

<sup>27</sup>Beacon Group Consulting, "Inside Ops: Partnering with an ETF Service Provider," 2013.

<sup>28</sup>*Financial Analysts Journal*, Volume 61, Number 2, CFA Institute, "Fundamental Indexation," Mar/Apr 2005. The authors discussed the idea of an alternative to cap-weighted indices, which created fundamentally weighted indices based on factors such as book value, cash flow, revenue, sales, dividends and employment.

## Active ETFs Already Here, Under Our Noses?

Actively managed styles have already made a large impact on the ETF industry, with a wave of enhanced, rules-based, "smart-beta" or "intelligent" indexing methodologies hitting the market. Arguably, the first smart-beta indexing methodology can be found in equal-weight ETFs, as the indices have to be calibrated beyond the traditional market-cap methodologies. For instance, the first equal-weighted ETF, the Guggenheim S&P 500 Equal Weight ETF (RSP), seeks to reflect the performance of the customized index, S&P 500 Equal Weight Index, which was created to equally weight component holdings.

One of the earliest active, smart-beta indexing methods was created through fundamental indexing. In the 2005 study "Fundamental Indexation,"<sup>28</sup> Rob Arnott, Jason Hsu and Phillip Moore argued that fundamentally weighted index portfolios would have outperformed the S&P 500, a cap-weighted index, by 2% per year over the 43 years covered by the study.

After the creation of these fundamental indexing styles, more equity ETFs have been launched based on hand-tailored indices that screen for specific qualities in component stock holdings in an attempt to beat broad market

<sup>29</sup>XTF: The ETF Experts, [www.xtf.com](http://www.xtf.com).

<sup>30</sup>Morningstar, "ETF Managed Portfolios Landscape Summary Q3," December 5, 2013.

indices. One successful example is the PowerShares S&P 500 Low Volatility Portfolio (SPLV). Launched in May 2011, this ETF has already grown to \$3.75 billion in assets under management, as of March 31, 2014. The tracking index consists of the 100 stocks from the S&P 500 Index with the lowest realized volatility over the prior 12 months. The ETF has been popular with investors wary of the market after the dot-com bust and financial crisis, desire some downside protection, yet still want equity exposure.

There are currently 394 enhanced index ETFs<sup>29</sup> that passively track customized indices. The new crop of ETFs, however, is focused on smaller benchmarks that screen for specific factors such as analysis of public-company filings relative to frequency of trades, and purchases of stocks and increases in holdings by a firm's insiders, as well as data-screening strategies that look for earnings analysis based on a company's returns. When comparing the analysis styles for determining "enhanced" stock ETF holdings, these new fund offerings show many similar traits to active management methodologies.

## ETF Managed Accounts Take a New Spin on Active Management

Through the ETF structure, managers are able to craft targeted strategies or, alternatively, take a closer look at the tool as a way to create portfolios entirely out of ETFs.

ETF managed portfolios, which hold 50% or more of their assets in ETFs, are a growing segment of the separate accounts space, accounting for \$86 billion in assets as of the end of the third quarter of 2013, a 37% growth rate over the same period in 2012.<sup>30</sup>

The ETF managed portfolio space provides advisors with two main strategies venues: strategic and tactical portfolios. A strategic mix includes assets that are meant to provide incremental returns over the long haul, shifting only to adjust holdings. The tactical approach will show changes based on economic and market developments. Within these two basic strategies, managers may employ various individual styles as they try to interpret the market.

Due to the ease at which ETFs are traded, managers can easily and quickly rebalance the ETF portfolios in a cost-effective way. Wirehouses are already

trying to modernize their separate account portfolios, shifting away from the older commission-based model and moving into fee-based compensation, which aligns with the favorable fee structure of ETF managed portfolios.

For instance, Schwab is steering clients toward its own WindHaven ETF managed portfolios, which has helped augment total assets under management in Charles Schwab's suite of ETFs. Not to be outdone, the Vanguard Group added model portfolios at the end of 2013, offering up asset allocations of its research team to advisors. Other large money managers, like BlackRock and State Street Global Advisors, along with smaller third-party ETF strategists and research teams, have launched their own models as well.

With ETF managed portfolios, managers can utilize their research to craft customized investment portfolios made entirely out of ETFs, providing clients with an alternative form of active management.

## The Future: Is It Now or Where Do We Go from Here?

Actively managed ETFs provide investors access to some of the industry's best money managers via a low-cost, tax-efficient and transparent product structure that also allows for trading intraday through investors' brokerage accounts.

While the actively managed ETF space is still in its nascent stages, active management may represent the next growth phase in the ETF industry. New product launches have helped propel active ETF flows and total assets, but it remains to be seen if this momentum will continue apace in the coming years. Adding wind to the industry's back and helping support the move from fixed-income-only offerings to balanced, alternative or even equity-focused funds, the SEC's lifting of restrictions on derivatives in active ETFs may be the catalyst behind a new wave of active offerings.

The asset management industry is one founded on innovation and ingenuity, and with more interest — by managers and investors alike — in ETFs overall, we expect to see greater growth and continued creative solutions orientation with active ETF offerings over the coming years. Given the historical nature of traditional ETFs, the fund vehicle is often associated purely with passive index funds, but as market participants become more educated with new and innovative wrappers, active ETFs may well develop to be the gateway for managers seeking to break into the ETF business and eventually rival traditional active mutual funds for market share.

## About ETF Trends

ETF Trends is one of the leading websites for financial advisors, retail and institutional investors focused on the exchange-traded fund (ETF) education. With a special focus on news, trends, analysis and the latest product information, ETF Trends seeks to empower investors around the world with greater knowledge about the many uses of ETFs. To learn more, visit [etftrends.com](http://etftrends.com).

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## About SEI

SEI (NASDAQ:SEIC) is a leading global provider of investment processing, fund processing, and investment management business outsourcing solutions that help corporations, financial institutions, financial advisors, and ultra-high-net-worth families create and manage wealth. As of March 31, 2014, through its subsidiaries and partnerships in which the company has a significant interest, SEI manages or administers \$582 billion in mutual fund and pooled or separately managed assets, including \$239 billion in assets under management and \$343 billion in client assets under administration.

SEI's Investment Manager Services division provides comprehensive operational outsourcing solutions to support investment managers globally across a range of registered and unregistered fund

## SEI Knowledge Partnership

The SEI Knowledge Partnership is an ongoing source of action-oriented business intelligence and guidance for SEI's investment manager clients. It helps clients understand the issues that will shape future business conditions, keep abreast of changing

specializing in the creation of customized portfolios for high-net-worth individuals. He has been involved in money management for more than 25 years. Mr. Lydon serves on the board of directors for U.S. Global Investors, Inc. and Guggenheim Investments. In early 2010, Mr. Lydon helped create the CNBC Model ETF Portfolios. Mr. Lydon is the author of "The ETF Trend Following Playbook," as well as "iMoney: Profitable Exchange-Traded Fund Strategies for Every Investor." He is co-founder of Virtual Summits, a provider of educational virtual events for financial advisors.

structures, diverse investment strategies and jurisdictions. With expertise covering traditional and alternative investment vehicles, the division applies customized operating services, industry-leading technologies, and practical business and regulatory insights to each client's business objectives. SEI's resources enable clients to meet the demands of the marketplace and sharpen business strategies by focusing on their core competencies. The division has been recently recognized as a Top Rated Fund Administrator by *Global Custodian*, as "Best Administrator — Client Service" by *CTA Intelligence*, "Best Fund Administrator" by *Buy-Side Technology* and "Most Innovative Fund Administrator" (Over \$30B AUA) in the U.S. for hedge funds and "Best Administrator — Technology Provider" in Europe by *HFMWeek*.

best practices and develop more competitive business strategies. The Knowledge Partnership is an initiative of SEI's Investment Manager Services division.

### Connect with the SEI Knowledge Partnership

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