

Development of Actively Managed Exchange Traded Funds and the Revelation to Chinese Financial Market

Haiyong Ma (Corresponding author)

School of Economics and Management, Changchun University of Science and Technology
Changchun 130022, China
E-mail: mhymark@gmail.com

Weiwei Zhang

School of Economics and Management, Changchun University of Science and Technology
Changchun 130022, China
E-mail: zhangsanxue@gmail.com

Received: September 22, 2010 Accepted: October 7, 2010 doi:10.5430/ijfr.v1n1p55

Abstract

In recent years, the mutual funds market grown very fast, as an innovation of ETF product, the actively management ETF has drawn so much attention. In this article, we will analysis the difference between actively management ETF and traditional mutual funds/ETF, and its current situation and challenges faced in the future. At the end of this article, the authors discussed the trends of actively managed ETF and give several advices according the actual situation of Chinese financial market.

Keywords: Exchange traded fund, Actively managed ETF, Mutual fund, Front running

Actively management exchange-traded fund (ETFs) refers to the innovative ETF product which management the stock portfolio actively, but listing in the exchange. ETF in recent years, developed rapidly, has been the most important financial instrument in the global financial market.

1. Active ETFs vs Actively-Managed Mutual Funds and Passively-Managed ETFs

1.1 Active ETFs vs Actively-Managed Mutual Funds

Firstly, compared with Actively-Managed Mutual Funds, Active ETFs gives the tax advantage; this is all the ETFs' advantage. Secondly, Active ETFs was more transparent for their daily disclosure requirement. Thirdly, Active ETFs have a lower expense ratio. Finally, compared with Actively-Managed Mutual Funds which commonly used open ended funds, Active ETFs have enough daily trading liquidity. (Daley, 2010)

1.2 Active ETFs vs Passively-Managed ETFs

Generally speaking, traditional Passively-Managed ETFs will trace a specific index, which made their return just copy the return structure of the relating index. Accordingly, Active ETFs have a higher expense ratio than their indexing counterparts due to higher trading costs. In contrast, portfolio managers who managed Active ETFs are take active positions to provide excess return over their benchmark return. Thereafter, active ETFs will have a higher turnover rate and transaction costs than index ETFs.(Nigam, 2010)

2. Current situation of Active ETFs

According to incompletely statistics, at the end of December 2009, The global mutual fund industry stands at around \$26 trillion while the mutual fund space in the United States is around \$12 trillion. And in the market out of the United States, Active ETFs emerging in other countries, at the end of June 2010, there are six Active ETFs in Canada, the total assets comes to \$84 million, and India is launching its first actively managed exchange traded fund, the MOST Shares M50. (Nigam, S.2010).

Except issuing active ETFs directly, there successful case of converting other types actively managed mutual funds to active ETFs. This include two kinds of conversion: converting the close end funds to active ETFs and converting the

traditional passively managed mutual funds to active ETFs. For example, in November 2009, Horizons AlphaPro In Canada has already successfully converted one of its mutual funds into an Active ETF.

3. Challenges faced by active ETFs

Exchange-traded fund were required to disclose its real-time holdings. This make it different from traditional actively managed mutual funds, which were just required to disclose it holdings periodically (usually 3 months),and it makes active ETFs face so many Challenges.

3.1 Challenges from transparency

Transparency Challenge comes from two aspects: one from front Running, which resulted from the rules of real-time disclosure of holdings. Another from the portfolio manager's trade-off between disclosure of holdings and sustain of arbitrage mechanism.

If portfolio managers reveal their holdings information, all the investors can use the information to construct their own portfolios without paying portfolio managers for their services. While this is less of a concern at the individual investor level, it involves a lot of money at the institutional investor level. Imagine, for example, if you are trying to sell short of a large position or buy long into a large position. Such a move can take days to implement. Your competitors can use the information to their advantage, trading against you for a profit; this strategy was known as the "front running".

Furthermore, there was conflict between the motivation of portfolio manager to reveal their holdings information and the maintenance of arbitrage mechanism in the secondary market. This becomes the arbitrage trading of active ETFs. Trades occur on the open market or via redemption for the underlying securities, if ETFs' price in the secondary market were different from the price of holding (net asset value of the fund), the arbitrageur will take chance of it and traded for an arbitrage profit. And for the active ETFs, if the company that creates the ETF does not reveal the underlying holdings information, these arbitrage mechanism cannot work. The result could be an ETF that trades at a substantial premium or discount to the net asset value (NAV) of its underlying holdings.

3.2 Challenges from lacking of track record

For newly issued active ETFs, the most important thing for those investors who emphasize on the performance of portfolio manager is about the funds track record. Usually, they use Morningstar ratings as the main selecting criterion benchmark. Generally speaking, most Active ETFs were so new that have track records shorter than 2 years, which is insufficient for them to receive Morningstar ratings. Because Morningstar ratings will only give rating to those funds which have run for more than 3 years.

But most of the newly issued active ETFs have very short track record, which are no more than one year, for those funds traded in the market, The oldest batch of actively-managed ETFs on the market was from PowerShares, will only hit the 3-year mark in April 2011. And it is understandable for the investor take a wait-and-see attitude to the newly issued active ETFs.

3.3 Challenges from servicing for the active ETFs

Active ETFs' portfolio structure was not steady like the passive managed ETFs. For the active ETFs' objective was to get a higher rate of return more than a benchmark rate of return, so the portfolio manager of Active ETFs must take a active trading strategy rather than a passively replicating an index. And this made Actively managed ETFs ace distinct servicing challenges due to the fact that their composition is subject to change at any time. (Greene, 2010)

At the same time, in order to make the Active ETFs appropriate transparency and more higher trading frequency to sustain a fully arbitrage mechanism. This will also make it more difficult to give the service as soon as possible, and it is more difficult than the same service to passive managed ETFs.

4. Development tendency of active ETFs and its revelation

4.1 The prospect of global markets of active ETFs

4.1.1 Different countries have different regulations for daily disclosure of holdings

The stringent requirement on daily disclosure of holdings for the Active ETFs will bring severe challenge to its development, especially on the front running and the motivation of the portfolio managers to disclose the information. For the requirement about the daily disclosure of holdings, the regulations of these countries are different: In the United States, the regulations require Active ETFs to provide daily disclosure of holdings, albeit with a one-day lag. In Canada, actively-managed ETFs are not required to provide daily disclosure of holdings. The regulators only require these funds to provide complete disclosure of holdings every 6 months or semi-annually. This makes it no different from other actively managed mutual funds. In Germany, the mode of processing was almost the same with Canada.

At the same time, in order to sustain enough arbitrage mechanism, in the actual operating process, market makers and designated brokers for the active ETFs in Canada and Germany were given access to information about the component stocks in the fund so that they can arbitrage to keep the fund price as close to the NAV as possible.

Therefore, the difference of these countries' regulations for the daily disclosure of holdings is mainly depends on the trade-off between keeping the investor's right to know and the portfolio manager's Privacy Policy of trading. From the point of application result, the mode of processing in Canada and Germany were more preferable: on the one hand, they keep the portfolio manager's Privacy Policy of trading; on the other hand, the investor's "right to know" were not be harmed through the representativeness of the market makers and designated brokers for the active ETFs' involvement in the arbitrage process. And these investors are still able to benefit from all the other advantages of Active ETFs over active mutual funds - lower cost, tradability, tax efficiency.

4.1.2 Shortage of available track record

Part of this problem can be solved by converting existing actively-managed mutual funds into Active ETFs. At present, more and more fund company selecting to convert the existing active mutual funds into actively-managed ETFs, by which, the long history of originally mutual funds can transfer to current active ETF's directly. And in United States, the Active ETF space could well witness more star portfolio managers step into the area. More such entrances will have a definite positive effect on the development of actively-managed ETFs. To a certain degree, it will enhance the attractiveness of these new active ETFs.

4.1.3 Current competition situation of mutual fund industry

For the traditional active mutual funds, the active ETFs maybe real competitors and a much bigger threat to their existence than indexing fund. It is because that the traditional active mutual funds and the passively indexing funds are two kinds of investor instruments, the market are intersected, and these funds are not competitors each other. Compared with active mutual funds, the active ETFs have so many advantages as the low cost, tax efficiency, transparency, and more liquidity. These give the traditional active mutual funds a direct threat.

4.2 The revelation to the development of domestic active ETFs

So far the active ETFs mainly depends on quantification models, this means that it is open to question for the active ETFs operation in the traditional sense. Because the active ETFs company require clear rules of discipline restrict its trading behavior. However, the promotion of active ETFs in China's fund market which is lack of the experience of quantitative management, the determining factor is the investors' acceptance. If investors have not enough degree of acceptance for the active ETFs, and as there are definite conditions for the issuance of Fund products, maybe active ETFs cannot met these access conditions.

Therefore, it is impossible to copy totally the overseas active ETFs' operational forms, but we can give more transparency to the product, and design a quasi-active ETFs (Cao, 2009). We can convert the existing active mutual funds into actively-managed ETFs to resolve the problem of deeply discount of close-end funds. And for the disclosure of holding information, the active ETFs do not have to rigidly adhere to daily revealing of holdings information, they can employ original way of disclosure, at the same time, use foreign experience for reference, the arbitrageur or the designated brokers were allowed access to information about the component stocks.

References

- Cao, C., He, T., and Wang, X. (2009). *The dawn of active ETFs and its new trends*: research report, United Securities
- Daley, P., Dorencz, P., and Bargerstock, D. (2010). *ETF Liquidity Explained*: Journal of Indexes
- Greene, A. (2010). *The Challenges of Servicing the Growing ETF Market*: Research report, State Street Global Services
- Nigam, S. (2010). Active ETF And Passive ETF Can Co-Exist: InFocus Articles, <http://www.dailymarkets.com/author/shishirnigam/>.
- Nigam, S. (2010). *Improving the Actively-Managed ETF Structure*: InFocus Articles, <http://www.greenfaucet.com/speciality-etfs/improving-the-actively-managed-etf-structure/72544>.