The Active Ingredient

By Russell Wild *Wed, Feb 5, 2014*

"In the past year or two, we've seen the introduction of 80 actively managed ETFs," writes Russell Wild, the author of ETFs for Dummies. "But they have not exactly set the investment world on fire..."

In March of 2008, Bear Stearns introduced the first actively managed ETF, the Bear Stearns Current Yield Fund. Later that year, Bear Stearns went belly up, and the first actively managed ETF, after just months from its creation, was put to rest.

Since then, the universe of index-tracking (passive) ETFs has grown exponentially, from several hundred in 2008 to 1,480 today. Purveyors have not only endeavored to track every possible index, but they have also created their own newfangled indexes to track. In search of sales, the industry has been trying to bury the stigma of Bear Stearns and raise interest in actively managed ETFS.

And so, in the past year or two, we've seen the introduction of 80 actively managed ETFs. The largest, and most successful, is the PIMCO Total Return ETF (BOND), with current assets of $4 billion. The smallest is… well, the smallest may be out of business by the time this article appears.

Active ETFs have not exactly set the investment world on fire. Why? The memory of Bear Stearns may be a deterrent. ETF investors may simply have a penchant for indexing. Or perhaps ETF providers are hesitant to reveal their secret sauces to investors: ETFs, at least to date, have required much more transparency than mutual funds. (ETF managers must disclose their holdings every day; mutual funds managers disclose theirs every quarter).

But unless ETF providers find another avenue of brand-extension, they will try to sell active ETFs, as well as to lobby regulators to equalize the transparency rules.

Is this good for investors?

As you know, most academics who have studied the issue have concluded, to the chagrin of many on Wall Street, that few actively managed funds beat the indexes over the long run. It's largely a matter of costs, which matter greatly in determining returns, as Vanguard advertisements attest.

Ah, but the new actively managed ETFs are considerably less costly than actively managed mutual funds. According to Morningstar, the average expense ratio of active ETFs is only 75 basis points, or about 60% of the average cost of actively managed mutual funds (126 basis points). If the academics were to compare passive investing with active ETF investing, indexing might not have such a clear edge.

That said, passive ETFs are similarly less costly than passive mutual funds. Passive ETFs have an average expense ratio of 60 basis points versus an average expense ratio for passive mutual funds of 75 basis points, per Morningstar. (Coincidentally, passive mutual funds and active ETFs have the same average expense ratio.)

So, to the extent that lower costs influence long-term returns, the new active ETFs, collectively, should perform better than active mutual funds, about the same as passive mutual funds, and not as well as passive ETFs.

Of course, costs aren't the only determinant of long-term returns. The quality of management (of both active and passive funds, but especially of active funds) is also critical.

Bear Stearns' management wasn't very good. We'll just have to wait and see about quality of management of the new active ETFs.

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