

ETFs Go Active

Inexpensive and active ETF strategies

BY MARK NOBLE

The exchange-traded fund market remains predominantly geared toward those looking for an inexpensive way to get exposure to market indexes. The low-cost nature of ETFs is attracting an increasing number of investors who view this investment option as a vehicle for active investment strategies. Discussions about ETFs have a tendency to turn into a debate about passive versus active investing. But the ETF doesn't have to be a passive investment.

Last month in the U.S., Invesco Powershares Capital Management, owned by AIM Trimark in Canada, launched the first actively managed equity ETFs. Powershares has launched three different ETFs that have similar mandates to some existing mutual funds, although they are not clones. "Prior to this, the products were all based on indexes; now, through an actively managed ETF, there is not an underlying index that the sub-advisor is managing against,"

says Ed McRedmond, senior vice-president of portfolio strategies, Invesco Powershares. "So the sub-advisor has more freedom or flexibility within the general mandate of the ETF as opposed to simply replicating the underlying index."

McRedmond says the actively managed ETFs were in development for about six years, with most of that time spent awaiting approval from the SEC. His company sees the vehicle as an opportunity to offer an investment product that fills a similar objective to an actively managed mutual fund, but at a lower cost. In addition, because ETFs are traded through exchanges on a daily basis, it will give investors more flexibility in how and when they choose to buy and sell into the ETF.

"An investor gets the benefits of active management they might be looking for through a traditional mutual fund, and by putting it into the ETF structure, you get the benefits of the ETF structure,

which are relatively lower expenses – tax-efficiency being part of that – as well as less of the internal costs and expenses of running a traditional mutual fund," McRedmond says. "It's really taking the best of both worlds and putting them in the active ETF package."

Actively managed ETFs also get rid of part of the problem mutual funds can run into with attracting and retaining money in the fund. By the same token, there are questions about whether actively managed ETFs could lead to daily ETF trading, which could cause troughs in unit value for the funds if the mandate were to fall heavily out of favour.

"I don't anticipate that many investors will be actively trading these; we hope, rather, they will be a core buy-and-hold type of product," McRedmond says.

Although Powershares is drawing attention to this new use of the ETF, they are not the world's first company to launch actively managed ETFs. Som Seif, president of Claymore Investments, says his company already launched two actively managed ETFs in the Canadian marketplace over the last few years, the Claymore Canadian

Financial Monthly Income ETF (FIE) and the Claymore Premium Money Market ETF (CMR).

"The benefit of an ETF structure versus a mutual fund is you get greater flexibility and liquidity. There is the ability for intra-day trading so you buy and sell whenever you want. You can use things like margin, limit orders and stop-loss orders – all the things that you can do with a stock," he says. "The reality is active money managers come with higher cost and with their own biases. Active money managers may or may not outperform an index, but you know long-term their costs are going to be higher."

Seif is a bigger proponent of using ETF as a passive index vehicle, which may or may not be used within an actively managed portfolio. Seif says particularly in the U.S., though, there are a growing number of managers opting to use the ETFs in active asset-allocation strategies.

"There have been a ton of studies over the last 20 years about where the value-add of money management is. They say 90% of your overall return comes from your asset mix, not your stock se-

lection."

This is the philosophy being employed by Canadian-based Hahn Investment Stewards.

Overseen by Wilfred Hahn, the former head of the Global Investment Group of RBC, the company offers nine Precision Core Portfolios investors can choose from. The portfolios are tactically allocated using ETFs and rebalanced when necessary. In effect, the company employs an active investment strategy using passive ETFs.

Davee Gunn, CEO of the company, says Hahn's choice to use ETFs over actively managed funds or security selection is due to a number of factors, but one of the main ones is cost. ETFs provide a very cost-efficient way to create types of portfolios that can be used to the exclusive purview of institutional investors. Gunn says the average embedded cost on an ETF is about 20 basis points.

"We are all about best of breed. Right now ETFs are the most cost-efficient way to build individual portfolios," Gunn says. She adds that with more than 1,100 ETFs available worldwide – another 500 waiting for approval by the SEC – there are very few asset classes that are not represented. A cost-effective portfolio can be constructed, giving investors the chance to diversify their holdings among any asset class they want, and even catering to some exotic tastes.

Hahn and his team employ a macro-selection process and create a mix of ETFs, taking into account aspects like their forecasts for the asset class, risk management, the underlying cost of the ETFs and their liquidity.

The portfolio is then rebalanced if an asset class experiences any "significant events." Hahn explains that this rebalancing is necessary to mitigate risk and has allowed his company to add about 125 basis points of performance to the portfolios over the five years they've used this strategy.

"It's not just active strategy that's important; it's the design of the portfolio," Hahn says. "They are designed to have enough asset classes inside them that are complementary or at least offer shock-absorbers. For example last year [to offset risk] we were taking opportunities, for correlation reasons, in Asian fixed-income and a couple of other areas like that. Today, with the advent of the ETF package, we are able to offer these richly diversified portfolios at a price level that still beats international portfolios – that was impossible five years ago." **AER**

Fund Wrap

Mutual fund sales continued to struggle in April, despite strong performance in global equity markets.

According to preliminary estimates from the Investment Funds Institute of Canada, net sales of mutual funds for the month fell somewhere in the range of \$57 million to

\$557 million. That's a bit of a decrease from the traditionally busy month of March, which saw only \$2.58 billion in net new money.

Total industry assets under management ranged between \$702.6 billion and \$707.6 billion, up approximately 2.54% from March.

Equity-based investment funds enjoyed the strongest returns in April, according to preliminary performance data released by Morn-

ingstar Canada. All but one of the 23 Fund Indices that track the performance of equity fund categories showed positive returns for the month, with 10 of them gaining 4% or more. This comes on the heels of a very volatile first quarter that saw practically all of those same indices finish in the red. The best performer in April was the Morningstar Emerging Markets Equity Fund. **AER**

MORNINGSTAR FUND INDEX

As of April 30, 2008	1M	YTD	As of April 30, 2008	1M	YTD
Emerging Markets Equity	6.0	-3.7	Global Small/Mid Cap Equity	2.3	-5.7
Canadian Equity	5.4	1.2	Canadian Neutral Balanced	2.2	0.7
Asia Pacific ex-Japan	5.2	-5.7	Canadian Small/Mid Cap Equity	2.1	-3.3
Japanese Equity	5.0	-2.0	Global Neutral Balanced	2.0	-0.9
Science & Technology Equity	5.0	-7.5	High Yield Fixed Income	1.9	0.4
Canadian Dividend & Income Equity	4.4	-0.8	2015 Target Date Portfolio	1.9	-0.2
Asia Pacific Equity	4.4	-5.1	2020+ Target Date Portfolio	1.8	-0.8
US Small/Mid Cap Equity	4.2	-6.3	2020 Target Date Portfolio	1.8	0.1
Canadian Focused Equity	4.1	-0.8	Canadian Focused Small/Mid Cap Equity	1.2	-6.1
Financial Services Equity	4.0	-5.9	2010 Target Date Portfolio	1.1	0.6
International Equity	3.9	-4.3	Health Care Equity	1.1	-6.2
Natural Resources Equity	3.5	5.3	Global Fixed Income Balanced	1.1	0.8
Global Equity	3.4	-3.9	Canadian Fixed Income Balanced	0.9	0.9
Tactical Balanced	3.3	-1.1	Canadian Money Market	0.2	1.1
European Equity	3.2	-3.3	US Money Market	0.2	1.0
Real Estate Equity	3.2	1.4	Canadian Short Term Fixed Income	0.0	2.6
Canadian Income Trust Equity	3.1	2.9	Canadian Fixed Income	-0.6	1.9
Canadian Equity Balanced	2.8	-0.2	Canadian Inflation-Protected Fixed Income	-1.7	3.1
US Equity	2.8	-5.3	Canadian Long Term Fixed Income	-1.7	-0.1
Global Equity Balanced	2.6	-1.0	Global Fixed Income	-2.6	4.3
North American Equity	2.3	-3.7	Precious Metals Equity	-10.7	-6.9