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A Journey Down Memory Lane: Mutual Funds to Active Exchange-Traded Funds

By Michael Andrews, CFA®

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There is a frothiness in today's markets that mirrors the mutual fund heyday of the late 1990s. Consider what's going on with special purpose acquisition companies (SPACs), the subreddit WallStreetBets and the mass adoption of social media to move markets, the record levels of margin debt, and cryptocurrencies.

Given current valuations, it is a situation all too similar to other historical market peaks—and it is increasingly hard to view near- to mid-term equity and fixed income future returns as anything other than likely to disappoint.

In early 1998, the DJIA was around 9,000, and average investors accessed the stock market via the mutual fund. Star managers such as Fidelity's Peter Lynch and Legg Mason's Bill Miller were becoming well-recognized names, and the industry was experiencing rapid growth. By 1990, assets under management (AUM) across U.S. mutual funds had exceeded $1 trillion, up from $135 billion at the end of 1979. This figure then doubled by the end of 1993, when AUM reached $2.07 trillion, and then doubled again by the end of 1997, when it reached $4.5 trillion, before surpassing $6.8 trillion in 1999 at the height of the dot-com bubble.[1] Over the same 20-year period, the number of mutual funds increased from 564 to more than 7,700.[2]

Much of this growth was driven by 401(k) defined contribution investment plans. Companies such as Fidelity Investments, Vanguard, and T. Rowe Price became household names, and many funds experienced tremendous growth. For example, the Janus Worldwide Fund grew from $208 million in assets in 1992 to $11 billion at the end of 1997; PBHG Growth Fund went from $3 million to $5.4 billion.

As the mutual fund industry was experiencing all this rapid growth, a competitor product was born. The exchange-traded fund (ETF) era began with State Street Global Advisors and the S&P 500 Trust or SPDR on January 22, 1993. From one fund in 1993, the ETF market grew to 102 funds by 2002, a fraction of the number of mutual funds available.[3] In 2008, the U.S. Securities and Exchange Commission (SEC) authorized the creation of ETFs that use active management strategies. Bear Stearns launched the first actively managed ETF, the Current Yield ETF (YYY), which began trading on the American Stock Exchange on March 25, 2008.[4] Unfortunately, the fund did not survive the Great Financial Crisis and Bear Stearns' demise.

As investment professional Richard Wanger said in 1998: "The returns we've had for the last three years are not sustainable. It's not going to be Christmas every day."[5] Like many at the time, Wanger knew a reversion to the mean was not a question of if but of when. And, as returns for the 10 years ended 2009 show, he was right (see table 1).

FEES IN THE '90s—THE BEST OF TIMES

The 1990s were characterized by growth and high fees. The market snowballed and, not surprisingly, careers and fortunes were built on the tailwinds of one of the most significant bull markets in economic history. However, as the dot-com bull market ended and a ferocious bear market began, investors increasingly focused on the cost of investment management. According to Morningstar, fees have declined for the past two decades and are now approximately half of what they were in 2000.

Table 1

RETURNS, 1930–2009

ASSET CLASS	1930–39	1940–49	1950–59	1960–69	1970–79	1980–89	1990–99	2000–09
S&P 500 Index	−0.1	9.2	19.4	7.8	5.9	17.5	18.2	−0.9
Large-Cap Value	−5.7	12.7	18.4	9.4	12.9	20.6	16.8	4.1
Small-Cap	2.3	14.9	19.2	13.0	9.2	16.8	15.5	9.0
Small-Cap Value	−2.6	19.8	19.6	14.4	14.4	20.1	16.2	12.8

Source: Dimensional Fund Advisors (Paul A. Merriman, "8 Lessons from 80 Years of Market History" (December 29, 2014), https://www.marketwatch.com/story/8-lessons-from-80-years-of-market-history-2014-11-19). Includes reinvestment of dividends.

In fact, in 2019, the asset-weighted average expense ratio across all mutual funds and ETFs was 0.45 percent.[6] Much of this decline has been driven by adopting low-cost passive investing, using index mutual funds and, more recently, ETFs. Predictably, this massive decline in fees dramatically has impacted the economics of the investment management industry (see figure 1).

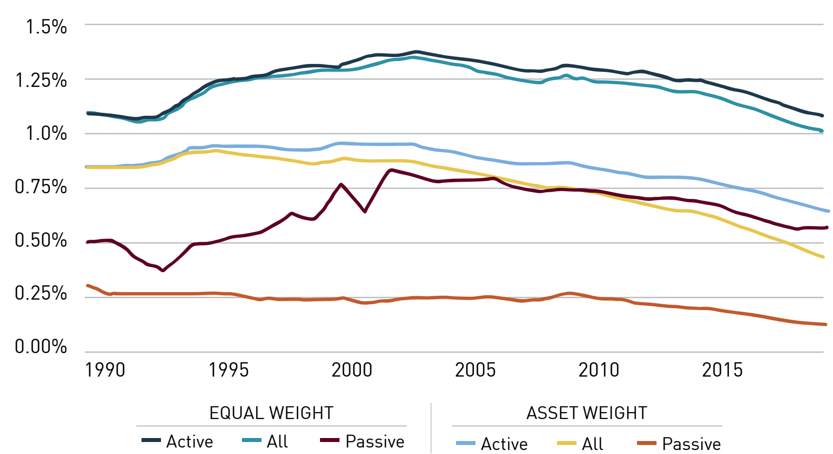
One of the industry's giants for a time was Bill Miller of the Legg Mason Capital Management Value Trust, which exceeded the S&P 500 every year from 1991 until 2005. In 2006, this one fund alone generated the considerable sum of $121 million in fees.[7] But this could not last. Miller left the fund in 2011 following a period of prolonged underperformance and outflows (see figure 2). As part of the active investment management industry, he was not alone as active management on the whole lost market share to passive giants such as Vanguard and BlackRock.

To compete effectively versus passive investment management, investment managers must provide top-performing and cost-effective offerings to their intermediary clients. For example, despite a challenging market environment, PGIM (formerly Prudential Investment Management) ended 2020 with $21.7 billion in net mutual fund flows—number two in the industry—and record mutual fund AUM of $160.4 billion, up 31 percent from 2019. PGIM is the fourth fastest-growing fund family by organic growth and has reached its 12th consecutive year of positive net mutual fund flows, primarily driven by demand for actively managed fixed-income funds. Eighty-six percent of the firm's mutual fund AUM is in funds rated at 5 and 4 stars by Morningstar. PGIM also has committed to lowering costs for investors and has executed 58 strategic fee reductions resulting in $166 million in annual shareholder savings since 2012.[8] Simply put, superior products in the right place at the right time have enabled PGIM to invest in its business and create a spiral of success and growth.

But many firms have been less fortunate, leading to consolidation in the industry. This trend is likely to continue, especially if there is a significant market correction.

Figure 1

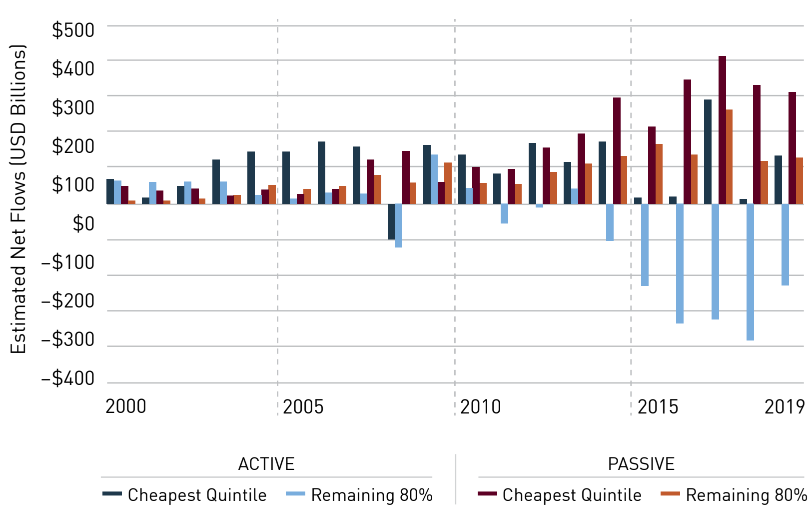
MARKING TWO DECADES OF FALLING FUND FEES



Source: Morningstar Direct. Data as of December 31, 2019.

Figure 2

EXPENSIVE ACTIVE FUNDS HAVE BEEN THE EPICENTER OF OUTFLOWS



Source: Morningstar Direct. Data as of December 31, 2019.

MUTUAL FUND RATIONALIZATION —IT'S NOT JUST BECAUSE OF ETFs

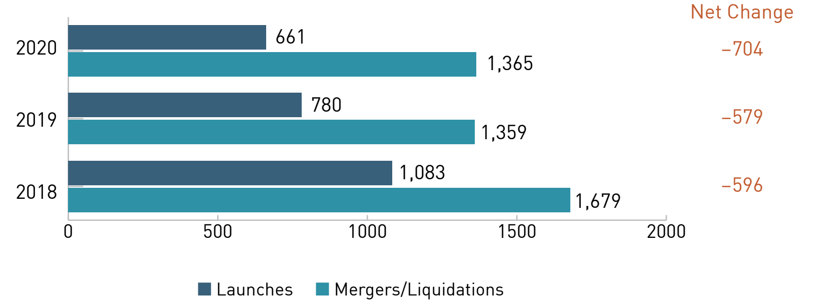
According to Morningstar data and analysis by Ignites, asset managers in 2020 continued to cut the number of available mutual funds for the third year in a row; 704 share classes were cut in 2020 (see figure 3). Although some of this decrease represents fund firms eliminating share classes that are no longer in demand, a significant portion results from investment-manager consolidation.

Overall, approximately 1,365 share classes were liquidated or merged away in 2020, roughly the same number as in 2019. But fewer than half of that—661—were created, down 15 percent from 2019. Across firms, 148 new mutual funds were brought to market in 2020, down 30 percent from 2019. Meanwhile,

Figure 3

CLASS COUNT

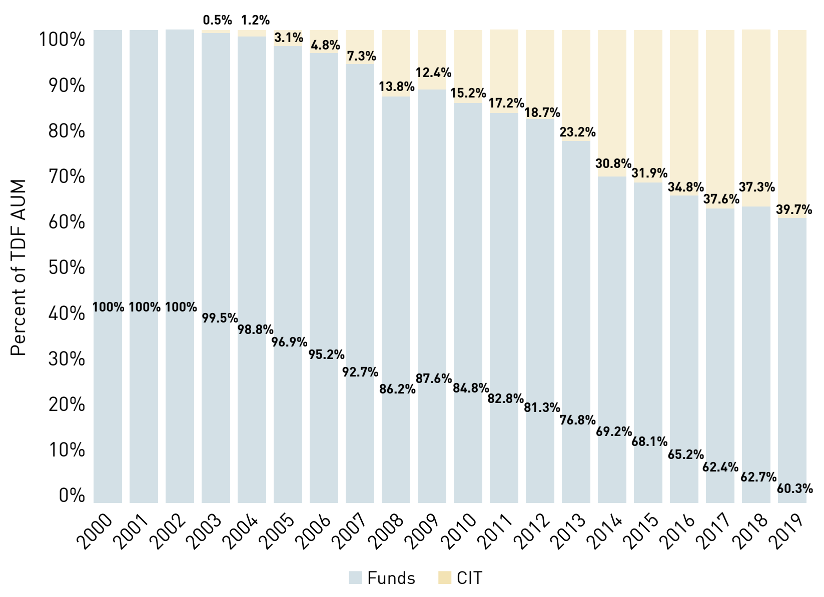
Share class launches fell 15% in 2020. Meanwhile, mergers and liquidations remained steady with last year's figures.



Source: Morningstar Direct. Data only includes open-end mutual funds. It does not include ETFs, money market funds, or funds of funds. Share classes that launched and became obsolete within the same calendar year were excluded.

Figure 4

PERCENT OF OVERALL TDF AUM IN MUTUAL FUNDS AND CITs SINCE 2000



Source: Stadion

507 mutual funds were taken off the market last year, a 16-percent increase from 2019, when 436 were eliminated.[9]

COLLECTIVE INVESTMENT TRUSTS

In the 1990s, the switch in retirement savings from defined benefit (DB) to defined contribution (DC) helped power mutual funds, which provided choice. Today, the fiduciaries responsible for 401(k) plans—especially large plans—increasingly are focused on cost. As a result, collective investment trusts (CITs) have become a critical DC tool because of their low cost and customizability. CIT industry assets more than tripled in the decade ending in 2018, climbing to $3.1 trillion. CITs are most prevalent in the large end of the DC market, where national consultants such as Mercer and Willis Towers Watson advised nearly $3.5 trillion of the $8 trillion in DC assets as of 2019.

Since the Pension Protection Act of 2006, off-the-shelf target-date funds (TDFs) have dominated the DC space. However, driven by fee pressure from plan sponsors and increased demand for customization, asset managers are positioning cheaper—and often identical—CIT options alongside their standard mutual fund offerings.

Morningstar reported that TDF providers launched 23 CIT versions in 2019 and 12 in 2018, compared with three new mutual fund-based series during those two years. Eight CIT-based series were liquidated or merged throughout the period, and five mutual fund series liquidated or merged. Five companies dominated the TDF business in 2019 with a 79-percent market share, just like they did in 2018 with a 78-percent market share. Vanguard (37 percent) was the leader, followed by Fidelity Investments (14 percent), T. Rowe Price (12 percent), BlackRock (9 percent), and Capital Group's American Funds (7 percent).[10] An excellent example of a large firm transitioning from the use of mutual funds to CITs is Nuveen. In late 2019, Nuveen partnered with SEI to launch the Nuveen TIAA Lifecycle Blend CITs, a series of 12 CIT-based TDFs and one retirement-income fund.[11]

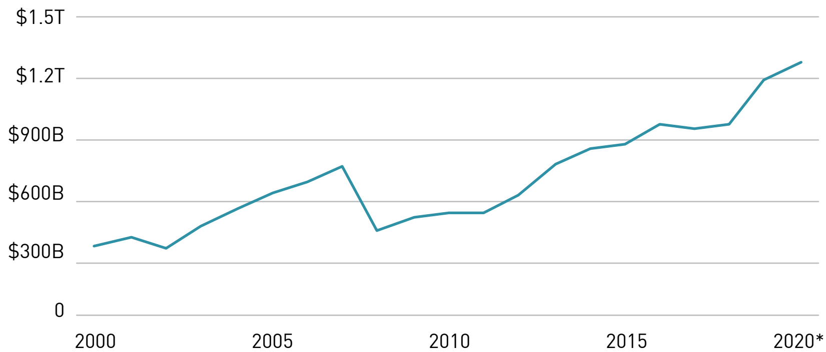
Figure 4 shows the percent of overall TDF AUM in mutual funds and CITs since 2000.

SEPARATELY MANAGED ACCOUNTS

In addition to CITs, several investment-management firms have launched separately managed account (SMA) strategies. These strategies often are clones of or similar to mutual fund strategies. They allow advisors to customize portfolios to optimize tax efficiency and reduce risk, frequently at a lower price. SMAs likely will continue to grow at the expense of mutual funds and perhaps other packaged products such as ETFs, especially if so-called direct indexing or custom SMAs become more popular. Recent corporate activities such as BlackRock's acquisition of Aperio, Morgan Stanley's acquisition of Eaton Vance and its Parametric subsidiary, and

Figure 5

SEPARATELY MANAGED ACCOUNTS GROWTH



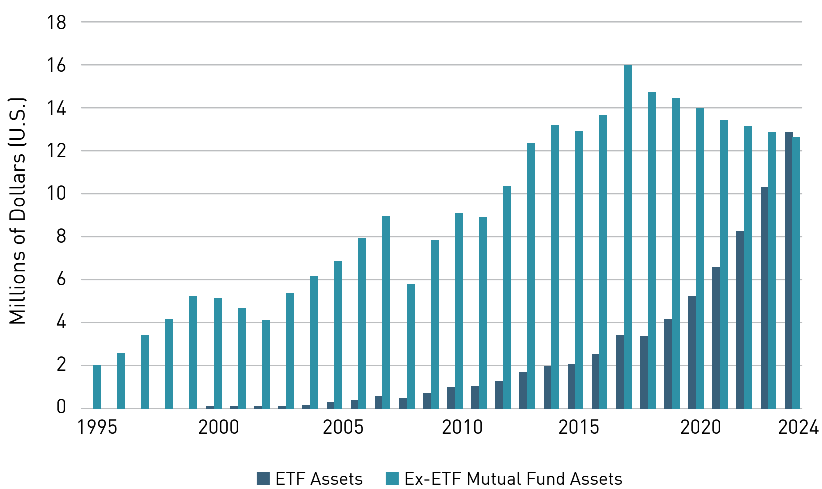
** Data as of September 30, 2020.*

According to data from JPMorgan Asset Management and Cerulli Associates, assets in separately managed accounts reached $1.27 trillion as of September 2020. That's 43 percent higher than five years earlier. Mutual fund assets, meanwhile, climbed 40 percent since 2015, to $16.46 trillion as of the third quarter.

Source: Ignites (Adrian D. Garcia, "Cutting Class: Shops Drop 704 Share Classes" (January 27, 2021), https://www.ignites.com/c/3037854/381674?referrer_module)

Figure 6

ETF ASSETS CROSS MUTUAL FUNDS IN 2024



Source: ETF.com, Investment Company Institute, FactSet

J.P. Morgan's acquisition of 55ip are all indicative of an industry that increasingly views tax optimization and personalization of individual accounts as the future. Assets in SMAs are now almost $1.3 trillion and expected to grow (see figure 5).

GROWTH OF ETFs—PASSIVE TO ACTIVE INVESTING

Since 2010, ETF industry growth has exploded. In 2015, Ronald O'Hanley, chief executive officer of State Street Global Advisors, said that ETFs were growing as fast as mutual funds had in the 1980s and 1990s. "We're kind of squarely in the '80s right now," he said, comparing ETFs with the heyday of mutual funds.[12] That growth shows no signs of abating; arguably it has accelerated of late. Unlike mutual funds, however, the ETF industry is dominated by three enormous providers of passive investment products—Vanguard, BlackRock, and SSGA.

ETF industry growth, however, has benefited players other than the top three. Goldman Sachs, ProShares, J.P. Morgan, and First Trust have managed to carve out a niche for themselves. Nevertheless, most of the benefits of ETF growth have flowed to a much smaller group of industry players.

But this may be changing. In June 2019, the SEC approved ActiveShares by Precidian Investments, the first active, semi-transparent ETF model, which has been licensed to third-party asset managers. As a result, in 2020, the industry saw the first active, semi-transparent ETFs with launches from American Century and Clearbridge. T. Rowe Price, Natixis, Fidelity, and Blue Tractor also have received approval to start offering active semi-transparent ETFs. T. Rowe Price opened four active ETFs in August 2020: T. Rowe Price Blue Chip Growth ETF (TCHP), T. Rowe Price Dividend Growth ETF (TDVG), T. Rowe Price Growth Stock ETF (TGRW), and T. Rowe Price Equity Income ETF (TEQI) in August 2020. Recently T. Rowe Price announced it would launch an ETF version of the $6.2 billion T. Rowe Price US Equity Research Fund.

Smaller firms such as Alger continue to unveil plans to actively manage mutual funds in a new ETF wrapper—the Alger 25 ETF and Alger Mid Cap 40 ETF. Large firms such as Fidelity are doing the same, and activity is expected to pick up in 2021 (see figure 6). Indeed, in October 2020, Fidelity revealed that it plans to bring the Fidelity Magellan Fund to market in an ETF wrapper in 2021.

The growth of the ETF industry has not gone unnoticed by more-traditional mutual fund users and active managers. One example is Dimensional Fund Advisors (DFA), which is the mutual fund industry's fifth-largest firm, and it remains a strong proponent of mutual funds. DFA's funds were among the earliest quantitatively run factor-based funds focused on value and small-cap investing. In 1989, DFA began allowing financial advisors to purchase its funds for clients, but only after those advisors successfully completed a two-day academic course on the firm's investing methodology and passed DFA's vetting process.

On November 18, 2020, DFA debuted its ETFs with two launches—the Dimensional US Core Equity Market ETF (DFAU) and the Dimensional International Core Equity Market ETF (DFAI), priced at 0.12 percent and 0.18 percent, respectively. At the same time, DFA filed plans to convert three tax-managed mutual funds to an ETF wrapper. Marking the end of an era, the two ETFs are available to anyone with a brokerage account.[13]

According to the CFRA's First Bridge ETF database, active ETFs manage $200 billion in assets. They pulled in 14 percent of industry net inflows in the year ended February 4, 2021, despite representing less than 4 percent of assets. ARK Funds is the largest active ETF provider, with $50 billion in assets, led by the success of the ARK Innovation ETF (ARKK). ARKK and some of the firm's other funds more than doubled in value in 2020. Meanwhile, First Trust, J.P. Morgan, and PIMCO continued to gather assets with actively managed fixed income ETFs, including the First Trust Low Duration Opportunities ETF (LMBS), the JPMorgan Ultra-Short Income ETF (JPST), and the PIMCO Enhanced Short Maturity Active ETF (MINT).

Historically, fixed income products were the driver of the active universe, but the tide shifted in 2020, driven by the success of equity funds run by ARK Funds. Although equity ETFs currently account for just 37 percent of the active ETF asset base, these offerings pulled in 54 percent of the net inflows in the past year. Fixed income funds gathered $29 billion, or 40 percent of the flows.

Despite the recent success, active equity ETFs represent just 1.6 percent of the overall equity ETF category's asset base, because index-based funds such as the iShares Core S&P 500 ETF (IVV) and the Vanguard Total Stock Market ETF (VTI) remain dominant. In contrast, active fixed income ETFs represent a more significant 10 percent of the fixed income ETF category.

During 2020, ARK pulled in $31 billion in new money, fourth-most overall behind the three largest asset managers but ahead of larger firms such as Invesco and Charles Schwab. Whether ARK's success will persist remains to be seen.

Active fixed income is driving PIMCO's flows, but J.P. Morgan's ETF presence is more diversified. PIMCO's $21-billion actively managed ETF business makes up 78 percent of the firm's overall ETF assets, with MINT and the PIMCO Active Bond ETF (BOND) combined managing $19 billion of assets.

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MINT is an ultra-short product appealing to investors seeking more income than money market funds can offer. Meanwhile, BOND is a core fixed-income product that has modestly outperformed the index-based iShares Core US Aggregate Bond ETF (AGG) in the three years ended February 4, 2021.

JPST is a peer of MINT and is J.P. Morgan's largest ETF, with $16 billion in assets. However, active ETFs represented only 4 percent of the firm's ETF assets. Other popular active products include the JPMorgan High Yield Research Enhanced ETF (JPHY), and the JPMorgan Ultra-Short Municipal Income ETF (JMST).

The fifth-largest active ETF provider is BlackRock, which manages approximately $12 billion in assets. The BlackRock Ultra Short-Term Bond ETF (ICSH) is the firm's largest active ETF, with $5.2 billion. Though BlackRock offers nearly two dozen active ETFs, active products represent just 1 percent of its ETF assets.

The future seems bright for active ETFs. In 2020, many large asset managers launched initial active equity ETFs. These included the American Century Focused Dynamic Growth ETF (FDG), the Dimensional US Core Equity Market ETF (DFAU), the Fidelity Blue Chip Value ETF (FBCV), the Invesco Focused Discovery Growth ETF (IVDG), and the T. Rowe Price Blue Chip Growth ETF (TCHP).[14]

Finally, a survey by the *Journal of Financial Planning* and the Financial Planning Association Research and Practice Institute found that, before 2015, more advisors were recommending mutual funds than ETFs—but four years later, those preferences were reversed. In 2020, 85 percent of advisors indicated they now use or recommend ETFs for clients, compared with 75 percent for mutual funds, according to the research.[15] Fifty-two percent of advisors said they plan to increase their ETF usage over the next year, compared with just 24 percent who said they were planning to increase mutual fund use. In short, if price and portability aren't the deciding factors, other developments are eating away at any remaining support for mutual funds. Schwab, Fidelity, E*Trade, and TD Ameritrade all have cut the cost to trade ETFs, stocks, and options to zero while buying a mutual fund still comes with a fee at many brokerages. On the heels of those announcements, Charles Schwab and other firms such as Fidelity are now allowing investors to buy and sell fractional shares.[16]

MUTUAL FUND TO ETF CONVERSIONS

Active, semi-transparent ETFs combine the advantages of active management with the liquidity and tradability of

ETFs, and industry observers tend to believe this will lead to growth in 2021. Remarkably, one potential growth area is converting existing mutual funds into ETFs.

But at present, only one fund, a small hedge fund named Guinness Atkinson, has managed to make the conversion, by moving two mutual funds to ETFs. Meanwhile, as noted above, DFA plans to complete the conversion of three mutual funds to ETFs in 2021.

Ropes & Gray states that, although there is no legal reason a mutual fund couldn't convert to an ETF, several practical and operational challenges must be overcome.

The Boston-based law firm Ropes & Gray has extensively researched the conversion process and has written a well-received whitepaper.[17] Ropes & Gray states that, although there is no legal reason a mutual fund couldn't convert to an ETF, several practical and operational challenges must be overcome.

First, mutual fund sponsors contemplating a conversion must explain to the funds' boards how a conversion is in the funds' best interest. In the case of a merger, existing shareholders must be assured that they will not be diluted. Also, boards must understand the structural differences between mutual funds and ETFs. An extensive list of items must be settled, including the following:

- Arbitrage mechanism
- Creation and redemption processes
- Implications of the conversion for shareholders
- Loss of the right to redeem individual shares
- Need for ETF shareholders to designate or establish a brokerage account to trade the ETF shares following the conversion
- Intra-day liquidity provided by the ETF structure
- Changes to the fund's principal and historical investment strategies
- Expected portfolio turnover, transaction costs, and tax consequences due to conversion
- Conversion costs and who will bear them
- Trading costs (i.e., bid-ask spreads) borne by existing shareholders
- Timeline for conversion
- Expected effect of conversion on the fund's total operating expenses
- Sponsor's ability to facilitate an effective arbitrage mechanism through arrangements with authorized participants
- Any potentially significant tax benefits due to operating as an ETF

Converting a mutual fund to an ETF should not have any significant adverse tax consequences to the mutual fund, the ETF, or its shareholders. Still, given the unique nature of the semi-transparent active ETFs, additional tax considerations or limitations may be relevant under the Internal Revenue Code. If the conversion is affected by a merger, approval by the mutual fund's shareholders may be required under a variety of corporate law or regulatory regimes.

Converting a mutual fund into an ETF raises essential business considerations, including the effects of the conversion on existing mutual fund shareholders and any existing agreements among the mutual fund, its distributor and/or its transfer agent, and various intermediaries. Unlike ETF shares held through brokerage accounts, many mutual fund shares are held directly with the mutual fund. Mutual fund shareholders will need to establish a brokerage account to buy and sell ETF shares they receive as part of the conversion. Additionally, sponsors will need to work closely with their service providers and intermediaries to ensure a smooth transition.[18]

CONCLUSION—A PROFITABLE AND THRIVING INDUSTRY

The heyday for mutual funds was the 1990s. AUM for mutual funds grew rapidly from $135 billion in 1979 to $6.8 trillion by the end of 1999. Despite the dot-com collapse, the Great Financial Crisis, and the COVID-19 crash, the industry remains successful. As of Q4 2020, mutual fund industry AUM was in excess of $18.2 trillion, more than three times ETF assets. Importantly, operating margins, though under pressure, remain exceptional. One study found the median operating margin for traditional U.S. publicly traded investment managers was 27 percent at the end of 2019, which, although down from 34 percent five years earlier, remains high.[19]

But mutual funds likely will remain under pressure. Product wrappers such as CITs, ETFs, and SMAs likely will experience higher organic growth rates. In particular, ETFs—whether traditional passive, transparent active, or semi-transparent active—seem destined to take market share gradually. According to the research firm ETFGI, more than 7,100 ETFs traded globally in May 2020.[20] This represents a tremendous growth rate since the first SPDR S&P 500 Trust (SPY) launch in 1993. That said, no part of the industry is immune from the impact of fee pressure, rising costs, technological change, and the ever-present threat of a significant market pullback. Success will continue to depend on meeting the needs of advisors and their clients, superior price-conscious performance, and constant innovation. Those firms able to compete in such an environment will be the winners.

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MUTUAL FUNDS TO ACTIVE ETFs

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