Active exchange-traded funds (ETFs) are open for investment. The important thing to remember is that what they look like today probably is different from what they will look like (and how they will operate) five years from now.

What is an Actively Managed ETF?
An actively managed ETF is an ETF that is not required to track an index. However, similar to actively managed mutual funds, actively managed ETFs may use an index as a benchmark.

Actively managed ETFs may follow a quantitative model that may look like an index, but as long as the ETF is not seeking to track the performance of an index (or inverse or leveraged exposure to an index), it should be considered actively managed.

To date only four firms have received the Securities and Exchange Commission (SEC) exemptive relief required to launch these products (Barclays, PowerShares/AER, Bear Stearns/J.P. Morgan, and WisdomTree), and only one of these firms (PowerShares/AER) received approval for equity-based actively managed ETF products. The other firms received approval for fixed-income or currency-based actively managed ETFs.

Many other firms are seeking exemptive relief from the SEC to offer actively managed ETFs; these include my firm, AdvisorShares, as well as Grail Advisors, XShares, Vanguard, and Managed ETFs.

Adding Actively Managed ETFs to Your Portfolio
You should view actively managed ETFs the way you would view a traditional actively managed mutual fund. Each product will have a prospectus, and you should read it carefully to understand exactly how the portfolio manager will implement the investment strategy.

You also should invest in actively managed ETFs the same way you would invest in an index-based ETF. In general, you should expect actively managed ETFs to have competitive expense ratios and to be more tax efficient than traditional actively managed mutual funds.

However, when investing in an actively managed ETF, pay close attention to commissions and watch the trading spreads carefully. You should rarely use a market order when buying or selling shares of an actively managed ETF. Every actively managed ETF should have a ticker symbol for the ETF and a ticker symbol for the

* Ticker: RSP, indicative ticker: RSP-IV (for Yahoo! Finance use ^RSP-IV)
"indicative value." Be sure to check this value when placing your order—this will help ensure you are trading as close to net asset value (NAV) as possible during the day.

If there is a significant-enough difference in the indicative value versus the public offering price (the “ask price” for buy orders and the “bid price” for sell orders), you should consider using the indicative value to guide the placement of your order. But keep in mind: If your goal is to get out quickly, a market order might be more appropriate than a limit order, because there is no guarantee that a limit order will be executed.

Figure 1 shows how the indicative value for the ETF is very close to the actual buys and sells for the ETF.

**Should You Use Actively Managed ETFs?**

If you use actively managed mutual funds as part of your asset allocation strategy, the answer is “yes”; if you do not, the answer is “maybe.”

Actively managed ETFs will bring new investment strategies, new investment management firms, and new investment managers. Similar to a traditional mutual fund, the investment strategy of an actively managed ETF may have a track record that would allow you to analyze the historical performance of the investment advisor. Do not assume every actively managed ETF strategy is from a new or unproven manager or has a new or unproven track record. You may be overlooking an investment strategy that could add value to your clients’ overall investment goals.

The potential advantages to using actively managed ETFs as part of your asset allocation strategy are lower operating costs, better tax efficiency, transparency, and liquidity. The potential downsides, as mentioned above, are commissions and spreads, which impact the true cost of ownership. Also, ETFs do not charge sale loads or redemption fees, but they do have the ability to charge 12b-1 fees, even though most do not.

**Do Actively Managed ETFs Offer a Performance Advantage?**

It is important to note that actively managed ETFs may not charge a lower expense ratio than a traditional actively managed mutual fund. Still, the ETF structure offers a distinct advantage over traditional mutual funds.

Shares in an ETF are traded on an exchange, so daily cash flows do not need to be managed by the portfolio manager. This can offer a significant savings in commissions and spreads that can allow an ETF to operate more efficiently than a traditional mutual fund. While this operational efficiency may not be evident from the expense ratio listed in the prospectus, all things being equal, it is a cost savings and a performance advantage (for both index-based and actively managed ETFs).

When purchases and redemptions are executed in an ETF, they happen with an “in-kind” basket of securities that should match the same securities in the same allocation as the ETF investment strategy. This in-kind process is the feature that index-based ETFs use to maintain tax efficiency. Actively managed ETFs also enjoy this feature, which allows an actively managed ETF to be on average more tax efficient than a traditional actively managed mutual fund.

The true cost of ownership for an actively managed ETF should be lower for the investor (though factoring in commissions and purchase spreads will provide a more accurate cost calculation).

**Are Actively Managed ETFs the End of Index-based ETFs?**

The SEC’s approval of the first actively managed ETFs should decrease the number of index-based ETFs.

A significant number of index-based ETFs have been registered but not launched, although many of them are in the form of leverage and inverse products from firms such as ProShares, Rydex, and Direxion. I expect those products will launch, with the marketplace determining if there is enough capacity for all of them to continue to operate successfully. I also expect there will be offerings of index-based ETFs with new or alternative beta, such as narrow commodity sectors, or the S&P/Case-Shiller Home Price Index.

Now that actively managed ETFs are available in the marketplace, you will see fewer quantitative strategies packaged into indexes for the sake of ETF product development; instead ETF sponsors will seek active ETF exemptive relief and develop and launch the quantitative strategy without taking the time or effort to develop an index on which to base the strategy. While many
Fidelity and Peter Lynch Settle “Gift” Case

According to a Securities and Exchange Commission (SEC) statement released on March 5, 2008, Peter Lynch “obtained numerous free gifts to concerts, theater and sporting events paid for by outside brokers.”

To settle the case without admitting or denying any wrongdoing, Mr. Lynch repaid the money ($15,948) and interest ($4,183). Fidelity, also without admitting or denying any wrongdoing, has agreed to pay an $8-million penalty to settle the matter with the SEC.

This is a shot across the bow to all of us in the financial services industry. SEC Deputy Director of Enforcement Walter Riccardi has said, “If higher-ups request tickets from a trading desk it may send a message to the traders that such misconduct is tolerated and could contribute to the breakdown of the compliance culture on the desk.”

We have an obligation to our clients to serve their financial interests. From the moment a representative of a mutual fund, insurance company, or money manager picks up the tab for your lunch, you must ask yourself the following: Am I accepting anything that would compromise our code of ethics and influence us in any way to take an action that was not in the best interests of our clients? Hardly a day goes by that some unethical conduct isn’t reported in the papers. Let’s not have any of our names included. Be on guard; protect yourself and your clients.

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Endnotes


Will debate the need for more strategies, continuous ETF development—index-based and actively managed—will continue to reinforce the importance of skilled and educated investment professionals to help manage effective and appropriate investment strategies for investors.

Index ETFs compete in the same marketplace as index mutual funds. Figure 2 shows that only 12 percent of the assets in equity mutual funds are index-based. This will provide a significantly larger competitive marketplace for actively managed ETFs as compared to index ETFs, and would suggest that, in the future, there will be significantly more actively managed ETFs than index ETFs.

What the Future Holds

Index-based ETFs are offered in several structures, including unit investment trusts, open-end investment companies, grantor trusts, publicly traded limited partnerships, and in a fixed-income structure called an exchange-traded note. Actively managed ETFs could have the same operating structures, although the actively managed ETFs currently offered are open-end investment companies. These actively managed ETFs also have daily transparency. Five years from now, you can expect different types of structures for actively managed ETFs, including some that provide intra-day transparency and others that are not transparent except for what is necessary to meet regulatory requirements, similar to the disclosures made for traditional actively managed mutual funds. As the ETF marketplace evolves and grows, it will be more important than ever to stay educated on the changes to ensure your investors are properly counseled in their investment strategies.

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