

# ACTIVE ETF ISSUER GUIDE

LOOKING BENEATH THE SURFACE OF ACTIVE ETFS



FOR PROFESSIONAL CLIENTS AND QUALIFIED INVESTORS ONLY

# 1. Active ETFs: overview

## What is an active ETF?

An ETF is an open-ended collective investment vehicle (or a pooled fund), that is traded on one or more exchanges. ETFs provide access to a portfolio of company shares, bonds or other asset classes, such as commodities or property across a broad set of investment strategies - index and active. Consequently, ETFs combine the diversification of an investment fund with the tradability of a share.

Active ETFs provide access to investment strategies managed by specialist portfolio managers who utilise their expertise to attempt to achieve certain investment goals or objectives, such as downside protection or regular income, seek to outperform a benchmark, or provide access to types of investments which may be hard to access through an index.

In short, Active ETFs are simply actively managed investment strategies delivered through an ETF wrapper, hence combining the characteristics of traditional active mutual funds, with the access, cost-efficiency and transparency of an ETF.

**Capital at risk.** The value of investments and the income from them can fall as well as rise and are not guaranteed. The investor may not get back the amount originally invested.

## Key characteristics: Mutual Funds & ETFS

|  | Mutual Fund  | ETF  |
|--|--|--|
| <b>Buying/selling shares</b>           | Once per day via fund company or broker              | Intraday on- & off-exchange                  |
| <b>Trading fees</b>                    | Typically none                                       | Yes  |
| <b>Full holdings disclosures</b>       | Typically quarterly                                  | Daily  |
| <b>Potential tax advantage</b>         | No   | Yes*   |
| <b>Minimum investment</b>              | May apply depending on share class                   | None   |
| <b>Liquidity sources</b>               | Underlying holdings                                  | ETF secondary market and underlying holdings |
| <b>Subject to capacity constraints</b> | Yes  | No   |
| <b>Suitable holdings</b>               | Liquid securities, illiquid securities, derivatives. | Liquid securities, derivatives.              |
| <b>Security lending possible</b>       | Yes  | Yes  |
| <b>Unit lending possible</b>           | No   | Yes  |

\*30% Withholding tax applied to dividends paid into mutual fund structure by US securities vs. 15% for an Irish-domiciled ETF

## Due diligence: Strategy first, vehicle second

ETFs are a way for asset managers to package and distribute investment strategies to investors. There are some real benefits to using ETFs to access active management. Some actively managed investment strategies are better suited to being wrapped in an ETF so it is important to ask your ETF provider certain questions to help evaluate this suitability. For some strategies and clients, the mutual fund still has an important role to play.

### Is the ETF the right wrapper for this strategy?

You should be asking your ETF provider some key questions to ensure the active investment strategy is well suited to the ETF wrapper:

**How diversified is the portfolio?** More concentrated strategies may have limits on optimal capacity beyond which the manager would have to invest in second choice securities if they continued to receive inflows.

**How liquid are the underlying securities?** Strategies investing in less-liquid holdings may trade at a significant premium or discount to NAV; this is worth considering depending on how long-term your view on the strategy is.

**Is the investment team willing and able to disclose daily holdings?** Certain strategies benefit from not disclosing holdings as it enables market participants to reverse-engineer or replicate a strategy and front-run trades. Strategies investing in broad, diversified markets are less likely to see this as an issue.

### ETFs have some clear benefits:



#### Cost

ETFs tend to have lower fees than mutual funds, this is due to a variety of factors such as:

- Trading on exchange rather than direct (reducing administrative costs)
- A lack of entry/exit fees



#### Accessibility

Another upside of ETFs is the low barrier to investing thanks to on-exchange trading – meaning you can invest in an ETF with an amount as little as a single share.

When contrasted with the minimum investment amount of many mutual funds (often several thousand dollars/euros/pounds), this makes the ETF accessible to a broader range of investors.



#### Liquidity

The secondary market liquidity associated with ETFs becomes even more beneficial for product quality as the ETF grows in scale, leading to tighter trading spreads, allowing investors to buy and sell more efficiently.

When liquidity dries up in underlying markets (as happened during COVID), ETFs become the price-discovery instrument allowing buyers and sellers to continue to trade.



#### Transparency

ETFs disclose full holdings on a daily basis.

This enables investors to have a look-through into underlying holdings and know exactly what they own and where their risks are day-to-day.

## Mutual funds have an important role to play

Certain clients and business models have a preference for mutual funds. This combined with the fact certain strategies are better suited to mutual funds means they will continue to co-exist alongside ETFs. Some benefits which are suited to delivery through mutual funds are:

### Constraining flows

Some active strategies may benefit from being able to close when they reach certain capacity limits. If a portfolio manager can't say "no" to new money, this could have an impact on what they invest in if their strategy has a relatively small pool of available assets. This inability to constrain inflows could result in the manager being forced to invest in assets they may not ideally want to own – negatively impacting performance of the strategy

### Illiquid assets

Active strategies which invest in illiquid securities or those not listed on exchanges (such as private markets) may also not be suitable for delivery through an ETF strategy. In these cases, the mutual funds still provides the best option.

Ultimately what really matters is what's inside the ETF. You should be asking questions about the people managing the portfolio, their process, and whether the parent firm aligns its interests with investors. Choice across wrappers provides clients greater convenience in selecting strategies to fit their portfolios.

## 2. The Issuer

### What should you consider when evaluating an ETF provider?

The number of exchange traded funds available has expanded rapidly in recent years, making the selection of the right fund a due diligence challenge. As the ETF industry has continued to grow and mature, the number of ETF issuers has increased.

When selecting an active ETF, it is just as important to ensure the issuer has the required attributes as it is to evaluate the management of the investment strategy. Every issuer offers access to a different platform with varying levels of expertise, experience, access and scale. In this guide we provide a framework to help you think about the right questions to ask to ensure you are choosing the best possible ETF issuers.

We believe there are **three key areas** you should consider when **evaluating an ETF provider**:

**Experience and track record in ETF management**

**Technology and risk management**

**Platform breadth and depth**

## **1. Experience and track record in ETF management**

### **How experienced is the ETF provider?**

Providers with a long history of designing and managing ETFs are more likely to have the expertise required.

### **Does the provider have the expertise specific to the asset class wrapped in the ETF?**

Some providers are more focused on a single asset class or a narrower style of products, managing ETFs invested in bonds requires different skills from those invested in equities for example.

### **How wide-spread geographically is the provider's expertise?**

ETFs can provide access to assets domiciled all over the world, having knowledge of these local markets can provide a significant advantage in trading and managing these assets within an ETF.

### **Does the provider have strong capital markets capabilities and partnerships across the ecosystem?**

The ability of an issuer to ensure the market quality of an ETF is maintained depends on their level of expertise and strength of their partnerships across the ETF trading ecosystem. Strong partnerships enable continued improvement of the ETF ecosystem leading to better outcomes for products.

### **What are the provider's total assets under management and ETF assets under management?**

Total assets can illustrate the level of trust investors in aggregate have placed in a provider; they also demonstrate the scale of a provider and give an idea of efficiencies which may come as a result. ETF assets can also give an indication of the provider's commitment to the ETF industry.

## **2. Technology and risk management**

### **What systems does the provider use to manage ETF data across the lifecycle of a product?**

Successful ETF management requires a high level of data quality and higher degree of effective forecasting and risk management. It is important that all teams involved in managing both the underlying portfolio and the market quality of an ETF can share data via purpose-built technology.

### **How does the provider manage ETF risk?**

Independent risk oversight backed by a disciplined process, deep expertise across markets, and an integrated global investment platform are all critical when it comes to managing risk.

### **3. Platform breadth and depth**

#### **Does the provider have global trading coverage?**

A provider with the ability for local exposures to be managed by teams with local expertise, in local markets can support trading activities 24 hours a day, sourcing liquidity across various counterparties.

#### **Is the issuer's trading function separate from the portfolio management function?**

Issuers who separate functions allows teams to specialize in their respective functions; this can lead to greater efficiency, minimized risks and improved performance.

#### **How much trading activity does the provider execute daily?**

Higher notional traded values can lead to greater efficiencies for the ETFs, which is beneficial for the underlying investors.

#### **Does the provider offer trading support and education?**

Securing quality trade execution is important to long-term returns. In fact, a systematic process for trade execution is as important as investment vehicle selection. Identifying the most appropriate trading strategy for ETFs requires an understanding of the multiple sources of ETF liquidity and ETF pricing mechanics.

## **Want to know more?**

If you want more detail on how to best evaluate ETFs and their providers we have teams who can guide you through this process as well as handy ETF due diligence guides available for you to refer to when you need more information or a deeper dive on a particular issue.

We work closely with ETF research teams across the industry to answer their queries and ensure their due diligence needs are met.

Please reach out to your BlackRock representative to find out more.

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