Majority of Investors Avoid Active ETFs, Citing Lack of Knowledge & Fees as Primary Factors

Exchange-traded funds (ETFs) are growing in popularity, as they combine thr best characteristics of both stocks and traditional mutual funds into a singular investment vehicle.

Generally speaking, four of the key advantages of ETFs over mutual funds are:

1. ***Tax-Friendly Investing*** – Unlike mutual funds, ETFs are very tax-efficient. Mutual funds typically have capital gain payouts at year-end, due to redemptions throughout the year; ETFs minimize capital gains by doing like-kind exchanges of stock, thus protecting the fund from any need to sell stocks to meet redemptions. Therefore, it is not treated as a taxable event.
2. ***No Investment Minimums*** – Many mutual funds have minimum investment requirements while ETFs can be purchased for as little as one share.
3. ***Lower Cost Alternative*** – The average mutual fund still has an expense ratio of 1% or more, whereas the 15 largest ETFs as of June 30, 2016, all have expense ratios that are no higher than 0.4%. Among the largest fund families, the highest average fund family expense ratio as of June 30 is 0.71% for First Trust. In addition, ETFs do not charge 12b-1 fees (advertising fees) or sales charges, as do many mutual funds.
4. ***More Trading Control*** – Mutual funds are traded once per day at the closing net asset value or NAV price. ETFs trade on an exchange all throughout the trading day, just like a stock. This allows for greater purchasing/selling price control and the ability to set protection features, such as stop-loss limits on your investments.

While there are definite advantages of ETFs over traditional mutual funds, many investors still favor traditional mutual funds over ETFs. To get an idea of how favored ETFs and mutual funds are, we asked our readers the following question last week:

What percentage of your investment portfolio is invested in exchange-traded funds (ETFs)?

Here are the results:

What percentage of your investment portfolio is invested in exchange-traded funds (ETFs)? [Please do not include closed-end or traditional open-end mutual funds.]

I do not invest in ETFs : 34% - Votes: 801

1% to 9% : 27% - Votes: 630

10% to 24% : 18% - Votes: 428

50% or more : 11% - Votes: 258

25% to 49% : 9% - Votes: 218

Don't know : 1% - Votes: 22

Of the 2,357 responses we received as of 6:00 a.m. (Central) on Sunday, September 11, 34% said they do not invest in ETFs. This is not to say, necessarily, that these readers prefer traditional mutual funds. They may choose to invest in individual stocks or do not invest at all in equities. Only 1% of respondents said they are not sure what percentage of the investment portfolios are invested in ETFs.

Among the 65% that said they do invest in ETFs, 41.1% of them said that less than 10% of their investment portfolio is invested in ETFs. Another 27.9% of those that said they are invested in ETFs have between 10% and 24% of their portfolio in ETFs. Nearly 17% of readers who invest in ETFs have more than 50% of their portfolios in ETFs.

Weekly Special Question

Within the ETF universe, actively-managed (non-index) ETFs are also gaining in popularity.ETFs were originally constructed to provide a single security that tracks an index, such as the S&P 500,m and trades intraday. While the majority of ETFs are structured to track an index, and thus are passively managed, actively-managed ETFs have the potential to benefit mutual fund investors and fund managers as well. However, actively-managed ETFs are not as widely available because there is a technical challenge in creating them. The major issues confronting money managers all involve a trading complication, more specifically a complication in the role of arbitrage for ETFs. Arbitrage is basically buying in one market and simultaneously selling in another, profiting from a temporary price difference. This is considered riskless profit for the investor or trader.

Because ETFs trade on a stock exchange, there is the potential for price disparities to develop between the trading price of the ETF shares and the trading price of the underlying securities. This creates the opportunity for arbitrage. If an ETF is trading at a value lower than the value of the underlying shares, investors can profit from that discount by buying shares of the ETF and then cashing them in for in-kind distributions of shares of the underlying stock. If the ETF is trading at a premium to the value of the underlying shares, investors can short the ETF and purchase shares of stock on the open market to cover the position. With index ETFs, arbitrage keeps the price of the ETF close to the value of the underlying shares. This works because everyone knows the holdings in a given index. The index ETF has nothing to fear by disclosing the holdings and price parity serves everyone's best interests.

The situation is a bit different for an actively-managed ETF, whose money manager gets paid for stock selection. Ideally, those selections are to help investors outperform their ETF's benchmark index. If the ETF disclosed its holdings frequently enough so that arbitrage could take place, there'd be no reason to buy the ETF: smart investors would simply let the fund manager do all of the research and then wait for the disclosure of his or her best ideas. The investors would then buy the underlying securities and avoid paying the fund's management expenses. Therefore, such a scenario provides no incentive for money managers to create actively-managed ETFs.

In the United States, active ETFs have been approved but are required to be transparent about their daily holdings. The Securities & Exchange Commission (SEC) denied non-transparent active ETFs in 2015. The SEC has also approved opening stock trading without price disclosures on volatile days concerning ETFs to prevent the record intraday drop that occurred last August when ETFs prices dipped because securities' trading halted while ETF trading continued.

The transparency rules regarding actively-managed ETFs means they are vastly outnumbered compared to passive ETFs. are not nearly as many of these types of ETFs as there are passive or index ETFs. According to Morningstar, as of July of this year, there were 156 actively managed ETFs, with 24 launched this year. But the overall category at about $26 billion still represents only about 1% of the overall ETF space. In addition, actively-managed funds, on average, have higher expense ratios. According to Morningstar, the asset-weighted average expense ratio for passive funds (traditional mutual funds and ETFs) was 0.18% in 2015, compared with 0.78% for active funds.

Given the unique challenges facing actively managed ETFs, this week's special question asked:

Do you currently invest in or would you consider investing in actively managed (non-index) ETFs? What is your opinion of these investment products?

In all, 358 readers offered their opinions and only 28% said they are currently invested in actively managed ETFs or would consider investing in them. The overwhelming majority of this group isn't currently invested in actively managed ETFs. And before they would invest in an actively-managed ETF, many respondents said they would need to learn more about these types of funds before making a final decision. Some of the other common threads among those in the group included:

- Does the performance justify the higher fees?
- What is the investment strategy of the fund?
- What is the track record of the fund manager?

For the 72% that said they are not invested in actively managed ETFs, not would they consider buying them, the overwhelmingly reason was the cost. Most do not believe that the higher costs associated with actively managed ETFs justify the possibility of outperforming an index ETF.

For others, the lack of a sufficient track record is a major deterrent–the oldest actively managed ETFs have only been around since 2008.

Here is a sampling of the responses:

- "Absolutely not. Best use of ETFs is for passive index investing."
- "Actively managed simply means another set of fees/costs. I'm with Buffett, et al, that a diversified index is most likely to beat any actively managed fund whether ETF or not."
- "An index of stocks works just fine. On the other hand, if the bond market is at the end of a 30-year-long bull market, I would rather invest in a managed fund that strives to manage losses by replacing old securities with new ones and can diversify among credit ratings and duration."
- "Depends. The performance would have to be significantly better to justify the higher management fees. If actively managed mutual funds are the guide, the odds are that the higher fees would not be justified by the active management."
- "I invest in index ETFs to be sure I have funds that track the hard-to-beat S&P 500 index (IVV) and diversify to the difficult to cover small cap sector (IJR). Professional managers are most likely to underperform these benchmarks and add expenses like mutual funds. I view managed ETFs as repackaged mutual funds – underperforming picks on average with higher expenses guaranteed."
- "No! Actively managed ETFs, in my view, contradicts the main advantages of investing in ETFs in the first place."
- "Yes, I would. Especially considering I have not been successful as a trader myself. I need to study more before I get back into trading/investing myself. And as much as I'd hate to pay someone else to do it, I assume an experienced manager would not lose as much of my account

as I have thus far."

- "Yes. A superior manager can use actively managed ETFs to realize the alpha by means of "smart beta." Smart beta is the new alpha. And actively managed ETFs have the potential to deliver."

Want to weigh in? Participate in our weekly member poll, updated every Tuesday, and see the results online at http://www.aaii.com/memberquestion.