



# ETFs Evolve Into Active Investment

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**ETF** (May 2008) 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. Many of ETFs' biggest boosters are investors who believe mutual fund managers can't beat an index benchmark consistently, making the management expense ratio (MER) on mutual funds unwarranted.

But the ETF doesn't have to be a passive investment.

Last month in the U.S., Invesco Powershares Capital Management, owned by its parent company, 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, where 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 have been 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.

"Certainly one of the potential benefits of an ETF is that you have somewhat greater flexibility from a trading standpoint if you want it. 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.

Actively managed ETFs are not the only way to employ ETFs in an active strategy, however. There is also active management of index ETFs, used by Canadian-based Hahn Investment Stewards.

Overseen by Wilfred Hahn, the former head of the Global Investment Group of the Royal Bank of Canada, 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 used to be 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. "If you look at the Ontario Teachers' Pension Plan annual report or the Yale Endowment annual report, you see allocation to infrastructure, timber, agriculture and almost every different asset class imaginable."

Gunn says with more than 1,100 ETFs available worldwide, 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.

"You now have access to ETFs through agriculture, gold bullion, pan-Asian bonds — we even just invested in Asian real estate," she says. "Because there are now more than 1,000 ETFs with another 500

waiting for approval by the SEC, you get into the same situation that you get as a stock broker, where you are saying 'Which ETF? What represents the best value?'"

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" that require the company to change the allocation. Hahn explains that this rebalancing is necessary to mitigate risk and has allowed the company to add about 125 basis points of performance to the portfolios over the five years he's been doing this than would have been added if he hadn't touched them.

"It's not just active strategy that's important; it's the design of the portfolio," Hahn says. "When we try to design portfolios, they are not indexed by any means, but they are designed to have enough asset classes inside of them that are complementary or at least offering what we call shock-absorber characteristics. For example, last year we were more concerned about risk. [To offset risk] we were taking opportunities, for correlation reasons, in Asian fixed-income and a couple of other areas like that."

Hahn is not a proponent of indexing, saying it's likely the best way to invest in efficient large cap spaces. In inefficient market spaces, like junior gold mining stocks, for example, he would prefer to hire an outside professional to pick the stocks. His company has identified more than 200 asset classes, so getting an expert security selector for each one is not cost-effective or even possible. ETFs provide a great equalizer to get that exposure if necessary.

"Today we can invest in a portfolio for middle-class Canadians that is a higher quality portfolio at a lower cost than I could do for a \$50 million institutional portfolio 15 years ago," he says. "All of sudden, as of the last couple years, asset classes are available that were only heretofore available to ultra-rich investors. The idea of trying to buy Asian fixed income was virtually impossible five years ago. 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."

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