Rise of Active ETFs: What Investors Should Know

Historically, most exchange traded funds (ETFs) have been passive.

But that's starting to change with more and more active ETFs coming to market. The growth in active ETFs is largely the result of traditional fund managers realizing that the ETF is a great wrapper and investment vehicle for a broad range of strategies. The result is that investors have more choices than ever before.

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Active vs. Passive

Passive ETFs are designed to track a particular index or sector—and, hence, do not aim to "beat the market." Rather, they tend to own a basket of securities (based, for example, on market capitalization). The buying, selling, and rebalancing process for these strategies is based on a specific set of rules outlined in the product's methodology. While they can be rebalanced occasionally if, say, an index is altered, they don't engage in buying or selling, for the purpose of generating excess returns. Active ETFs, by contrast, are designed with the goal of outperforming a benchmark index or sector. Helmed by professional fund managers, these ETFs may employ a proprietary mix of quantitative and qualitative investment strategies to inform buy and sell decisions. Ideally, an active ETF will deliver alpha, a risk-adjusted return that beats a given benchmark.

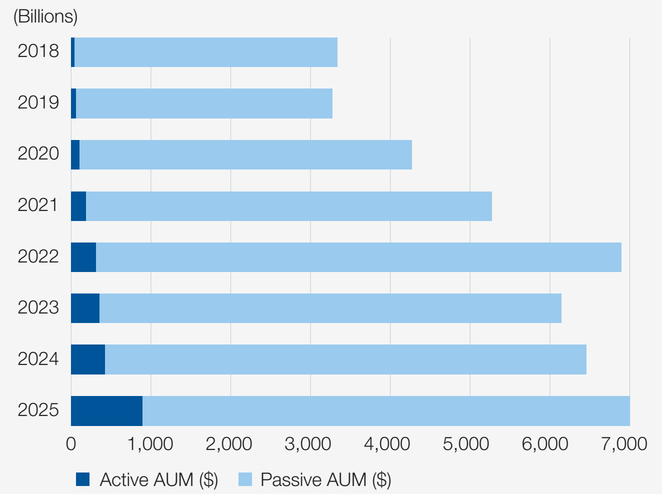
Why Investors Might Choose Active

Investors may gravitate toward active ETFs due to a desire to outperform the market—and a belief that their ETF is led by professional managers with the ability to do so. In theory, active managers—and active ETF managers—are more likely to be focused on capturing market inefficiencies or markets with potential opportunities to derive alpha.

At the same time, active ETFs have more flexibility to choose their reference benchmark or even to choose multiple benchmarks. Active ETF managers can then use the securities and financial instruments within their stated strategy to attempt to outperform their benchmark(s).

Diversify Your Portfolio

ETFs offer potential benefits in terms of diversification. From an asset allocation standpoint, owning ETFs can complement and augment the other building blocks of an investor's portfolio—whether that's cash or cash equivalents, individual securities (equities or fixed income), or alternative investments (e.g., private equity, hedge funds, or real estate).
The scope of ETFs has broadened considerably in recent years. Investors now have the choice of adding active ETFs to their portfolios.



Source: FactSet

Important Information

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For mutual funds each transaction involving a realized gain or loss is known as a taxable event. Taxable events thus accumulate throughout the year. At year end, the fund's investors may receive a taxable distribution or "capital gains distribution," representing the gains generated by the fund's transactions passed along to the investor.

ETFs, on the other hand, through the creation and redemption process, allow the Issuer and the Authorized Participant to minimize taxable events by exchanging ETF shares and underlying securities "in-kind" when possible, making capital gains distributions less likely. In this way an ETF investor's capital gains are not influenced by other investors entering and exiting the fund.

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