ETMFs and 'smart beta' bring Exchange Traded Fund managers into new waters

The emergence of new trends and further substantial growth in assets under management made 2014 yet another significant year for exchange traded funds (ETFs). Actively managed ETFs and "smart beta", in particular, are driving the ETF sector well beyond its traditional confines, writes A&L Goodbody partner ELAINE KEANE.

Historically, ETFs have fallen firmly within the "passive" camp, with the ETF designed simply to mirror the performance of its underlying index. This type of product has typically been considered to be suitable for an investor seeking a long-term core holding that would be a foundation from which to build tactical or alpha-seeking exposure within a portfolio.

Recently, however, the market has been trending towards "active" products which provide the manager or index provider with the flexibility to select securities or create an index with the intention of outperforming a passive benchmark based on proprietary research. Because active ETFs typically select a unique mix of assets against which to benchmark, they often have higher fees while the underlying indices may also struggle to comply with the ESMA disclosure guidelines for ETFs.

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This challenge has been brought into sharp focus following the recent approval by the Securities and Exchange Commission of Eaton Vance's proposed new exchange traded managed fund (ETMF), a hybrid product bearing characteristics of both exchange traded and mutual funds. ETMFs seek to provide the tax, cost and performance efficiencies most readily associated with ETFs. But trades are executed on the basis of the ETMF's next end of day NAV, plus or minus a premium representing trading costs, in a process known as "NAV-based trading" which is more characteristic of a traditional mutual fund.

The primary attraction of ETMFs for fund managers is that they will only be required to disclose their portfolio holdings on a quarterly basis (with a 60 day delay), rather than on a daily basis, as is the case with actively managed ETFs. This is particularly helpful for active managers who may have refrained from launching ETFs before now due to concerns about portfolio confidentiality. ETMFs combine the advantages and investor appeal of ETFs, while at the same time easing apprehensions around reverse engineering of portfolios.

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In the European context however, ETFs are predominantly established as UCITS, and it remains to be seen whether an Irish UCITS ETMF will be feasible in the immediate future. On 18 November 2014, the Irish Stock Exchange, often the primary listing venue for ETFs regulated in Ireland, removed its requirement that actively managed ETFs disclose details of their portfolio holdings on a daily basis. While this volte-face by the ISE is a welcome development within the wider ETF community, it contrasts sharply with the current position of the Central Bank of Ireland. This requires that managers of active ETFs "ensure that information is provided on a daily basis regarding the identities and quantities of portfolio holdings". Regulatory developments are continually evolving, but nevertheless it is clear that the UCITS regime – as implemented by the Central Bank at the time of writing – may face significant challenges in facilitating the ETMF model.

Some market commentators believe that a third choice exists for ETF providers and investors – smart beta – that can more effectively bridge the gap between the passive and active worlds. Essentially, a smart beta index is a transparent rules-based index that provides exposure to specific factors, market segments or investment strategies.

Proponents of smart beta products argue that capitalisation-weighted indices tend to suffer from market drag. This is due to overweighting of overvalued securities and underweighting of undervalued securities. Active management, on the other hand, can lack transparency and incur higher fees.

They therefore argue that smart beta products can provide investors with the benefits of capitalisation-weighted products, such as transparency, low costs, diversification and liquidity and at the same time deliver superior performance via exposure to indices that eschew traditional compositional norms in favour of arguably more sophisticated indices created on the basis of such screens and filters as rising sales, earnings, book value, dividends or cash flows, volatility or momentum.

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The overriding purpose of these products can therefore be summarised as attempting to capture more of the upside of the market whilst alleviating some of the downside, but within the safety and familiarity of an ETF.

With the increased investor appetite for active and smart beta products matched by steady inflows of assets, it is difficult to imagine any waning in the popularity of the ETF sector in 2015. However, ETF providers and market regulators still need to address the obvious issue of the level of transparency required in order that the proprietary strategies of ETF providers are protected and investor needs met. While industry stakeholders seek to ameliorate the acknowledged flaws in the ETF market, that include market fragmentation, off-exchange lending and settlement and post trade transparency, the real risk is that future growth in the ETF market may be stymied by the ever increasing cost of regulatory compliance.

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