John Hancock Investment Management

Developing a framework for active ETF due diligence

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"Active ETFs can offer investors the potential outperformance of active management along with the benefits of the ETF structure. A strong due diligence framework is key for guiding investment selection, as these benefits can vary based on the underlying strategy."

Key takeaways

- The rise in the number of active ETFs along with assets managed under these types of funds underscores the importance of developing a comprehensive understanding and strong due diligence framework for navigating the active ETF landscape.
- While the ETF structure can offer benefits such as lower costs, increased tax efficiency, and transparency, the extent of these advantages varies depending on the underlying strategy.

Executive summary

Since the enactment of the ETF Rule in 2019, the active ETF landscape has expanded rapidly, offering investors the ability to leverage the benefits of active management within a liquid, transparent, and tax-efficient structure. This paper presents a framework for assessing active ETFs, highlighting the distinctive aspects of this investment structure that need to be considered when evaluating and selecting these funds.

For financial professionals
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A look at the rise of active ETFs

Active exchange-traded funds (ETFs) have experienced a remarkable surge in recent years, offering investors a diverse range of investment strategies across various asset classes within a liquid and transparent structure. Since the passage of SEC Rule 6c-11, also known as the ETF Rule, the number of active ETFs in the marketplace has grown exponentially.

Additionally, assets within actively managed ETFs have soared in recent years in response to market volatility amid rising interest rates. While active ETFs currently represent only around 7% of total ETF assets, nearly a third of all ETF flows have been directed toward these types of strategies so far this year.[1]

The rise in active ETFs underscores the importance of gaining a comprehensive understanding of the active ETF landscape. Active ETFs can offer investors the potential outperformance of active management along with the benefits of the ETF structure. A strong due diligence framework is key for guiding investment selection, as these benefits can vary based on the underlying strategy.

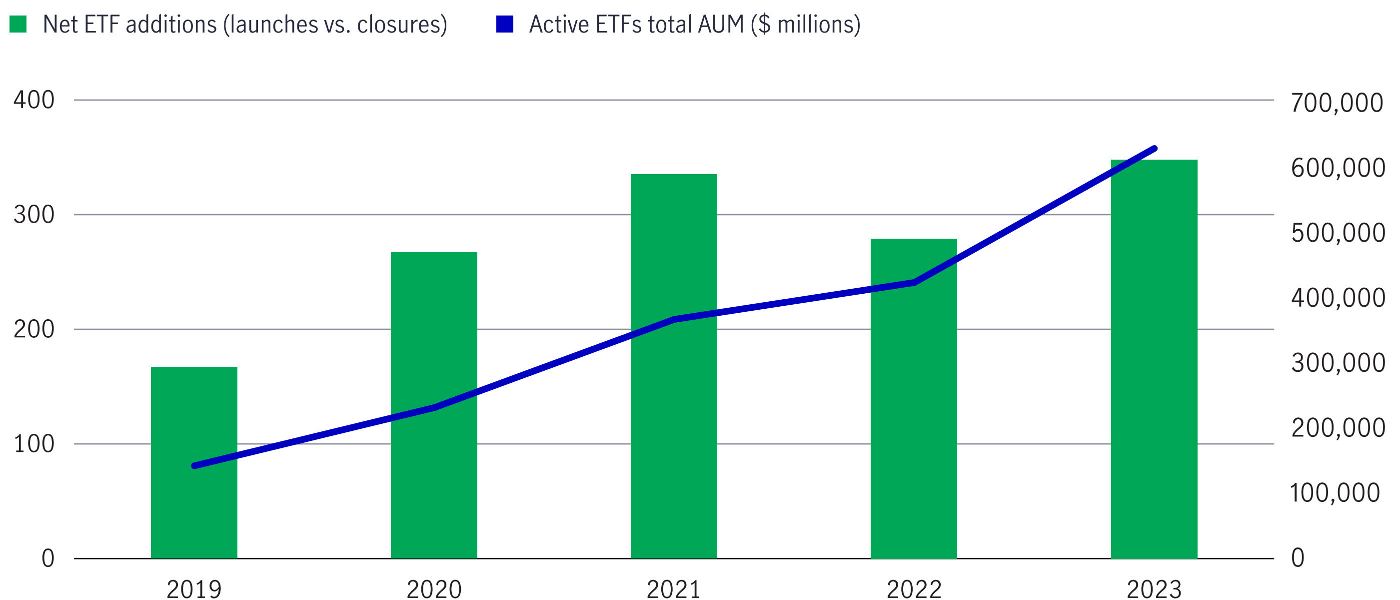
What is the ETF Rule?

SEC Rule 6c-11, also known as the ETF Rule, is a regulation passed in 2019 that streamlined the ETF approval process, allowing more funds to come to market without the need for exemptive relief from the SEC.

One of the key aspects of the rule is the allowance for the use of custom baskets within the creation and redemption process. This provision provides managers with greater flexibility to manage an ETF's portfolio and liquidity, particularly in markets in which the included securities may be less liquid or more difficult to access.

The creation/redemption process is fundamental to the unique benefits of the ETF structure. The implementation of the rule opened the door for active strategies to enter the market within a liquid, transparent, and tax-efficient structure.

The number of active ETFs, and assets managed within these funds, has grown significantly since 2019



Source: Trackinsight, data as of 12/29/23, includes North American ETFs only and excludes other ETP products (ETPs, ETNs, ETCs).

1 "Active ETFs Gain appeal Amid Volatility," ETF.com, 4/18/24.

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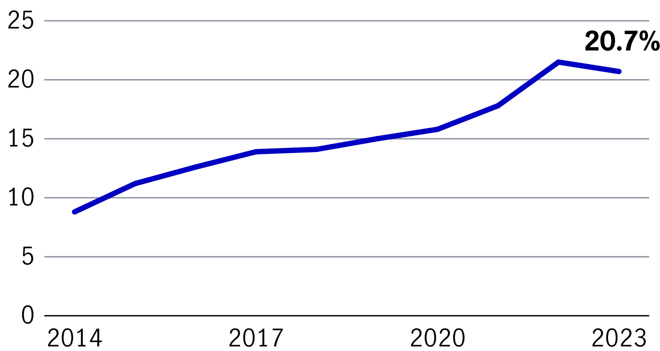
Advisors are increasingly interested in using ETFs

Financial advisors are increasingly viewing ETFs as an essential component of their clients' portfolios due to their many benefits: lower cost, transparency, liquidity, and a higher degree of tax efficiency. A decade ago, financial advisors were allocating just under 10% of client portfolios to ETFs. Since then, the number has more than doubled, topping 20% by the end of 2023. This upward trend is expected to continue, with ETFs continuing to gain share within client portfolios.

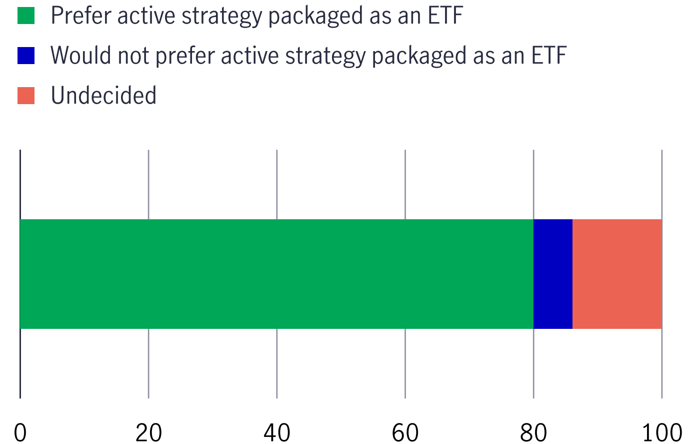
Financial advisor allocation to ETFs (%)



Source: "U.S. Exchange-Traded Fund Markets 2023," Cerulli Associates, 2023.

ETFs are becoming the preferred choice for active exposure

Percentage of survey respondents (%)



Source: "The Global ETF Survey 2024," Trackinsight, 2024.

Recent surveys also point to a clear preference for gaining active exposure through the ETF structure. With over 80% of respondents now favoring an active strategy packaged within an ETF over a mutual fund, this reflects a significant shift in investor behavior and a notable departure from the historical dominance of active mutual funds within investor portfolios.

How do active ETFs come to market?

Launch—The most common method, an asset manager or fund sponsor designs an investment strategy, creates the portfolio of securities, then lists the ETF on an exchange for trading. This method can lead to innovation, providing flexibility to design and implement a new strategy, but it requires a high degree of resources and necessitates building a track record and gathering assets.

Conversion—An existing mutual fund or separately managed account (SMA) is reorganized into an ETF, maintaining the same investment strategy and holdings. This process is complex, requiring navigating regulatory requirements and operational differences between the vehicle structures.

Clone—These ETFs are created by replicating the investment strategy and holdings of an existing mutual fund. This allows investors to access the same investment strategy as the original fund within the framework of an ETF but requires careful management to ensure the ETF can mirror performance.

ETF share class—These ETFs represent a specific share class of an existing mutual fund, allowing investors to access the same investment strategy and holdings. So far, this approach has only been applied to passive strategies, but it represents a potential avenue for active ETFs to come to market in the future.

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The three Ps of active ETF due diligence

When conducting due diligence on active ETFs, we believe it's important to examine the three Ps: people, process, and performance. While evaluating active ETF shares' similarities to assessing other actively managed products such as mutual funds or SMAs, there are also unique aspects that should be carefully considered.

People

Active ETFs have been brought to market by a wide range of firms ranging from small, boutique ETF-only asset managers to legacy mutual fund managers. When considering the key decision makers responsible for managing an active ETF and its operations, here are a few questions to keep in mind:

- What's the issuer's commitment to building out their ETF capabilities?
- Does the issuer have strong relationships with authorized participants and market makers?
- Does the issuer provide ETF-related education and research to support financial advisors?

Process

Having a clear understanding of how an ETF might perform across a variety of market environments can help ensure alignment with the desired objectives and risk tolerance. Some key considerations for active ETFs might be:

- **Is capacity risk likely to be an issue?** Since ETFs can't close to new investment like mutual funds can, it might be possible for an active ETF's assets to grow to a point where it begins to affect the fund's ability to effectively execute its investment strategy, particularly in less liquid parts of the market.
- **Is the ETF limited in what it can invest in?** Due to regulatory and structural differences, ETFs that are designed to replicate the performance of an existing mutual fund may be limited in their ability to fully replicate the strategy.
- **What tools and processes do they use to optimize trading and liquidity?** Management teams can employ different tools and practices to enhance trading and liquidity within active ETFs. Key considerations include the use of in-kind or cash creations, the ability to employ custom baskets, and whether market makers can hedge exposure using highly liquid instruments.

Performance

When evaluating an ETF that's been launched as a clone of a mutual fund, here are some considerations to keep in mind:

- How is the ETF being managed to capitalize on the ETF structure? Is there some drift in the strategy to optimize tax efficiency?
- How is clone defined? Does the ETF use the same mandate or does each fund hold the same portfolio?

The three Ps are a starting point for evaluating active ETFs. The next section dives into how the benefits of the ETF structure—lower cost, higher tax efficiency, and transparency—might differ between active ETFs depending on their underlying strategy.

Evaluating an active ETF's cost

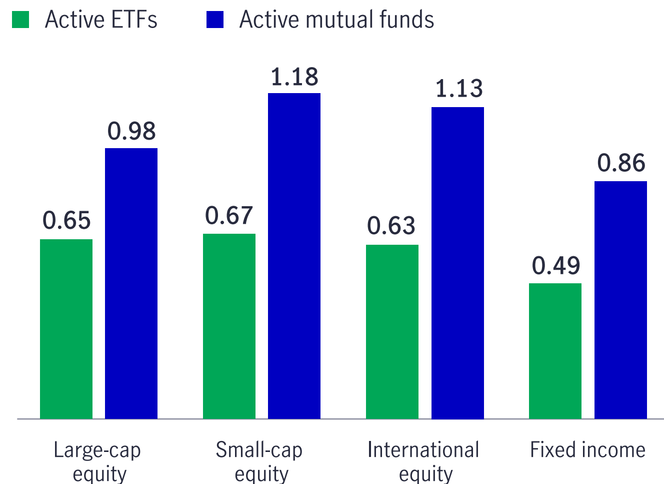
ETFs are often touted as being cheaper than mutual funds, and this is generally true for both active and passive ETFs. Several factors contribute to lower expense ratios for active ETFs:

- **Greater operational efficiency—**ETFs are bought and sold on an exchange and don't process investor transactions directly, resulting in lower administrative and operating costs.
- **No sales loads—**ETFs typically don't have sales loads, which are fees charged to investors when they buy or sell shares of a mutual fund.
- **No 12b-1 fees—**ETFs don't typically have 12b-1 fees, which are marketing and distribution fees charged by some mutual funds.

These factors result in active ETFs having, on average, lower expense ratios than active mutual funds.

Active ETFs tend to be cheaper than active mutual funds

Average expense ratio (%)



Source: Morningstar Direct, as of 6/26/24.

The stated expense ratio is only one facet of understanding an ETF's cost. Another key factor to consider is liquidity since ETFs have bid/ask spreads due to intraday trading.

Active ETFs that have tighter bid/ask spreads generally:

- Focus on widely traded, liquid sectors or areas of the market
- Have sufficient assets and high average daily trading volume

Conversely, active ETFs that focus on niche or illiquid areas of the market or that have lower daily trading volume typically have wider bid/ask spreads. Typically, spreads will decrease over time as an ETF gathers assets and secondary market volume increases.

Bid/ask spreads can also vary based on asset class. International ETFs usually have wider spreads than domestic equity ETFs due to additional risks, such as currency exchange rate fluctuations and time zone differences, resulting in limited periods of overlap with U.S. trading hours.

It's imperative to look beyond the expense ratio when evaluating an active ETF. Wider spreads can have a significant effect on the cost of owning and trading an ETF, leading to a higher level of tracking error that may detract from performance. Issuers should be prepared to explain what they're doing to minimize spreads in their ETFs.

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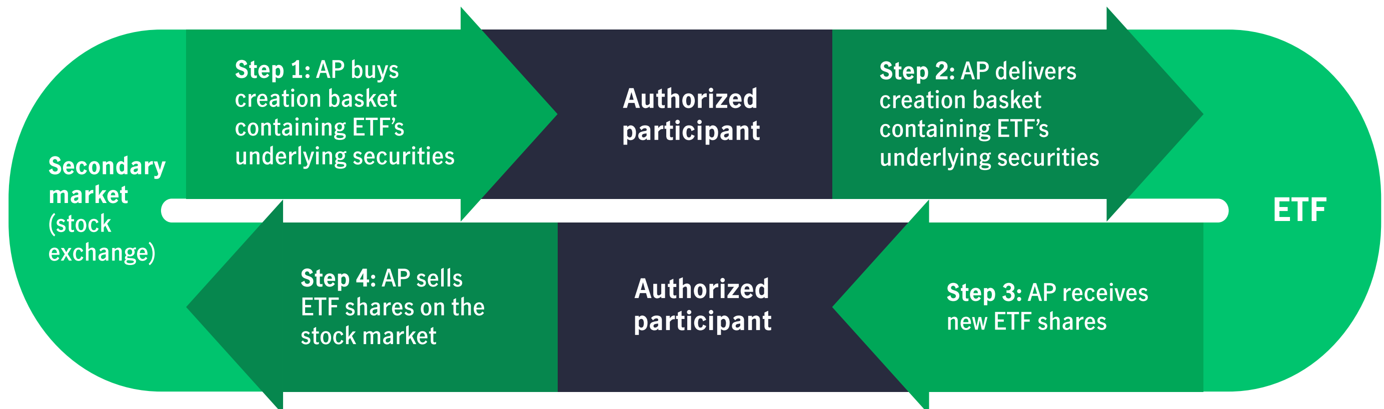
Explaining the tax efficiency of ETFs

ETFs are often seen as more tax efficient than mutual funds because of their unique creation/redemption process. Unlike mutual funds, which use cash transactions to create or redeem shares, ETFs can make use of in-kind transactions, which aren't considered taxable events.

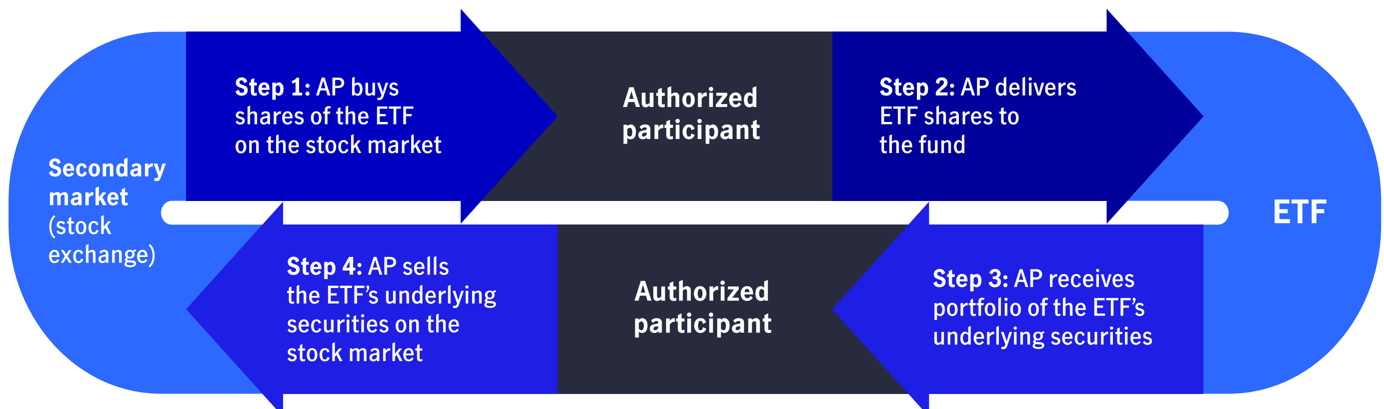
At the center of this process are authorized participants (APs), who are the only entities that can interact directly with ETF sponsors to create and redeem large blocks of shares, known as creation units. These APs include brokers, financial institutions, and market makers, and each ETF typically has multiple APs.

To meet demand for new ETF shares, APs use the daily disclosed holdings of the ETF to acquire the stocks and bonds in the portfolio, then deliver this basket to the ETF sponsor in exchange for new shares of the ETF. Conversely, during a redemption, APs return ETF shares to the ETF sponsor in exchange for the underlying securities, effectively reducing the number of outstanding ETF shares.

Creation process (equity ETFs)



Redemption process (equity ETFs)



Source: ETF.com, John Hancock Investment Management, 2024.

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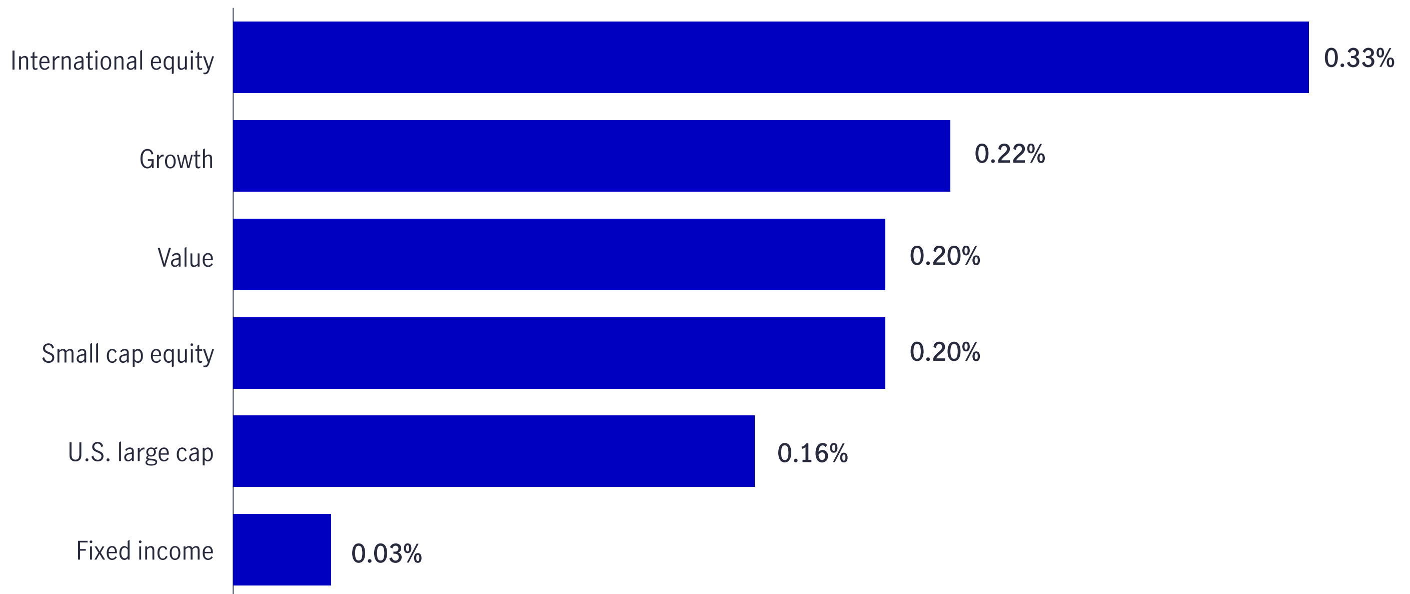
Since they won't need cash on hand to meet investor redemptions, this process typically allows ETFs to hold less cash, benefiting the fund in a strong market. These in-kind transactions can also help ETFs to avoid distributing capital gains to shareholders, boosting their tax efficiency. In a typical year, only around 5% to 7% of ETFs will distribute a capital gain.[2]

This tax advantage can offer significant value for investors who hold these vehicles in taxable accounts. A recent study compared the after-tax returns of matched pairs of ETFs and mutual funds, accounting for factors such as fund family, investment objective, and cost structure. The study aimed to highlight the increased tax efficiency provided by the ETF wrapper. The results revealed a clear advantage for ETF after-tax returns, demonstrating the measurable value added by the ETF structure in terms of tax efficiency.

The creation/redemption process that underpins the ETF structure has helped ETFs to earn a reputation as a tax-efficient vehicle. ETFs have been shown to offer higher post-tax returns relative to equivalent mutual funds.

ETFs offer higher post-tax returns relative to equivalent mutual funds

Difference in average annualized post-tax returns of matched pairs of ETFs and mutual funds over the prior 10 years



Source: The *Wall Street Journal*, George Mason University, John Hancock Investment Management, 2/4/23.

2 "Few ETFs are Paying Out Capital Gains in 2023," Morningstar, 12/1/23.

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Factors affecting the tax efficiency of an active ETF

While the structure of ETFs generally makes them more tax efficient than mutual funds on average, the tax efficiency of an active ETF can vary widely due to several factors. When evaluating the tax advantages offered by an active ETF, it's important to consider the following:

- **Does the ETF use cash or in-kind redemptions?** Some ETFs will have the option to use either cash or in-kind redemptions, but cash redemptions can be more likely for certain asset classes, which will lower tax efficiency.
- **What's the ETF's turnover rate?** High turnover strategies are less likely to be tax efficient due to frequent buying and selling of securities, which may cause the ETF to realize capital gains that aren't fully offset by the creation/redemption process.
- **Is the ETF concentrated in a limited number of stocks?** Concentrated ETFs are less likely to be tax efficient due to holding a relatively small number of securities, which can lead to a higher likelihood of realizing capital gains.
- **What is the ETF's AUM?** ETFs with lower assets under management (AUM) may have reduced tax efficiency due to limited redemption activity, removing that lever for the ETF to manage its tax basis.

Fortunately, active ETF managers have several options available to them to help increase the tax-efficiency of the fund.

- **Using custom baskets to rebalance—**An ETF may use a custom basket to help optimize the portfolio during a rebalance. This can be particularly useful when securities held within the portfolio have appreciated and need to be trimmed. By using a custom basket, the portfolio manager can choose only the securities with the lowest cost basis to give to the AP without triggering a taxable event.
- **Using a systematic trading approach—**Using a systematic trading approach can help limit turnover and assist with managing capital gains and losses more effectively, potentially reducing tax implications.

Understanding the trading strategies used and how they might affect tax implications can help investors make more informed decisions about the potential tax efficiency of an active ETF.

When assessing an active ETF's approach, it's crucial for investors to understand how effective the fund and APs may be in using the creation/redemption mechanism and what trading strategies are employed to enhance the portfolio's tax optimization.

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Does ETF transparency matter?

ETFs are often celebrated for their transparency. Unlike mutual funds, which are required to disclose holdings on a quarterly basis, many ETFs share their holdings daily, giving investors visibility into the underlying holdings and providing a greater understanding of what assets they're investing in.

In 2019, the SEC gave regulatory approval for the first semitransparent ETFs, paving the way for active ETF managers to develop funds that keep their strategies somewhat hidden. As their name suggests, semitransparent ETFs don't reveal the entirety of their portfolio in real time—although they do typically disclose large portions of their holdings daily and their full holdings on a periodic basis, such as quarterly.

Semitransparent ETFs offer solutions to two key issues faced by active ETFs:

- Risks of front-running, or trading in advance of the ETF's trades, which could hurt performance
- Investors replicating the manager's strategy

To date, the launch and assets accumulated by semitransparent ETFs have been modest. This can be attributed to the fact that the fully transparent structure is well suited for passive and smart beta ETFs, along with some active ETFs.

However, semitransparent ETFs may be a better fit for a subset of actively managed funds:

- Funds that are offered in both ETF and mutual fund formats since all shareholders will own the same securities
- Funds providing exposure to less liquid markets, such as small caps, which are more vulnerable to market manipulation and price volatility

When it comes to transparency, the best structure depends on what the ETF is trying to achieve.

Semitransparent ETFs vs. fully transparent ETFs at a glance

Type of ETF	Daily portfolio disclosure details	Typically used for
Fully transparent passive ETFs	Holdings disclosed daily and estimated NAV released every 15 seconds during trading day	Market-cap-weighted index and smart beta strategies across geographies and asset classes
Fully transparent active ETFs	Holdings disclosed daily and estimated NAV released every 15 seconds during trading day	Actively managed portfolios across geographies and asset classes
Semitransparent active ETFs	May use: • Disclosure only to AP representative • Proxy portfolio that approximates actual portfolio • Estimated NAV released every 15 seconds for most semitransparent structures • Holdings released daily but without actual weightings	Actively managed portfolios, currently available only for U.S. equity strategies

Source: John Hancock Investment Management, as of 6/30/24. AP refers to authorized participant. NAV refers to net asset value.

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Putting it all together

As the active ETF landscape continues to expand, with issuers introducing more complex and innovative strategies, it's become increasingly important to establish and maintain a robust due diligence framework for the selection and evaluation of active ETFs.

Active ETFs offer investors the potential for alpha generation by providing access to the expertise of skilled portfolio managers who seek to outperform the market, while the benefits provided by the ETF structure can contribute to enhancing the overall portfolio management and investment experience for clients.

However, the extent of these advantages can vary widely based on a range of factors, including, but not limited to, the fund's underlying strategy, AUM, and trading and portfolio optimization processes. Careful selection and evaluation are essential for those who are looking to leverage the potential benefits of active ETFs for their clients.

In our view, active ETFs can potentially deliver the best client experience in areas of the market in which the advantages of the ETF structure are most evident. This includes highly liquid areas of the market with securities that trade on domestic exchanges.

While active ETFs may not outperform their benchmark every year, looking at long-term rolling returns can offer insight into their historical propensity to outperform. Our research indicates that within areas of the market such as value stocks or traditional or municipal fixed income, strong management teams might have the ability to outperform the index over the long term, potentially adding alpha over passive investments.

Selecting the appropriate allocation for an active ETF is just as important as selecting the right fund. By considering the potential for outperformance within specific areas of the market, investors can make informed decisions to optimize their investment selection.

Semitransparent ETFs are different from traditional ETFs. *Traditional ETFs tell the public what assets they hold each day. These ETFs will not. This may* ***create additional risks*** *for your investment. For example: (1) You may have to pay more money to trade the ETF's shares. These ETFs will provide less information to traders, who tend to charge more for trades when they have less information. (2) The price you pay to buy ETF shares on an exchange may not match the value of the ETF's portfolio. The same is true when you sell shares. These price differences may be greater for these ETFs compared with other ETFs because they provide less information to traders. (3) These additional risks may be even greater in bad or uncertain market conditions. (4) These ETFs will publish on its website each day a "Tracking Basket" designed to help trading in shares of the ETF. While the Tracking Basket includes some of the ETF's holdings, it is not the ETF's actual portfolio.*

The differences between these ETFs and other ETFs may also have advantages. By keeping certain information about these ETFs secret, these ETFs may face less risk that other traders can predict or copy its investment strategy. This may improve these ETF's performance. If other traders are able to copy or predict the ETF's investment strategy, however, this may hurt the ETF's performance.

For additional information regarding the unique attributes and risks of the ETF, see the ETF's prospectus and statement of additional information.

Investing involves risks, including the potential loss of principal. These products carry many individual risks, including some that are unique to each fund. Please see each fund's prospectus to learn all of the risks associated for each investment.

ETF shares are bought and sold through exchange trading at market price (not NAV) and are not individually redeemed from the fund. Shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. A commission is charged on every trade.

This material does not constitute tax, legal, or accounting advice, is for informational purposes only and is not meant as investment advice. Please consult your tax or financial professional before making any investment decisions.

It is important to note that there are material differences between investing in an ETF versus a mutual fund. ETFs trade on the major stock exchanges at any time during the day. Prices fluctuate throughout the day like stocks. ETFs generally have lower operating expenses, no investment minimums, are tax efficient, have no sales loads, and have brokerage commissions.

Mutual funds trade at closing NAV when shares are priced once a day after the markets close. Operating expenses may vary. Most mutual funds have investment minimums and are less tax efficient than ETFs; many mutual funds have sales charges and they have no brokerage commissions.

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