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Active ETF insights: A survey of the semitransparent active ETF landscape

Key takeaways

ETFs have grown exponentially by offering investors a cost-aware, tax-efficient, and liquid vehicle through which to invest.

Active ETFs have attracted investor interest by combining the structural benefits of the ETF vehicle with the potential investment advantages of active management.

Semitransparent active ETFs, which seek to shield the day-to-day trading of portfolio managers, may represent a compelling opportunity for investors to access active management via the ETF vehicle.

ETF market size, investment mechanics, and structural benefits

U.S. ETFs represent approximately $6.6T in assets. The exchange-traded fund (ETF), by virtue of its unique structure, has become an indispensable investment vehicle within the U.S. wealth management marketplace. ETFs trade on exchanges like closed-end funds and can issue unlimited quantities of shares like mutual funds. The first ETF offering such features launched in 1993 and pursued a passive investment mandate. Since then, U.S.-listed passive ETFs have grown to represent ~$5.7T in AUM. In 2003, the first smart beta ETF launched, and such ETFs have since grown to ~$650B in AUM. In 2007, the first active ETF launched, and fully transparent active ETFs now represent ~$250B in AUM. ETFs' staggering organic growth, especially since the Global Financial Crisis, has been driven largely by their alignment with secular trends toward lower costs, greater tax efficiency, and greater liquidity.

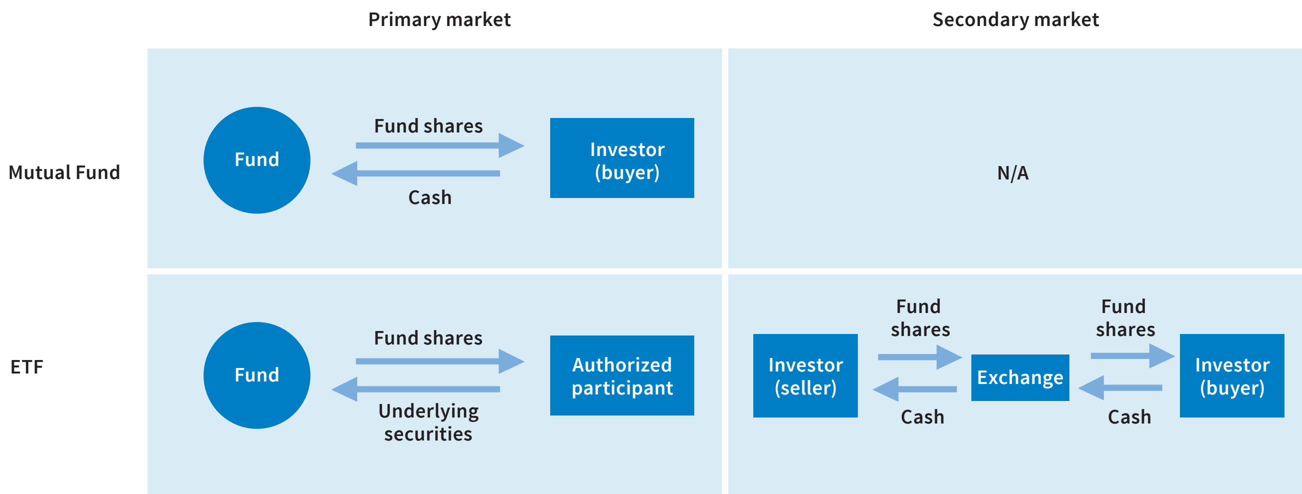
Sources: Putnam, Morningstar.

Unique mechanics

ETFs can offer the benefits of both mutual funds and closed-end funds because they offer two layers of liquidity:

- In the **primary market**, institutions called "authorized participants" (APs) create and redeem shares directly with the ETF to match the supply of shares with demand for those shares in the secondary market. The crucial distinction between this process and the traditional mutual fund process is that APs typically effect creations and redemptions in kind by delivering a "basket" of securities and cash, in exchange for shares.
- In the **secondary market**, individual buyers and sellers, facilitated by firms called "market makers," trade shares of the ETF on an exchange. The crucial distinction between this process and the closed-end process is that the availability of primary market liquidity allows APs to arbitrage away modest premia/discounts to help mitigate persistent dislocations between the ETF's market prices and NAVs.

Transaction types



Key benefits

Because of its unique mechanics, the ETF offers investors a cost-aware, tax-efficient, and liquid vehicle through which to invest. The ETF's competitive costs are driven by the significantly limited role of the transfer agent, as well as the industry convention of charging an "all in" management fee and having the ETF sponsor bear the non-management-fee expenses.

The ETF's tax efficiency rests on two pillars. First, the in-kind creation/redemption process allows the ETF to selectively "flush out" appreciated securities without realizing fund-level capital gains. The second pillar of ETF tax efficiency is that the secondary market bears most of the trading, which allows investors to buy and sell shares of the ETF without prompting the portfolio manager to generate fund-level capital gains by buying and selling to satisfy investor redemptions. The ETF, unlike the mutual fund, offers intraday liquidity by allowing investors to buy and sell shares throughout the trading day at a market price rather than at the end of the day at NAV. Given the ETF's structural benefits, it is not surprising that the ETF is the fastest-growing investment vehicle within the U.S. marketplace.

Origins of semitransparent active ETFs

The exchange-traded fund's rise has unquestionably been aided by increased investor appetite for passively managed investments. That said, the ETF industry's passive orientation has largely been driven by asset managers. Understandably, they have been reluctant to offer their actively managed strategies in a vehicle requiring daily disclosure of full portfolio holdings. Herein lies the impetus for semitransparent active ETFs (STAs).

Sensitive to protecting active managers' intellectual property, several firms submitted proposals to the SEC that would allow active managers to offer their strategies in the ETF vehicle without requiring them to disclose their full portfolio holdings each day. In late 2019, the SEC approved the first such model. The SEC has since approved several additional models that similarly seek to offer the ETF vehicle's benefits while protecting managers' intellectual property (to prevent front-running) and clients' investment performance.

Two STA models

The semitransparent active ETF models approved by the SEC break cleanly into two camps — the Precidian model and the proxy portfolio models licensed by several other firms.

The Precidian model seeks to keep managers' "secret sauce" secret by introducing a party called the "authorized participant representative" (APR). The APR, typically a custodial bank, facilitates primary market transactions between the ETF distributor and its APs.

In a creation under this model, the AP delivers cash to the APR in exchange for shares of the ETF. At the same time, the APR delivers the ETF's underlying securities to the ETF in exchange for the shares it delivers to the AP. Crucially, the exact composition of these securities is subject to a non-disclosure agreement between the ETF and the APR. The APR's role allows the ETF to create and redeem shares in kind, preserving one of the vehicle's key tax efficiency tools, without requiring the ETF to publish its holdings publicly each day.

Comparison of ETF transparency models

	Traditional daily-disclosing ETF	Precidian-style ETF	Proxy-based ETF
First ETF listed	January 1993	March 2020	June 2020
Structure sponsor(s)	—	Precidian	Blue Tractor Fidelity Invesco New York Stock Exchange T. Rowe Price
Full holdings disclosure	Daily	Monthly or quarterly (per ETF issuer)	Monthly or quarterly (per ETF issuer)
Daily holdings disclosure	Full holdings	Full holdings only to APR via confidential account	"Proxy portfolio" intended to track performance of actual ETF without disclosing full holdings
Mechanism	Full holdings disclosed daily to entire market; true ETF holdings used to create and redeem shares	Full holdings disclosed daily to APR; true ETF holdings used to create and redeem shares (in-kind from APR's perspective, cash from AP's perspective)	Proxy portfolio disclosed daily to entire market; proxy holdings used to create and redeem shares

ETFs leveraging a proxy model function much the same as fully transparent ETFs. However, when an AP creates or redeems shares of such an ETF, it does so using a "proxy basket" rather than the fund's exact securities and weights. This arrangement allows a proxy model ETF to preserve the existing ETF ecosystem without exposing ETF shareholders to potentially harmful predatory trading strategies that seek to front-run the trading of securities held by the ETF. The various proxy models create such baskets differently: Some models publish aged holdings, some selectively reweight security positions, and some disclose optimized portfolios that substitute individual positions with replacement securities.

The emerging $260B+ market for active ETFs

The industry narrative regarding semitransparent active ETFs, by understandably focusing on the novel aspects of the various STA models, has implicitly understated how relevant active ETFs already are. Though the STA represents an evolution of the ETF vehicle itself, STAs fundamentally seek to fill the same structural and investment demands as $260B+ of ETFs already in the market. Though active ETFs have garnered significant media attention mostly since the SEC's 2019 approval of the Precidian ETF model, active exchange-traded funds have quietly grown to $260B+ in AUM, comprising a modestly sized but rapidly growing segment of the ETF market. Transparent active equity ETFs alone represent ~$100B in AUM, a significant increase from just ~$10B at the beginning of 2019. With investors expressing demand for more active management in the ETF vehicle and asset managers beginning to respond, the space is set to grow in both fully transparent and semitransparent products.

Active ETFs — by category	AUM ($M)	Flows ($M)	
		1YR	3YR
Total	263,541	95,543	156,996
FI — Short/Ultrashort Term	59,993	9,672	39,517
Sector Equity	27,412	20,537	22,113
U.S. Mid Cap	27,134	15,801	18,515
FI — Core/Core Plus	21,155	6,302	14,089
FI — Gov't	12,559	5,675	11,097
FI — Credit	18,133	10,459	10,738
U.S. Large Cap	30,491	4,722	6,826
FI — Muni	7,532	3,687	6,185
Commodities	12,312	5,187	5,775
Defined Outcome	6,268	1,710	5,127
FI — Other	8,565	1,962	4,252
Non-U.S .Equity	6,846	3,422	3,760
Derivative Income	3,510	2,870	3,123
Allocation	4,878	1,194	1,878
U.S. Small Cap	12,136	1,167	1,653
FI — Nontraditional/Multisector	1,567	574	791
Trading	550	103	562
Alts	1,388	298	513
FI — Non U.S.	1,112	201	483
FI — Long Term	—	—	—

Sources: Putnam, Morningstar.

The STA market today

Management style and structure of STAs drive investor interest. The case for STAs is simple — they combine the potential benefits of ETFs with the potential benefits of active management. ETFs offer cost aware, tax efficiency, and intraday liquidity. Active management offers professional oversight, active risk management, and the potential for outperformance. Active ETFs represent the natural evolution of a marketplace that continues to see the value of active management while demanding the efficiencies that ETFs offer.

ETF vehicle

- Cost aware
- Tax efficiency
- Intraday liquidity

Active ETFs

Active mangement

- Potential for outperformance
- Active risk management
- Professional oversight

Emerging product trends

Since STAs first launched in early 2020, 11 issuers have launched ~40 ETFs. Those ETFs have amassed ~$2B in AUM, much of which has been raised via their issuers' affiliated wealth management businesses and pooled vehicles or via direct-to-consumer brokerage platforms. Issuers have generally chosen to extend existing mutual fund strategies to the STA vehicle, with only a few STAs reflecting truly novel strategies. Some issuers have entered the market with passive-like pricing, while others have priced their STAs in line with their mutual funds' advisory share classes. That being said, a consensus has begun to emerge around pricing STAs close to the clean shares of related mutual funds.

	ETF	Launch	AUM ($M)	Expense ratio	Relationship to existing MF		
					75%+ overlap	Cheapest MF class	ETF vs. cheapest MF
	All except AUM & 75%+ overlap show median		1,826	0.59	22	0.55	**-0.01**
1	Large Growth ETF 1	Jun-20	373	0.59		0.45	**0.14**
2	Large Value ETF 1	Mar-20	249	0.42		0.49	**-0.07**
3	Large Growth ETF 2	Mar-20	239	0.45		0.50	**-0.05**
4	Large Growth ETF 3	Aug-20	173	0.57		0.56	**0.01**
5	Large Blend ETF 1	Jul-20	149	0.39		0.44	**-0.05**
6	Large Value ETF 2	Jun-20	96	0.59		—	—
7	Large Blend ETF 2	Aug-20	68	0.50		0.50	**0.00**
8	Large Blend ETF 3	Jun-20	64	0.59		0.55	**0.04**
9	Large Value ETF 3	Aug-20	49	0.54		0.55	**-0.01**
10	Large Growth ETF 4	Aug-20	41	0.52		0.52	**0.00**
11	Large Blend ETF 4	Mar-21	35	0.85		—	—
12	Large Growth ETF 5	Feb-21	34	0.59		0.69	**-0.10**
13	Large Growth ETF 6	Feb-21	31	0.59		0.45	**0.14**
14	Mid-Cap Growth ETF 3	Feb-21	27	0.60		—	—

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	ETF	Launch	AUM ($M)	Expense ratio	Relationship to existing MF		
					75%+ overlap	Cheapest MF class	ETF vs. cheapest MF
	All except AUM & 75%+ overlap show median		1,826	0.59	22	0.55	—0.01
15	Mid-Cap Blend ETF 1	Feb-21	24	0.64		—	—
16	Real Estate ETF 1	Feb-21	21	0.68		—	—
17	Mid-Cap Growth ETF 4	Jul-20	18	0.45		—	—
18	Large Blend ETF 5	Jun-21	16	0.34		0.35	-0.01
19	Real Estate ETF 2	Feb-21	15	0.59		0.74	-0.15
20	Large Blend ETF 6	Sep-20	14	0.90		0.84	0.06
21	Large Growth ETF 7	May-21	11	0.55		0.55	0.00
22	Mid-Cap Blend ETF 2	Sep-20	11	0.85		0.85	0.00
23	Large Value ETF 4	Jan-21	10	0.00		—	—
24	Large Blend ETF 7	Sep-20	7	0.80		0.85	-0.05
25	Large Blend ETF 8	Dec-20	7	0.48		—	—
26	Large Growth ETF 8	May-21	7	0.55		0.68	-0.13
27	Large Value ETF 5	May-21	6	0.55		—	—
28	Large Growth ETF 9	May-21	5	0.64		0.68	-0.04
29	Large Blend ETF 9	Jun-21	5	0.39		—	—
30	Large Growth ETF 10	May-21	5	0.59		0.66	-0.07
31	Large Value ETF 6	May-20	4	0.49		0.48	0.01
32	Large Growth ETF 11	Feb-21	4	0.90		—	—
33	Large Blend ETF 10	Jun-21	2	0.59		0.75	-0.16
34	Large Blend ETF 11	Jun-21	2	0.59		0.75	-0.16
35	Real Estate ETF 3	Dec-20	2	0.59		—	—
36	Mid-Cap Growth ETF 5	Dec-20	1	0.59		—	—
37	Large Growth ETF 12	Dec-20	1	0.48		—	—

Source: Putnam.

Functional success in the early days

While the sample size remains limited, STAs have generally experienced strong volumes and reasonable bid-ask spreads. The STA 3-month median bid-ask spread of 16 bps roughly approximates the transparent active equity ETF median bid-ask spread of 20 bps. STAs generally exhibit wider spreads and shallower on-screen liquidity than highly scaled and/or passively managed ETFs. However, market makers have facilitated progressively higher-quality markets, and little evidence of a "transparency spread premium" has emerged. In fact, Putnam's analysis of the factors driving ETF bid-ask spreads (see below) suggests that management style (passive vs. smart beta vs. active), market-cap focus, and trading volume drive spreads more than transparency does.

	Management style			Cap size			3-month average volume		
	Passive	Smart beta	Active	Large	Mid	Small	High	Medium	Low
20th	2.9	5.7	11.7	4.0	8.2	11.6	2.4	7.0	9.6
40th	5.8	10.0	17.7	7.2	11.5	15.2	3.9	12.3	17.4
Med	7.4	12.7	20.1	9.6	13.4	17.1	5.8	14.8	20.1
60th	9.7	15.6	23.8	14.6	16.9	19.2	7.2	17.1	22.8
80th	19.7	22.7	35.3	23.8	24.7	24.9	11.9	24.0	36.1

Sources: Morningstar, Putnam. All U.S. equity ETFs with 3 months of spread and volume data. As of 6/30/21.

The future of STAs

Less than 18 months into its life, the semitransparent active ETF has proven the efficacy of its concept while attracting significant curiosity and modest assets. Over the short-to-intermediate term, Putnam expects existing STAs to gain further traction with direct-to-consumer brokerage platforms. They will also likely start becoming available via larger wealth management platforms as those STAs accrue longer track records, begin to meet AUM minimums, and continue to demonstrate the integrity of their licensing models.

Putnam expects further STA adoption as major asset managers continue to enter the space, broker-dealers determine their home office coverage models, and clients increase their demand for active strategies in an ETF vehicle wrapper of the active strategies with which they are familiar. While the SEC may soon allow the various STA models to expand beyond domestic equities, the equity focus within the STA space will likely continue for some time. Though the STA market's growth may be episodic in its early days, the secular forces underpinning its emergence suggest STAs will inevitably gain meaningful market share over the next 3 to 5 years.

These ETFs are different from traditional ETFs. Traditional ETFs tell the public what assets they hold each day. This ETF will not.

This may create additional risks for your investment. For example:

- You may have to pay more money to trade the ETF's shares. This ETF will provide less information to traders, who tend to charge more for trades when they have less information.
- 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 this ETF compared with other ETFs because it provides less information to traders.
- These additional risks may be even greater in bad or uncertain market conditions.
- The ETF 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 this ETF and other ETFs may also have advantages. By keeping certain information about the ETF secret, this ETF may face less risk that other traders can predict or copy its investment strategy.
- This may improve the 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 Principal Investment Risks section of the prospectus. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemed from the fund. Brokerage commissions will reduce returns. The funds have limited public-trading history and operate differently from other actively managed ETFs that publish their portfolio holdings on a daily basis.

Investing involves risks; principal loss is possible. Shares of any ETF are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemed from the fund. Brokerage commissions will reduce returns.

Tracking Basket risk. The fund's Tracking Basket structure may affect the price at which shares of the fund trade in the secondary market. Although the Tracking Basket is intended to provide investors with enough information to allow for an effective arbitrage mechanism that will keep the market price of the fund at or close to the fund's NAV per share, there is a risk that market prices will vary significantly from NAV. ETFs trading based on a published Tracking Basket may trade at wider bid/ask spread than ETFs that publish their portfolios daily, and therefore, may cost investors more to trade. These risks may be increased during periods of market disruption or volatility.

Arbitrage risk. The fund will provide certain information intended to allow market participants to estimate the value of positions in fund shares. Although this information is designed to facilitate arbitrage opportunities in fund shares to reduce bid/ask spread and minimize discounts or premiums between the market price and NAV of fund shares, there is no guarantee the fund's arbitrage mechanism will operate as intended and that the fund will not experience wide bid/ask spread and/or large discount or premium to NAV.

Predator trading risk. Although the fund seeks to benefit from keeping its portfolio information secret, market participants may attempt to use the Tracking Basket, or reverse engineer the arbitrage mechanism to identify the fund's trading strategy, which could result in such market participants engaging in certain predatory trading practices that may harm the fund and its shareholders, such as front-running the fund's trades of securities.

Authorized participant concentration risk. The fund may have a limited number of financial institutions that act as authorized participants (APs), none of which are obligated to engage in creation and/or redemption transactions. To the extent that those APs do not engage in creation and redemption orders, there may be a significantly diminished trading market for fund shares or fund shares may trade at a discount (or premium) to NAV and possibly face trading halts and/or de-listing. This risk may be heightened due to the fact that the fund does not disclose its portfolio holdings daily, and it could be greater during market disruption or periods of volatility.

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