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Converting **Active Mutual Funds** into **ETFs**: a Holistic Assessment

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Background on Semi-Transparent ETF Models

A great deal of excitement has been generated over the past six months as the SEC has approved several ETF operating models that will allow the sponsor to not disclose their portfolio or creation/redemption basket every day to the market. Whether you call these models "non-transparent," "semi-transparent," or "periodically disclosed," the point is that they fundamentally change a tenet of today's ETF trading mechanism – full transparency into the basket of securities that is being created or redeemed from the fund that day[1]. This SEC has become comfortable that the alternative mechanisms proposed by these applicants to enable price discovery – a confidential account (Precidian/ActiveShares), hedge or proxy portfolios (T. Rowe Price, Fidelity, Natixis/NYSE), or a basket of portfolio securities with different weightings (Blue Tractor) – will be able to keep the market price in line with the NAV of the fund.

With only 2% of ETF assets invested in active products, the push by active managers to identify mechanisms for hiding their "secret sauce" from the marketplace in an ETF wrapper has continued and resulted in the recent filings and ultimate approvals. Fixed income managers such as PIMCO have become more comfortable with fully transparent active ETFs, but front running or backward engineering the manager's strategy across the vast universe of bonds is much harder than with exchange traded equities. These concerns among equity managers are not unreasonable considering the continued growth of computing power and artificial intelligence (AI) which provide viable tools for bad actors to unwind an active manager's investment approach.

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Next Stage of ETF Growth?

Will these new semi-transparent models usher in the next stage of ETF product growth? The benefits of the ETF wrapper vs. mutual funds are known – lower operating costs, tax efficient structure, and reduced trading costs. Active managers who have launched smart beta ETFs or even transparent active products have opted to create an ETF product line alongside their mutual funds and closed-end funds. The active products have tended to be either clones of existing mutual fund strategies (MINT for PIMCO; or TOTL, Doubleline's sub-advised total return strategy packaged as a SPDR ETF) or unique products (Franklin's LibertyShares suite of smart beta, active, and passive ETFs).

1. This paper will use "semi-transparent" to describe these approaches as some level of transparency is present in each model.

Mutual Fund –> ETF Conversion – Does it Make Sense for You?

Another option that may become available is to convert active mutual funds to semi-transparent active ETFs. Analyses have been written about the legal and operational considerations in such conversions, but firms also need to examine broader business, distribution and governance ramifications. No one wants to be the first firm to make such a move, but someone will eventually take the leap. Each firm will face a different set of questions depending on the scale of their operating model and relative performance. We encourage active managers to conduct a holistic review across their entire operating platform to determine their best path. Those assessments should consider the following aspects:

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Level of Alpha & Current Mutual Fund Flows

How strong are flows into current mutual fund products? What does the manager have to lose by making the change? If the investment strategy is not generating alpha, putting it into an ETF wrapper is not going to make it better. The exception may be where an ETF wrapper can lower the cost enough to make the strategy more competitive or tax efficient. This requires a fund-by-fund and investment team-by-investment team review.

Portfolio Manager (PM) Knowledge of ETF Processes & Additional Skills

Running an ETF with a basket of securities – either transparent or not – requires creating that basket on t-1 and managing it throughout the trading day. Two specific aspects of an ETF basket need to be managed – tax efficiency and custom basket requests. The in-kind redemption mechanism will naturally improve the tax efficiency of the portfolio, while proactive management of tax lots represents the "gold standard" of ETF portfolio management. Second, custom baskets may be another tool available to PMs thanks to the new ETF Rule. Throughout the trading day, requests for custom baskets will come in from Authorized Participants (APs) creating and redeeming shares, and PM teams will need to accommodate these. Operations teams can perform some of these processes, but PMs should not detach themselves from the core basket activities impacting their portfolio.

Front & Middle Office Technology to Support ETFs

PMs may need different technology tools to enable those daily basket activities. The most appreciated tax lots should find their way into the redemption baskets each day for the relevant security, and portfolio changes from custom baskets need to be incorporated real time. Some of the semi-transparent models will also require the daily maintenance of proxy or hedge portfolios which may require different tools than active managers have in-house today. Successful ETF sponsors have capital markets teams that ensure APs and market makers can efficiently trade their funds. Not only do those skill sets not exist in traditional mutual fund shops, the technology tools required to perform the analytics and support client trading must be bought or built.

Distribution & Product Compensation

The key to gathering assets for any new product – mutual fund or ETF – is to gain approval for sale on platforms at wirehouses and other brokerage and RIA firms. Today, the approval process is quite long for new products, and it remains to be seen whether distributors would evaluate new semi-transparent ETFs any differently if the mutual fund performance can travel with the new ETF wrapper. Also, 12b-1 distribution fees are not part of the unitary ETF structure, but successful ETF sponsors must still participate in fee sharing arrangements with distributors. From a compensation perspective, mutual fund managers have been trying to move away from pure commissions on gross fund sales for mutual fund wholesalers. "ETF Specialists" are paid more on net sales and qualitative factors which should improve alignment between sales teams and business goals.

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Cost of Supporting Mutual Fund & ETF Operating Models

Since ETFs are exchange traded and all shareholder accounts are held at financial intermediaries, the manager's cost to maintain ETFs is lower. As primarily unitary fee products, ETFs tend not to have different share classes that need to be maintained and managed with distributors.

Governance & Cost of Converting Mutual Funds to ETFs

Technically, there may be a way for a mutual fund registrant to convert their funds to ETFs without a shareholder vote through a merger into an affiliated ETF (Rule 17a-8). But this has never been done for a mutual fund to ETF merger, and it's unclear whether the SEC would approve this method. Even if the regulators agree, would any fund board allow a mutual fund merger into an ETF without asking their shareholders? Registered shareholders at the mutual fund's transfer agent would have to sell out of their shares likely creating a taxable event, or some type of a transfer of shares to a brokerage account where the ETF is held would have to be created that doesn't exist today. The same could be the case for a shareholder in a retirement account with a 401(k) recordkeeper. Firms considering the conversion of mutual funds and porting over the track record to an ETF wrapper should likely plan on the one-time expense of a shareholder proxy as part of that conversion. A robust conversation should also occur between the board and the manager about whether the funds should pay for that proxy if shareholders will, in fact, be receiving a lower cost and more efficient ETF wrapper at the end of the day.

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Full Conversion to ETF Product Line – Bold Move or Fool's Errand?

Ultimately, asset managers may have to decide whether they can profitably be in both the ETF and mutual fund businesses. In a market where prices for active management continue to decline, can managers afford to continue investing in the infrastructure to support both product lines? While active semi-transparent ETFs must gain traction in the marketplace first, full conversions or complete commitment to the ETF product wrapper would allow sponsors to both:

Lower shareholder costs for the same active investment strategy

- Tax efficiency
- Elimination of 12b-1 fees
- Lower portfolio trading expense
- Less cash drag from in-kind mechanism
- Custom basket flexibility

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Reduced operating expense

- Elimination of transfer agency infrastructure
- Simplified unitary fee structure
- Potential elimination of mutual fund board if two boards are currently maintained for both mutual funds & ETFs
- Reduction of teams that calculate mutual fund wholesaler commission

Investments will be required though as noted above to add a capital markets team, build additional tools, and conduct a one-time shareholder proxy. A holistic assessment will help each manager determine which path makes the most economic sense for their business. As one senior ETF executive put it, "can we keep offering our ice cream in both cups and cones, or do we have to make a choice at some point to only produce and sell cones?" Change is happening so rapidly now across the industry that managers have to be prepared to assess and act quickly and decisively.

ABOUT US

Di Costa Partners is the market leader in governance, proxy advisory and solicitation services for registered funds including mutual funds, ETFs and closed-end funds.
We offer asset managers a program of market analysis, strategic advisory, governance guidance, ownership profiling and solicitation campaign planning and execution.
Di Costa Partners' deep experience in the space and analytical approach allow us to better understand shareholder sentiment. Utilizing our proprietary analytics, Di Costa Partners provides fund company clients with strategic insight into their shareholder bases to develop a comprehensive communications strategy to drive positive voting outcomes.
Execution is a key component of our offering. We have the necessary platform and campaign resources to help funds achieve successful shareholder meeting results.

CONTACT US

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Steve Messinger is President of Di Costa Partners.
Mr. Messinger joined DCP from BlackRock where he most recently served as Managing Director and Executive Vice President of the iShares funds. In this role, Steve oversaw the governance of the largest ETF complex including leading shareholder proxy solicitations. He has also worked for Morgan Stanley Investment Management and advised asset managers at Ernst & Young and Beacon Consulting, now part of Accenture.