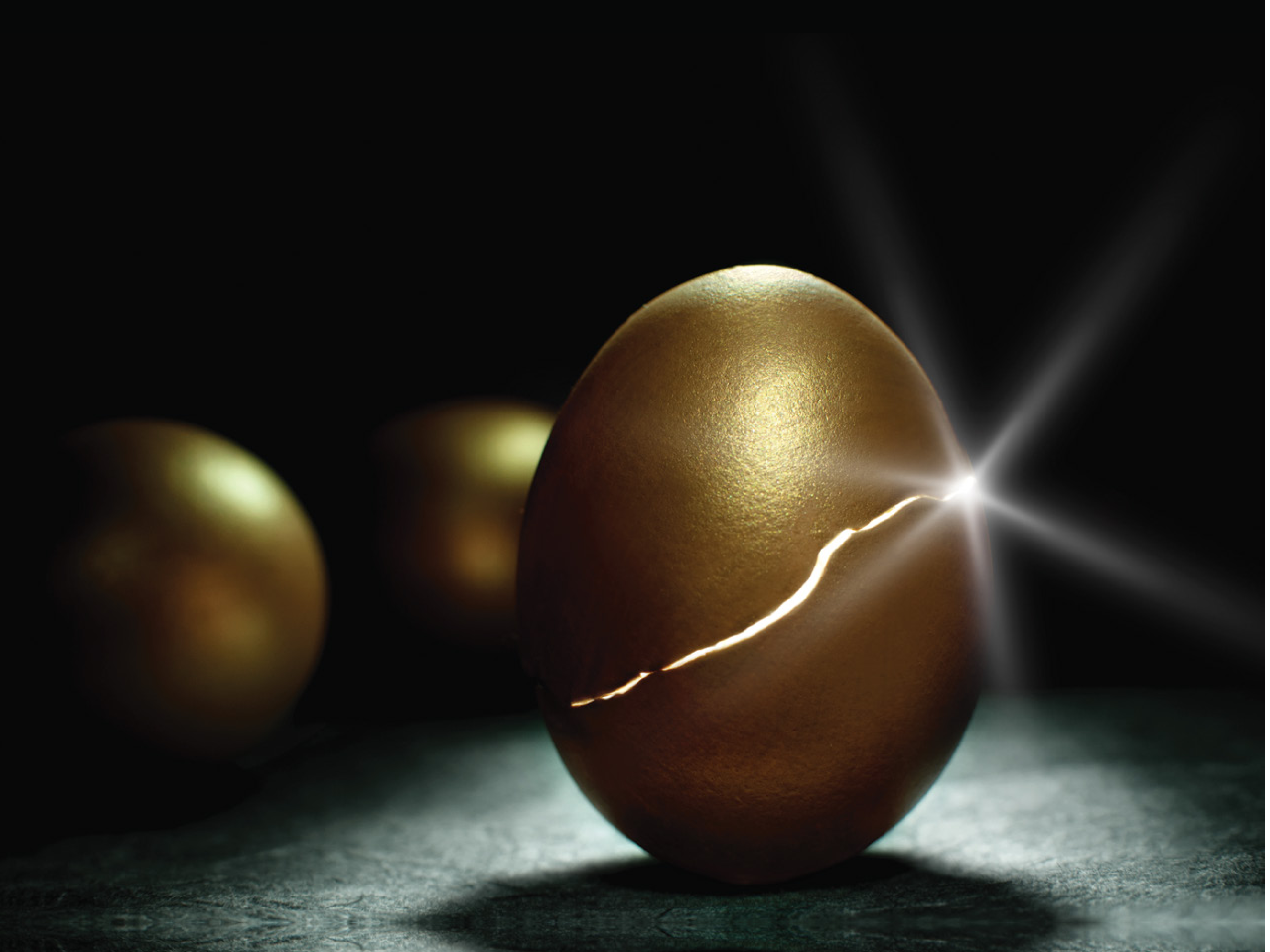
ON THE MOVE

Australia is home to one of the most forgiving portfolio disclosure regimes for active ETFs in the entire world. Five years since inception, the options remain limited and the segment has attracted only $3.5 billion in FUM. But momentum is gaining. **Kanika Sood** reports.



01:
Brett Cairns
chief executive
Magellan Asset Management

02:
Alva Devoy
Australia managing director
Fidelity International

There is a fund manager that draws particular envy from many in Australia's funds management industry.

Hamish Douglass' Magellan consistently beats the markets, has raised a mouth-watering $83 billion and can pull a crowd at roadshows like no other.

Among its lesser highlighted achievements is that it opened the door for active managers to list their funds on the stock exchange without squandering away their investment ideas.

Here's how it happened.

In 2014, Douglass, then-chair Brett Cairns[01] and newly hired head of governance and advisory Craig Wright were executing a plan Cairns had set in motion the year before.

At the time, Magellan had roughly $35 billion in funds under management. It ran mandates for institutional investors and had a loyal following among financial advisers who used their unlisted trust funds.

What the group wanted was more self-directed investors, like those in self-managed funds.

This subset of investors lacked the enthusiasm to fill out 25-page forms but their portfolios bulged with shares and they were familiar with using the stock exchange.

"So, rather than harangue people to just get over it and come play in the unlisted space, we had to bring our intellectual property to the listed space. And that's where the active ETF comes from," Cairns says.

His plan faced a major roadblock.

At the time, all ETFs followed a similar model. They were developed with a third-party in the system, called a market maker.

The market maker's job was to go out and buy and sell securities as investors moved in and out of the fund.

In doing so, the market maker took on risk but kept the difference on the securities' sale or purchase.

But to do its job, this third party had to be handed a full list of what was inside a portfolio.

"And the problem becomes that once the external market maker knows what's in the portfolio, everyone needs to know what's in the portfolio. Otherwise he has an unfair advantage and it is unequal treatment – that's the law, we can't have insider information," Cairns says.

The way the industry and regulators overcame this potential for unequal treatment was ETFs had to make mandatory daily disclosures of their full holdings to everyone – which is akin to professional suicide for active managers.

The problem Cairns had to solve before he could get Magellan's global fund onto the ASX was how to skip the requirement for disclosing the fund manager's stock picks for the global fund which already had over $6 billion at the time.

"The light bulb moment was that the risk was in the wrong spot. So rather than having it outside the system, the market making risk had to be inside the system," he says.

The solution was to do away with the external market maker and take on the role of making the market itself, not dissimilar to how unlisted funds operate. Any revenue made on the bid/ask spread went back into the fund.

Deutsche Bank was moved to the role of an agent. It no longer bought and sold the securities and hence didn't pocket the profit, as it had done in the traditional ETF model. Instead, it was paid a fee for its services and its role ended at executing instructions sent to it by Magellan.

"For example, the responsible entity of the fund would say we will happily sell a unit at $2.51, we will buy it back at $2.49 and Deutsche would post those prices for us and if the market moved, we had the system set up for us to adjust the spread," Cairns explains.

"Once we figured all of that out, we had to work with ASIC around why we would want to bring the market making inside and why as a consequence of that, the disclosure regime would be different."

Eventually, Magellan negotiated a disclosure regime that was full portfolio but quarterly with a two month delay, bringing it on par with unlisted trusts.

The fund manager went back and forth with ASIC demonstrating its risk management practices, pulling from instances in its global fund's 10-year record.

Fast forward five years and it now has $1.8 billion in its actively managed ETFs pulled through 27,500 unit holders, while keeping its intellectual property protected.

Baby steps

Many other fund managers called upon Magellan for advice on internal market making, and Cairns obliged for the benefit of a more lively active ETF market in Australia.

The active segment now has offerings from AMP Capital, Montgomery, Kerr Neilson's Platinum and other managers – all put at ease by the culling of daily disclosures. Multi-boutiques like Ian Macoun's Pinnacle and Challenger's Fidante are looking toward active ETFs as a channel to raise assets to manage.

About 20 active ETFs were using the internal market making model, at end of last financial year.

In all, Australia's regime is ahead of the US which only recently approved its first active ETF that is given some relief from daily disclosures to protect its intellectual property, and Canada which experimented with blind trusts to prevent IP leakage without great success.

It is largely why Fidelity chose the Australian market as the first in which to launch its active ETF offering.

"The Australian mechanism is elegant and it allows the active ETF to create and redeem units without disclosing all its holdings," Fidelity International Australia managing director Alva Devoy[02] said at the time.

> "
> *All the unlisted funds with this internal market making mechanism should be accessible via the exchange.*
> **Brett Cairns**

"There is also no market arbitrage as investment banks are not competing for a profit."

Yet this feat of homegrown financial engineering is only one side of the picture.

Actively managed products still command only $3.5 billion, the size of a small boutique.

This seems even smaller when stacked up against the ETF segment's total of about $48 billion and the $300 billion in retail unit trusts.

Some of the biggest players, including BlackRock and State Street, have so far stayed out of active ETFs.

So, why the subdued raise?

Investor appetite

ETFs offer benefits to both sides of the table.

The fund managers, for their part, are spared the same paperwork agony (the investor's broker would do the know-your-client and anti-money laundering checks), get to diversify their investor base and may earn more fee than from their institutional mandates.

The investor gets to put their money to work in an active strategy without filing paperwork every time, they are spared the high minimums of unlisted trusts and can move in or out of the ETF relatively easily.

The ETF industry has traditionally weaned its investors on low-cost index products. Now as the investment side gets more nuanced than simple indexing, ETFs still face a perception problem almost, that they must be low cost.

An area Aussie investors have shown hunger for are international equities. Active ETFs investing in the asset class accounted for 60% of the segments total at December end.

But why are global equities so hot?

Because they are much easier to invest in than direct foreign shares, according to Pinnacle Investment Management director of listed products Chris Meyer[03].

Meyer says 300,000 Australian investors have brokerage accounts that can invest in global equities but only 50,000 of these are active. He gives three reasons for it.

"Most of the major global equity markets (US and UK) are not open during Australian daytime hours. Your share transactions on these markets and their live share prices are happening while you're asleep. It's hard to feel a part of it," Meyer says.

"Investing in US shares requires filling out the dreaded W8-BEN form. Even spelling mistakes can throw you out, let alone letting Uncle Sam know that you exist."

"Lastly, the costs of converting your AUD to USD to buy those offshore shares are often much more than brokerage rates."

An active ETF listed on the ASX would solve all three problems: no odd times, no W8-BEN required and the ETF issuer gets wholesale rates when trading in offshore markets.


Fidelity Global Emerging Markets Fund (Managed Fund) (ASX: FEMX)
Active ETF
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03:
Chris Meyer
director of listed products
Pinnacle Investment Management

04:
Alex Vynokur
chief executive
BetaShares

05:
Kris Walesby
chief executive
ETF Securities

Last year also brought Australia's first batch of actively-managed fixed income ETFs, as an antidote to chronically bond-underweight but income-hungry investors. One of these has raised over $60 million.

Both of these suggest if an active ETF solves a problem in their portfolio, Aussie investors and advisers may be willing to cross over to the more expensive side of ETFs.

"There is a lot of education required before you start to see big momentum in the ETF space and that includes educating brokers as well as end clients," Devoy says.

"ETF providers will have to build supporting infrastructure, the way Magellan has done, something like portals with a huge repository of education modules on ETFs."

Great expectations

Players like Fidante, Fidelity and Magellan have chosen to invest time and money and launch their active ETFs in-house.

Others, like AMP Capital and Legg Mason, have sought the help of external ETF issuer Betashares, which is now pushing $500,000 across its active lineup.

"We are very clear that our core competency is as an ETF manager where we are experts and have a significant amount of IP. So we are not looking to build our own internal investment teams [for active funds] but to partner with top-tier managers," Betashares chief executive Alex Vynokur[04] says.

Another ETF issuer waiting in the wings with similar expertise to Betashares is ETF Securities.

"We have had about 20 conversations with fund managers and the reason they haven't actualised yet is most managers don't have a business plan for ETFs," ETF Securities chief executive Kris Walesby[05] says.

"A lot of them believe an ETF will create a distribution channel that requires little effort. This is not true."

Walesby views the approach as a recipe for disaster.

Fund managers are accustomed to working with platforms and advisers. To sell their funds as an active ETF, they must cover other cohorts: stockbrokers, wealth management firms and direct retail investors. This requires both a change in marketing approach and extra manpower on the sales force.

If the fund managers are doing it in-house, they may need to build processes and external vendor relationships, for example with market makers or market agents.

Then there is the question of breaking even on the cost of setting up an active ETF.

"Most fund managers think they'll roll the dice and see what happens but when we tell them what they actually need to do to break even, they are surprised."

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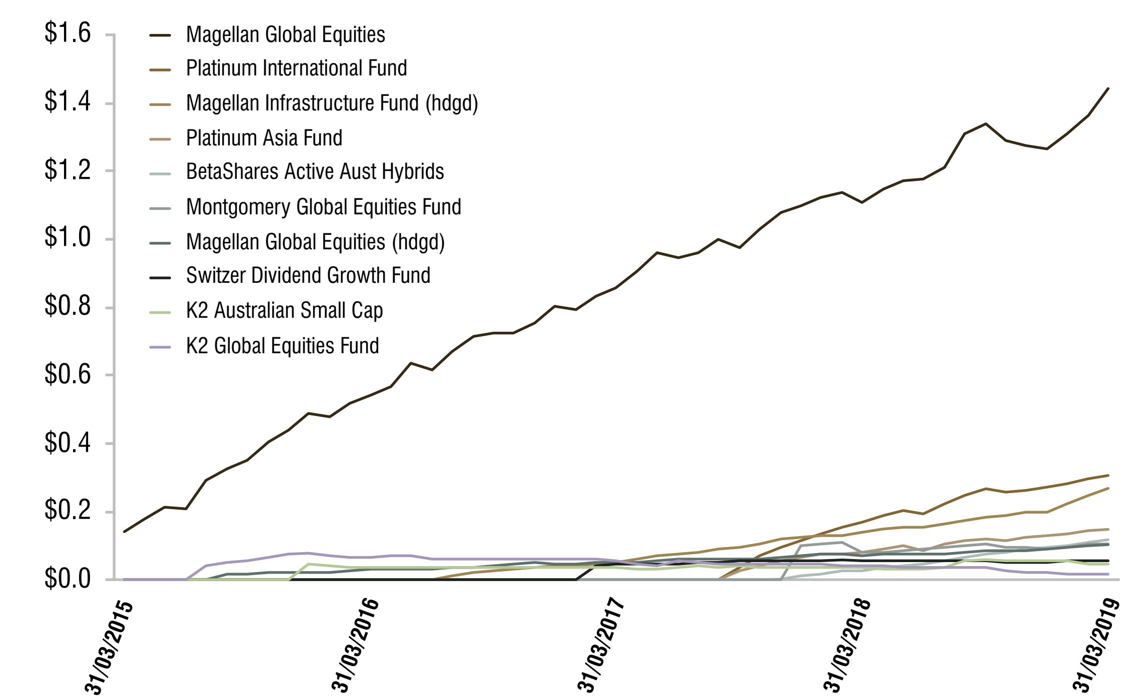
> **Alva Devoy**

Figure 1: Monthly revenue of active ETFs (m)



Source: Rainmaker Information

Walesby reckons an active ETF investing in international equities would need to raise between at least $25 million and $50 million before it can turn a profit. But it depends on the fund's management expense ratio.

There is help on the way however.

The fund manager may use an ETF issuer to do a simple white label-type product where the issuer takes on all the fixed and variable costs, adds a profit margin on top, bills it to the manager and gives them an active ETF.

Alternatively, they may use an ETF issuer as a consultant while setting up systems in-house. Or the two may do a full-blown joint venture where they share the workload and the costs.

One distribution channel active ETFs can't ignore is the platforms, also the natural habitat of unlisted trusts.

It is worth taking a look at what fund managers have reaped from active ETFs so far. Dyall's research calculated the revenues all products in the segment would have made during the time to December end.

The industry was bringing in less than $3 million a month in total revenues from all active ETF products, as at December end (see figure 1). Nearly half of this revenue was generated by Magellan's global equities fund from its $1.1 billion through a 1.35% p.a. management fee and a 10% excess return fee. The fifth highest-grossing ETF on the list is one investing in hybrids for 55 bps, holding about $29 million of net assets.

Active ETFs are also not the only vehicle to get an active fund on the exchange; there's also mFunds, listed investment trusts and listed investment companies.

The latter two are better suited than active ETFs for illiquid investments but may mean more high-pressure or timed raises for fund managers and premium/discount or tax treatment concerns for investors.

Smart beta funds, which invest in a section of an index instead of the whole of it with the aim of outperforming the market at a fee lower than active managers, have also been picking up market share in net flows, according to Rainmaker head of investment research John Dyall[06] (Figure 1).

The closest alternative to active ETFs in their simplicity and investment style are the ASX's mFund, where the options keep growing but total funds under management sits at under $1 billion.

"I think if you were to give a broker an option between an mFund and an active ETF of the same strategy, they would most certainly pick the ETF," ActiveX investment specialist Sam Morris[07] says.

Spreads

Active ETFs are not without flaws though.

The ETF industry, as a whole, is still in its infancy in Australia. It has a lot to add in product choices, liquidity, more effective spreads and market makers.

06:
John Dyall
head of investment research
Rainmaker

07:
Sam Morris
ActiveX investment specialist
Fidante Partners

08:
Liam Shorte
director
Verante Financial Planning

"ETFs are mainly buy and hold instruments in Australia. Investors aren't trading them to take tactical short term positions like they do in the Europe. Over time, as trading improves, it will make the spreads more compelling," Walesby says.

The bid/ask spreads have generally trended downwards in Australia (except a spike in December last year), according to latest Rainmaker research.

Last year, ASIC's review of the ETF industry found similar - spreads were largely behaving well and issuers were monitoring them.

However, it noted active ETFs which used the internal market making mechanism, of which there were 20 products at the end of last financial year, could have wider spreads.

"As the actual portfolio composition is not publicly disclosed each day, it is difficult for an independent market maker (who does not know the portfolio composition) to compete in market making," the review reads.

"This may tend to lead to spreads for non-transparent active quoted managed funds which are larger than those for a transparent ETP with underlying securities in the same asset class. A more concentrated underlying portfolio is also likely to contribute to wider relative spreads."

A tale of two exchanges

Future improvements in spreads and market making aside, the Australian ETF ecosystem has two major changes on the horizon.

The dominant ASX is switching its traditional settlement systems to a blockchain infrastructure while the smaller Chi-X is ready to start listing ETFs, adding a competitor.

ASX has pitched the blockchain system as a much-needed upgrade to the exchange's legacy systems that would deliver benefits to its users and be optional to use.

A Deloitte report leaked to the *Australian Financial Review* in March claimed that in reality, the exchange had not established any rules on how any harvested benefits would funnel back to issuers of ASX listings and their investors.

In April, ASX chief executive Dominic Stevens addressed the market's concerns in a roundabout way at an investment conference.

"I would suggest it is quite a low bar to expect that fully implemented, a DLT [distribution ledger technology] system would give the industry a mere 1% value benefit," Stevens said.

Despite the kerfuffle, most ETF issuers appear to have a positive view of the ASX's changes due for a 2021 release.

Yet, to date, none have started developing a DLT node to connect to the blockchain, even as the ASX launches a customer development environment - a sandbox of sorts that lets the exchange's users test out how well the systems they have been building in-house fit with the blockchain.

"We are absolutely thrilled but we are not building a DLT node for the moment as a matter of priority in the pipeline of our work," Davoy says.

Meanwhile ASX rival Chi-X, whose name many self-directed investors may not even know, is trading up to 40% of the daily ETF volumes in Australia and it wants to do more.

The eight-year-old exchange is well advanced in starting a quoted funds market of its own, meaning it wants to list ETFs instead of just trading them. When its licence arrives, the initial listings will be active fixed income funds.

And it has already lured away some primary listing business from the ASX.

"We are looking to launch a Kapstream active ETF through Chi-X instead of ASX as issuing, hosting and trading costs are competitive but more importantly, Chi-X is has worked very hard to develop a contemporary listing rules framework after extensive industry consultation that can accommodate a wider range of high quality fixed income strategies," Fidante's Morris says.

A world without unlisted trusts

To sum it up, Australian investors have shown early interest in buying their actively managed funds through the exchange, the disclosure regime negotiated by Magellan and now the industry standard has put fundies at ease about their intellectual property and ETF issuers have racked up experience in launching these products.

> *Most fund managers think they'll roll the dice and see what happens but when we tell them what they actually need to do to break even, they are surprised.*
> **Kris Walesby**

The big question is could the $3.5 billion active ETFs overtake the unlisted managed funds market?

Verante Financial Planning director Liam Shorte[08] says he is hearing of more and more advisers using listed funds instead of their traditional unlisted counterparts, including for actively managed strategies.

But it is unlikely this would amount to an adviser exodus away from unlisted trusts in the near future.

"It may actually turn around the other way because platforms are cutting their fees," Shorte says.

For his part, Shorte has moved all his equities exposures to the listed space, including investing through an active ETF. For his property exposures, he is using a mix of unlisted funds like the Australian Unity healthcare property fund and active ETFs from AMP Capital and Betashares (RENT and GLIN).

"It is mainly about the delays with the documentation requirements in the unlisted space," he says.

"About half of our clients are off platform because they don't want to pay the fees and listed funds are easier to manage for them. If more people want to move off the platforms, it is easier for us to do that if that money is invested in listed funds."

One possibility is that investors going into unlisted funds would then be able to go out through an ETF if they wish, in what could marry the unlisted space with active ETFs.

When Magellan set up its first ETF, it established a pool separate from the one its unlisted fund used. However, if it were to do it again today from the scratch, it would keep one pool for both sets of investors.

"There's no plan to combine them, it may never happen. What I am strongly suggesting is that it is exactly the same portfolio, exactly the same fee structure, the same manager, the same everything. And now that disclosures are the same too, we don't really need them both," he says.

The next part of the puzzle is determining what, if any, constitutional changes need to be made to make this transition. It could be argued all unlisted funds with an internal market making mechanism should be made available on the exchange. **FS**