Trading Up: How Active ETFs Revolutionized Investing

>> Necessity is often the mother of invention, that was certainly true for exchange traded funds, or ETFs, and the fund's inventor, Nate Most. The necessity in this case was market liquidity, which evaporated almost instantly during the stock market crash of 1987, known as Black Monday. When the SEC investigated the stock market crash, it identified a need for institutions to trade stocks more efficiently, and more cost effectively throughout the trading day to help markets run more smoothly. At the time, Nate Most was at the American Stock Exchange, and looking for ways to differentiate the Amex Stock Exchange from other U.S. exchanges. Collaborating with the SEC and Standard & Poor's, he engineered the first ETF in the U.S. in 1993. Known as SPY, the fund was designed to track the S&P 500 Index. With one trade investors could buy or sell a basket of those 500 stocks quickly and cost effectively. This innovative new product led to thousands of new ETFs and trillions of dollars in assets invested. Then, in 2019, the SEC passed the ETF Rule, making it easier and cheaper to launch new funds. This paved the way for a major expansion of the ETF landscape, particularly for active strategies. Today, after more than 30 years since their introduction, ETFs continue to evolve. What might tomorrow hold for the ETF landscape, and for the millions of investors who rely on these funds? And what new products will be created that continue to drive growth? To understand today's investment landscape, it's important to know how we got here. This is The Outthinking Investor, a podcast from PGIM that examines the past, the present day opportunities, and the future possibilities across global capital markets. Matt Collins is head of ETFs at PGIM Investments. Eric Balchunas is senior ETF analyst with Bloomberg Intelligence, and author of the book, "The Institutional ETF Toolbox." And Dave Nadig is an independent financial futurist. He helped design and market some of the first ETFs and co-authored the book, "A Comprehensive Guide to Exchange Traded Funds," for the CFA Institute. Exchange traded funds hadn't existed for very long before the first massive change in the ETF landscape, which was a pivot toward the retail market, and making the case for individual investors. Eric Balchunas recalls this evolution and how both institutional and individual investors came to benefit from the funds.

>> What really was discovered by Barclays in particular, about five years after SPY launched, these things could be sold to retail because Amex just wants institutional traders to trade SPY. But they're like wait, this is like a mutual fund, but better. So they saw the cheap prices and the convenience, and so Barclays in particular, I think, deserves a lot of credit for taking the idea of the ETF and promoting it to retail. And that's where iShares was born and ultimately, Vanguard entered, then BlackRock bought Barclays. State Street had SPY, ultimately they opened up to become more retail as well. And so, over the next 30 years, you now have this really interesting combination of these products that are used both by retail [inaudible] institutions for different needs. Retail may go in for 10 years, institution may go in for 10 minutes, and they both kind of use the same exact shares, they pay the same fees, and they benefit from each other, because their liquidity actually helps bring the spread down. So it's kind of the Swiss Army Knife of a product. And so you could use it for whatever you want, and this other nice happy accident was that it's tax efficient because of the way shares are created and destroyed. Unlike a mutual fund, you don't get capital gains randomly. If you sell the ETF, you have to pay taxes, but you don't like just sit there and get a capital gains distribution. And the enduring attraction for institutional investors, I think, is really liquidity. That's the one thing institutions can't get anywhere else. Everybody rolls out the red carpet for these big investors, but what they can't get in these other products, like separate accounts, and the derivatives market, in some ways, is this sort of like futures liquidity but with, again, a physical backing. And you can also lend the ETF. There's several things they can do with ETFs that make them very convenient.

>> Matt Collins also sees the increasing demand for ETFs as a reflection of our culture and the impact of technology.

>> Everyone wants instant access, but more importantly, they want to know what they're buying, right? They want to know the details, they want to see the pictures, and they want to buy it at a low cost. Now if you think about sort of the core tenets of what's going on with an exchange traded fund, it plays to the societal trends that are going on in the market, where they demand transparency, low cost, and instant demand. With an ETF, everyone can use their PC, their iPad, or their iPhone, to access an ETF as they see fit. But more importantly, the ETF gives you a daily transparency. Now if you compare and contrast that with other investment vehicles that exist in the market, maybe they don't see it at all. Maybe they see it on a monthly basis. And I think the way the market is going, they're demanding this transparency.

>> That transparency is crucial for institutional investors. But it's also driven much demand from advisors and individual investors.

>> The idea of sort of the DIY, do-it-yourself investor, you're always going to have advised assets. That is a critical component of the market, but the do-it-yourself investor is only growing, and the easiest way for them to access a diversified strategy, versus buying a particular stock on their own, or particular bond on their own, it's far more compelling for them to buy diversified products through an ETF. But that couples itself with the advised channel as well.

>> That's led to massive growth in the share of portfolio assets held in ETFs over the past five years or so. This is especially the case for advised assets. Dave Nadig explains.

>> I think you have to look back to coming out of a 2000, 2001 bear market era, advisors were really looking for products that would help them build portfolios better. And so that era, from say 2000 to past the Global Financial Crisis, into the 2010s, really was the advisor era of ETFs. Just recently, a few years ago, we finally had the passage of what's called the ETF Rule, which actually made ETFs something you're allowed to do. Prior to that, ETFs were always issued by exception. You had to get permission to break a bunch of rules, both at the exchange, and with the Division of Investment Management at the SEC. You don't have to do that anymore, it's written into the law, so ETFs exist as a buy rate product, given the Federal Code, that makes them much easier to manage, it really puts to bed any question about whether ETFs are here to stay as the dominant investment vehicle in U.S. markets.

>> It took several years after the first equity ETFs were launched before the first bond ETF was created. This was a leap of faith at the time, and quite a shift in the ETF landscape.

>> What you're doing now is you're putting bonds into an equity wrapper. And what's fascinating about that is A, there was a little nervousness, like can you really do that? Is there a liquidity mismatch? But B, what bond

ETFs really did was show the desperate desire for people to trade bonds like stocks. Because there is no bond exchange, you have to call people on the phone, it's very archaic. A bond ETF you can trade just like shares of Microsoft, and people love that. And over the years it determined that the liquidity mismatch wasn't really that big of a problem. People have gotten accustomed to trading bond ETFs in crises, and I think the bond ETF really is almost become like the bond exchange that never existed. Gold is probably another big one, when that came out, I think that was 2004, this was like wait, you can put gold, like gold bars in an ETF? That was huge, and so gold ETFs did very well, then multiple competitors came out. Then they put silver in it, platinum/palladium, and [inaudible] oil futures in them. As a commodity area, I think also was a huge milestone. And then Smart Beta. This is where they took the index and they said hey, instead of giving you a market cap weighted index, like the S&P, let's weight them by dividends, or let's use fundamentals and screen for like price to book, price to earnings, and then we'll weight this other way, and we'll do this, and that, and to me, this was -- Smart Beta was really interesting because it was taking active strategies or preferences, and programming them into a robotic index.

>> Actively managed ETFs were a natural extension of this evolution, and now have around a trillion dollars in assets. That rapid growth has come as a surprise to anyone who thought the transparency of ETFs was too high a hurdle to attract enough assets. On the surface daily transparency should be a deal breaker, giving market participants the opportunity to front run these active funds. That is, to buy and sell the fund's posted holdings ahead of the fund, making it harder for the fund to keep expenses down and returns up. But this hasn't been the case.

>> What's just shocking, I think, to anyone even as bullish as anyone in this industry might be, half of those assets have come in the last two years. And there is a fundamental shift in the market going towards active managed ETFs. And it's not necessarily that hey, all of a sudden I need active. What's happening is traditionally large active managers didn't have an ETF, until I would say three years ago was when we saw sort of a material uptick in traditional asset managers known for actively managing their strategies, to say you know what, we believe in transparency, we're not going to be front run, we don't mind if people see what we buy on a daily basis. Go for it. And now that you're saying okay, I've been doing this strategy in these three other vehicles for 30 years, here it is in an ETF, that's where the demand's coming from. It's going into strategies that investors know and love. But, what we've known for 30 years now in the ETF industry, it's traditionally been a passive market, an index-based market, and it wasn't because people were necessarily just saying oh, I only want passive, it's because there weren't active offerings to compete. And one component that's changed is all of these managers are offering their ETF, number one, but number two, what's happening and what we've heard from advisors in particular, and institutional investors, is the gap in the expense ratio on passive, compared to the average active mutual fund, the spread between the two is just too wide. And with the influx of active ETFs, I think in addition to being comfortable with transparency, a lot of managers are comfortable offering their active strategies at a low cost. There still is a premium on active management, but what we've heard from advisors is just narrow the gap, and that makes me comfortable as a fiduciary to buy this active ETF now that you've narrowed the spectrum of costs. So it's the powerful combination of give me what you're known for, and give it to me at a reasonable, competitive cost. That's how you get to a trillion dollars in just a couple years. But it's just been staggering the amount of interest going to active.

>> In fact, that influx of assets may even underscore the role of advisors in helping individual investors meet their investment goals.

>> So good active managers have moved their strategies into the ETF wrapper. The demand is definitely there. The challenge for investors is nothing got any easier about analyzing an active manager to determine whether or not they're going to be a right fit in your portfolio, you can get access to everybody, all sorts of access inside the wrapper, but you still have to decide whether or not that's the right fund for you, and that has not gotten any easier. That's still as tough as it's ever been. So, nothing about the ETF wrapper makes this any easier or harder, buyer beware.

>> Now we're seeing buffer ETFs, also known as defined outcome ETFs, to help individual investors meet their goals. These are protection based products and they limit losses on the downside. But they also limit gains on the upside. A fund might track the S&P 500 with a 10% buffer, for example. If the index was down 10% for the year, investors would see zero losses in the fund. But it's also limited on the upside, so if the index was up 30% for the year, the fund might only have 15% gains. These narrowly defined outcomes make it easier for investors to accept an appropriate level of risk for their long-term goals.

>> What we are finding is investors like to live in a more narrowly defined range of outcomes. It changes how they view equity exposure. When we talk about goals, we always then say retirement. Well, retirement for one person might be 60 years old, and for someone else, in 30 years it might be 80 years old. But there's other goals out there. It could be your children's education, it could be saving for a wedding, it could be saving for a house. We view it as sort of your fixed time horizon goal. People don't want to take risk if they're saving for a house in four years. So these defined outcomes are really meant to put a window frame and then match up people's goals with their equity experience. Whether it's the financial advisor talking to their client, or the individual investor, with these defined outcomes over a one-year period, all of a sudden it's like, well I understand exactly why I'm up X-percent, or why I'm down Y-percent. It just makes performance management and risk management easier for clients. Now I think on the up front, it does require a little bit more education on how these work. I would say there's a little more up front education to save on the backend of performance management and risk management understanding from all client types.

>> It's no surprise this type of product is drawing strong interest from advisors and especially amid increasing uncertainty in the markets.

>> What I heard from one financial advisor is they had a particular client in mind that appeared to be somewhat wealthy, but also completely unwilling to buy an equity. And they're unwilling to buy an equity back they don't want to take a business that they just sold, their life's work, when they sold the business maybe there's several million dollars just sitting in cash, but that investor is 55 years old. They may have 40 more years of risk or life ahead of them, and the financial advisor spends every day talking to this client, it's like, seems like a lot now, but how will inflation impact what this is worth in 40 years? And they use these defined outcomes to take that investor off the sidelines, give them equity-like returns, but do it in a way where the client says, okay, I'm worried about the S&P being down 30%, but you buy a 20% before product, so now they know that they can only be down 10%.

>> At the other end of the spectrum are alternative ETFs. This is where investor needs diverge somewhat, as the market pushes the envelope for less liquid assets.

>> I am not convinced that you can take something like SpaceX and wedge it into a daily trading vehicle when there's no transparency and no mechanism to decide what SpaceX is worth today, versus yesterday. The industry is trying to solve that problem very hard, lawyers are pushing very hard at the SEC to get products approved. There have been filings from a bunch of folks already. I'm skeptical those products will even work. I'm actually less skeptical they'll get approved, I think we're going to be in a very permissive regulatory environment for the foreseeable future. That puts the burden on you with the end investor, to be even more skeptical. Because simply having the product approved is not going to be a stamp of approval that it will be subject to no fraud, no trading hiccups, no breakages in the system. I do worry about that with the absolute edge of liquidity. So junk bonds, junk munies, those markets can lock up when economic conditions get weird. However, if you're going to invest in those asset classes, you really have to ask yourself, what are your alternatives. And if your alternatives are buying a traditional mutual fund, that's not necessarily better. We've seen that unwind happen and it's not pretty. A traditional mutual fund in that position, when say the underlying market locks up, the only thing it can do is close. The only thing it can do is just stop processing redemptions, and we've seen that. In an ETF that's not really a problem, because you can still go to the market and hit the sell button. You may not like the price, and that's on you, you have to make that call. But there will be a market and somebody will take that off your hands. You don't have that option when your mutual fund closes.

>> ETFs have continued to be a great source of liquidity, even in volatile market environments.

>> If you were to draw a chart of ETF volume and the stock market, every time the market crashes, ETF volume spikes. And that's good. But we always say, when things get tough, ETFs get going. And that is exactly what they were used for. If we saw liquidity go down in a crisis, I'd be more worried. So that's why we actually look at ETF volume as a sort of fear gauge. If you see high ETF volume, these people are freaking out. So every crisis we've seen them be used to offset risk, tweak your portfolio. There's a couple cases where like a high yield muni fund trades at a steep discount, but I think even the people trading that understand that the bonds in it haven't been priced in like three weeks. When the Fed decided to buy bond ETFs as a way to provide liquidity to the entire market, and kind of save America, that was a huge endorsement that ETFs had become mainstream, or durable, is that the Fed, who you think is the smartest financial brain in the world, decided to use those in order to do the liquidity. And we've seen ETFs used in India, China, and Japan in particular, by the central banks to do some things with the market. When I was writing my first book, I found many cases of like an institution in Japan that would actually use EWJ to invest in its own country. So it would use a U.S. ETF that invests in Japanese stocks, because EWJ traded a one basis point spread and an institution come in with a large order and not move the market. Or even be seen. So the U.S.'s liquidity actually is so big that it can attract institutions from other countries because again, you can't create that. Liquidity is not something that can be manufactured, it has to grow naturally in the environment. And we just have so much of it, we used to say that we export liquidity. But that's one thing that has slowed down growth in those countries to a degree, is the institutions are just so seduced by the U.S. liquidity, even when they're investing in stuff in their own market. We also have generally cheaper prices here for the expense ratio. So you get lower fees, more liquidity, and if you're an institution, you have the access to invest across borders like that, you're probably going to use U.S. ETF. Over time I think some of those countries will have enough liquidity to keep them at home. But it'll take a little while.

>> Thirty years since the first ETF was created. The landscape continues to evolve. What changes might we see in the next year or two?

>> I think we will see ETFs share classes of mutual funds. So there's like 44 companies that want to just bolt on an ETF share class to the mutual fund. That would be really interesting, because then you could just switch over to the ETF without selling your mutual fund, and with not tax hit. So that's, that would be major. I think that happens this year, maybe early next year. I think we have an insane amount of all-coin ETFs, because the new SEC chair is more pro-crypto. The SEC will be tested, their limits will be tested. But I think we see a lot of those. I think, I bet the bitcoin ETF hits $100 billion, it's now at 60, and it would be by far the fastest ETF to $100 billon, probably will do it in a year and a half. And the next fastest will have been six years. So I look for that, that's my prediction. And I'll throw in one extra, which is something to watch which is just private assets being put into ETFs. Private credit, private equity. The industry's going to continue to try to push the envelope on that and I think we'll see movement there as well. I think we're going to see a lot of product, last year in 2024 we saw, I think the second largest number of products launched in ETF history, might have been the largest, hundreds and hundreds of products. Almost all of them fall into one of a handful of categories, either they were using options to mold a pattern of returns, either giving you some sort of defined outcome stream, or generating more income off of another asset base. The other big thing that is just obvious on the road is crypto. There's so many crypto funds that have now been filed. So there are smart ways to approach crypto, there are less smart ways to approach crypto, it won't matter, all of those products will get approved and launched in 2025. And so again, this puts the onus back on the individual investor.

>> And because ETFs have gone from niche to mainstream, they've come to reflect what's going on in the broader global economy.

>> I suspect we're going to see investment product based around that. A tariff-based analysis of international trade and investing in those countries that are perceived to be the beneficiaries of those policies most directly. I've talked to a number of portfolio managers that are already starting to think about their portfolios that way. I suspect by the time we're halfway through this year we'll have active product that is either very specifically America First trade dominant, or anti that, investing in the non-U.S. trade blocks, where we're seeing increased cooperation. I mean the fact that the EU is not talking about negotiating direct trade agreements with China should make investors pay attention. Maybe that's better for the EU than we think it is.

>> ETFs are a key part of the fabric of our global securities markets and we'll continue to see the landscape evolve. These funds have proven time and again they can handle just about any asset, continuing to provide liquidity, tax efficiencies, and billions of dollars in cost savings. Thanks to Matt Collins, Eric Balchunas, and Dave Nadig for their insights on the ETF landscape. The Outthinking Investor is a podcast from PGIM. Follow, subscribe, and if you like what you hear, go ahead and give us a review. If you enjoyed this episode and want to hear more from PGIM, tune in to our Speaking of Alternatives podcast. See the link in the show notes for more information.