UNDERSTANDING ACTIVELY MANAGED EXCHANGE TRADED FUNDS

With so many investors and their advisors questioning traditional market thinking about index-based investing, exchange traded funds (ETFs) are starting to move beyond their traditional passive, index territory into more active management.

To some, it's a fad. To others, it's a serious threat to the territory traditionally held by mutual funds. Yet one thing so far is clear. Many of the biggest names in the mutual fund world are now seeking permission from the Securities and Exchange Commission to offer actively managed ETFs. For advice on this new generation of securities, investors should speak with a qualified financial advisor such as a Certified Financial Planner™ professional.

ETFs are baskets of securities that trade like stocks and until recently have almost always tracked market indexes like the Standard & Poor's 500. ETFs have certain advantages over mutual funds – they generally have offered lower fees and tax advantages than mutual funds, and clearer tracking of their underlying investments because they are require to make that disclosure daily.

Here's what's changing. After the ETF industry won regulatory approval for actively managed funds after a 10-year effort, and so the first actively managed bond ETF surfaced last spring with a few more based on stocks. What does active management mean? That managers have more leeway to choose the underlying investments within a fund, while indexed funds require holdings to mirror its chosen index.

What will make things interesting in the new ETF world is the continuing requirement that these active managers disclose every step they make. This is why active management is a challenge, because in the traditional mutual fund world, managers don't have competitors looking over their shoulders when they try to build or exit positions. In the ETF world, disclosure is made on a daily basis, so managers have to worry about competitors mimicking their strategy and foiling their efforts to get the best price for their investments.

Some experts believe that as this category develops, the first baby steps for investing will go toward major stocks that are generally less volatile and therefore tougher for competitors to mimic. Others believe that actively managed ETFs will operate with a series of managers whose moves would be tougher to spot on any particular ETF's disclosure list. However actively managed ETFs evolve, it makes sense to ask the following questions:

How will these investments fit into my overall portfolio? It makes sense to look at how ETFs fit into one's overall portfolio mix given particular retirement and investment objectives as well as tax considerations.

How about fees? One of the chief advantages of index-based ETFs was low expense ratios. Actively managed funds generally do cost more. Try and get an idea of what the fee structure will be before you invest, and compare them to similar investments in the mutual fund arena.

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What are the tax issues? Active ETFs have better tax advantages because the fund manager can sell the lowest-basis stocks via in-kind stock transfers through the creation and redemption process. This helps systematically reduce the tax exposure for investors.

What about the track record? This is a very good point, because as a relatively new investment category, it's important to realize that these new categories of ETFs won't have terribly long investment records to compare to other investments. Do your homework first.

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