Why active managers use ETFs

By Mark Stacey and Florence Narine

A growing number of active fund managers invest with exchange traded funds, not because they want to take a more passive approach, but to help them become even more responsive to opportunities and risks that arise from changing market conditions around the world.

While ETFs are well known for being a low-cost, efficient way to replicate the "market" through broad-based stock indices, it's less recognized just how integral they've become – even to the most ardent stock pickers -- in the ongoing management of mutual funds, pension plans and institutional portfolios. In Canada, 82% of asset managers now use ETFs to gain some degree of exposure to equities, says a 2017 study by Greenwich & Associates. And 28% of current equity ETF investors plan to increase allocations in the next year, with 57% of them planning to boost allocations by 10% or greater.

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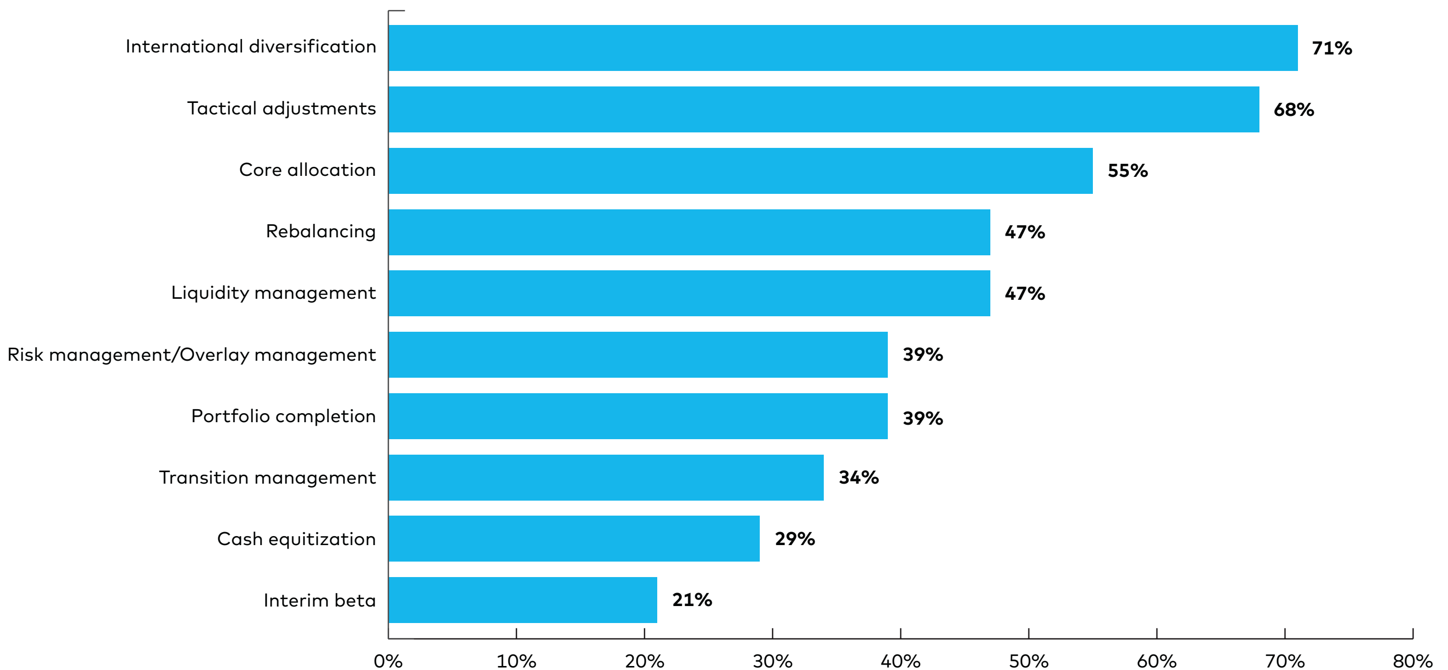
ETFs used for a broad variety of applications



Note: Based on 38 responses.
Source: Greenwich Associates 2016 Canadian Exchange-Trade Funds Study

In many of these cases, ETFs are being used to help facilitate asset allocation decisions in a more efficient manner than would be the case for individual securities. The decision to overweight or underweight an asset class, sector, geography or factor often requires swift execution to be effective in today's fast-moving market environment.

For example, when stock markets sell off aggressively, as they did in February of this year, some managers will address the market's deteriorating momentum and heightened volatility by increasing the cash position in their portfolios. These moves can sometimes be significant (i.e. zero to 50% or more of holdings). By utilizing ETFs, they can be executed for a minimal cost and require far less time and fewer trades than would have been the case if the manager needed to sell one half of an equally diversified portfolio invested in individual stocks.

Even fund managers who primarily invest in individual stocks will hold a small percentage of ETFs in their portfolios from time to time, using them to enhance liquidity, reduce single stock risk in smaller, less liquid markets, and/or as stop gaps to fulfill short term tactical adjustments. For instance, if the outlook for a particular country or sector improves, an ETF can be purchased to add weight to that position until such time that one or more individual stocks is properly assessed and deemed a buying opportunity. This could mean holding an exchange-traded fund for a few weeks or an extended period depending on the criteria involved. On the flip side, an ETF can be used to reduce exposure if the outlook for a country or sector worsens, but the manager likes his related individual holdings and doesn't want to sell them just yet.

Beyond offering these various advantages, exchange traded funds are also gaining traction with some active managers as an alternative way to hedge equity market risk. This includes ETF options (i.e. puts and calls), but also may involve shorting a particular ETF security that is strongly correlated to a portfolio's core holdings. While the use of exchange traded funds as a hedge is still more the exception than rule, broader adoption is expected once the size and liquidity of the ETF market increases and new products that invest in truly diversifying assets and strategies are introduced.

As ETFs become more ensconced in the portfolios of active managers, it is important to recognize them as a complement to the management process rather than a replacement to it. Active decisions about where to invest and how to gain exposure to a market remain paramount and exchange traded funds are one of several tools that can be used to execute on those ideas more efficiently.

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