ADVISER FUND UPDATE
Market Summary and Commentary for Individual Investors from Adviser Investments

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Fidelity Wants to Reinvent ETFs

Fidelity has gotten creative in an attempt to solve the active stock-fund manager's problem of daily portfolio transparency in exchange-traded funds (ETFs) with something called an "exchange-traded active fund." The firm proposed this hybrid structure in an August 11 petition to the Securities and Exchange Commission, and is touting the new product as one that can deliver the desirable features of an exchange-traded fund—potential tax efficiencies, intraday trading and real-time pricing determined by the market—combined with the firm's storied active management talent.

Fidelity has already successfully launched actively managed bond ETFs, where daily reporting of holdings is not as much of a concern, since the portfolios are much harder to replicate and bond trading works differently than stock trading. Why is daily disclosure an obstacle for actively managed stock ETFs? It would mean that anyone following the ETF could replicate the portfolio or front-run anticipated trades, making it more difficult to get favorable prices on stocks. This is why Fidelity is seeking to introduce its exchange-traded active funds (ETAFs), which would eliminate the daily disclosure requirement.

Fidelity proposes structuring these ETAFs like closed-end funds, but their take would "modernize" them. Closed-end funds have similar features to both open-end mutual funds and ETFs. Like mutual funds, they hold a basket of securities that do not need to be disclosed daily, but like ETFs, there are a finite number of shares and they trade throughout the day, meaning that investors may be able to buy shares at prices above or below the net asset value (NAV) of the fund's portfolio. Unlike open-end mutual funds, closed-end funds are not required to offer daily redemptions (open-end funds have up to seven days to pay proceeds on the sale of shares, but they usually pay within one or two days), meaning that investors who wish to sell their stake have to find buyers for their shares.

Fidelity's ETAF investors will be able to sell their shares to other buyers on the open market (the same as for ETFs or traditional closed-end funds), or they can use the built-in workaround—if they can't find buyers, Fidelity will have a standing offer to repurchase shares on a weekly basis at NAV, providing a decent fallback option for investors who need to sell and can't find a buyer.

To bridge the gap between active ETFs' daily disclosure requirement and Fidelity's desire for opacity, the firm has outlined a plan to publish its ETAF holdings on a 30-day delay. However, in the interim, the firm would maintain a "tracking basket" of stocks using the most recent holdings data priced on 15-second intervals throughout the day. The idea is to give investors an approximation of the value of the underlying portfolio.

Hypothetically, if the fund was run by a manager with a low-turnover (infrequent trading) style, this approximation could be fairly accurate. For a high-turnover strategy, the basket's price may not be an accurate reflection of the current portfolio. To provide additional points of reference, Fidelity would report the fund's actual NAV each day along with a method to reconcile any deviations between it and the tracking basket's NAV. The firm asserts that this would give traders the tools by which to make informed decisions as to the value of the ETAF.

There are already non-transparent variations on ETFs available: Eaton Vance's "NextShares," or "exchange-traded managed funds," that apply an active manager's "secret sauce" but also trade on exchanges with aims to deliver potential discounts to NAV and greater tax efficiency than a similar mutual fund. NextShares, launched earlier this year, currently offer an equity strategy, a municipal bond fund and a third following a global equity income strategy.

Critics have charged that NextShares has struggled to land broker-dealers to offer their funds as a result of a unique trading mechanism that would require updates to trading platforms and add costs, and because they are difficult to explain to potential investors. Fidelity's proposed ETAFs would look and trade more like traditional ETFs.

Making active stock management available in a widely accepted non-transparent exchange-traded product is a potential game changer, both for the Boston-based fund giant and the ETF industry as a whole, as it could potentially open the floodgates for Fidelity to create ETAF counterparts of any of its actively managed funds.

Our view: Fidelity continues to innovate its way into the ETF marketplace. As we've covered extensively, the fund giant has made decisive inroads to the ETF landscape, showing a clear dedication to carving its own niche in a marketplace it was late to embrace.

It remains to be seen when or if these ETAFs hit the market, and no specific guidance on potential funds or expenses has been provided. If they follow the pattern of the actively managed bond ETFs, they will cost the same as their regular open-end mutual fund shares.

ETAFs would certainly be a novel twist on the traditional ETF, and may be embraced by those who desire the ability to trade actively managed funds intraday. For buy-and-hold investors, ETAFs may not hold the same appeal—end-of-day pricing and the ability to redeem shares on a daily basis through Fidelity may be preferable.

We'll be following this story to see how it develops, and will report back with any news.

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