

Mutual-Fund Alternatives to Active ETFs

By [Paulette Minitier](#) | [Paulette Minitier Archive](#) | Published: July 21, 2008

IS ANYONE ELSE confused by the new "actively managed" ETFs?

By now you might've heard of these ballyhooed hybrids that boast the best qualities of mutual funds and exchange-traded funds. In theory, you get the same level of active portfolio management available in mutual funds, while also enjoying the discount pricing and anytime trading of ETFs. After years of regulatory gridlock, the first actively managed ETF, **Bear Stearns Current Yield** (YYY: 100.39, +0.00, +0.00%), [debuted](#) this spring. It was quickly followed by the PowerShares Active series ([PQZ](#), [PMA](#), [PQY](#) and [PLK](#)).

PowerShares is a pioneer in pushing ETFs beyond their traditional roots of passively tracking indexes. Its Active ETFs include three stock funds and one fixed-income fund. Invesco, a global money manager, and AER Advisors, a private company focused on developing active ETFs, are each managing two of the ETFs. I spoke with PowerShares' senior veep of [portfolio strategies](#) and AER's chairman to get a better sense of how these active ETFs work and add value for investors.

Essentially, these are quant funds that use screens and mathematical models to build portfolios based on short-term market momentum, earnings growth and price-to-earnings ratios. A manager makes trades based on a model's calculations. At the Active AlphaQ and Active Alpha Multi-Cap, for instance, where AER Chairman David O'Leary calls the shots, the ETFs will drop up to three losing stocks a week. "We're always selling off companies that aren't performing well," says O'Leary, who owns both ETFs he manages and has been researching these strategies since the 1990s.

Underlying this approach is a belief that "sector allocation matters more than stock picking," O'Leary says, so the ETFs go heavier on sectors producing "alpha" — superior returns based on their model — and lighter on the weaker ones. "Most active [mutual] funds don't beat the market in part because many try to forecast what's going to happen in the future, whereas with our research we just go with what the market is doing," O'Leary says.

I'm glad I spoke with O'Leary, because his approach differs from that of most mutual fund managers, who generally buy stocks they believe will be worth more several years from now than they are today. So if you're simply looking for the cheaper equivalent of a buy-and-hold mutual fund that's getting an extra tweak from a manager's stock-picking prowess, these active ETFs may not fit the bill.

That doesn't make them bad [investments](#) for some, but at this juncture the strategy falls short of the promised breakthrough of getting mutual fund-style investing on the cheap. At a 0.75% annual fee, these first active ETFs are continuing the trend toward higher fees for what were supposed to be bargain-basement baskets of stocks. On the quant front, I'd also add that math models can and do fail. Just look how badly the ratings agencies' models did at deciphering mortgage debt.

Until these active ETFs build a track record I'd opt for proven alternatives. With the help of Morningstar, we compiled a list of [no-load mutual funds](#), available to retail investors, with expense ratios less than 0.75% that have beaten the **Vanguard 500 Index fund's** (VFINX) tax-adjusted returns for the past three years. Check them out. One will likely be a better fit in your portfolio.

Better Bets					
Name	Ticker	3-Yr Return*	Tax Cost Ratio	Expense Ratio	
Vanguard 500 Index	VFINX	3.99	0.28	0.15	
Van Kampen Exchange	ACEHX	12.29	0.24	0.46	
American Funds Fundamental Invs F	AFIFX	10.42	1.06	0.58	

ING Corporate Leaders Trust B	LEXCX	9.13	1.10	0.49
American Century One Choice: Very Agg	AOVIX	9.02	0.84	0.00
Consulting Group Large Cap Growth	TLGUX	8.97	0.13	0.70
ING Fidelity VIP Growth S	VPGSX	8.79	0.17	0.30
ING Fidelity VIP Contrafund S	VPCSX	8.24	0.33	0.30
Fidelity	FFIDX	8.14	0.52	0.56
American Century One Choice: Agg	AOGIX	8.14	0.95	0.00
ING American Funds Growth	IAFSX	8.03	0.10	0.52
American Funds Grth Fund of Amer F	GFAFX	8.02	0.78	0.61
TIAA-CREF Instl Growth & Income Retire	TRGIX	7.99	1.59	0.38
ING T Rowe Price Divers Mid Cap Growth I	IAXIX	7.69	0.98	0.66
First American Strat Aggr Alloc R	FSASX	7.65	0.74	0.65
Vanguard Small Cap Growth Index	VISGX	7.59	0.06	0.22

*Post-tax, annualized
Source: Morningstar