Dimensional Investing in an Active ETF Structure

Jun 26, 2020

Dimensional recently announced plans to add to our investment offering by launching three new actively managed exchange traded funds (ETFs) that will offer broadly diversified, all cap core exposure to US, non-US developed, and emerging markets. The new ETFs, planned for later this year, will be managed in accordance with the same investment philosophy, research, and systematic investing approach as our existing portfolios, but in an actively managed, transparent ETF structure.

Dimensional has a long track record of delivering our investment strategies in different types of vehicles and account structures, among them mutual funds, separate accounts, and commingled trusts. Our goal with any vehicle is to determine how to add value in a manner consistent with our core tenets within the rules and parameters of that vehicle type. We prefer to give our clients the choice in how they access our investment expertise if we believe we can offer a similar investment experience independent of the vehicle type.

Many considerations went into our decision to offer actively managed ETFs. This article focuses on the ETF Rule ("the Rule") adopted by the US Securities and Exchange Commission (SEC) in September 2019, which streamlines regulations governing most ETFs and allows for greater flexibility in their day-to-day management. We believe that this improved flexibility, along with the technology and processes we already have in place, will be beneficial in allowing us to bring our investment philosophy and approach to an active ETF format.

ADDING VALUE THROUGH ACTIVE IMPLEMENTATION

At Dimensional, active implementation includes: (1) the research we do to identify market segments with higher expected returns, (2) our translation of that research into portfolio design, (3) our daily approach to portfolio management, and (4) flexible trading to reduce costs. Our value-added proposition starts with designing investment solutions that offer broad diversification in the markets or market segments in which they invest while emphasizing securities with higher expected returns identified by research. For example, most of our equity strategies emphasize securities with smaller market capitalizations, lower relative prices, and higher profitability. The daily portfolio management process for our mutual funds and other vehicles is centered on keeping these strategies consistently focused on the premiums they are intended to capture while maintaining broad diversification and taking into consideration short-term drivers of expected returns, as well as costs and tradeoffs.

Flexibility in what we can buy and sell for our portfolios each day provides us with a greater ability to take into consideration information from markets daily in this process.

What kind of information matters in informing our decisions on what to buy and sell for our strategies? In practice, there are many considerations, such as current market prices, current company fundamentals, corporate activity, cash flows, and market events, to name a few. For example, as current market prices change and company fundamentals change, so do size, relative price, and profitability characteristics, and therefore expected returns. Incorporating current information daily allows us to rebalance portfolios incrementally over time and keep them positioned according to their intended characteristics.

Evaluating current market liquidity on a daily basis is also important. Liquidity varies over time and among different securities in the market. For example, smaller capitalization stocks generally have lower and more variable liquidity than larger cap stocks, as do stocks traded in certain markets, like smaller emerging markets.

WHAT IS ALLOWED FOR ETFS GOVERNED BY THE ETF RULE?

Prior to the adoption of the Rule, ETF sponsors had to apply for individual exemptive relief from certain parts of the Investment Company Act of 1940, a process which resulted in varied conditions across hundreds of exemptive orders. The Rule defines a standardized set of conditions for transparent index and active ETFs. It also provides a consistent set of disclosure requirements to allow enhanced information for ETF investors in the secondary market. Perhaps most significantly, the Rule permits the daily use of non-pro rata baskets, which are baskets that do not mirror the underlying holdings of the ETF, and different baskets for transactions on the same business day ("custom baskets") in the creation/redemption process.

According to the SEC, "The adoption will facilitate greater competition and innovation in the ETF marketplace, leading to more choice for investors."[1]

THE ROLE OF CUSTOM BASKETS IN DAILY REBALANCING

Like a stock, an ETF trades on an exchange. An investor generally buys and sells shares of an ETF through their brokerage account, rather than placing orders with the ETF directly.

Authorized participants (APs) are large institutional investors (like market makers and banks) that transact directly with an ETF provider to create or redeem shares of an ETF. They do this through the creation and redemption process. This is a process where an AP delivers an in-kind basket of securities and cash in exchange for shares or creation units of the ETF (creation), or delivers shares of the ETF in exchange for an in-kind basket of the ETF's underlying securities and cash (redemption).

The ETF manager determines the list of securities to include in the in-kind basket. One of the roles the AP plays in the creation process is to acquire the securities that the ETF manager has determined the ETF will accept in exchange for ETF shares. Before the rule, exemptive reliefs for active ETFs generally required creation and redemption baskets that represented a pro-rata basket of the ETF's holdings.

By giving managers choice in the baskets they provide APs in the daily creation/redemption process, custom in-kind baskets can be used as part of a daily rebalancing process to improve expected returns. When the ETF receives or delivers in-kind baskets that represent pro-rata baskets of the underlying ETF, the composition of the ETF is not affected. However, custom in-kind baskets can be used to adjust the underlying holdings, potentially playing a useful role in the portfolio rebalancing process. Portfolio managers of ETFs can also rebalance their portfolios by executing trades directly in the market on behalf of the fund. Custom in-kind baskets give them another tool.

How and to what extent a manager takes advantage of the flexibility afforded by custom baskets largely depends on their investment proposition, approach to daily portfolio management, and the technology they have in place to manage the associated tradeoffs.

The mechanics of trading differ between mutual funds and ETFs, but the goal is the same—to minimize the impact of trading costs on the premiums that portfolio is seeking to capture. For ETFs, custom baskets are an additional tool that provides the manager with more choice in how to manage trading costs through the baskets they provide APs as well as the trading activity they engage in directly, such as rebalancing activity and the investment of cash received from dividends or other corporate actions or APs. For example, by taking into consideration liquidity in the custom baskets, ETF managers may be able to provide APs with baskets that involve lower transaction costs to assemble or liquidate vs. pro rata baskets. Lower transaction costs for APs can potentially result in smaller spreads on the ETF shares trading on the market, which benefits investors when they transact in the ETF on an exchange. The spread is the difference between the market's best bid and best offer at any given time.

Creating intelligent custom baskets that use daily information from markets—while at the same time ensuring that the ETF continues to be managed toward its intended design—requires the ability to manage complex tradeoffs daily. Dimensional has technology and tools in place to evaluate these tradeoffs as well as a global Portfolio Management team with experience overseeing the daily process.

In the mutual funds we manage, our active implementation enables investor cash flows to be used for efficient portfolio rebalancing. Custom basket flexibility can allow us to use the ETF creation or redemption process for efficient ongoing rebalancing. Thus, just as in our mutual funds, we can use client trading activity to benefit all fund shareholders.

SUMMARY

In sum, the ability to use custom creation and redemption baskets daily offers greater flexibility in the management of ETFs. Flexibility is an important part of our process, as we believe that using information in markets daily helps us to increase returns, manage risk, and reduce costs in our implementation process. We have the systems and processes to deploy this approach effectively in actively managed ETFs that will complement our investment offering.

1. www.sec.gov/news/press-release/2019-190.