Actively-Managed ETFs:

A Disruptive Force to Be Reckoned With

STATE STREET

Frank Koudelka
Global ETF Product Specialist,
State Street

Jeffrey Sardinha
Head of ETF Bridge Team,
State Street

Scott Livingston, CFA
Head of ETF Capital Markets,
T. Rowe Price

Timothy Coyne
Head of ETFs,
T. Rowe Price

Exchange Traded Funds (ETFs) have historically been synonymous with indexing or passive investing. The first true actively-managed ETF was launched in 2008.[1] For the first 10 years that the actively-managed ETFs were available, they never exceeded US$10 billion in net annual inflows and the market share remained at one percent of the overall ETF market.

A shift began to occur in 2015 when the regulatory environment began to ease some of the barriers to growth. These included: the lifting of the derivatives moratorium, allowance of international ordinary equities, expansion of generic listing standards, approval of periodic holdings disclosure, passage of the ETF Rule and enabling the conversion of mutual funds to ETFs. Taken in aggregate, the changes have expanded the toolkit for active managers to effectively participate in the ETF marketplace.

The entry of T. Rowe Price into the active ETF marketplace during 2020 was a much-anticipated event, after the firm first signaled interest with a regulatory filing in 2009. The firm has epitomized active management,focusing on investing in growth stocks after its founding in Baltimore, Maryland in 1937. Since then, the global investment manager has expanded to 17 countries and grown asset under management to US$1.4 trillion.[2]

We partnered with T. Rowe Price 10 years prior to their ETF market entry in the development of service models and launch planning, culminating in the funds' public availability today. We currently provide services including basket creation, dissemination, settlement, custody, fund accounting, order-taking, financial reporting, performance and investment analytics, and transfer agency services to T. Rowe Price's suite of funds. Frank Koudelka, our global ETF product specialist and Jeff Sardinha, head of ETF bridge team spoke with Tim Coyne, global head of ETFs and Scott Livingston, global head of ETF Strategy and Capital Markets of T. Rowe Price, about their entry into the ETF market, their growth strategy, challenges and future plans.

[1] SEC.gov/Archives/edgar/data March 25, 2008

[2] T. Rowe Price website May 31, 2022

Frank: State Street first partnered with T. Rowe Prices' ETF efforts in 2011, 10 years before your launch. We worked on developing workflows and contemplating technology changes to support the proposed model. Scott, you were there pretty much from the start. Can you take us down the memory lane and discuss what changed and what stayed the same?

Scott: Thanks Frank. And you are correct – it was a long journey but one we thought was incredibly important so that investors had a choice when it came to ETFs and weren't restricted to only index returns less fees. Our conversations with regulators extended way back – there are even mentions as early as **2009** in the Wall Street Journal about our thoughts on active ETFs.

To address your question – what stayed the same was our goal and our core beliefs. Our goal was to offer investors the ability to access our active management expertise in the ETF wrapper – a wrapper that offers certain investors benefits relative to other product structures. Where this became tricky, particularly on the active equity side, was that the Securities and Exchange Commission (SEC) had always required ETF issuers to disclose holdings each day as a condition for approval. Underpinning the SEC's requirement of daily holdings disclosure was their belief that would enable market makers to price ETFs around their net asset value (NAV) if they had this data resulting in good trade execution for investors. We agreed with the SEC that it was important for ETFs to trade around NAV, but we believed that there was other information that market makers could use to ensure orderly and efficient ETF trading markets.

For passive products, disclosing holdings each day was not an issue and the information had very little value since in most cases the benchmark constituents and weights were already widely known. As an active manager, we were concerned that disclosing our holdings each day could lead to the front-running of our trading strategies, which ultimately increases our transaction costs and hurts our client's performance. So instead, we went to work on developing an efficient ETF process that would shield our investment intellectual property thereby protecting our client's performance, while also giving market makers the information they needed to make markets in our ETFs. We wanted to accomplish both objectives without complicating the ETF structure in the marketplace. To do this, we engaged with the entire ETF ecosystem – State Street included – to collectively develop a model that would make sense so that we could garner broad support for our proposal.

While some of the languages of our process and supporting data points may have changed during our conversations with the SEC, perhaps the biggest change during this period was investor preferences. We saw ETFs continue to grow in an explosive way as more taxable investors began to appreciate the convenience, versatility, relative tax-efficiency and lower costs of the ETF wrapper. This only added further conviction to our belief that it was important to get a model approved that would allow active managers the ability to offer ETFs without subjecting investors to performance degradation. The SEC, to its credit, also noticed more investors gravitating to ETFs and put in the work to understand the various proposals to ensure they would operate as intended in the market. While the journey may have taken some time, we believe the outcome is a big win for investors of all kinds. For those that prefer active management, they can now consider the ETF wrapper. For investors that prefer the ETF vehicle, they now have added choice if they want to go beyond the returns of a benchmark.

2009

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Frank: Thanks Scott. So, although it was a journey of more than 10 years with the regulators, all of the T. Rowe Price-stated goals remained in place when approval was finally granted. Turning to you Tim. You joined T. Rowe Price later in the ETF journey with a strong pedigree of the investment wrapper, including stints at the American Stock Exchange and running the global capital markets function for the SPDR ETF business. What are you most excited about?

Tim: Thanks, Frank. As you described, I've spent a significant part of my career working with ETFs and that was by design as early in my career I recognized the power of the structure and believed it would lead to massive growth. Joining a firm like T. Rowe Price was a no-brainer with its client-first approach and deep history of excellent active management.

I think my experience provides me with a good perspective on how to integrate ETFs across the firm, recognizing that, in many ways, ETFs are different from other investment products. For example, an ETF is operationally unique and is a listed security. Thus it requires a high degree of sustained and strategic engagement with market participants - a key difference from mutual funds and other fund structures. While ETFs provide us with an opportunity to engage with existing clients, it also provides the opportunity to expand our reach to develop new client relationships. In many cases ETF clients may have different questions and needs, so their expectations of us as an ETF issuer may be different. Our teams approach is to leverage existing infrastructure and capabilities where they exist, and be thoughtful to build out new capabilities that are required as an ETF Issuer to best serve our clients.

We are really excited about the ETF opportunity for the firm and I believe we are entering an interesting time for ETFs. We've seen explosive growth in passive ETFs, but investors today seem to really be looking for differentiated strategies that have the ability to navigate various market cycles – and that is what T. Rowe Price does. While we are in the early innings of our business, we continue to believe the next leg of ETF growth will be fueled by active products. We are already starting to see it with strong flows and launches on the active side.

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Jeff: A key tenet of the T. Rowe Price launch was to protect trading strategies, which protects investors, but also not to complicate the ETF structure for the marketplace. Scott, how has this been accomplished?

Scott: That was certainly our goal, Jeff. During our model design phase, we focused on what made ETFs trade so efficiently in the market – and in our view it was the ecosystem and roles that various firms played in supporting ETFs. So, we didn't want to disrupt that or add complexity for complexity's sake. Instead, we worked with market makers to design a package of information that they could use in-lieu of portfolio holdings that would serve the same purpose of helping them value and support the funds intra-day. We also looked at the creation and redemption process and didn't want to change that either. Instead of using a disclosed holdings basket for a typical creation, authorized participants can use our daily disclosed proxy basket, which is designed to both track the performance of the fund's underlying securities and serve as an efficient creation basket. By leveraging existing ETF processes, we were able to keep the efficiency of traditional ETF trading and not add any new firms or costs into the process.

But, most importantly, this means our ETFs look and feel just like any other ETF in the market for investors- except they come with the potential for outperformance. The model simply combines the benefits of the ETF wrapper with the value of T. Rowe Price's active management. Finally, investors get all of the information and disclosure they have come to expect in our active mutual funds.

We believe we have really threaded the needle here and with over a year of trading under our belt, the results speak for themselves.

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Jeff: Tim, so we've heard about the thoughtful journey that T. Rowe Price undertook to enter the ETF market. What results have you seen thus far?

Tim: We've been really pleased with the traction that we've got thus far. We entered the market in August of 2020 with the launch of our first four equity products and we have since added a fifth. Then we brought three fixed income strategies to market at the end of September last year. The fixed income ETFs that we launched do have daily disclosed holdings since we are comfortable doing that on these funds. The fixed income market operates much differently than equity, which makes it very difficult to front run any trades we are executing in portfolios.

All the funds have been well-received by investors and we are excited about the growth we will see in the products this year. Initially, we had seen interest from advisors and retail investors, which tend to be the earliest adopters of new ETFs; however, recently we've seen some of the larger broker-dealers starting to take a deeper look at active ETFs. That makes sense as we now have a track record of the ETFs trading in the market.

Speaking of the trading history, we are seeing tight spreads and ample liquidity across all our products, including those that don't disclose daily holdings. For the ETFs where we are shielding IP to protect client performance our spreads have been leading, but it's important to note that all products using these various models have traded well. In fact, many of them are trading at attractive levels even compared to similar funds that do disclose holdings each day.

This is all important because spreads essentially become part of the cost of ownership for investors. They can also be a reflection of the confidence liquidity partners have in a product or process so, although we expected these early results, they are encouraging.

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Frank: Scott, there has been a broader debate in the market and that's active versus passive. This led to much of the growth of ETFs at the expense of mutual funds. But at the same time, actively-managed ETFs are becoming a larger and larger segment of the ETF market. How does T. Rowe Price think about this as it relates to its launch?

Scott: We believe there are use cases in a client portfolio for both ETFs and mutual funds, as well as both active and passive strategies. As an active investment manager, we see our job as offering world-class active investment strategies that can improve the investment outcomes of our investors. We then want to offer those strategies in various wrappers so that the end investor can use whatever works best for them. So, our entry into ETFs was really about giving clients a choice, which we think is always a good thing.

As you stated earlier, ETFs have historically been synonymous with passive investing. We don't think that should or will be the case on a go-forward basis. ETFs are simply a way to deliver an investment strategy, passive or active. With the recent regulatory changes that allow active managers to shield IP or bring ETFs efficiently to market under Rule 6c-11, we fully expect the growth of active to continue in ETFs.

Frank: Tim, T. Rowe Price has now expanded from its initial launch of five equity ETFs to three fixed income ETF launches. Tell us about that and future plans both domestically and globally.

Tim: Ultimately, we want to offer investors a robust suite of ETFs across asset classes and regions. We've taken an important step with the launch of our initial active fixed income ETFs and you can expect us to continue to grow our lineup there in 2022 and beyond. On the equity side, our products have traded exceptionally well, which we hope will lead to approvals to launch additional types of investment strategies using our process to shield investment IP. While the US is the largest ETF market and we continue to focus on getting that right, ETFs are really a global opportunity and that is how we intend to build our business. While it is premature to go into details for now, you can expect us to continue to build out our business in a thoughtful way including across geographies where it makes sense.

Jeff: Has T. Rowe Price contemplated converting any of its mutual funds to ETFs? Why or why not?

Scott: We've certainly seen the headlines of the ETF conversions and expect there to be more. It's important to note, however, so far only ETFs that can disclose holdings each day have been converted. Second, there are many operational complexities that need to be considered when converting a mutual fund to an ETF. These include the mix of underlying shareholders – will all of them benefit from and desire an ETF? There could be retirement investors in the mutual fund that do not have a brokerage account, for instance. As stated earlier, we continue to believe there are use cases for both mutual funds and ETFs and do not believe converting from one to another necessarily guarantees success. Instead, we continue to monitor the health of all our investment strategies and vehicles to make sure we are offering our best investment ideas to our clients in as many ways as they seek to access them.

With all that said, this is still a development that we continue to monitor and could consider if it was what was best for our investors.

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State Street Corporation
One Lincoln Street, Boston, MA 02111

www.statestreet.com

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