Active Management in the ETF Wrapper: When Skill Meets Structure

How the ETF structure changed what's possible for actively managed strategies

KEY TAKEAWAYS

- The choice between active and passive management is a separate decision from the choice of ETF or mutual fund wrapper. Active strategies, along with passive strategies, can live inside the ETF wrapper, and increasingly do.
- Active management's value tends to be most visible when markets show wide dispersion or narrow leadership (a small number of stocks driving most of the index return).
- Active ETFs combine conviction-driven security selection with the ETF wrapper's potential structural advantages (which also apply to passive ETFs): daily transparency, tax efficiency, and intraday liquidity.

Overview

The active-versus-passive debate may be framed as a binary choice. It isn't. Active describes a portfolio management approach, a manager making deliberate, research-driven decisions about which securities to own. ETF describes a fund wrapper, a structure that trades on an exchange and uses the in-kind[1] creation[2] and redemption[3] mechanism. Those are two separate decisions.

For decades, active strategies lived almost exclusively in mutual funds. Over the past five years, that has changed substantially. Active ETFs have become one of the fastest-growing segments of the asset management industry, with the universe expanding across virtually every asset class and style.[*]

Why It Matters

We believe the case for active management is not that it always outperforms a passive index. It is that under certain market conditions, an active manager with a clear process and demonstrated skill has the opportunity to add value.

That potential opportunity tends to be most visible in two environments:

- **High dispersion:** when individual securities within an index produce widely divergent returns. When dispersion widens, getting selection right matters more.
- **Narrow leadership:** when a small number of names drive most of the index's return. Active managers can choose whether to participate, underweight, or diversify.

None of this guarantees active outperformance. But it sharpens the question of when active management may be likely to be worth its fee.

How It Works

Active management means deliberate decisions about positioning. Passive tracks an index.

Passive	Active
TRACKS AN INDEX	MANAGER DECIDES
Holdings match a published index. Returns aim to mirror the benchmark. Potential lower fees, no active risk[4], no opportunity to add value through selection.	Portfolio manager makes deliberate selection and weighting decisions. Potential higher fees and active risk of underperformance.

In our opinion, the case for paying active management's potential higher fees rests on the manager's ability to generate alpha, returns above the relevant benchmark, adjusted for risk, net of fees, with consistency over multiple market regimes. Not every active manager does. The dispersion of outcomes among active managers is part of what makes manager selection itself a meaningful decision.

The ETF wrapper doesn't change any of that. What it does change is the structural environment in which the strategy lives: daily transparency, potential tax efficiency, intraday liquidity. For an active strategy, daily holdings disclosure makes the manager's process visible and auditable in a way quarterly mutual fund reporting may not.

Practical Implications

For advisors and investors considering active management in the ETF wrapper, three potential takeaways follow.

1. **Treat the wrapper choice and the strategy choice independently.**
   Whether to be active or passive, and whether to use an ETF or mutual fund, are two separate questions. The answers do not have to move together.

2. **Calibrate the case for active management to market conditions.**
   Active strategies may be more likely to demonstrate value when dispersion is wide or leadership is narrow. In broad, undifferentiated rallies, low-cost passive exposure may be hard to beat.

3. **Use the ETF wrapper's transparency to evaluate active managers.**
   For actively managed ETFs, daily holdings disclosure can provide greater visibility into portfolio positioning, making the strategy's implementation more transparent to investors.

At Clough Capital

Clough Capital has been an active manager since 1999. CBLS (Clough Hedged Equity ETF) and CBSE (Clough Select Equity ETF) bring the firm's research-driven, conviction-led approach into the ETF structure, both actively managed, both publishing full holdings daily. The firm's tagline captures the conviction: always active, never passive.

Definitions

1. An in-kind transaction is one settled by delivering securities rather than cash. When an ETF redeems in-kind, it hands an authorized participant a basket of portfolio securities instead of selling those securities and paying out cash, which is why an in-kind redemption does not itself require the fund to realize a capital gain.

2. Creation is the process by which new ETF shares come into existence. An authorized participant delivers a specified basket of securities, cash, or both to the fund and receives a large block of newly issued ETF shares in return. Creation allows an ETF's share count to grow to meet investor demand.

3. Redemption is the reverse of creation. An authorized participant returns a large block of ETF shares to the fund and receives a basket of the fund's securities, cash, or both. Redemption allows an ETF's share count to shrink when investors sell.

4. Active risk is the risk that an actively managed portfolio performs differently from its benchmark, in either direction, because the manager holds securities in different weights from the index or holds securities the index does not. It is the risk an investor accepts in exchange for the possibility of outperformance, and it can result in underperformance.

IMPORTANT DISCLOSURES

Investors should consider the investment objectives, risks, charges, and expenses carefully before investing. This and other information are contained in the prospectus, which may be obtained by visiting www.cloughcapital.com/etfs or by calling 855-393-0559. Please read the prospectus carefully before you invest.

Active management involves higher fees and the risk of underperformance relative to passive alternatives. There is no guarantee that an active strategy will outperform its benchmark or that any investment objective will be achieved. The success of an actively managed strategy depends on the portfolio manager's skill, research process, and judgment, all of which involve risk. Past results do not predict future results.

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A passive ETF employs a "passive management", or indexing, investment approach and seeks investment results that correspond (before fees and expenses) generally to the performance of its underlying index. The ETF is not "actively" managed. Therefore, it would not necessarily sell or buy a security unless that security is removed from or added to the underlying index, respectively. Unlike typical "passively managed" ETFs, there is no index that an active ETF attempts to track or replicate. Thus, the ability of the ETF to achieve its objectives will depend on the effectiveness of the portfolio manager.

This does not indicate an active investment strategy is superior to a passive investment strategy, nor does it guarantee better investment performance or results.

An ETF's portfolio may differ significantly from the securities held in an index. You cannot invest directly in an index; therefore, its performance does not reflect the expenses associated with the active management of an actual portfolio.

* Source: Morningstar Direct. Figures for active ETF growth are drawn from Morningstar Direct fund flow and asset data.

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