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Active vs Passive ETF's

You could divide up the ETF world into two camps; active ETF's and passive ETF's. Most ETF's are passive - they try to recreate an existing portfolio or index, for instance the S&P 200 index on the Australian Stock Exchange. A passive ETF would simply buy the 200 shares comprising that index. An active ETF, on the other hand, does not stick to the index but relies on a manager to get the best outcome within the funds parameters.

What's the difference? An example of a passive ETF is STW. It's an ETF issued by SPDR that tracks the ASX 200 index. The index is really just a list of the largest (by market value) 200 companies listed on the Australian Stock Exchange. So the manager of STW buys the top 200 companies and holds them for you. It's pretty simple. An example of an active ETF is AUST. That's issued by Betashares and is a portfolio of Australian shares. The fund has a manager who tries to use strategies to reduce risk. So the portfolio is "actively" managed rather than simply replicating an index.

Generally speaking an active ETF is likely to charge higher fees than a passive ETF. That's because they employ a manager to spend time maximising the returns of the fund. A good thing if they are able to achieve it. That's the issue, most actively managed funds do not add a lot of value. Some do, but many don't.

Higher fees are not the only thing to consider when choosing active or passive. There may also be a hidden fee when investing in active funds. That hidden fee is the cost of buying or selling the ETF. Again as a generalisation, active funds have a higher buy sell spread than passive funds. The average difference between the price at which you can buy an ETF and the price at which you can sell an ETF is 0.26% for passive ETF's and 0.54% for active ETF's. The reason for this is that the price at which you buy and sell ETF's is controlled to a large extent by market makers, professionals who buy and sell ETF's in order to ensure liquidity, ensure that you can buy or sell at any time. Now it is harder for a market maker to give you a good price on an active ETF simply because it is harder for them to know what is in the ETF. Remember that a passive ETF simply replicates a list of shares, that's simple to do and the market makers know exactly how to price the ETF. But in an active ETF the market makers find it more difficult and so the price to buy and sell is wider apart. That is a cost to you.

Pro's

Passive - lower fees, smaller spread = lower costs

Active - a dedicated manager trying to get you a better return

Here is a link to our [Financial Services Guide]