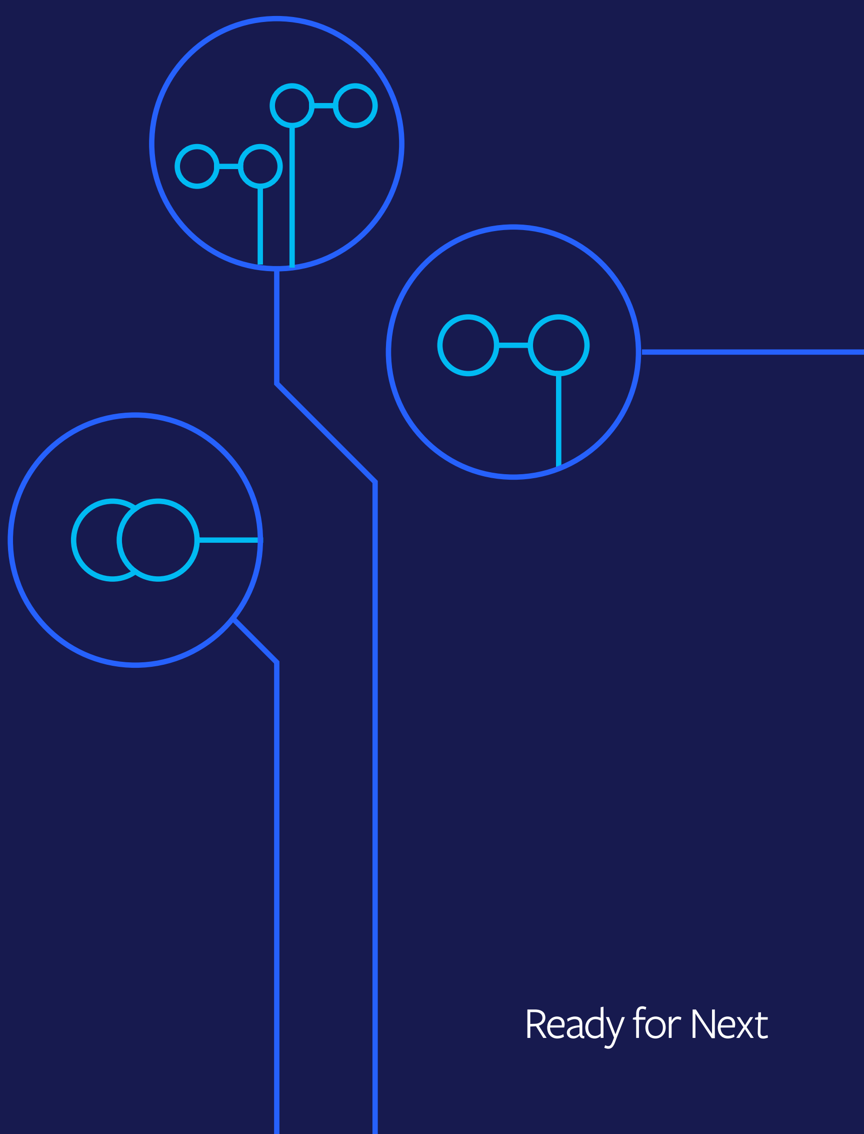
Broadridge®

ASSET MANAGEMENT

All in the family

Active ETF Clones, Siblings, and Cousins



Ready for Next

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Active ETF considerations

Relationship

Is this ETF related to a fund?

- Determine if an Active ETF is a Clone, Sibling, or Cousin of an existing mutual fund.
- **Clone** – mutual fund and ETF have the same investment mandate and highly correlated holdings and outcomes.
- **Sibling** – mutual fund and ETF have very similar investment mandates, however, correlation of holdings and outcomes is low.
- **Cousins** – mutual fund and ETF have investment mandates in same general strategy with marginally related outcomes.

Board considerations

Pricing and outcomes for investors

- What are the operational differences between fund and ETF?
- What is the methodology for pricing of management fee versus additional services?
- Does pricing policy change based on type of product – Clone, Sibling, Cousin?
- Are there potential impacts to investors remaining in a mutual fund due to a launch of a similar ETF, e.g., price increase, tax implications?
- With different boards, what responsibility to communicate concerns exist?

Management considerations

Assets, flows, pricing, and distribution

- Will a Clone ETF impact flows to an existing mutual fund, and what are the trickle-down impacts?
- What is the expected distribution channel of the ETF?
- Do Reg BI implications play into the determination of Clone, Sibling, Cousin?
- Can you clearly articulate the differences between products that aren't Clones from mandate to structure and service perspectives?

Active ETF general considerations

Structure, distribution, and a growing market

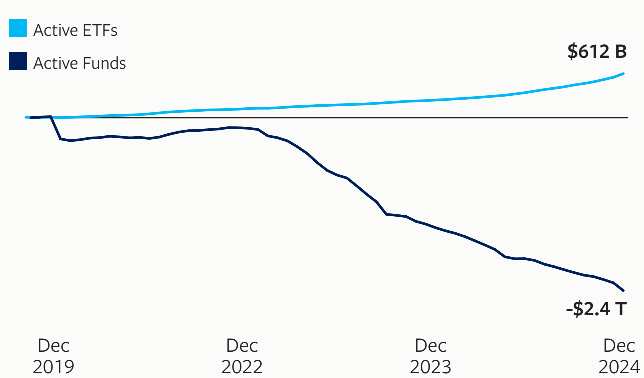
- Do we have the capabilities and skills to manage an ETF? If not, do we build or buy?
- Does the structure of a product impact our target margins? If so, how do we ensure agreement of key stakeholders?
- What are limitations of ETFs, such as inability to be sold to DC's? Can we live with those limitations given our current and planned business model?

Active ETF landscape

The proliferation of Active ETFs is creating many questions and challenges for mutual fund boards and product teams. In the 2023-2024 time period, Active ETFs have accounted for more than 75% of ETFs launched in the United States. Active ETFs are now the single largest ETF segment when subdividing "passive" into market-cap and smart beta offerings. While many of the Active ETF launches have centered on buffer ETFs or other defined outcome ETFs, such as those offered by Innovator and First Trust, the greatest concerns Broadridge receives from boards and management centers around more traditional investment strategies for Active ETFs.

When compared to active mutual funds, the Active ETF has been the clear winner when looking at asset flows, bringing in a cumulative $612.0 billion over the past five years compared to the active mutual funds net outflows of more than $2.4 trillion. Active ETFs are also dominating in the product launch arena with over 1,800 as of December 31, 2024. In the past two years Active ETFs have accounted for 920 new launches compared to 288 launches for passive ETFs. This rapid growth of products and the ability to attract new assets has put Active ETFs front and center in the thought process for product development, fund boards, and advisers. While the products seem straight-forward and appear to have many benefits to investors compared to traditional mutual funds, there are many areas of focus boards and asset managers should consider as they develop and monitor Active ETFs.

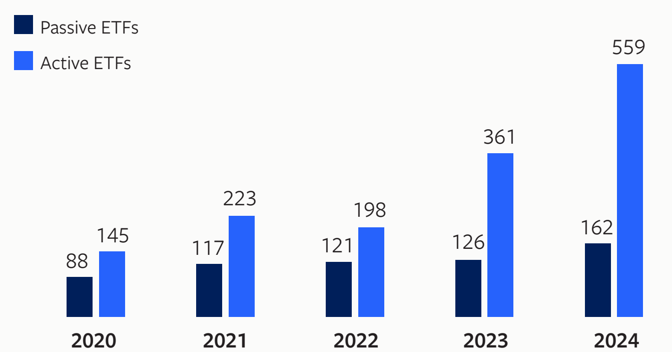
Cumulative flows ($Bils) to active products, 2020-2024



Source: Broadridge GMI

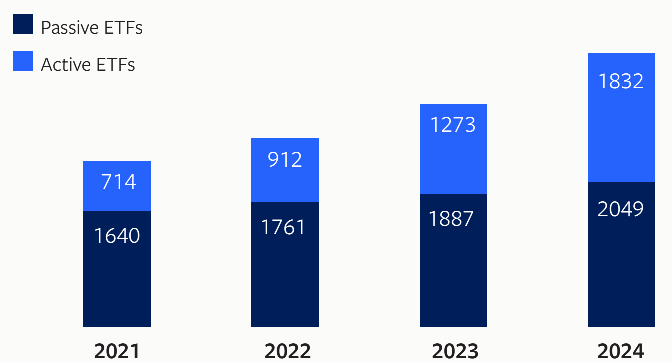
Setting aside outcome-oriented strategies, the latest generation of Active ETFs are often compared to similar products in an existing mutual fund wrapper, yet we find that investment strategy may vary, from being near-duplicates to being only somewhat similar. Active ETFs that are related to funds are certain to grow regardless of the SEC's eventual action on ETF share classes. When, or if, the SEC approves an ETF share class the number of Clone funds will grow significantly. Our conversations with both fund boards and management follow a similar path: how do –and why should –the governance, pricing, and distribution decisions of Active ETFs differ from traditional active funds?

ETF Launches (2020-2024)



Source: Broadridge GMI

Total ETFs (2020-2024)



Source: Broadridge GMI

Defining family relationships

To help clarify and define the degree to which Active ETFs follow similar established active mutual funds, Broadridge has developed a set of metrics that define Active ETFs as Clones, Siblings, or Cousins. To classify these matched pairs, we aligned the universe of Active ETF by the similarity of performance, beta, names, and investment classification with a fund in the same fund complex. We then calculated the Active Share and Tracking Error of the ETF to the matched fund. Funds closely aligned on one or both metrics are considered Clones that produce similar performance and volatility outcomes. As these metrics further vary, the Active ETF products are segregated into Siblings (somewhat similar) and Cousins (marginally related outcomes).

Our research has excluded Vanguard products where there is an ETF share class. These products fit within our Clone definition; however, given their unique space in the market, have been excluded so as to not cloud additional comparisons.

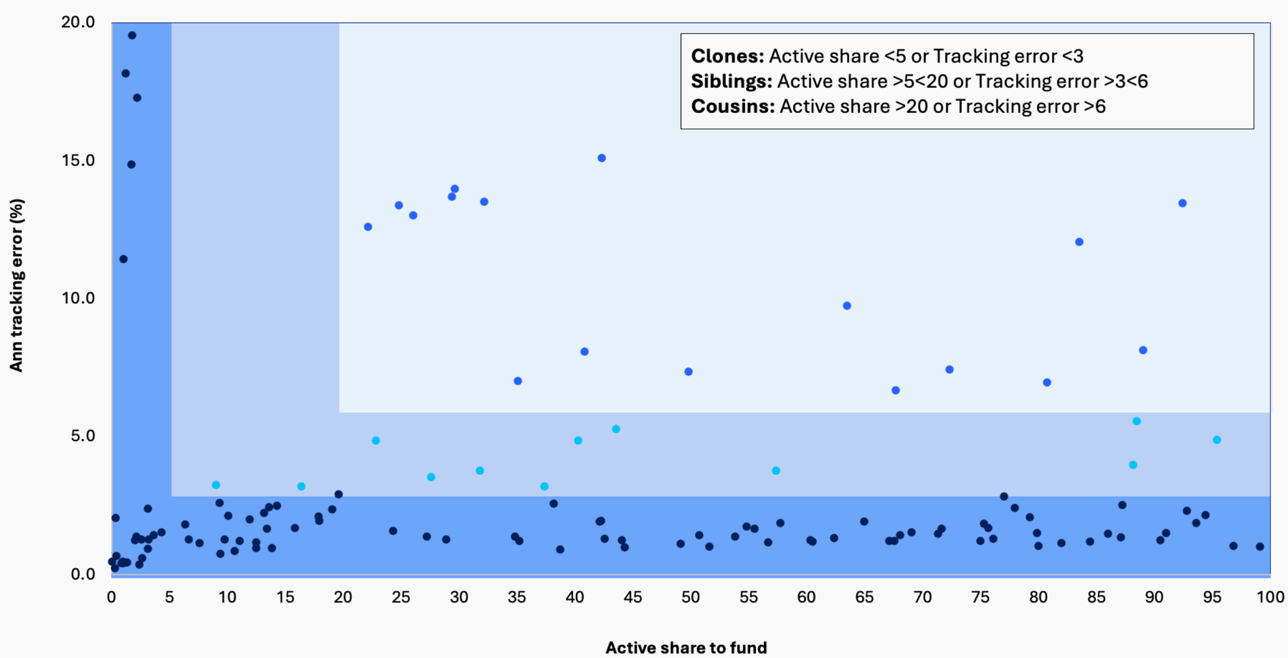
Clones – are those products with an active share of 5% or less or an annualized tracking error of 3% or less.

Siblings – track the portfolio and/or the performance of the fund less closely. They have an active share between 5-20% or annualized tracking error from 3-6%.

Cousins – occupy the area outside of the above bounds.

Initially, our research suggested using both metrics to tightly define the Clone concept. Subsequent conversations with Active ETF managers revealed that portfolio overlap alone can be misleading. Outflows from the active mutual fund necessitate portfolio substitutions in the ETF basket that can lead to active share widening, but those substitutions can also limit the degree of tracking error. While tracking error is the more accessible metric, we find active share offers most useful.

Active ETF relationships: Clones, Siblings, Cousins



Source: Morningstar Direct

What does it all mean?

Thus defined, conversations and decisions related to governance, pricing, and distribution challenges may become more specified and nuanced. Broadridge understands that not all firms will recognize our definition of each product type; however, the value of setting standards and framework is to level-set the conversation for all parties and provide structure, consistency, and guidance across various use cases.

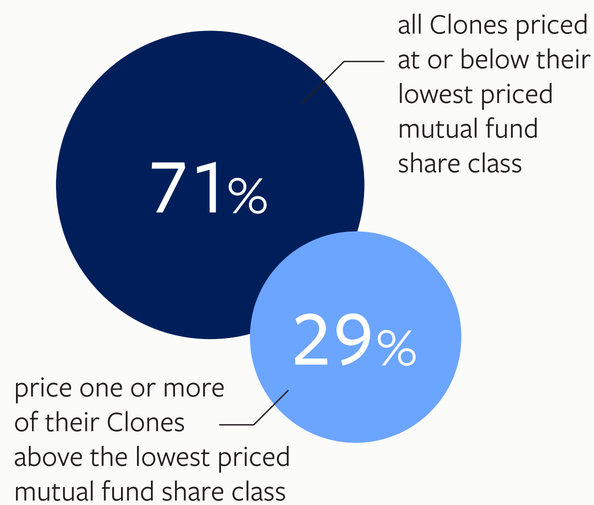
In our discussion with boards, counsel to boards, and product teams, there are recurring themes that we have encountered:

15(c) – What considerations should a board make when launching or evaluating Active ETFs that are related to an existing mutual fund? Should the products be compared to each other or be evaluated in isolation of each other? If mutual fund assets shift dramatically to the ETF, are there means to protect remaining fund shareholders from substantial capital gains?

Pricing – What is the pricing expectation for Active ETFs that are Clones of existing mutual funds? Does pricing strategy vary if the Active ETF isn't a Clone but is instead a Sibling or a Cousin?

Distribution – Does the launch of an Active ETF Clone create new or different considerations for the mutual fund? Is the expectation that the AUM of the fund will decrease and the AUM of the Active ETF will increase? Are there potential downstream repercussions related to Reg BI depending on the distribution channel?

Of 31 advisors identified with Clone products...



ETF Pricing vs Mutual Funds

While advisors have different approaches to pricing, ETFs deemed substantially similar to a mutual fund counterpart are generally priced lower than the lowest mutual fund share class.

Active ETF pricing

Our recent review of total expense ratios found that 63% of Active ETFs are less expensive than the lowest cost share of their mutual fund counterpart, with Clones typically priced closest to the fund and Cousins differing the most. In speaking with different asset managers offering substantially similar strategies of ETFs and mutual funds, fund naming/branding and strategy differentiation also seems to be at the forefront of advisors' decision making on pricing distinctions when bringing products to market. Given their presumed divergent outcomes and additional adjustments, a greater pricing differential for Cousin strategies aligns with our expectations.

Pricing differentials for Active ETFs generally makes sense. While the portfolio management work between an Active ETF Clone and a mutual fund is often identical (or practically identical given considerations for liquidity of mutual funds), there are reasons pricing will differ. The most objective reason for pricing differences sits squarely with the different administrative and operational work needed to run an ETF versus a fund and accounts for the largest portion of cost differences between funds and ETFs. This difference in operational costs is the primary reason Broadridge does not include mutual funds in the peer groups of Active ETFs in 15(c) reporting. Despite the inevitable comparisons that will be made between the ETF and the fund at the advice or end-client level, their comingling within a peer group will create unnecessary disparities in the board's analysis of costs.

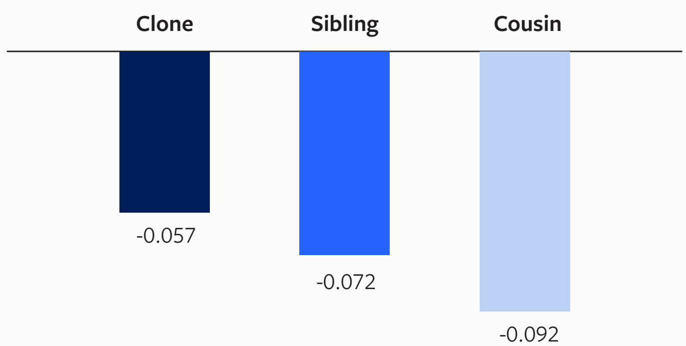
While boards may ask management to detail operational service and costs differences, the table below highlights a few of the more common service provider differences between the two wrappers.

	Fund	ETF
Transfer agent	Yes	Limited
Lead market maker	No	Yes
Intraday value agent	No	Yes
Authorized participants	No	Yes
Fund accountant	Yes	Yes
Custodian	Yes	Yes
Distributor	Yes	No

Average TER

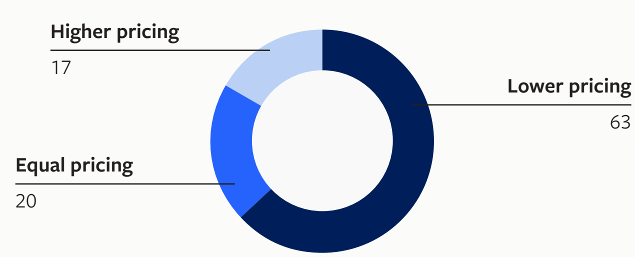
		ETF	Mutual Fund
US Equity	Clone	0.48%	0.53%
	Sibling	0.51%	0.60%
	Cousin	0.50%	0.65%
International Equity	Clone	0.76%	0.93%
	Sibling	0.50%	0.52%
	Cousin	0.45%	0.49%
Bond	Clone	0.38%	0.42%
	Sibling	0.52%	0.55%
	Cousin	N/A	N/A
Muni Bond	Clone	0.34%	0.39%
	Sibling	0.20%	0.49%
	Cousin	N/A	N/A

Average basis point difference ETF vs MF



Source: Broadridge GPI

ETF Pricing Relative to Lowest Priced MF Counterpart Clones/Siblings/Cousins



Source: Broadridge GPI

Conclusions

Pricing between Active ETFs and mutual funds may vary due to market expectations and competitive forces. Today, there is a general expectation that ETFs are priced less than mutual funds and fund companies need to adjust pricing (and margins) to be competitive against other ETFs. Other commercial considerations, such as gaining or defending market share and gaining and retaining access to preferred distributors and platforms, further complicate pricing decisions. The challenge is that no “right” answer exists and boards, product, and distribution teams will need to collaborate more than ever to make the final call on pricing.

It’s also imperative to consider implications for investors who remain in the mutual fund. It may be fair to expect that the launch of a Clone ETF will pull non-retirement assets out of the fund. Conversely, the launch of a Cousin ETF may be expected to gather assets from completely new investors and leave current fund investors unaffected. These product-level decisions may lead the board to ask questions about foreseeable positive and negative outcomes for fund investors. Our research indicates that Sibling and (especially) Cousin ETFs produce lower flows impacts to the mutual fund. While firms have always launched funds with the expectation of gathering assets, historically, cannibalization (the effect of new products drawing assets from current products), was always to be avoided; nowadays, that avoidance looks less practical if one is to have a growing presence in the ETF business at all.

The difference in prices between a fund and a Clone ETF is the primary concern Broadridge has heard from boards and management. We believe that by defining what is a Clone, that boards and management will be able to have a more effective pricing conversation. As the market for Clone ETFs evolves, especially with the potential of ETF share classes, there will be an expectation from regulators and boards to ensure all investors are being treated fairly. Understanding structural, operational, and market-driven factors that impact funds versus ETFs is a reasonable starting point. Equally, given the likely scrutiny from regulators and boards, might we see fund companies launching products that are Siblings or Cousins to lessen potential conflicts that would arise from the launch of a Clone?

Actions

While many of the same challenges exist whether there is a single board overseeing all products or there are distinct fund boards and Active ETF boards, separate boards will require management to spend additional time explaining how the related products impact each other. In both cases, the board has a fiduciary responsibility to the investors in each product, and those fiduciary responsibilities may be in contrast to each other. We believe the following key steps will aid in the review of Clone, Sibling, and Cousin ETFs:

- Agree to the relationship between the Active ETF and the fund; define how to measure the outcomes that identify the relationship; at Broadridge we have looked at the active share, tracking error, beta, and trailing returns to identify if a product is a Clone, Sibling, or Cousin.

- Document and discuss the operational similarities and differences between managing a mutual fund and an ETF. Gain an understanding as to the cost impact of the operational differences.

- Discuss market conditions that impact Active ETF versus mutual fund pricing and distribution. While Clone Active ETFs generally are less expensive than the fund, is there a competitive environment that may impact pricing and margins to consider?

- Especially in the case of Clone Active ETFs, there should be a discussion between product management, distribution, and the board related to expected outcomes from an asset perspective. Everyone should have an understanding of what will likely happen to the fund assets and the Active ETF assets over time and what actions will be considered to protect the best interests of investors in each product.

- When products fall into the Sibling and Cousin categories, ensure that there is a consistent message on the difference between the offerings. This will allow boards to more effectively look at the products as autonomous and lessen the likelihood of confusion in the distribution space.

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