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Three Outperforming Active ETFs

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For quite some time, active management has been almost exclusively in the domain of mutual funds. Investors used these funds in order to, hopefully, dial up the return while keeping risk levels at comfortable levels, relying on a manager's due diligence to select securities for a basket. On the other hand, when investors bought up ETFs, they tended to stick with index-tracking products such as SPY or AGG, getting exposure to a broad number of names cheaply and easily. Yet while index-based products have dominated the ETF market thus far, there are a few areas that investors have begun to warm up to active funds in exchange-traded product form.

Namely, investors have embraced active ETFs in the bond and small cap markets while also taking a closer look at some international-focused funds as well. Beyond these few examples, assets have remained low in many of these products and have remained there for quite some time. This trend is likely due to a number of reasons largely centered on how the market evolved over the last few years. First, active ETFs were a little late to the party, coming several years after many funds had already established huge asset bases. This keeps trading volumes low for active ETFs and can often times scare off many investors from these products. Second, many of the so-called 'superstar' mutual fund managers haven't moved over into the ETF world, keeping interest low. Although this could be changing soon, especially if PIMCO launches an ETF version of its total return bond fund. Lastly, and most importantly, active funds—be it in mutual funds or ETF form—have a long history of underperforming their benchmarks. Most managers fail to match the return of the indexes they match up against which is a major reason for the huge popularity of index-based ETFs in the first place (Inside The SuperDividend ETF).

While often times this is true, there are a few cases in which the watchful eye of a manager has led to outperformance when compared to a benchmark. This has even been true in the ETF space, despite the few choices that exist in many categories at this time. Below, we take a closer look at three of these examples in which active ETFs have beaten out their index-tracking counterparts in terms of year-to-date returns, even when adjusting for expenses:

PowerShares Active Mega Cap ETF (NYSEArca:PMA - News)

Although mega caps, which consist of some of the largest firms in the country, are very well researched and liquid segment, this PowerShares fund has found a way to outperform broad market funds so far in 2011. The product uses Invesco Institutional's proprietary stock model which is based on several factors. These aspects relate to four key concepts; earnings momentum, price trend, management action, and relative value. Each stock is ranked by this model, and the result is a "weight-of-the-evidence" forecast of the expected annual forecasted excess return for each stock compared to other stocks within their respective industry for the next month. The securities are also evaluated for risk using at least 17 variables, potentially giving the fund a lower risk portfolio as well (see Three All-Star Leveraged ETFs).

This technique results in a portfolio of about 56 securities with heavy weightings towards health care and technology. In terms of top individual holdings, three oil companies, ConocoPhillips (NYSE:COP - News), ExxonMobil (NYSE:XOM - News), and Chevron (NYSE:CVX - News) take the top three spots and the rest of the top ten consists of tech and pharma firms. Interestingly, Wal-Mart (NYSE:WMT - News) doesn't receive a top ten allocation and actually is absent from the portfolio at time of writing. This system has certainly paid off for investors in PMA so far in 2011, as the fund has risen by about 4.7% on the year, more than enough to offset the fund's relatively high expense ratio of 75 basis points.

This return of PMA compares favorably with a number of low cost options in the mega cap ETF space. The Vanguard Mega Cap 300 Value Index ETF (NYSEArca:MGV - News) has lost about 1.9% on the year, putting a sizable difference

between itself and PMA. While the lower expense ratio certainly helps, PMA still crushes MGV in year-to-date terms. A similar situation is apparent in the iShares Russell Top 200 Index Fund (NYSEArca:IWL - News) which actually tracks the same index that PMA takes its securities from. This fund, which charges 20 basis points in fees, has done better than MGV but is still underperforming PMA, rising by only 40 basis points so far this year.

AdvisorShares DENT Tactical ETF (NYSEArca:DENT - News)

For investors seeking a global approach, this AdvisorShares fund, based on the work and managed by Harry S. Dent, Jr., could be an interesting way to go. The fund seeks to achieve long term growth of capital by identifying, through proprietary economic and demographic analysis, the overall trend of the U.S. and global economies and how consumer spending patterns may change. The product then takes this information and buys and sells ETFs accordingly, giving the fund exposure across a number of asset classes and countries. The portfolio is monitored daily given market changes and the portfolio can be reallocated at any time using a sell discipline designed to mitigate risk (read Forget FXI: Try These Three China ETFs Instead).

Currently, the fund is heavily exposed to both cash and short-term Treasury bills in the form of TIP. A precious metals ETF, DBP also receives a good chunk of assets, although this could change if the economy stabilizes. This strategy has pushed the fund down about 5.9% since the start of the year and it charges one of the higher expense ratios in the industry at 1.65%.

While this might sound quite poor, if investors compare this return to global-focused ETFs such as VSS or VEU, a trend of outperformance begins to appear. In fact, these two ETFs have lost, respectively, 16.2% and 11.5%, far outpacing the losses experienced by investors in DENT. Investors should also note that this is even taking into account the extremely lower fee levels that VSS and VEU charge which are about a full percentage point lower than DENT. It is also important to realize that while DENT participated in the surge for much of the early part of the year, the fund remained flat in the summer while its counterparts fell sharply, thanks in large part to the fund’s sell discipline and movement towards lower-risk securities (read HDGE: The Active Bear ETF Under The Microscope).

PowerShares Active U.S. Real Estate Fund (NYSEArca:PSR - News)

While the American real estate market has been weak and this fund has seen rough periods of trading on the year, the product has still managed to beat out its more diversified counterparts. This is largely thanks to the fund’s methodology which is much like the aforementioned PMA. With that being said, there are some key differences that investors should be aware of between the two methods. First, PSR looks to achieve total return through both capital and current income investing in securities of companies that are principally engaged in the U.S. Real Estate industry and included within the FTSE NAREIT All Equity REITs Index. Securities are then included based on quantitative and statistical metrics that identify attractively priced securities and manage risk. This focus can potentially give the fund a better basket of securities and the ability to outperform comparable benchmarks (see Top Three High Yield Real Estate ETFs).

This focus gives the fund a basket of about 56 securities with the vast majority going towards companies that are structured as REITs. Simon Property Group (NYSE:SPG - News) takes the top spot at just under 11.1% while Ventas (NYSE:VTR - News), Equity Residential (NYSE:EQR - News), and Vornado Realty Trust (NYSE:VNO - News) all make up at least 5.3% as well. The fund is a little light on the yield front—paying out 2.9%-- and it has a relatively high expense ratio of 80 basis points, about seven times greater than some of the low cost options in the space. Nevertheless, the fund has risen by about 5.6% so far this year, pretty good considering the market headwinds that are present.

These gains are even more impressive when compared to some of the other real estate ETFs in the space, and especially those that target the broad-based American real estate market. These funds, such as Vanguard REIT Index ETF (NYSEArca:VNQ - News) and the iShares Dow Jones US Real Estate ETF (NYSEArca:IYR - News), have both had a rough time in 2011 as VNQ has risen by just 0.8% and IYR has slid by 1.5% since the beginning of the year. So although both of these funds charge but a fraction of PSR’s costs, they have not been able to match up in terms of performance by any stretch, even when taking into account their relatively cheap nature from a management fee perspective.

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