The ETF fee that has an annual escape clause

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Goldman Sachs made a big debut in the exchange-traded fund market with its recent introduction of smart beta portfolios. Goldman came in at such a low fee level that it put the existing fund managers on notice: Goldman was prepared to undercut the market to win in the intensely competitive ETF space.

Behind the scenes, though, there was some grumbling about the fee structure Goldman used to undercut the market. Goldman was offering annual fee waivers on its smart beta ETFs to bring down the cost to investors — fee waivers that would need to be renewed annually.

One ETF industry insider told me that at recent conferences, smart beta competitors could be heard whispering about this Goldman Sachs fee approach. But if the issue of fee waivers is worthy of whispers, there needs to be a lot more whispering in the ETF industry on a regular basis, and about a lot more ETF companies. There are 549 ETFs that offer a fee waiver that must be renewed annually, according to Morningstar data. That's a little more than one-quarter of the ETF industry.

Roughly 25 percent of ETFs, instead of simply setting their fee at a permanently low level, use a waiver that must be reapproved each year. If you're an ETF investor, have you been checking to make sure your fund is reapproving the fee waiver annually? Or did you not even know this practice existed?

The waiver is a way for the fund sponsor to pick up a sizable part of the fund's tab. For example, if an ETF has a 50-basis-point management fee (0.50 percent annually) and a 25-basis-point fee waiver, investors only pay a fee of 25 basis points.

And that's good for investors.

Niels Holch, a lawyer and head of the Coalition of Mutual Fund Investors, said it's understandable that companies coming out with ETFs want to be extremely price-sensitive at

launch and it's hard to see a scenario in which they could remove the waiver without becoming less competitive, but he added, "We should have simplicity in fees."

After being contacted by CNBC about the fee waivers and saying that the company had heard from a few investors about this issue, Goldman spokesman Andrew Williams said the company was replacing the fee waivers on its five smart beta ETFs with permanent, lower fees set at the same rates as under the fee waivers.

Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF (GSLC): 9 basis points

Goldman Sachs ActiveBeta Europe Equity ETF (GSEU): 25 basis points

Goldman Sachs ActiveBeta International Equity ETF (GSIE): 25 basis points

Goldman Sachs ActiveBeta Japan Equity ETF (GSJY): 25 basis points

Goldman Sachs ActiveBeta Emerging Markets Equity ETF (GEM): 45 basis points

So Goldman put what passes for a controversy in the ETF industry to rest, but its move still leaves one question: What about the rest of the hundreds of ETFs that are still using these waivers?

"I never understood fee waivers," Holch said. "Make it less complex for everyone by starting lower on a permanent basis."

There are technical reasons why some ETF companies use fee waivers.

Leveraged and inverse ETFs (e.g. 3X Bull Market ETF), with high trading costs, tend to use waivers. But since investors trade these ETFs daily rather than hold them for the long term, there's little reason to pay attention to an annual fee waiver renewal requirement.

There are also SEC requirements that "acquired fund" costs be disclosed as part of a fund's expense ratio, which comes into play with funds of funds. Say an ETF is an international equity fund of funds that invests in five single-country stock funds. An investor doesn't want to pay the fees associated with each of those five underlying funds, even if all of the fees need to be disclosed in fund literature. The waiver allows the manager to disclose, and also, eliminate those fees.

Some fund companies clone existing mutual fund strategies for the ETF market and may opt to use waivers to keep the ETFs in line with traditional fund pricing. In industry parlance, that's called rationalized pricing. Say a mutual fund company has 50-basis-point fees across its U.S.

stock funds, but in the ETF market it can't compete at that price. So it offers a 25-basis-point fee waiver on a new U.S. stock ETF, making the effective fee 25 basis points.

"The manager is saying, 'We know we normally price at X, but in order to get traction in the ETF market, we need to undercut ourselves," said fund industry lawyer Michael Mabry of Stradley Ronon Stevens & Young.

(One might wonder why the traditional funds remain priced so much higher, but that's another matter.)

A risk to the investor is if average advisory fees across the ETF industry started to drift up these fee waivers might no longer be necessary.

But don't panic. ETF industry logic suggests this is unlikely. Why? Because there is nothing stopping any ETF company from raising fees — except the intense fee-based competition that now dominates the investment industry.

"We do track this and think it's worth our time. However, we rarely see [the waiver] roll off and the actual fund expense ratio change," said Paul Britt, senior ETF analyst at FactSet Research Systems.

If an ETF wasn't gaining enough assets and the manager decided it could no longer afford to offer the waiver because it wasn't making enough money on the portfolio, it's more likely the ETF would be shut down than the fee waiver removed. And many ETFs do close. The ETF would do no better competing in the market once it doubled its expense ratio.

"It's exceedingly rare these expire," said Ben Johnson, director of ETF research at Morningstar. But he added that when you opened up the prospectus for the Goldman Sachs ActiveBeta U.S. Large Cap Equity ETF and saw a 9-basis-point expense ratio by virtue of a generous waiver, "Optically, it doesn't look good. It leaves a shadow of doubt."

Johnson said the issue won't go away, even if it flies beneath the radar of most investors, because it's the appearance, or optics, that could lead some investors to believe ETFs with waivers have expense ratios that are "infirm."

"There is potential, regardless of how small it might be, that it could expire and you would pay more," Johnson said. "People would rather see one single line item if for no other reason than to give them a sense or perception of stability."

Trust, but verify

In a recent case where a fee waiver did end, it was dictated by unique circumstances in the bond market, but it does show that this issue of why a fee waiver is used at a fund launch can get a little "squishy."

The iShares Treasury Floating Rate Bond ETF (TFLO) had the distinction of being the cheapest ETF in the world — it was, literally, free, with a zero expense ratio since launching in February 2014. But that ended on Feb. 29, 2016, and the current expense ratio is 0.15 percent. There's a perfectly reasonable explanation, one which iShares says has nothing to do with using temporarily low fees as a marketing wedge. TFLO was launched at a time of unprecedented low rates, and without a zero expense ratio, investors would have been paying for a fund offering little to no return potential.

BlackRock's iShares said the decision to launch with a fee waiver, and recently remove the waiver, relate to the yield trends in the bond market, and the fee waiver was never an effort to entice investors. However, Britt said it would not be hard to call that argument "semantics," and contend that launching with a zero expense ratio was an "enticement," regardless of bond yield dynamics.

Here's the real "iffy" issue: Most ETF documents refer to the waiver by stating something like, "The fee waiver must be renewed annually. The fund has no intention of removing the waiver."

In the least, investors should mind the words of caution from a person whose job revolves around carefully choosing and reviewing words. Fund lawyer Mabry: "Saying you don't intend to do so means you don't *currently* intend to do so."

Intentions can change.

The bait-and-switch scenario does seem unlikely. To put this in terms a consumer can understand, these ETF fees should not be compared to online subscriptions or memberships that renew annually, and renew even if the price has changed. More than once I've gotten too comfortable with my Amazon subscribe-and-save items, only to realize that for months I had been paying more than the original "hook me" price.

Still, more retail investor and retirement dollars are going into passive investments, including ETFs, and more asset managers are focusing on bringing ETFs into the market rather than traditional, actively managed mutual funds. And the new Department of Labor rule on fiduciary

duty, just finalized, will encourage even more investing dollars be placed in low-cost, passive funds, according to experts. One "giddy" estimate from the ETF industry projects that as much as $1 trillion of individual retirement account money could flow into ETFs as a result of the new rule.

So in this ETF case, I think an old Russian saying — invoked by Ronald Reagan during the waning days of the Cold War and arms negotiations with the Soviets — is the best advice: Trust, but verify.