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PERSPECTIVES

COVER YOUR BASES OR SWING FOR THE FENCES? THE CASE FOR ACTIVE ETFS

For many, the words actively traded ETF sound like an oxymoron. Since its inception, the ETF vehicle has been largely synonymous with index tracking. It is, however, just a tool: one through which any investment strategy may be delivered. Passive is as such no more tied to ETFs than index funds are to the traditional '40 act vehicle. With active ETF assets rising over $320 billion since 2017 to a global footprint of $436 billion today, the product has clearly seen an explosion of growth.

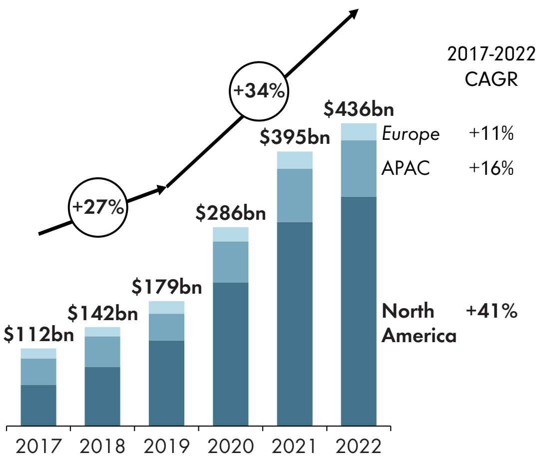
However, with much of this expansion coming from the U.S., and to a lesser extent APAC, is there a case to be made for the product in Europe? And if so, what's the gameplan for asset managers?

A U.S.-centric growth path

The growth of the active ETF market today has been predominantly American. ETFs in the U.S. have structural advantages: a taxation benefit over mutual funds, a positive regulatory climate* making it easier to launch ETFs, and a willing retail investor base hungry for the product.

These growth drivers are, however, distinctly American. The same taxable benefit for ETFs does not exist in Europe, regulators haven't taken the same liking to the vehicle, and most importantly, distributors and their end clients have a much less developed appetite for ETFs. A similar structure is not yet in place for the success of the ETF in Europe, though the tide may be turning.

Global active ETF market growth by domicile (2017-2022)



Sources: Simfund, Indefi analyses.

Note: (*) the SEC's Rule 6c-11 (the "ETF rule", 2019) established a clear regulatory framework for ETFs, removing the necessity for ETFs to receive an exemption under the Investment Company Act. This reduced cost and time to market for new ETF launches.

A whole new ball game – three scenarios for European growth

While there is no significant European demand identified for active ETFs, why should asset managers jump at the opportunity now? In Europe, active ETFs will see significant growth in one of three scenarios:

1. Elimination of the rebate model – ETF growth is substantially restrained by the rebate model in European distribution. As intermediaries do not receive rebates on ETF sales, they have little incentive to offer an active ETF over an actively managed fund.

However, if planned regulations at the EU level ultimately outlaw rebates, distributors will have to adapt their renumeration model, removing barriers to ETF sales. Furthermore, intermediaries' interests will thus be more clearly aligned with clients, pushing them to choose the vehicle with lower relative fees and the most transparency.

2. Growth of digital distribution – ETFs are an ideal fund vehicle for a young and increasingly-disintermediated investment base that prefers to manage their investments via their smartphone as opposed to through a financial advisor. The platforms through which these digital natives invest rarely offer the classic open-ended investment fund.

While a nascent space in Europe, digitalization is happening quickly – assets distributed through digital channels are expected to reach ~€500 billion by 2026. Active ETFs, with shares that are bought and sold intraday, can be seamlessly distributed through these channels, allowing access to new investors.

3. Mass customization becomes a must – With the growth of personalized investment solutions like SMAs and direct indexing, customization rules the day in the U.S. investment universe. However, with Europe well behind the U.S. in terms of managed accounts, active ETFs may serve as the best first step toward customized investment products on the European side of the pond.

With their high transparency, low minimums and versatile purchasing structure, active ETFs can serve as the right building blocks for a model portfolio in even the lowest-minimum accounts. Regulatory tailwinds provide a boost as well – the 2022 MiFID II amendments outline the need for distributors to consider an investor's sustainability preferences, an easier requirement to satisfy with low cost, thematic building blocks.

Also, once an ETF platform is established, product speed and cost to launch decrease considerably relative to mutual funds. Though each vehicle must reach sufficient scale to be profitable, which can create challenges for maintaining an extensive product range, an ETF platform will grant managers a more agile product development process that can effectively cater to rapidly changing investor trends and new, more individualized demand.

Two different routes for asset managers

For most European managers, particularly those that remain anchored to their active management DNA, the rise of the active ETF provides an opportunity to evolve their model to hedge market disruption risk and/or enhance competitiveness. We see two strategic scenarios:

"Cover your bases" – Establishing the technology required to distribute prized actively managed strategies through channels that could prove dominant in the future is a necessary hedge for any manager. A shift toward a more digital, customized, or rebate-less European fund ecosystem are far from minute probabilities. Launching, purchasing, or partnering with an ETF platform today allows managers to stay nimble in a landscape subject to change as the UCITS model is potentially disrupted.

"Swing for the fences" – The asset management industry is undoubtedly moving toward a lower fee, more transparent, and more client-focused field of play. Active ETFs fulfil these requirements better than mutual funds. This makes active ETFs a potential competitive edge for asset managers, providing the opportunity for growth now, as well as the chance to become a "brand name" in the product for the future.

For managers, active ETFs appear as the next paving stone in the mass-customization journey.

Indefi is a strategy consulting firm that provides asset managers – from the top 10 largest global firms to boutique and private market specialists – with an actionable roadmap to achieve their growth objectives. Operating across Europe and the U.S., Indefi maintains both a global view and deep local market expertise. The firm's guidance, grounded in conviction and insight, spans growth strategy, market entry, product development and enhancement, sustainability, and M&A support. For more information, please visit www.indefi.com.