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SPECIAL REPORT

Navigate volatile markets with active ETFs

Taming the market turbulence with active ETFs
Fidelity International

Active ETFs to surge on demand, product innovation and regulatory tailwinds
Jamie Gordon, Features Editor, ETF Stream

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A trifecta of inputs to spur the next growth engine within European ETFs

Jamie Gordon, Features Editor, ETF Stream

Active ETFs are the next product class in focus in Europe, with asset managers swarming to enter the market, much as issuers flocked to roll out ESG, theme and smart beta ETFs in years past.

The difference with the launch frenzy in active ETFs is this story has been led not just by ETF specialised fund promoters but large mutual fund managers looking to ride the momentum currently enjoyed by the nascent product class.

In fact, in what has already been a record-breaking year for inflows into European exchange-traded products (ETPs) as a whole, active ETFs have punched well above their weight in terms of net new asset gathering – with Q3 being a standout period.

Jose Garcia-Zarate, associate director of passive strategies at Morningstar, commented: "Active ETFs, which have captured significant

attention, attracted €4.8bn and represented 7.7% of all ETF flows for the quarter.

"While this segment is experiencing triple-digit organic growth rates, it is still growing from a very low base - active ETFs account for just 2.2% of total ETF assets in Europe."

Nascent demand

Although active ETFs have had to wait until the past year for their moment in the sun, the "low base" Garcia-Zarate references mean demand for the strategies may still be in its infancy.

In fact, according to a recent survey by Research in Finance, little over a third of European fund selectors allocate or are planning to allocate to active ETFs.

The European Fund Selector Survey, which interviewed 900 retail, institutional third-party fund buyers and distributors, found only 21% of European selectors currently allocate to active ETFs, with a further 13% planning to do so by the end of 2024.

The figures underscore that the

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Jose Garcia-Zarate
Associate Director of Passive Strategies
Morningstar

European active ETF market is very much still in its nascent stages, with the €45.5bn active ETF assets under

management (AUM) at the end of H1, according to Morningstar data, still representing a small slice of Europe's more than €2trn ETP market.

Education is also likely to play a role in uptake, with 22% of the market completely unfamiliar with active ETFs, Research in Finance found.

Regionally, Switzerland is the most positive on the product class, with 28% of investors surveyed allocating to active ETFs, followed by Spain and Germany at 27%, respectively.

The product class is still well behind the US in terms of market share, with the research attributing this to several factors including lack of tax advantages, incompatibility of business models and lack of availability through European brokerage platforms.

Peter Sleep, investment director at Callanish Capital, said "a lot" of new issuers are likely still yet to enter to capture incoming demand, however,

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Peter Sleep
Investment Director
Callanish Capital

harnessing this will not be entirely low-hanging fruit.

"Actives are going to be a huge growth space and a place where we will see a lot of new entrants," Sleep said.

"Traditional fund salespeople need to have a different skill set and a different set of people they need to contact to get onto buy lists, which may be an uphill slog."

Gaps in the product set

ETF Stream's Quarterly Buyer Barometer at the end of H1 also outlined why fund selectors may be hesitant to allocate to the product class. Central among these was 'a limited range of products', with 25% of respondents citing this as a reason behind their reluctance to allocate – higher than any other factor.

Where we think an active approach makes sense is when you can leverage proprietary quantitative, fundamental or sustainable research to deliver the specified investment outcomes for clients whether that is returns, alignment to sustainability goals or both.

Neil Davies
Head of ETF Product Strategy and Management
Fidelity International

To-date, inflows into UCITS active ETFs have been dominated by lower tracking error, 'strategic beta' products; however, there are calls for greater optionality within the high conviction active product set.

Karin Wiederkehr, co-founder and managing director at IMP AG, commented: "The strategies are also very complimentary to the clients that we have, where they usually already have existing portfolios at the big banks and get their asset allocation according to market cap. We would select an active ETF where we see it can add value in terms of niche strategies or select industries."

There are also plenty of gaps within fixed income, with just 33 active ETFs addressing the asset class in Europe by June this year, versus 87 strategies on the equity side.

This, to many, is also counter-intuitive, given the mechanical benefits of actively selecting fixed income issuance versus rules-based approaches, with credit ETFs often capturing the most liquid bonds and rewarding the most indebted issuers with larger allocations in the process.

Illustrating why this is not a recipe for strong performance, more than half of active managers in nine out of 12 fixed income categories outperformed their benchmarks during H1, with this not accounting for the different AUMs boasted by each active fund.

In fact, one category – US dollar denominated short and intermediate investment grade – saw just 13% of active managers underperform in H1.

Another aspect of active bond ETFs that is becoming more relevant for investors is in sustainable investing. In recent years, a changing regulatory landscape with increasing emphasis on sustainability has raised demand for strategies that can optimise risk-return drivers with non-financial outcomes, such as decarbonising a fixed income portfolio.

"Where we think an active approach makes sense is when you can leverage proprietary quantitative, fundamental or sustainable research to deliver the specified investment outcomes for clients whether that is returns, alignment to sustainability goals or both" said Neil Davies, head of ETF product strategy & management at Fidelity International.

Regulators charm active

Finally, it is worth noting that regulators are trying to court active managers with increasingly favourable policymaking.

For instance, in July Luxembourg announced actively managed ETFs domiciled in the region would be exempt from subscription tax after 2025, as the country looks to become the domicile of choice for active ETF issuers.

Alain Goebel, tax partner at Arendt said while the preferred domicile of an ETF is dependent on many factors, "the proposed changes are definitely improving the competitiveness of Luxembourg in this respect".

Not to be outdone, In October the Central Bank of Ireland (CBI) announced it would converge its approach to listed share class naming rules with other jurisdictions.

"This makes it a much more realistic prospect for fund managers looking to enter ETFs through this channel," said Stephen Carson, partner at A&L Goodbody.

Final Word

In sum, active ETFs may now dominate investment headlines either side of the Atlantic, but in Europe, investor education and demand, the spectrum of products available and regulatory familiarity with the product class all remain in their infancy. Europe's next ETF growth engine has just left the starting blocks.