

ETFs 2018: opportunities and obstacles for active ETFs

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What will it take for active exchange-traded funds (ETFs) to achieve their full potential?

Active ETFs are growing as barriers to entry fall. It's time to review the obstacles – and the opportunities

Actively managed ETFs have enjoyed steady growth in recent years, albeit from a low base. Active ETFs and exchange-traded products (ETPs) reached a global total of USD \$104bn in August 2018, the 43rd consecutive month of net global inflows. Growth is particularly strong in the US, South Korea, Hong Kong and Australia. ETF Connect, a cross-border scheme that would give mainland Chinese investors exposure to overseas assets through exchange-traded funds (ETF) listed in Hong Kong, offers further potential, given the size of the mainland Chinese market and Asian investors' demand for active strategies.

Set against this, active ETFs are struggling in some markets. Europe, in particular, is falling behind other regions, with around 10% of active ETFs and only a fraction of net inflows. And EY research points to strong growth in the US over the next three years, expectations are lower in Europe.

We believe that overcoming a few obstacles could enable active ETFs to grow to over USD \$200bn by 2021. In this article, we review the pros and cons of issuing actives, suggesting how promoters can navigate potential obstacles and maximize the attractions of active ETFs.

Active ETFs can offer compelling benefits

We see a significant untapped opportunity for active ETFs in the space where the interests of investors and promoters overlap. After all, a majority of the world's financial assets are still held in

actively managed strategies, and active ETFs provide a potentially appealing wrapper for much of this capital. The benefits of the ETF wrapper include:

- ▶ **Intra-day liquidity.** ETFs can be traded whenever markets are open, in contrast to mutual funds that effectively trade once a day.
- ▶ **Tax treatment.** Irish ETFs investing in the US enjoy a withholding tax advantage of 15% over mutual funds. The Internal Revenue Service (IRS) treatment of capital gains also makes ETFs more appealing than mutual funds for US taxpayers.
- ▶ **Transparency.** ETFs provide greater transparency over their underlying holdings than mutual funds.
- ▶ **Redemptions.** ETFs cannot impose "gates" in periods of market stress. They sell at the quoted bid price, rather than redeeming a proportion of net asset value. And, although investors are subject to bid/ask spreads, unlike mutual funds they don't levy anti-dilution fees or redemption charges.

More specifically, active ETFs offer investors a relatively liquid and convenient way to access alpha-generating strategies. This is particularly attractive when direct ownership of the underlying assets is difficult, either due to illiquidity, minimum investment size or local restrictions on investor access to unlisted securities.

For issuers, active ETFs offer higher margins than core passive ETFs and higher growth than traditional active funds. This is illustrated by the number of active managers that have already launched ETFs, and EY research shows that almost all market participants expect more firms to enter the active ETF space.



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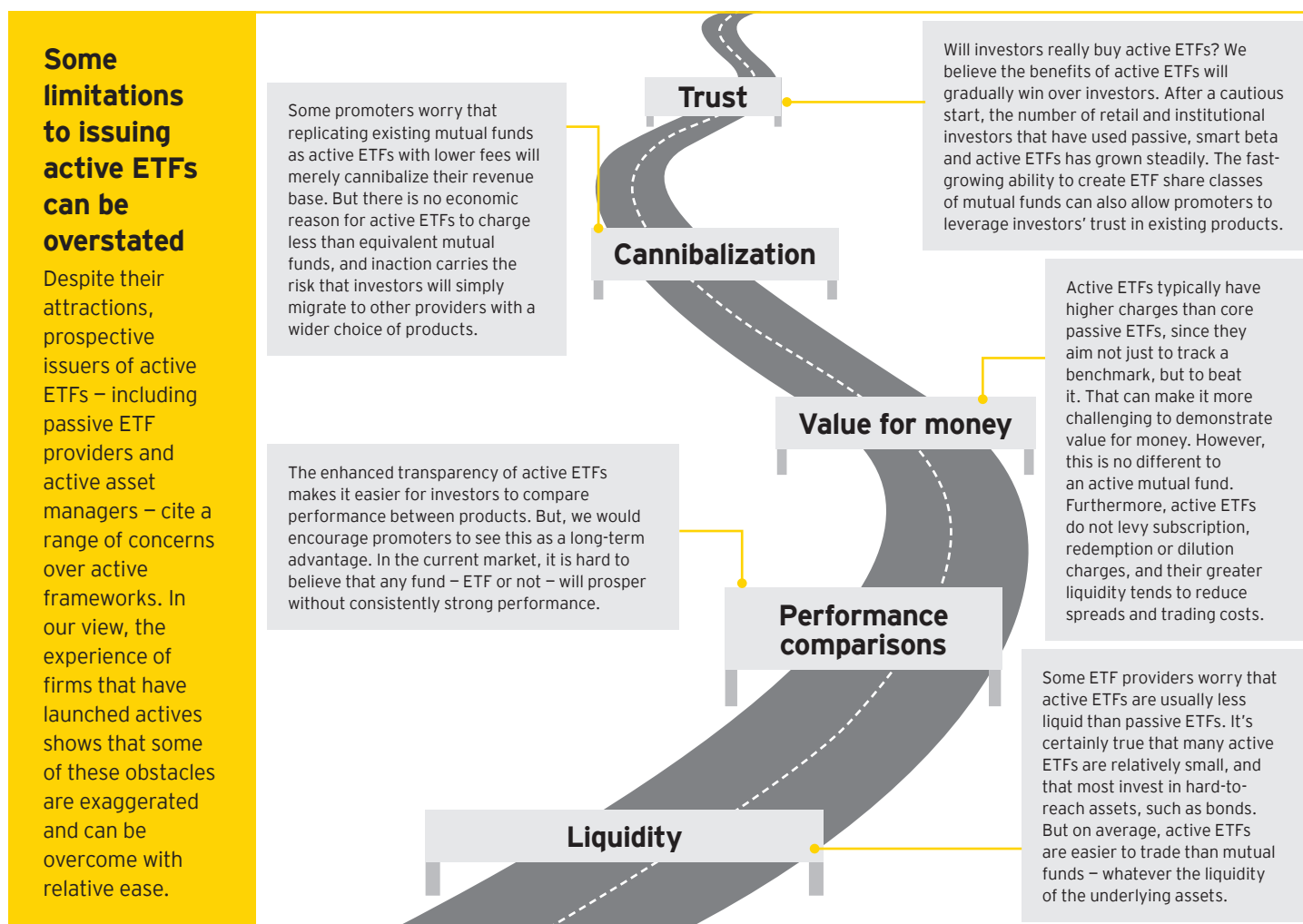
... But can pose challenges to issuers

The potential attractions of active ETFs do not mean that they are suited to every investor – or issuer. Understanding whether and how active ETFs meet investor needs is essential to achieving successful outcomes.

As illustrated in the below graphic on “limitations to issuing active ETFs”, we believe that the challenges posed by active ETFs can sometimes be overstated. Nonetheless, there are a number of critical factors that promoters need to consider before taking the decision to launch active ETFs:

- ▶ **Compatibility.** Active ETFs will not suit every investment manager’s business model. Issuing ETFs requires significant upfront investment and should be part of a committed long term strategy. Getting the balance between ETFs and mutual funds is particularly important.
- ▶ **Operations.** The management and operation of ETFs is very different to that of mutual funds. That is true in a number of key areas including listings, the creation and redemption of units, daily trading and distribution. The upfront and ongoing costs can be very large, especially for firms that do not currently issue ETFs.

- ▶ **Demand.** Investors can be slow to adopt active ETFs, especially in Europe. Despite the potential size of the active ETF market, promoters should only launch active ETFs in full knowledge of the current market’s size and growth.
- ▶ **Liquidity.** Despite intra-day liquidity, active ETFs are less liquid on average than passive ETFs. For example, in the US in September active ETF turnover rates were 0.7% compared with 1.9% for all ETFs. One reason is that active ETFs often focus on less liquid underlying portfolios that investors cannot easily access themselves. Another is the small size of active ETFs relative to passives, at both fund and market level. Lower liquidity tends to widen spreads, pushing up ownership costs. However not all investors need to trade active ETFs frequently, and some will accept lower liquidity in exchange for greater accessibility.



Upfront costs may also deter some firms, but barriers to entry are falling

As already mentioned, the upfront costs of building an active ETF operating model can be a significant deterrent to potential new entrants.

The good news is that market entry routes are opening up fast. One example comes from white label platforms. White labeling offers potential ETF issuers “off-the-shelf” market access, without the need to build proprietary infrastructure. For active managers with no experience of ETF operating models, white labeling is a relatively fast and affordable way to acquire new capabilities.

Another new avenue – especially in Europe – comes from ETF share classes of mutual funds. This allows firms to “create an ETF” within an established fund. The Central Bank of Ireland addressed this approach in a recent paper following on from its ETF consultation of 2017. In the US, Vanguard’s patent on ETF share classes poses challenges for promoters considering this approach.

Portfolio disclosure is the most problematic area for actives. However, there are solutions here too

There is no doubt that the need for portfolio disclosure is the factor most likely to deter firms from issuing active ETFs. Where required, the need to make daily disclosures of fund holdings is particularly problematic for stock-pickers.

Nonetheless, the ETF structure can work well for many actively managed strategies. Because many bonds are thinly traded, daily disclosure does little to hinder active fixed income funds. Quantitative strategies are also suited to ETFs since the frequency of trading typically exceeds the frequency of disclosure.

In any case, it is wrong to imagine that portfolio disclosure creates perfect transparency. Portfolio construction files are often restricted to exchanges or authorized participants, and very few investors require truly continuous transparency. In practice, even the largest passive ETFs cannot provide totally accurate intra-day net asset values (iNAV) if they hold assets in different time zones.

The reality is that levels of active ETF transparency vary widely. In Europe, for example, Deutsche Boerse requires daily disclosures, but BATS Europe, Euronext Dublin and the London Stock Exchange (LSE) do not. National variations can also give potential issuers some practical examples of how to resolve the disclosure conundrum.

- In **Canada**, active ETFs often use non-disclosure agreements to limit public knowledge of their portfolios. That can limit the number of market makers able to generate liquidity for the ETF, but it helps managers to maintain privacy over their strategies.

- In **Australia**, some active ETF promoters act as their own authorized participant. Again, this has the benefit of maintaining confidentiality, but brings potential disadvantages in terms of liquidity and price discovery.
- In the **US**, the refusal of the U.S. Securities and Exchange Commission to authorize non-transparent ETFs has seen the emergence of hybrid exchange traded mutual funds (ETMFs), also known as exchange traded managed funds. These provide intra-day access on exchange without needing to meet ETFs’ transparency requirements.



Time for a fresh look at active ETFs?

Active ETFs may never achieve the scale of their passive counterparts, but this is a sector with huge potential to build on recent growth and significantly expand its current share of global financial assets. For the right strategies, active ETFs offer a range of benefits to investors and issuers. The potential for growth is illustrated by data from ETFGI, an independent ETF and ETP research firm, which shows that although global ETF assets are 9.5% of those held in mutual funds, the comparable figure for active ETFs is just 0.2%.

Set against that, it's undeniable that active ETFs pose a few challenges to potential issuers – most notably on the sensitive topic of portfolio transparency. But, in our view, some of these obstacles can be overstated. And with regulatory attitudes shifting and new routes to market opening up, barriers to entry are falling fast.

That means that this is a good moment for firms interested in launching active ETFs to re-evaluate their costs and benefits. Instead of waiting for a single global framework to appear, potential issuers should ask themselves whether active ETFs can complement their existing strengths. They can then learn from the experience of others and develop an active offering that meets the needs of their investors.

Summary

The active ETF market is sometimes seen as a challenging one for new entrants. But the attractions are strong, and barriers to entry are falling. Now is a good moment for potential issuers to take a fresh look at active ETFs.



“Unlike passive ETFs, there is no single global framework for active ETFs. And in our view, national variations in regulation mean this is likely to persist. But that does not mean that issuers – or investors – should ignore this potentially valuable product.”

Kieran Daly

Associate Partner, Audit, Wealth & Asset Management

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