Active ETFs: Finally Ready for Prime Time?

By Robert Owens, Managing Director, SEI Investment Manager Services | August 29, 2019

The phenomenal growth of ETFs since their inception in the 1990s has been inextricably linked to the growth of indexing. With a few isolated exceptions, actively managed ETFs have so far failed to attract significant new assets. That may be changing. Spurred on by recent regulatory developments, a growing number of heavy hitters are rolling out active ETFs.

The State of Play

A decade since they were first introduced, there were 283 active ETFs in the US market by the end of 2018.[1] The global tally is even higher after more recent adoption in markets such as Australia. After faltering initially, net flows to active ETFs have recently hit their stride in the US market, more than quadrupling from $6.4 billion in 2016 to $27.2 billion in 2018. This represents an impressive 9.4% of total net flows to ETFs last year, up from an average of 2.1% annually since the first active ETF was launched in 2008. Helping boost these figures is the growing popularity of factor-based investing, a semi-active approach embraced by a number of firms including Vanguard, which launched six factor ETFs in 2018 alone.[2]

These achievements are remarkable, but the impact of active ETFs to date should not be overstated: They still account for less than 0.5% of total ETF and mutual fund assets. Furthermore, only a select group of managers have achieved any notable success. The largest active ETFs are exclusively fixed income products, and the five largest active ETFs accounted for more than half of all flows in 2018. Bond strategies account for three quarters of all active ETF assets and a similarly dominant share of net flows. Equity strategies have been almost completely shut out.

Recent Developments

Until recently, transparency was the highest hurdle faced by most equity managers otherwise interested in capitalizing on investor interest in ETFs but they were concerned about the potential for front running. Some managers tackled the issue head on and created fully transparent, actively managed ETFs. Some bond strategies and MLPs enjoyed success, but many failed to gain traction in a market dominated by low cost index products.

Active managers who remained on the sidelines have now been given a boost by the recent Securities and Exchange Commission (SEC) approval of a new type of non-transparent actively-managed ETF that reduces the disclosure of portfolio holdings from a daily to a quarterly event. Over five years in the making, Precidian Investments was granted approval to license its ActiveShares actively-managed, non-transparent ETF structures. Precidian currently has licensing agreements with nine investment firms including Nuveen, Legg Mason, the Capital Group and BlackRock, but we expect the SEC's formal approval to cause more firms to seriously look at launching similar products using the Precidian or competing mechanisms.[3]

Taking the benefits of active management with the tax efficiency and intraday liquidity associated with ETFs, investors look to benefit from another investment vehicle to go alongside mutual funds, separate accounts and other options. It is too soon to determine if the ActiveShares structure proves successful, but Precidian has gained first mover advantage with its May 20 SEC approval. The product will likely soon face competition; time will tell if this advantage turns out to be meaningful and sustainable or whether it just jumpstarts the actively managed ETF industry. [4]

What Next?

After operating on the fringes of the industry for the past decade, active ETFs are poised to enter the mainstream. Equity managers and quants with a vested interest in not divulging the specifics of their trades now have at least one vehicle primed and ready to make their strategies available to the growing universe of ETF investors. More vehicles and innovative structures are likely to follow, benefitting the investor through variety and diversity

We expect the universe of ETFs to expand significantly over the next few years, placing further pressure on other more traditional investment vehicles. Active ETFs based on already familiar strategies will be particularly well placed to capture asset flows. Rooted in the secular trend toward low cost passive investments, the explosive growth of ETFs is about to be turbocharged by the introduction of high quality active management. Regardless of their investment philosophy or whether they currently offer smart-beta index or fully transparent ETFs, successful asset management firms of the future will need to be structure-agnostic and have an ETF strategy going forward.

[1] Strategic Insight, SimFund Database, December 31, 2019 [Note: All statistics in this section are derived from queries of the SimFund database]

[2] Lizzy Gurdus, Here’s what this $1 trillion money manager is watching in the ETF market, CNBC, July 28, 2019.

[3] Lizzy Gurdus, The first confidential, actively managed ETF just got SEC approval. Here’s how it works, CNBC, June 15, 2019.

[4] Lewis Braham, A New Structure for Active ETFs Could Satisfy Managers, Investors, and Regulators, Barron’s, July 12, 2019.