INVESTMENT MANAGERS BUSINESS

# ETFs: Into the spotlight.

As ETFs are embraced by more investors, growth and innovation are accelerating.

**After operating in the shadow of mutual funds for many years, ETFs are now center stage. No longer restricted to passive investment strategies, they are playing more roles in more portfolios than ever before. What's next?**

# Executive summary.

## As ETFs are embraced by more investors, growth and innovation are accelerating.

Active ETFs are punching above their weight and thematic approaches are resonating with investors. Fixed-income ETFs are proliferating into the municipal bond market and collateralized loan obligations. Alternative ETFs are growing far faster than those in plain vanilla categories.

Despite a bevy of opportunities, the ETF business is highly competitive, with extreme fee pressure, high fixed costs, and rigorous transparency requirements. Experienced administrators, ETF strategists, and turnkey trusts can guide the way and help managers avoid missteps. New entrants should look for partners who can lower barriers to entry, shorten time to market, provide distribution muscle, supply operational expertise, and help build a presence in global markets.

Success hinges on being able to gauge the trajectory of change, particularly as use cases evolve. Understanding how ETFs are being evaluated, chosen, purchased, and monitored is vitally important. ETFs already provide outstanding building blocks. If risk parameters, yields, and other criteria can be dialed in with even greater precision, advisors will be better positioned to deliver specific outcomes to their clients.

ETFs may currently be the best way to package investment ideas in a way that will be noticed and appreciated by investors, advisors, and media. Whether expanding an established brand or building one from the ground up, this is a profound opportunity for any manager willing to invest the time and effort into carving out an identity in the global ETF marketplace.

# From role players to superstars.

**ETFs are on a roll. Having steadily built momentum since their modest origin in Canada more than 30 years ago, ETFs are now impossible to ignore.**

After initially tracking broad indexes, ETFs offered exposure to narrower indexes before pioneering smart beta strategies and eventually active strategies. They are now ubiquitous, and product innovation has reached a fever pitch.

Is the ETF market maturing? Hardly. ETFs are set to go from strength to strength, propelled by several converging factors. There are many reasons for the ascent of ETFs, not least of all their flexibility. These low-cost, tax-efficient, and liquid vehicles attracted a broad spectrum of investors by offering precisely targeted exposure to baskets of securities in a convenient format. Fee-based advisors and hedge fund managers alike were empowered, using ETFs for everything from core allocations to tactical portfolio adjustments. The fundamentally attractive features of ETFs mean we can expect continued adoption and acceptance globally.

Sales and redemptions of ETFs initially ebbed and flowed alongside mutual funds. As ETFs proliferated into more categories, consistent inflows to ETFs continued even as mutual funds began to suffer sustained outflows. In a five-year period ending in November 2023, long-term mutual funds collectively reported net outflows in 33 out of 60 months. During the same period, ETFs only had net outflows in six months (Figure 1). Sustained organic growth meant U.S. ETFs accumulated net inflows of almost $2.6 trillion over five years, while more than $1.3 trillion flowed out of long-term mutual funds (Figure 2). This $3.9 trillion differential swells to an even more impressive $4.8 trillion when cumulative net flows are compared over a 10-year period.

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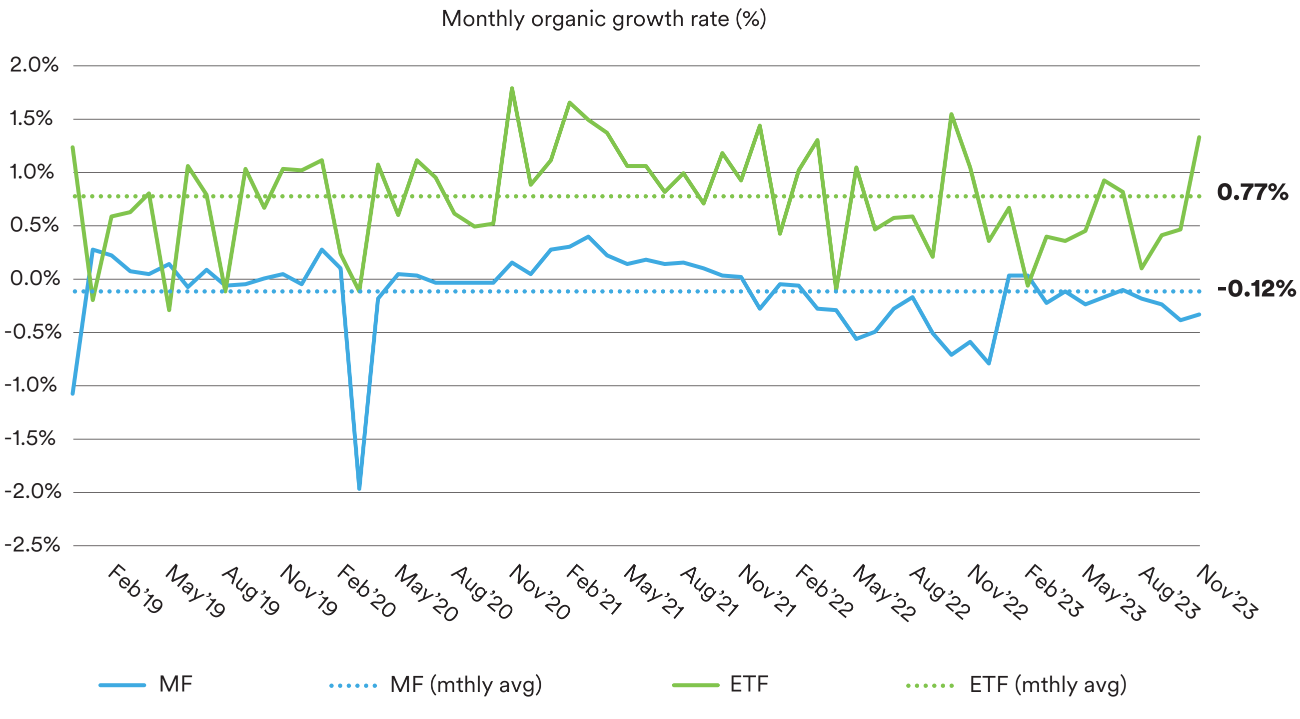
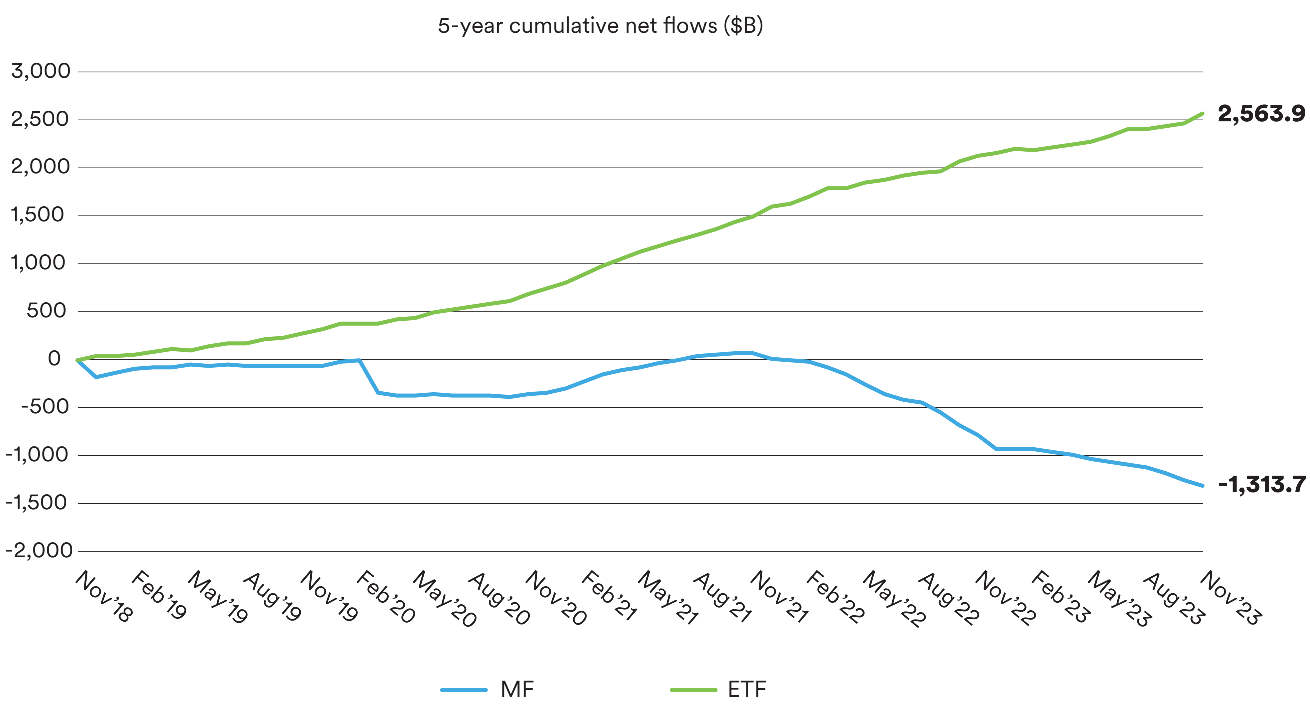
**Figure 1. Consistent inflows to ETFs and persistent outflows from mutual funds**




Source: Simfund Database, 11/30/2023.

**Figure 2. Undeniable momentum**




Source: Simfund Database, 11/30/2023.

# Surging innovation.

## Active management

Large swaths of the equity market are well-served by ETFs offering exposure to traditional indexes. Common variants range from style tilts to unusual weightings. Now that the technical puzzle of offering actively managed strategies has been resolved, we should expect a growing flood of active equity ETFs attempting to capitalize on the expertise of investment professionals worldwide. After years of anticipation, actively managed ETFs are flooding the market. While the number of index ETFs changed little from 2018 through 2023, active ETFs exploded. As of November 2023, they numbered more than 1,300, representing 32% of all ETFs versus 11% five short years earlier.

The proliferation of products driving this fivefold increase is remarkable, but it also underscores the difficulty in achieving scale amid growing competition. Average assets per active ETF rose far more slowly and now total $382 million per fund. This represents less than 11% of the $3.5 billion found in the average index ETF (Figure 3). Active ETFs are nevertheless punching above their weight. Despite representing only 5% of total ETF assets at the beginning of 2023, active ETFs accounted for 25% of total cash flows to ETFs during the first 11 months of that year.

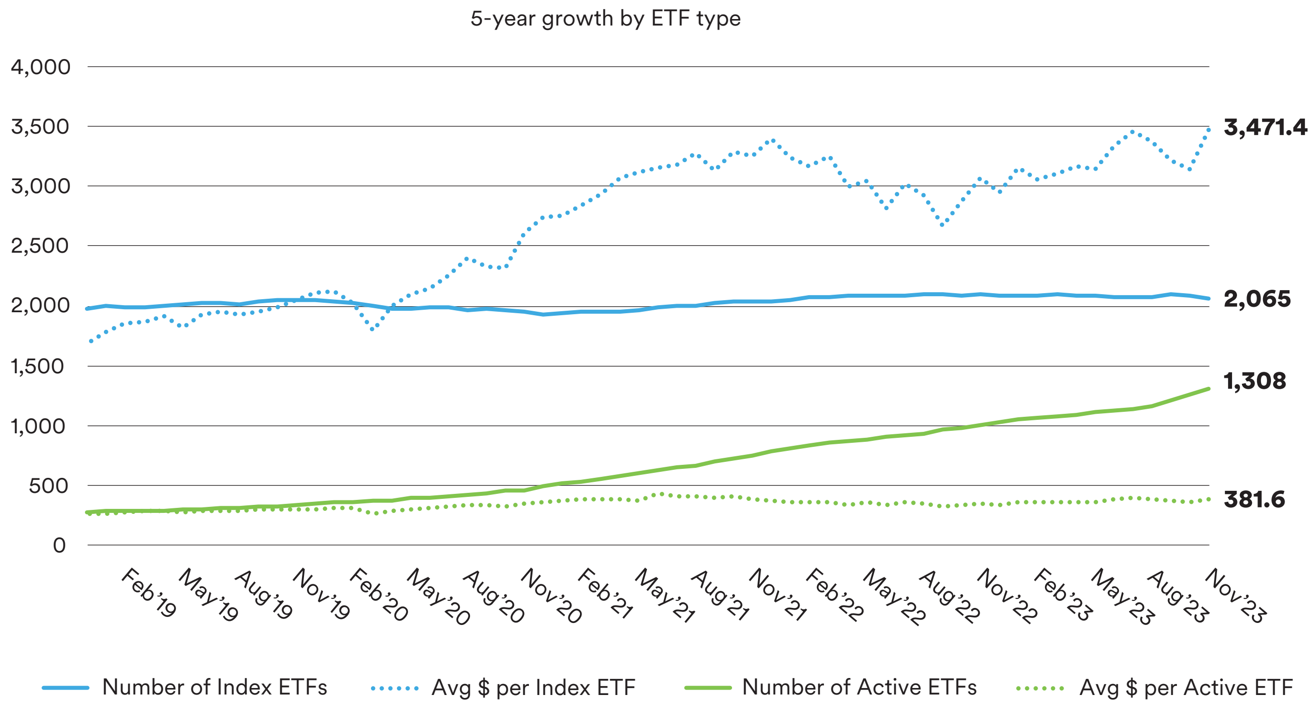
Despite some obstacles, actively managed strategies have many fans and a deep foundation. Research-driven active strategies that were previously limited to the institutional market may shake up the competitive landscape as they become directly available to individual investors for the first time.[1] As more established active managers package their expertise as ETFs, longer-term market prospects will become clearer. How successful active ETFs will ultimately be is anyone's guess. Performance track records and fund ratings will guide most decisions alongside brand recognition and cost.

## Thematic strategies

Instead of trying to differentiate themselves with stock-picking prowess within established styles, more managers may adopt thematic approaches. Rather than staking their conviction on the prospects of individual companies and their management teams, a growing number of managers are banking on the fact that they can invest in the potential of an idea. With news and information available to virtually everyone instantaneously, it may be less about finding an edge than observing that certain trends are gaining momentum and may even have the potential to change the world. ETF sponsors certainly think so, judging by the number of thematic product launches. Genomics, electric vehicles, robotics, renewable energy, and artificial intelligence are only some of the many themes already being tracked by ETFs.

[1] James Comtois, "CastleArk Enters ETF Market With Large Growth ETF CARK," *VettaFi*, December 7, 2023.

**Figure 3. Active ETFs are proliferating**



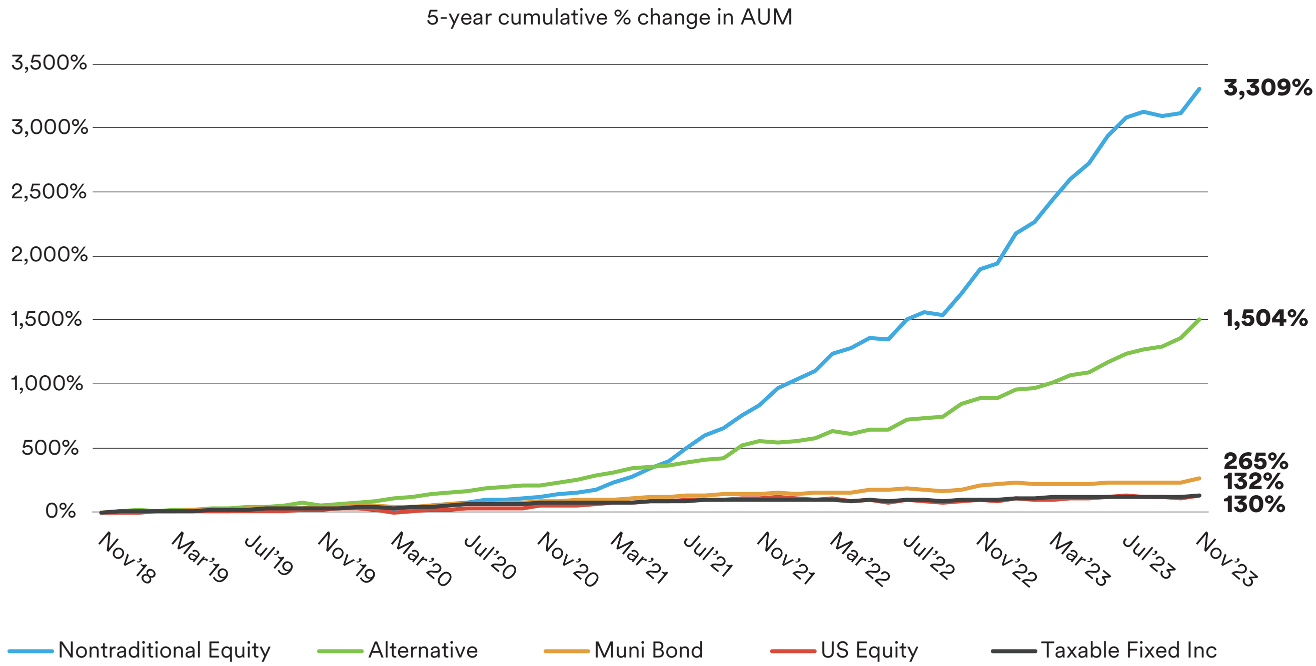

Source: Simfund Database, 11/30/2023.

## Fixed income

The size of the market makes equity ETFs a tempting entry point for new market entrants, but they may have more luck getting marketplace traction in other asset classes. Taxable bond ETFs grew strongly in the wake of the global financial crisis of 2007-08 as investors embraced their diversification and liquidity. Now, municipal bonds are a growing presence in the ETF market, with assets growing 265% from 2018 through 2023 (Figure 4). High yields attracted many tax-sensitive investors to these products, which are attractive options amid volatile markets and provide diversification benefits against the default risk of individual municipal bonds. Collateralized loan obligations (CLOs) are another vast part of the fixed-income market that is now accessible via ETFs. Having only been available since 2020, CLO ETFs are still outside of the mainstream, but they are promising enough that in 2023, nine separate funds were competing to capture assets in this segment.[2]

[2] Deutsche Bank, "CLO ETFs Come of Age," February 21, 2023.

**Figure 4. Alternative strategies off to the races**




Source: Simfund Database, 11/30/2023.

## Alternatives

One of the biggest opportunities in the ETF market is likely to be in alternative investments. A growing number of firms are taking aim at this space, but it is too early to identify dominant players. Still operating in small niches, ETFs with alternative and non-traditional equity strategies have demonstrated remarkable growth in recent years. While assets under management in mainstream ETF categories such as U.S. equities and taxable fixed income grew 130% from 2018 to 2023, nontraditional equities and alternative ETFs grew by an astonishing 3,300% and 1,500% respectively (Figure 4).

**Nontraditional equities and alternative ETFs grew by an astonishing 3,330% and 1,500%, respectively, from 2018 to 2023.**

Flows were divided between active and passive strategies as the fortunes of individual funds fluctuated, but it is worth noting that the lion's share of net flows (79%) over that five-year period went to three ETFs in Morningstar's Derivative Income category. The covered-call and other options strategies underlying these products are aimed at generating yield while offering some protection against declining markets. This combination has proven irresistible to many investors but may lose its luster if a bull market contributes to consistent underperformance.

The next frontier may be private markets, which are being heralded in some quarters as "the next active." The illiquidity of this asset class is not a natural fit with the inherently liquid ETF market, but there is strong demand from individual investors, leading to a few product launches that attempt to bridge the gap.

# The value of partnerships.

**Accelerating demand is a compelling reason to enter the market, and ETFs may currently be the best way to package investment ideas in a way that will be noticed and appreciated by investors, advisors, and media.**

Success, however, is hardly guaranteed. It is a competitive business with extreme fee pressure, high fixed costs, and rigorous transparency requirements.

Given these conditions, many managers choose to work with partners who can guide the way and help avoid missteps. As fund conversions become more commonplace, managers will want to partner with world-class administrators who have experience managing this process. Greenfield efforts could benefit from working with external ETF strategists, who specialize in researching, designing, and managing ETFs.

Managers launching new ETFs should consider the potential advantages of working with a turnkey trust that acts as a single point of contact for the myriad partners required. These cost-effective solutions can lower the barriers to entry, offer accelerated time to market, provide distribution muscle, supply operational expertise, and facilitate many other aspects of the business.

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# A bright future.

## Critical expertise provided by capable partners can improve the odds, but success hinges on being able to gauge the trajectory of change in this fast-moving market.

One aspect of ETFs that is not often discussed is the informational value contained in flow data. Widespread use by a wide variety of investors combined with the uniquely liquid nature of the product itself means unique, real-time insights into the heart of the industry and minds of investors. Keeping a close eye on the characteristics of ETF launches that are particularly well-received could reap benefits for anyone positioned to follow close behind.

Use cases matter. Advice delivery is evolving, and research sources, trading platforms, and planning software are all changing. There is an app for everything. Gamification is widespread. The user experience is paramount. AI is embedded. Investment fundamentals are critical, but understanding how ETFs are being evaluated, bought, and monitored is equally important.

ETFs are a blank slate. They provide outstanding building blocks for advisors constructing portfolios for their clients. If risk parameters, yields, and other criteria can be dialed in with even greater precision, advisors will be better positioned to deliver specific outcomes to their clients. Similarly, ETFs might increasingly be designed to reflect the concerns or values of narrower demographic slices, rather than simply touting vague ESG orientations. Generational distinctions, political alignments, and highly targeted social causes could all entice significant numbers of investors.

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Globalization should not be ignored. ETFs are used and understood globally, and their worldwide adoption is a trend that managers and sponsors ignore at their peril. There are regional nuances, but ETFs are nevertheless one of the most portable investment vehicles available. Growth rates may also be higher elsewhere. Of the $10 trillion held in ETFs globally at year-end 2023, approximately $7.5 trillion is in the U.S., compared to only $1.6 trillion in Europe. Faster growth in Europe may shrink the gap in the coming years.[3]

The ETF market is not yet mature. Innovation is widespread and growth is accelerating as ETFs are embraced by a growing number and variety of investors. Whether expanding an established brand or building one from the ground up, ETFs are a growth opportunity for any manager willing to invest the time and effort into carving out an identity in the global ETF marketplace.

[3] Sylvie Chapelle, “The ETF: The Prodigal Child of Finance?,” Societe Generale, December 18, 2023.

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