Research Institute

April 2024

Marketing Material

DWS

# Yes, Virginia, there are Active ETFs…

*"Please tell me the truth, is there a Santa Claus"*

Virginia O'Hanlon, 1897

IN A NUTSHELL

— Exchange Traded Funds (ETFs) are usually associated with passive approaches that track broad-based market indexes. And rightly so – of the $11.1tn of global Assets Under Management (AUM) wrapped in these structures, around $10.4tn, or 94%, is passive, leaving just $700bn, or 6%, in Active ETFs.

— But there has never been a legal or regulatory reason to prevent active strategies from using the ETF structure, rather it has been operational issues that have typically meant managers have stuck to mutual funds. That is changing.

— We address the main pros and cons of the two principal fund structures, mutual fund and ETF, in the specific context of active and passive strategies, and how, and why, the industry landscape is changing. We use a Q&A approach.

## The Big Picture

**Set the scene for me, of all the global assets under management (AUM) how much is active and passive, and of all the AUM in ETF structures, how much is active and passive?**

According to the October 2023 report, *The World's Largest Asset Managers*, by the Thinking Ahead Institute and Pensions & Investments, the 500 biggest fund managers in the world together manage around $114tn as at the end of 2022. If we use that as a decent proxy for all globally invested assets, then the report further states that actively managed strategies are about 65% of that total, and passive 35%. Keep in mind that different organizations define these terms in different ways, and put different parameters around the question (such as US versus global, or discretionary versus non-discretionary), so you may see a range of numbers on this topic, but these proportions are aligned with much of what we have seen in the industry over the years.

Now, if we zoom in, and look at just the ETF market, the comparable numbers, according to Morningstar as at the end of 2023, are a total market size of about $11.1tn, of which $10.4tn is in passive strategies, and $700bn is in active. So, in the ETF market only around 6% of AUM is active (versus 65% for all AUM in total). But it is enough that, unlike with Santa, you can't doubt the existence of Active ETFs (hence the title of this piece – Virginia, you may rest assured).

**So, is it fair to say that ETFs are typically thought of as passive for good reason?**

Absolutely. If just 6% of the ETF market is active, compared to 65% in the broader industry, then investors are right to equate ETFs in their minds to passive strategies – at least so far.

But, of course, it is this last caveat that's interesting. Because, if one looks at the composition of the ETF market over time, then it tells a very different story. Figure One (see below) shows the percentage of global ETF AUM that is allocated to active. Although we have referred so far to "just" 6%, that share has grown quite significantly in a relatively short time, from 0.35% of the market in 2008, to 6.43% in 2023. So, we need to be very clear on two distinct, but likely related, trends in the asset management industry. The first is

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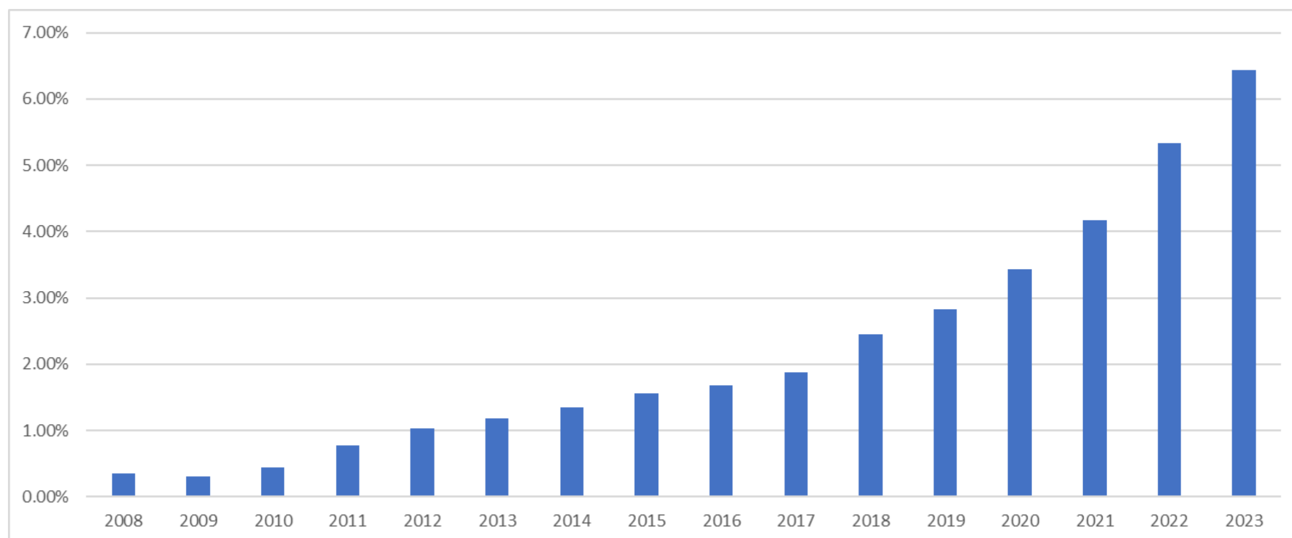
the much discussed growth of passive strategies versus active strategies across all AUM in total, and the second is the growth of active strategies versus passive strategies across all ETF AUM. Yes, these seem contradictory.

Figure One: The Share of the Global ETF market that is Active (as a % of all AUM)




Source: Morningstar, DWS, as of 12/23

**So how do we reconcile these two trends? Why is the Active ETF market growing at a faster rate than the passive one in the context of the broader trend towards passive?**

It is likely a combination of factors in our view.

Firstly, the Active ETF market is relatively smaller and untapped compared to passive ETFs. That makes it easier to launch innovative products that do not already exist as an ETF (either as brand-new strategies, or instead of, or as well as, existing mutual fund strategies) and to grow the market.

Secondly, there were relatively recent regulatory changes that have made it easier for managers to launch ETFs. The SEC approved Rule 6c-11 in 2019 (known as the "ETF rule")[1] which gave sponsors more flexibility around how they create and redeem ETF shares. The result was increased interest in the ETF structure. In addition to that, the ability - that only Vanguard originally had - to add a separate ETF share class to an existing mutual fund was protected by a patent that has now expired. All these changes potentially ease the offering of ETF structures, and we see evidence of that in the filings of asset managers who are using this structure to add ETF share classes to their existing mutual funds.

Finally, there is the efficiency, transparency, and tradability of the ETF structure itself (see below), which, based on the growth of the ETF market over the last 30 years or so, investors seem to like. The industry has seen the widespread adoption of ETFs on "no-transaction-fee" (NTF) platforms by US broker-dealers, and the creation of ETF-focused model portfolios. Both could be underlying drivers for further interest in Active ETFs. Of course, these may speak more to the fund vehicle rather than the strategy, so it does remain to be seen with Active ETFs which is the more important selling point.

[1] https://www.sec.gov/rules/2019/09/exchange-traded-funds

**Ok, I am comfortable with the broader industry trends, but now I need to ask the question that perhaps should have come first - what exactly is an Active ETF?**

It is very simply an investment fund with two key properties. The first is that it has a portfolio management team that are trying to generate outperformance against a benchmark, and not simply attempting to track an index as closely as possible (which is what happens with typical passive approaches). The second is that they are doing this in an ETF structure, and not in a mutual fund structure.

Keep in mind that, as the industry has evolved, the line between Active and Passive has blurred, possibly to the point of irrelevance (though these terms are used pervasively so we're stuck with them for now). Perhaps two additional useful ways of thinking about this are: the extent to which the final portfolio differs from its starting universe (analogous to its destination), and the degree of discretion that was exercised in getting there, i.e., was it a rules-based thematic or smart beta approach, or was it solely for the PM team to decide (analogous to the journey). In our view, Active ETFs will lie on the more differentiated and discretionary ends of these spectrums.

**How can I evaluate the performance of Active ETFs?**

This will need a slight shift in mindset. With most passive ETFs there are two key performance metrics – Tracking Difference and Tracking Error. Essentially the first is the difference between the performance of the fund and the index it tracks over a given period (and is largely driven by the fee of the fund), and the second is the dispersion of the fund returns and the index returns. In both cases investors want them to be as small as possible - they want fund performance that is as close as possible to index performance over any given time frame, and they want the relative returns to map as closely as possible. They recognize of course that ETFs that do not fully replicate their indexes (so called "optimized approaches" – see Glossary), or which track less liquid markets or assets will have a harder time doing this than for high volume, liquid, fully replicable, markets.

When one switches to Active approaches, it is no longer about trying to pin an index performance, rather it is about using manager skill to give the investor something more (chiefly either less risk for the same return, or more return for the same risk). In this world, it is better to evaluate after fee returns against a suitable benchmark, or against the competition.

It can get a little technical for sure, but essentially investors need to compare the fund and the benchmark to evaluate two main aspects – the risk (measured by beta), and the return (measured by alpha). The full details of this approach are beyond the scope of this paper, but, in other research, we have suggested using after fee returns, checking for the statistical significance of the beta and the alpha, making sure that the alpha is economically meaningful, and looking at its evolution and consistency over time. Of course, one would also want to discuss with the management team their process for alpha generation to satisfy yourself that it is robust, intuitive, and repeatable. And, in addition to the performance, this conversation might include other aspects of active management such as turnover, conviction, active share, holding period etc. Be aware that, just because a fund is categorized as active according to one data provider, it might behave quite passively (so you may need to decide for yourself where it sits according to your own classification).

**What benchmark or index do they track?**

Hmm, a trick question. Active managers do not attempt to track indexes, they leave that to passive funds. Active managers are typically trying to beat benchmarks (and benchmarks, yes, are typically indexes, but they do not have to be). In the case of Active ETFs most of the big data providers will assign what they believe is an appropriate benchmark, but we do urge some caution here, and encourage investors to think carefully about this question.

For example, if one evaluated a value manager against the S&P 500 over the last decade or so then we suspect that they would have had a torrid time given the powerful run up that some of the large-cap growth names have had during that period. But, surely it would be a little disingenuous to conclude from that that value managers were doing their jobs poorly. After all, an investor who allocates to a value manager is actively seeking an exposure to that style tilt.

We would argue that a value manager is best judged by reference to a value benchmark, and not against the broader market. To be sure, these are subtle, and, at times, complex arguments, and the topic of benchmarking can't be done justice in this short paper, but one quick and simple rule of thumb for a good benchmark against which to evaluate performance is that it should have a very high correlation to the fund (at least around 0.90-0.95).

**Should I use Active ETFs tactically or strategically?**

In principle they can be used for either purpose. But we might lean more towards a strategic usage, and for a very simple reason – alpha generation usually operates quite slowly. The inclusion of an active component arguably makes more sense as a long-term strategic holding because quality alpha generation is likely to be a long-term prospect. There will be periods of over and underperformance, but the goal is that over the *long run* the manager can outperform. As such they should not be judged over a short time (which holding them tactically effectively does).

Putting this another way, if an investor wanted to express a tactical view in a particular asset class, then there is no real advantage to having an active component, they might just as well use a fully passive vehicle. After all, it is the asset class that they have a view on in the short run, not the manager's added value. Note that our answer to this question is quite different to the use case for passive ETFs which we would argue investors can equally use to express very short-term tactical views, or multi decade buy-and-hold strategies. The important distinction is between the *asset class exposure*, or beta (that both Active and Passive offer) versus the *skill exposure*, or alpha (that only the Active offers, and which comes to fruition over time).

## The ETF Structure

**What are the advantages and disadvantages between Active ETFs and Active Mutual Funds?**

Let's assume that we are comparing two identical strategies run by the same team, with an identical process and at the same cost. In other words, and with our scientist hats on, let's change just one variable – the fund structure. Also, note that, a broadly similar regulatory landscape applies to both active ETFs and to actively managed mutual funds (the 1940 Act in the US, and the UCITS framework in Europe – see Glossary). If we accept these premises, we believe there remain three principal distinctions.

The first is the tax efficiency[2] of the ETF structure. At the fund level (note *fund* level, not *investor* level), ETFs are typically cited as more tax efficient than mutual funds for two reasons. One is that, as predominantly passive strategies, they have lower turnover, and therefore trigger fewer capital gains. Of course, since we are now comparing identical active strategies (see scientist comment above) this no longer applies. However, the second efficiency does. ETFs are often able to pass out securities "in kind" to Authorized Participants (APs – see Glossary) in exchange for ETF shares, which means that they can redeem securities, often those with the lowest cost base, without causing a taxable event (this is not always possible, some stocks, particularly in emerging markets, often cannot be transferred in kind).

The second distinction is one that we discussed above, and it is the transparency of the structure. Now, we won't claim that this is necessarily either an advantage, or a disadvantage, rather it is an important distinction. Some investors might prefer to know what assets they are holding in real time, others may believe that's potentially costly information to have to give away. Similarly, some managers might not believe that reporting holdings daily is detrimental to their process, others might. Of course, the chances are that if an Active ETF exists, the managers believe that the pros outweigh the cons, and their interest is aligned with their investors. But it is worth checking their thinking on this point. The industry has also tried to implement so called "non-transparent", or "semi-transparent" Active ETF structures where, for example, the holdings are shown, but only with approximate weights, or where not all the holdings are fully detailed. This structure is currently limited to securities that trade on an exchange during US market hours (so bonds are currently out of scope, and it's not yet a global structure). Time will tell whether these impediments are removed, or whether the structure catches on, but, to be clear, in this paper we are discussing fully transparent Active ETFs.

Finally, ETFs are listed and traded on stock exchanges just like an ordinary share and therefore can be bought and sold, and even sold short, all day long. As with the transparency point, we won't claim this is necessarily an advantage for Active ETFs. Investors may initially believe that the more trading frequency the better, but, given our comment about the strategic nature of Active ETFs, we suspect that could be a specious feature.

So, let's call it two ties, and a win for the ETF structure.

[2] DWS does not give tax advice. Tax treatment depends on individual circumstances and may be subject to change in the future.

**Do they cost more than Mutual funds? Does the alpha justify the cost?**

According to Morningstar, “ETFs tend to be cheaper than mutual funds” which they attribute to the “advice, marketing, distribution, and recordkeeping” costs of mutual funds. We would probably add, given what we said above about the split between active and passive strategies in the ETF and mutual fund worlds, that we would expect ETFs to be cheaper because of their tendency to offer index tracking solutions. It is probably only right and fair that an active fund should charge more for the research and manager skill required to generate alpha (and, as we have discussed, they are held to a different standard because of that).

So, the real question is not, are ETFs less costly than mutual funds, but, are Active ETFs less costly than their mutual fund equivalents? We suspect they will tend to be for two reasons. Firstly, the well-reported trend of fee compression in the asset management industry could mean that newer launches come at lower fees than before, and, secondly, because if an ETF is being offered alongside an already established mutual fund there could be less marginal cost for the new structure to absorb.

The second question is not specific to Active ETFs, but is true of any active strategy, including mutual funds and hedge funds. We would refer you to our response on performance evaluation where we advocated using after fee returns. Certainly, we are not of the view that some investors seem to adopt, that cheaper is always better. That may be true for ostensibly identical index tracking funds, but, at the risk of sounding facetious, we believe most investors would happily pay a 10% management fee for a 100% return, so it becomes a simple question of what you get for your money - if the after-fee returns are impressive enough then one can argue it shouldn’t matter what you paid to access them.

**Is the sole reason for Active ETFs versus their Passive ETF equivalents alpha generation, or are there other advantages?**

That’s surely the main one. Some managers may talk about actively managing downside risks, and that could be important too, but it can’t be a matter of purely de-risking, because that is something that investors can do for themselves (by, for example, blending their equity and fixed income holdings to a risk level where they are comfortable). So, we think that evaluating risk-adjusted returns will still matter, even if a manager touts their lower volatility as a selling point.

**Does the transparency of the structure concern the Portfolio Managers?**

It might concern some. And this was typically cited as one of the main reasons that active managers might prefer the mutual fund structure (or semi-transparent or non-transparent ETFs). To remind ourselves of the argument, most ETFs are required to fully report all their holdings every day, whereas mutual funds typically report on a slower cadence, either monthly or quarterly. The fear therefore was that other investors could use those daily holdings, and perhaps their change from day to day, to anticipate whether a manager was trying to unwind or build a position in a particular stock. Armed with this knowledge they might then buy or sell that stock in advance of the manager having to trade it themselves, and, in theory, win to the subsequent flow. Of course, this is a fully permissible activity because the holding information is public.

So, for active managers to be comfortable using the ETF structure, they need to believe one of three things: either that this activity is not predictable in advance (i.e., that they can get to the size they wish to quickly, and without giving their hand away), or that the activity wouldn’t occur even if did take them a number of days to trade to the size that they wanted, or that if the activity did occur, it wouldn’t be sufficiently detrimental to performance that they mind.

We suggest that this is a good question for investors to ask of their portfolio management teams when considering Active ETFs. And of course, in that spirit, DWS should provide its own answer to the question. Whilst we recognize that this could be an issue for funds that change their position sizes often, for large funds that are significant holders of a particular outstanding free float, or for very tactical approaches that try to capitalize on short term price moves, none of these currently apply to us.

**What are the conditions of an Active strategy necessary to manage the intraday liquidity offered through the ETF wrapper?**

Perhaps the simplest way to think about this is by analogy. Any normal passive ETF needs to track an index, and that index will likely have a set rebalancing date when names are added and removed. It may also have to deal with corporate actions such as mergers and spin-offs that will create turnover in the fund. So, if one simply thinks of an active manager as like an index committee that changes the composition of the holdings (but based on their own analysis) then, in some sense, not much has changed for the team operating the ETF. Of course, the changes are likely to be more frequent, and possibly move the weightings around much more, so sufficient

underlying liquidity is key to support that higher turnover and likely higher portfolio concentration, but, in essence, it is business as usual.

**Will the ETF arbitrage still operate?**

As a reminder, the ETF arbitrage is a well-known mechanism that incentivizes some market participants to buy or sell an ETF and buy or sell its underlying assets if the price discrepancy between the two grows too large (with "too large" meaning, there's risk-free money to be made - after all costs - by doing so). Investors are sometimes skeptical of arbitragers, but our view is that they are providing a useful function here – they are constantly ensuring that the price of the ETF is in line with its underlying assets. That means that an investor doesn't have to worry too much about that issue, and can rest easy in the knowledge that there are economic forces keeping the ETF price and the underlying asset prices well aligned.

Since this arbitrage is based on a known, and published, set of securities that the ETF sponsor stands ready to accept or deliver (the so-called "creation basket", see below), then we envision the same arbitrage potential whether an ETF is active or passive – and, again, that's a result that is more likely to help the end investor than hurt (as well as aligning prices, it drives volumes).

**How are the creation and redemption baskets impacted?**

The creation and redemption baskets are the list of securities that we mentioned above that the ETF sponsor will accept or deliver in return for creating or redeeming ETF shares. Everything in the ETF ecosystem should operate in pretty much the same way regardless of whether the fund is active or passive, with perhaps one minor distinction. There are times when ETF sponsors can be a little more fluid about that securities list, and even arrange "custom" or "negotiated" baskets with APs. In the case of Active ETFs, we believe that the basket may be a little stricter, in the sense that an active manager may be more discerning about the securities they do and do not want. Remember, the active manager is analyzing each of their securities carefully, and taking a stock specific view. The manager of, say, a passive fixed income fund may have a bit more leeway over the bonds they are prepared to take in or out of the portfolio, if the broad features (credit, duration etc.) keep their tracking errors tight.

**Do particular strategies or asset classes lend themselves to Active ETFs (or, put another way, do liquidity or other constraints make certain approaches unviable)?**

Many funds and investment strategies face constraints, be it liquidity, or capacity, issues. We discussed one of these above where we argued that some PMs might be reluctant to have their holdings reported daily, particularly if they are so sizeable a holder of a specific stock, or change their positions so frequently, that they believe market participants might trade on that information. In that case, they may prefer the relative opaqueness of the mutual fund structure (and rightly believe that that is also in the interest of their fundholders).

So, it is true that Active ETFs may not work for every asset class or approach, but keep in mind that companies think very carefully and analytically before they launch any product. Any questions of viability will be carefully addressed in advance, and, of course, their mettle will be properly tested in the furnaces of the market. The very fact that an Active ETF has launched is strongly suggestive that the PM team believe that any additional AUM will be manageable, and that the structure won't impede their alpha generation process, either by giving away their holdings, or by making the fund so large that its alpha potential is impaired. But it is an important question because, as an open-ended structure, ETFs can't close to additional inflows (as mutual funds and hedge funds can). So, be sure to ask the question - how big would be too big?

If your question is less about the fund structure, and more about in which asset classes active approaches could be more effective, that's a much bigger question. We'd probably point readers to the seminal S&P Indices versus Active (SPIVA) reports by S&P Global which examine that question in detail. We note though, that, according to Bloomberg, of the roughly 2,300 ETFs that they list as Active (of c.10,700 in total), around 1,300 are equity and around 600 are fixed income (with the remainder mainly either Mixed Allocations or Alternatives). So, it doesn't seem as though the industry believes that Active ETFs are only suitable for certain asset classes.

**Final question – are you sure Santa exists?**

If you haven't ever read it, see the eloquent reply that The Sun newspaper gave to Virginia in 1897 - he exists.

## Glossary

Act of 1940: The Investment Company Act of 1940 is an act of Congress that regulates the organization of investment companies and the activities they engage in.

Active: An investment strategy that seeks to outperform a particular market or asset class through manger skill in security selection and timing.

Alpha: The difference between an investment's actual return, and its expected return, given its level of risk. Active managers are typically seeking to generate positive alpha.

Authorized Participant (AP): An authorized participant is an organization that has the right to create or redeem ETF shares with the ETF issuer.

Benchmark: A benchmark is an index or other value against which an investment's performance is measured.

Beta: Beta is a measure of volatility that captures a security's systematic risk according to the capital asset pricing model.

Capital Asset Pricing Model: An influential financial framework that quantifies the relationship between rewarded, and unrewarded, risks and returns.

Create: When an ETF issuer creates new shares and delivers them to the AP in an agreed-upon quantity. These newly created shares increase the number of outstanding shares in the ETF.

Creation (Redemption) Basket: Is the list of specific securities and/or cash that an ETF issuer will accept or deliver in return for creating or redeeming ETF shares with an AP.

Duration: Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Exchange-traded fund (ETF): A security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Hedge fund: An investment vehicle less regulated than a mutual fund that pools capital from different investors and uses different investment strategies.

Mutual fund: A mutual fund combines funds from many investors with the intention of purchasing securities.

Passive: An investment strategy that seeks to replicate as closely as possible the performance of an index.

Optimized Replication: A fund that tries to replicate the performance of an index but without holding all the assets in that index.

Redeem: After accumulating a large block of ETF shares – referred to as a redemption unit – an AP can exchange those shares for an equivalent value of the basket of securities that make up the ETF.

Sharpe ratio: Puts an asset's excess return (the return above the risk-free rate) in relation to the asset's risk as measured by its standard deviation.

Shorting: selling (stocks or other securities or commodities) in advance of acquiring them, with the aim of making a profit if the price falls.

Tracking Difference: Tracking difference is the difference in return between a fund and its benchmark (or index). Fees are often an important component, and investors typically want it to be as small as possible.

Tracking Error: Tracking error is an unwanted deviation between, for example, an index fund and a portfolio.

UCITS: The Undertakings for Collective Investment in Transferable Securities (UCITS) is a regulatory framework for mutual funds in the European Union (EU).

Volatility: The degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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as of 04/01/24; CRC_100485 (4/2024)

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as of 04/01/24; CRC_100485 (4/2024)