Active ETFs in Europe: Small, Shy, and on the Rise

The universe is growing, but most offerings are less active than you'd expect.

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Key Takeaways

- Despite their growth, active ETFs currently comprise a modest segment, accounting for just around 2% of total ETF assets in Europe.
- ETFs present a growth opportunity for active managers, but so far assets have mostly funneled to a few issuers, like J.P. Morgan, Pimco, and Fidelity.
- ETF investors love low fees. Reflecting this sentiment, the European market for active ETFs has exhibited a notable shift toward greater cost efficiency, with the asset-weighted representative cost decreasing to 0.27% by March 2024 from 0.41% in March 2013.
- Unlike in the US, in Europe, like-for-like strategies aren't typically available simultaneously in ETF and open-end fund format.
- Unlike mutual funds, ETFs can't close to new investors when they get too big. Strategy capacity is critical in the ETF structure. Focusing on ETFs that hold liquid securities and reasonably diversified portfolios is a good way to limit capacity risk.
- Fixed income was the most popular active ETF asset class early on, but active equity ETFs have gained the throne as the menu of available options broadened.
- The European active ETF market features many quantitative strategies and sustainability themes, across both equity and fixed-income asset classes. However, most asset managers have yet to explore the opportunities presented by actively managed multi-asset ETFs.
- Most of the active ETFs available in Europe are "shy-active," with lower active share and/or tracking error than similar active open-end funds. As a result, investors should moderate their excess returns expectations from such products.

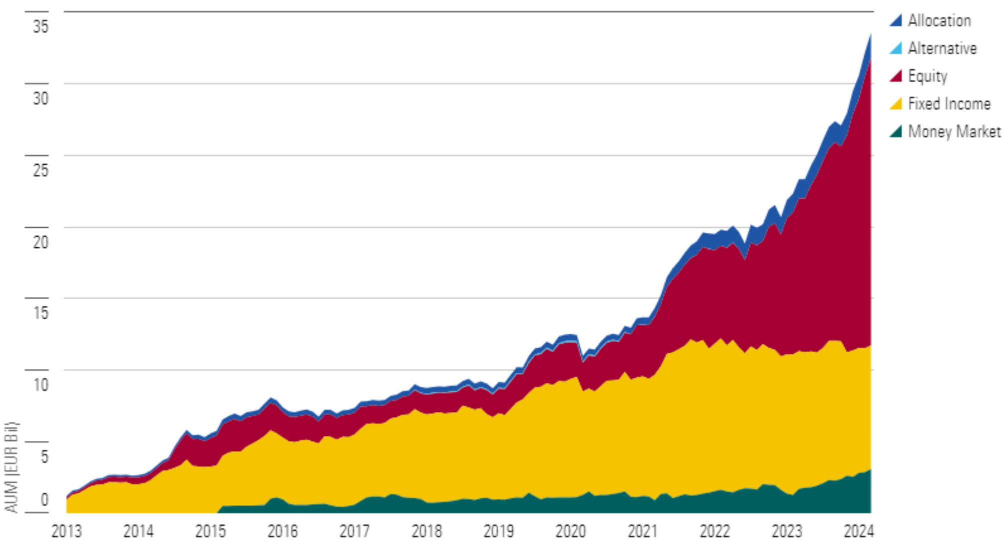
A Source of Growth for Active Management

Exchange-traded funds are a type of investment vehicle that combines some of the key benefits of traditional mutual funds, such as their ability to invest in a diversified basket of stocks and/or bonds, with the flexibility and accessibility of stocklike real-time trading on an exchange.

The ETF market is typically identified with low-cost passive investing. This is a natural consequence of how the market has developed. In fact, even now, most assets globally are in ETFs that track the performance of an index, and so it is clear why investors and other stakeholders make this association. However, an ETF is just a vehicle in which theoretically anything can travel. This includes actively managed strategies, whose investment objective is typically that of delivering returns above a benchmark of reference.

In recent years, assets in active ETFs in Europe have experienced exponential growth. As of March 31, 2024, European investors have access to 87 active ETFs, which have accumulated approximately EUR 33.8 billion in assets. While initial growth in the active ETF market coincided with a boom in bond strategies (in an environment of low interest rates where active management was seen as higher-potential), equity active ETFs have gained significant momentum over the past two years, aggregating over EUR 20 billion. Traditionally, most active managers were reluctant to disclose their "secret sauce" by revealing their holdings daily, as required by ETF regulations. However, traditional fund companies are now embracing ETFs as an additional distribution vehicle for their strategies.

Exhibit 1 Active ETFs' Growth Has Accelerated in Recent Years

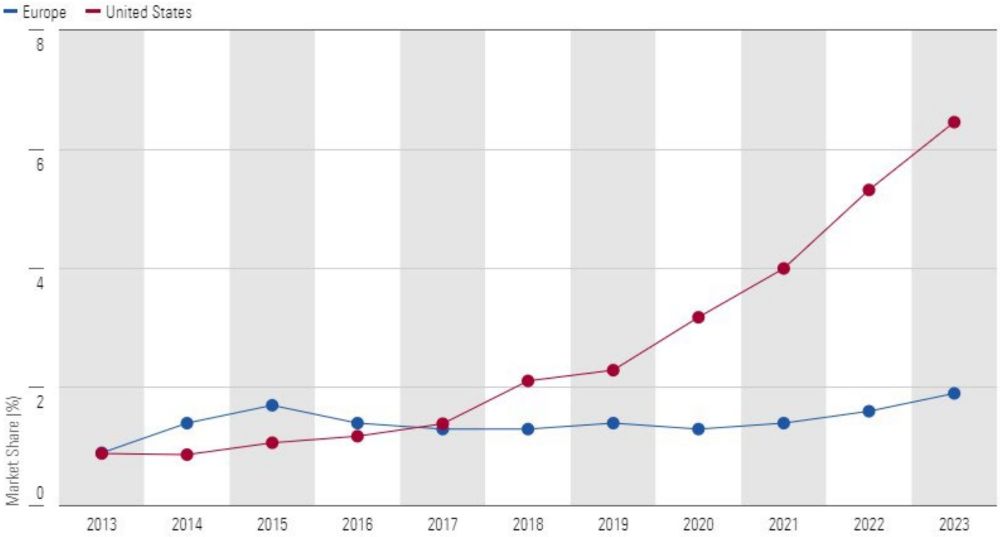


Source: Morningstar Direct. Data as of March 31, 2024.

Although the active ETF market only accounts for around 6.5% of total US ETF assets and 1.9% of total European ETF assets, active ETFs are gaining market share in both regions. The big shift in the US was the SEC's approval of the ETF Rule in 2019, which allowed for custom creations/redemptions. This regulatory change was followed by the first mutual fund to ETF conversion in 2020, further accelerating active ETF adoption in the US.

The European active ETF market is expected to experience accelerating growth as an increasing number of prominent asset managers enter the field. Recent news has been flooded with announcements from major players such as Robeco, BlackRock's iShares, Eurizon Capital, ARK Invest, and others, all either launching or planning to introduce active ETFs in Europe. This interest from established institutions suggests that the active ETF space is poised for expansion.

Exhibit 2 Active ETFs' Share of the Overall ETF Market (%) in Europe and the United States

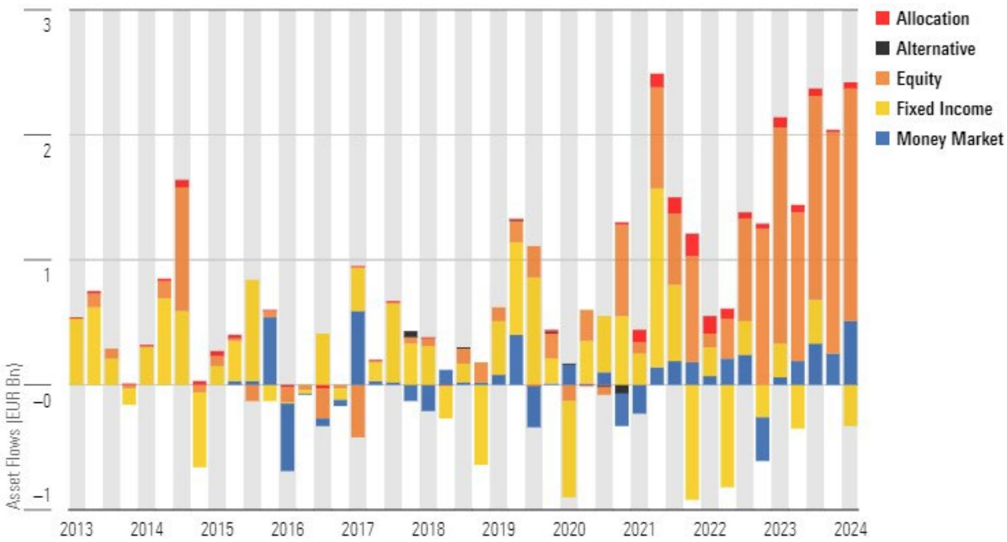


Source: Morningstar Direct. Data as of March 31, 2024.

Flows into active ETFs have increased in recent years, with the majority of the flows directed toward equity strategies. Most of these products have seen net positive flows over the trailing 12-month period through the end of March 2024—totaling around EUR 6.4 billion in overall net inflows for the cohort. This is an especially strong figure considering that European active equity funds have had large outflows over that span—signaling that the active ETF segment has largely bucked the negative trend. JPM's and Fidelity's research-enhanced ranges captured the bulk of the inflows. One notable exception is Ossiam ESG Low Carbon Shiller Barclays CAPE US Sector UCITS ETF, which has shed over EUR 800 million in the first quarter of 2024—around three fourths of its previous year-end assets.

In contrast, flows into fixed-income active ETFs have shown a seesaw pattern over the past two years. These flows have largely been driven by the largest bond fund in the cohort: Pimco USD Short Maturity ETF. For example, this fund experienced more than EUR 1 billion in outflows in the month of November 2023 alone, as investors tactically reallocated away from short-term USD rates. Furthermore, over 2023, active ETFs in the ultra-short-term European bond space, such as Pimco Euro Short Maturity ETF, JPM EUR Ultra Short Income ETF, and Franklin Euro Short Maturity ETF, experienced outflows. Conversely, funds invested in longer maturities steadily gained net inflows during the same period.

Exhibit 3 European Active ETFs' Asset Flows



Source: Morningstar Direct. Data as of March 31, 2024.

Active ETFs: A Threat to Strategic Beta?

The ETF market started off and grew on the merits of providing low-cost exposure to standard market-cap-weighted indexes. However, many ETFs now offer a hybrid-type strategy known as *strategic beta*—also known as *smart beta*—that aims to marry the benefits of passive and active investing strategies.

Strategic-beta ETFs are designed to capture academically substantiated factors such as value, low-volatility, momentum, and quality, which have been shown to provide returns above the market over long periods and have been understood and exploited by active managers for decades.

Strategic-beta ETFs track the performance of an index, and so from the point of view of fund management, they are passive products. The market of strategic beta has grown in absolute terms in the past decade on the back of flows, capital appreciation, and new launches. However, as a proportion of total assets in the global ETF market, assets in strategic-beta ETFs have remained tightly range-bound at 15%-17% (and in Europe have stayed even lower, never exceeding 8% of market share). This is often interpreted as a sign that the strategic-beta ETF market has reached its potential.

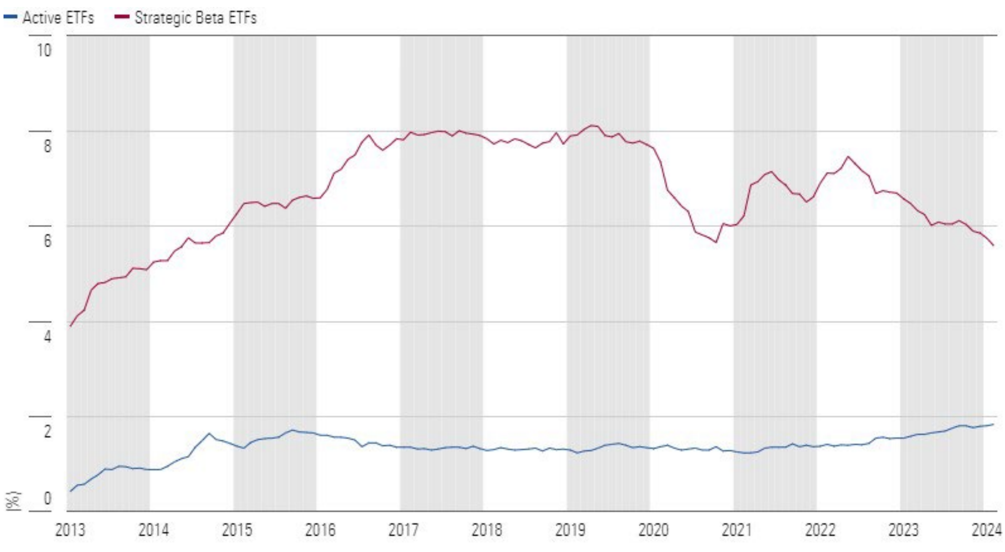
Compared with traditional passive players, there is an additional burden to creating a distinctive strategic-beta investment strategy. This also imposes an additional educational burden on the side of promoters of these products to attract investors. The complexity of explaining and understanding the mechanics of an intricate index is often highlighted as a barrier for further growth of the strategic-beta ETF market. For this reason, strategic-beta ETFs, particularly those encapsulating the more complex investment strategies such as, for example, multifactor ETFs, are sometimes touted as prime candidates to transition into active ETFs.

The rationale for this is twofold. First, freeing the ETF managers of these complex strategies from the constraints of tracking an index affords them flexibility to better navigate changing market environments and potentially exploit pockets of value ignored by the benchmark. Second, it could become easier for the proponents of these products to market them to investors on the strength of in-house active research capabilities.

In Europe, we had some anecdotal evidence to support this view with the decision by J.P. Morgan to switch the JP Morgan Global High Yield Corporate Bond Multi-Factor ETF from strategic beta to active in August 2023. In its passive incarnation, the ETF tracked an index that incorporated several construction techniques akin to active decisions. The index screened the high-yield bond universe to exclude issuers and bonds based on liquidity metrics—for example, a bond's minimum outstanding—and then proceeded to select issuers with strong value, quality, and momentum characteristics. In other words, this was not your run-of-the-mill passive fund.

High yield is one of the areas of the bond market where active managers have more latitude to add value relative to a passive approach—for example, by exploring the less liquid areas of the market typically ignored by benchmarks. Hence, the switch allowed J.P. Morgan to market the strategy by selling the expertise of its team of high-yield bond managers and the additional value they could bring to the fund. Also, J.P. Morgan has made its name in Europe as a leading provider of active strategies via the ETF wrapper, and so from that perspective, the switch tied in with its overall business strategy.

Exhibit 4 Strategic-Beta and Active ETFs' Market Share of the Overall ETF Market (%) in Europe



Source: Morningstar Direct. Data as of March 31, 2024.

Exhibit 4 shows that the market share of strategic-beta ETFs has been declining in recent years, currently standing at 5.6%. Investor behavior has largely been influenced by performance chasing, particularly favoring the dominant "Magnificent Seven" stocks, referring to the US tech sector. This trend has prompted a shift away from strategic-beta ETFs toward market-cap-focused investments.

Given that an increasing number of active managers are considering the merits of packaging and distributing their investment strategies in an ETF format, we expect the menu of available options to expand significantly as new entrants join the race. This is in recognition of the increasing popularity of the ETF wrapper with investors. However, there can be advantages and disadvantages, both for asset managers and investors, to using an ETF as the vehicle to market and access an active strategy. Below, we list the most relevant.

Benefits of the ETF Structure

Transparency

The ETF wrapper typically provides full transparency of holdings on a real-time basis. Investors in ETFs are seldom in the dark as to what their fund holds. This can help investors to make informed choices about the merits of a strategy and enhance their trust in the asset manager. From a technical standpoint, the transparency of holdings is also key to allow authorized participants and other market makers to price ETFs with accuracy, thus potentially resulting in lower bid-offer spreads and improved liquidity of ETF shares in the secondary market. In the US, regulatory changes have allowed the distribution of not fully transparent ETFs, though that format has struggled to gain traction. In Europe, meanwhile, all ETFs remain under obligation to disclose holdings fully.

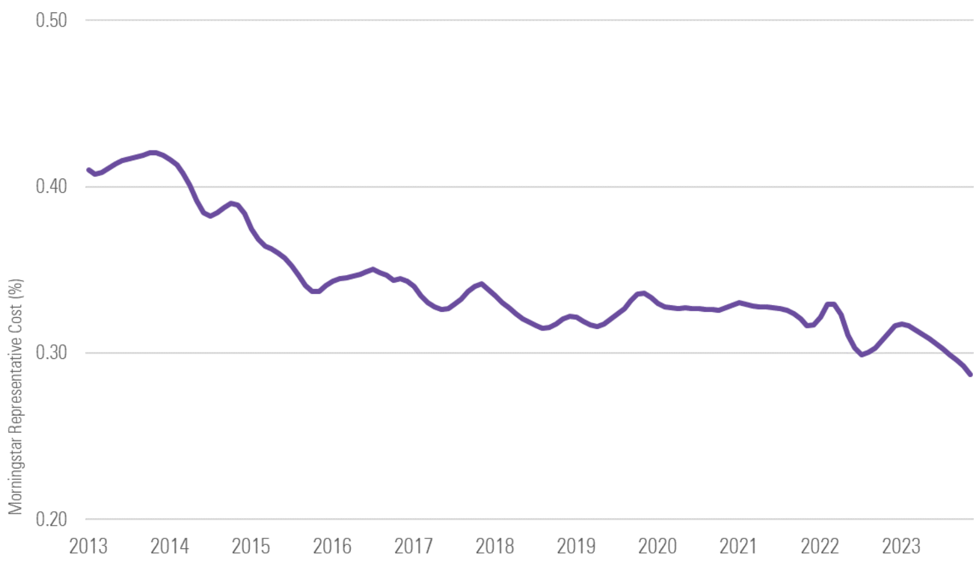
Ease of access

The real-time stocklike trading nature of ETFs paves the way for the democratization of investing. At the click of a button, anyone can have access to strategies—passive or active—that have been traditionally out of bounds to the common investor. ETFs can thus allow active asset managers to reach a wider client-base, across multiple markets, without having to build and maintain a dedicated distribution network in each market. The benefits for investors are twofold. First, by lowering barriers to entry, ETFs have the potential to significantly broaden the palette of available strategies for investors in each local market. Secondly, ETFs bypass the traditional commissions-based distribution models that are still the norm in many markets, including most of continental Europe. Avoiding retrocessions means that the cost of owning an active ETF is drastically lower compared with a similar active mutual fund. Increased ease of access can be a double-edged sword, however, by attracting investors with shorter-term horizons, who might be tempted to use ETFs tactically. But overall, the active ETF structure has the potential to largely improve investor outcomes.

Potentially lower management costs

Active managers considering the use of the ETFs could also benefit from the lower management costs typically associated with the wrapper if they're able to build critical mass in terms of assets. This could help active managers better compete against the tide of low-cost passive investing by improving investor outcomes. Morningstar's long-held view is that one of the most damaging factors affecting an investment over the long term is the impact of high management fees. The three-month rolling average Morningstar Representative Cost Ex Transaction Fee (Annualized) for European active ETFs indicates a marked decrease in recurring fees over the past decade. From a representative cost of 0.41% in March 2013, there has been a decline to 0.28% by March 2024, highlighting a trend toward enhanced cost efficiency in the European ETF market.

Exhibit 5 European Active ETFs' Asset-Weighted Average Morningstar Representative Cost (%)



Source: Morningstar Direct. Data as of March 31, 2024. The Morningstar Representative Cost Ex Transaction Fee (Annualized) excludes transaction costs and one-off or third-party fees. It reflects the ongoing costs levied by the management group, providing an annualized perspective on the fees payable over a year. Three-month rolling data.

Drawbacks and Challenges of the ETF Structure

Transparency considerations

Active managers who are required to provide full transparency of holdings on a real-time basis may feel it is too risky to publicize their intellectual property. After all, active management is predicated on the human ability to pick stocks or make bets on certain economic sectors or countries to deliver returns above the market. Revealing the “secret sauce” of alpha generation could expose active managers, they argue, to the risk of front-running—that is, of other market stakeholders piggybacking on their research efforts. This could negate their edge and ultimately penalize investors in the fund. This is more likely to be a higher risk for managers of equity strategies than bond strategies due to the different nature of the markets, the bond market being less transparent and operating over the counter. On the other hand, transparency is unequivocally a positive for investors, as it allows them to fine-tune their portfolio construction by having a clear understanding of their risks and exposures at any given time.

Transparency has often been cited as a barrier to the growth of the active ETF market. However, the evidence in the United States is that active ETF providers have brushed aside these concerns and mostly opted for the fully transparent framework.

Lack of capacity constraints

Any active manager considering using ETFs must assume that they will lose a key power, namely that of saying "No" to new investors. The ETF structure doesn't allow—at least not yet—for the possibility to enact soft, let alone hard, closures to new investors. While open-end funds can enact subscription fees to curb inflows, ETFs can only charge creation/redemption charges on the primary market: They cannot institute any barriers to entry on the secondary market, where most trading takes place. The potential for capacity issues is clear, particularly for the more concentrated strategies, and while some asset managers may market strategies less aggressively as they start nearing capacity, they have no practical, direct way of preventing asset bloat.

Liquidity

Drawing from the point above, launching an active ETF calls for careful assessment of liquidity constraints of the underlying that could undermine the ability to create and redeem ETF shares. This could also impair the tradability of the ETF on the stock exchange, leading to wide bid/offer spreads that would add to the overall cost of buying and owning the fund. Alternatively, managers might respond to liquidity challenges by increasing the number of holdings, trading up the market-cap ladder, or reducing active risk. This is a bad outcome for investors, as it changes the nature of the strategy they initially purchased.

Tax Considerations

In the US, ETFs generally have a tax advantage over mutual funds, but the extent of this advantage varies depending on the fund's investment strategy and the type of assets it holds. ETFs can avoid realizing capital gains by exchanging shares for underlying holdings and vice versa through their creation and redemption process, which does not create a taxable event. This contrasts with mutual funds, which must buy or sell holdings to accommodate inflows or redemptions, potentially triggering taxable events. However, the ETF structure does not help with taxes on dividends, interest, or most gains from derivatives. Consequently, stock ETFs typically benefit more from in-kind creations and redemptions than bond funds, as they tend to have more capital gains. While investors still need to pay capital gains taxes when selling their ETFs, the ability to choose when to realize gains can be advantageous, and the higher tax efficiency of ETFs can lead to lower overall costs and improved long-term results for investors.

In Europe, however, the tax treatment of ETFs differs from that in the US, and investors do not enjoy the same tax advantages. In fact, some European countries may impose more stringent tax treatments on ETFs compared with mutual funds or underlying securities. For example, in Spain, ETF investors cannot benefit from the "Traspasos" tax break, which allows mutual fund investors to defer capital gains when switching between funds. Meanwhile, Ireland-domiciled UCITS ETFs offer a unique tax advantage for investors. By domiciling ETFs in Ireland, the percentage of withholding tax on US equity dividends is halved to 15% from 30%.

These tax advantages highlight the importance of considering local tax laws and regulations when making investment decisions, as the tax efficiency of ETFs may vary significantly across different jurisdictions.

Regulation

ETFs domiciled in the European Union are regulated under two key EU Directives: the Markets in Financial Instruments Directive and the Undertakings for Collective Investment in Transferable Securities. MiFID is the regulatory framework for investment intermediaries and the trading of financial instruments. Under MiFID, firms are required to report ETF transaction details such as trade volume and price. UCITS is the regulatory framework for managing and selling investment funds and deals with aspects such as disclosure of holdings.

The implementation and enforcement of these legal frameworks, alongside the oversight of the local fund markets, including the authorization of new fund launches, is the responsibility of the local regulators of each EU member state.

Most European ETFs, and almost all active ETFs currently available for sale, are domiciled in Ireland or Luxembourg. This makes the Central Bank of Ireland and the Commission de Surveillance du Secteur Financier the two key local regulators for ETF-related matters in the region.

The choice of one domicile over another for European ETFs can be driven by several aspects, for example, the different tax treatment of dividends of US equity holdings in physically replicated ETFs, which as of now is more favorable for funds domiciled in Ireland. Meanwhile, Luxembourg's finance minister announced in March 2024 a plan to cut the subscription tax, or taxe d'abonnement, currently levied on active ETFs—ETFs that track an index are exempt from this tax in order to enhance the competitiveness of the grand duchy as a domicile for active ETFs.

However, when it comes to the interpretation of UCITS regulations around the disclosure of holdings, there is no difference. At present, any UCITS ETF domiciled in the EU is required to disclose all holdings daily. In fact, the CBI explicitly says that "it will not authorize an ETF, including an active ETF, unless arrangements are put in place to ensure that information is provided on a daily basis regarding the identities and quantities of portfolio holdings."[1]

Some confusion around disclosure of ETF holdings arises from the fact that local stock exchanges in Europe where ETFs are listed and traded have different requirements about disclosure of holdings. For example, the London Stock Exchange has no specific disclosure requirements, Deutsche Borse only requires ETFs to disclose daily the top 20 positions, while Euronext requires full daily disclosure. Besides, in the case of Euronext, a pan-European network of local exchanges including Amsterdam, Milan, and Paris, investors also have had to contend with specific regulations of each country. For example, in recognition of the growth of the active ETF market, the French government announced in February 2024 the removal of all conditions under its monetary and finance code that had prevented the listing of active ETFs in the Paris exchange.

This variety of rules at exchange level can be disconcerting and certainly add to the sense of fragmentation and lack of harmonization of the European ETF marketplace. Importantly, however, these rules do not supersede the requirement for daily full disclosure of holdings that ETFs must comply with to be approved as UCITS funds by EU regulators. Said otherwise, providers of UCITS ETFs remain legally bound to provide full holdings data to investors and other stakeholders. This is typically found in the ETF providers' websites.

1 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/ucits/guidance/ucits-qa-39-edition.pdf?sfvrsn=9ceb991d_1

In the European space, active ETFs also represent a leap in terms of distribution capabilities, potentially providing an avenue to further democratize access to a broad set of strategies. As the EU has a diverse set of rules on retrocessions, many local markets are still dominated by the commission-based model for advisors. A blanket ban on retrocessions across the EU would force intermediaries to demonstrably select funds based on client suitability and investment merit alone, which all else held equal would favor cheaper funds, including active ETFs.

Characteristics of Prominent Asset Managers' Active ETF Ranges

In Europe, the active ETF landscape is biased toward lower-alpha, lower-active share products, as well as quantitative and sustainability-tilted products, in both equities and fixed income. By contrast, only a few asset managers have ventured into actively managed multi-asset ETFs.

J.P. Morgan currently offers the largest range of Europe-domiciled active ETFs (25). The firm is extremely bullish on the benefits of transparency, liquidity, and tax advantages in the US brought by the ETF wrapper. While these are not perfect clones of its existing mutual fund range, some are reasonably similar, such as the JPM Green Social Sustainable Bond ETF JGN, which offers a similar exposure to the JPM Green Social Sustainable Bond UCITS mutual fund LU2545253671 at a lower cost. Within equities, the firm offers multiple research-enhanced ETFs that incorporate its analysts' forward-looking fundamental ratings on stocks, but in a diversified and systematic fashion rather than a concentrated, high-conviction portfolio.

Fidelity is another group offering a similar range of research-enhanced equity strategies in ETF format. The firm sees these as an interesting middle ground between fully active and fully passive portfolios: Its active ETFs are benchmark-aware and systematic, using optimizers to incorporate analysts' forward-looking fundamental ratings and sustainability assessments in a final, low-concentration portfolio. The firm's research-enhanced equity ETFs bear a price tag of 30 to 50 basis points annually, closer to a passive or strategic-beta strategy than a typical active strategy.

Similarities between J.P. Morgan and Fidelity don't stop there: Both firms also offer Paris Agreement-aligned multifactor corporate credit portfolios in an active ETF format. These quantitative strategies typically follow a rules-based approach to security selection, which also places them in a relative middle ground between passive and full-fledged active management.

On the more active side, bond giant Pimco was one of the first to leverage the ETF format in the US, pioneering the Pimco Active Bond ETF BOND in 2011 under former CEO Bill Gross' watch. Its ETF product development in Europe has been more timid, as the firm argues it will only launch a strategy in an ETF format if it is convinced that it can bring a durable edge versus competitors. As of the date of this report, Pimco's active ETF range in Europe consisted largely of very liquid short-duration products (Euro, US, Sterling) and a covered bond product. The price tag for these is not particularly compelling: For example, the 35-basis-point annual representative cost for the Pimco Sterling Short Maturity ETF falls in its Morningstar Category's most expensive fee quintile. At the other end of the spectrum, the firm saw no room for actively managed high-yield or emerging-markets bond ETFs, where transparency and/or scalability could prove constraining. In other parts of the world (US, Canada), Pimco has launched ETF shares within its existing mutual fund structures and has indicated an interest to do the same in Europe, contingent on regulatory advancements to make this more seamless.

As of the date of this report, AXA Investment Management offered a small number of active ETFs (two on equities, three on fixed income) but indicated plans to add to its range, particularly on fixed income. These products leverage resources from the group's fundamental analyst groups but are usually managed with a lower tracking-error budget and lower alpha ambitions than a similar active open-end fund. As an example, AXA IM ACT Biodiversity ETF ABIA tracks a proprietary strategy that incorporates the team's bottom-up stock picks, but it produces a diversified portfolio of around 90 holdings with a large-cap bias. That is markedly different from the team's actively managed AXA WF ACT Biodiversity mutual fund LU2429085033, which holds around 40 stocks and is biased toward mid-cap companies. The firm views its ETF and mutual fund ranges as complementary and has not indicated plans to offer ETF shares within its existing mutual fund structure.

Invesco is also present with five products, a range that has grown over time (and should expand further in the future) since its 2019 launch of the ESG Global Equity Multi-Factor strategy, its oldest and largest ETF to date. Most of its range is run by the Frankfurt-based quantitative solutions arm and the strategies therefore rely on the proprietary factor-based investment models, employing a systematic approach that the firm says is continuously enhanced as the team researches and develops new signals and systems. The ESG bent is strong across all products.

Amundi also features in the list of largest active ETF providers, primarily, though, through one product, the money market Lyxor Smart Overnight Return ETF. The firm also offers three multi-asset active ETFs, which it adopted from the Lyxor acquisition. At the time of writing, Amundi had not indicated plans to launch additional active ETFs and argued that the appetite for such products in Europe was still very limited in its view.

Last but not least, industry behemoth iShares came in later to the party with two new fund launches in April 2024 and even more in the hopper. The new products tick several boxes in terms of intercepting emerging industry trends, from the integration of sustainability factors to an outcome-based investment approach. The firm offers two income-oriented active equity ETFs targeting the global and US markets. The strategies are run by the firm's systematic equity group and employ a quantitative process that combines a proprietary "dividend rotation" model with an option and future overlay in order to target a steep yield of 7% and a market beta of 0.9. While the strategies adopt a relatively complex process, they also seize on the recent success and popularity of options-based strategies.

Exhibit 6 10 Largest Active ETF Providers in Europe

Provider	AUM (EUR Bil)	No of ETFs	Market Share (%)
JPMorgan	13.6	25	44.2
PIMCO	4.5	6	14.6
Fidelity	3.4	11	11.1
Amundi	3.0	4	9.9
Natixis	1.2	4	3.9
HSBC	1.1	1	3.4
AXA IM	1.0	5	3.4
Vanguard	0.9	4	2.8
Franklin Templeton	0.7	6	2.2
Xtrackers	0.6	2	2.0

Source: Morningstar Direct. Data as of March 31, 2024.

A Deeper Dive Into Existing Offerings

Not all active strategies are well suited to an ETF wrapper. The key limiting factors boil down to transparency and capacity. Active managers tend to closely guard their "secret sauce," and as a result, there are practically no concentrated, high-conviction active strategies available in an ETF format. Transparency in itself is not a structural impediment, though. Either changes in the regulatory framework or simply market participants getting more comfortable with the disclosure requirements could potentially lead to wider adoption of high-conviction strategies with full transparency.

Capacity refers to the fact that ETFs cannot be closed to new investors in the event that the asset base becomes so large that it could endanger the manager's ability to add value through active management. As a result, only very scalable strategies, invested in instruments with deep liquidity, are suitable for active ETFs. The ease of access can also potentially mean a more volatile asset base, which can represent a headache for portfolio managers, meaning that active ETF strategies need to be designed in such a way to withstand rapid inflows and outflows. On the plus side, though, the share creation/destruction process inherent in the ETF format protects investors from extreme liquidity shocks. The trading activity in ETFs often takes place in the secondary market and doesn't involve any direct transactions in the funds' underlying components. Even in a mass-liquidation scenario where ETFs' prices fall below their net asset value, market makers can step in to exploit the arbitrage opportunity, thus restoring the supply/demand balance.[2].

Relative to their index-tracking counterparts, active ETFs have the benefit of flexibility in security selection and portfolio construction. As a result, they solve an inherent limitation of strategic-beta products—that is, the lack of adaptability to changing market conditions. Strategic beta is a form of active management, but it takes a hardcoded, rules-based, formulaic approach to portfolio management. Hence, asset managers entering the active ETF space have mostly focused on areas where active management has a reasonable edge against both passive investments and, more broadly, indexed products.

Investors typically associate ETFs with low fees—and that view is hard to shake. This means active managers are nudged to offer competitively priced products, which typically implies more-constrained strategies with lower potential for excess returns relative to a traditional passive, market-cap approach. Moreover, product launches have also been focused in areas where demand is hot, such as sustainable investing. In fact, around 80% of the active ETFs in our cohort are classified as either SFDR Article 8 or Article 9. As ESG regulation continues to evolve, active ETFs' flexibility means they are better suited to adapt to the increasingly stringent requirements mandated by regulators, compared with passive options, which automatically follow index rules.

Taken together, these factors sketch out the typical profile of the active ETF: cheap, liquid, scalable, transparent, sustainable, and benchmark-aware. These traits often rhyme with "shy actives" constructs. Scalability also implies that asset managers often employ some form of systematic rules in their investment processes, even if discretionary inputs are still relevant. Similarly, many are designed as core building blocks of an asset-allocation framework. All the major European categories are represented, with some exceptions such as global large-cap growth, global large-cap value, Europe ex-UK equity, and global emerging-markets bond-local currency, where there are no available options at the time of writing.

Thus far, thematic funds account for a relatively small proportion of overall assets under management among European active ETFs. However, active management seems ideally suited for thematic investing given the inherent difficulty of constructing robust thematic indexes. Additionally, since many active thematic funds currently available in the market charge very high fees, there could be a place for active ETFs priced more reasonably. Similarly, in the income investing space, active strategies have generally had decent success rates and maintain a strong leadership in terms of market share. Active ETFs could thus represent a major improvement relative to passive and strategic-beta products.

So far, most active ETF strategies are unique: In the European market, we find only one active ETF applying a strategy already available in a mutual fund format (JPM UK Equity Core, GB00B55QSH09). As a result, a "wrapper-agnostic" future, whereby strategies are offered across a variety of vehicles, seems still distant. For the time being, mutual funds and active ETFs appear to have found a peaceful coexistence, with specific strategies and asset classes best suited for one wrapper or the other.

2 Johnson, B. 2019. "ETFs Add Liquidity to the Bond Market, Not Risk." Morningstar. Oct. 4, 2019. https://www.morningstar.com/etfs/etfs-add-liquidity-bond-market-not-risk

Lastly, the ownership analysis reveals that fund-of-funds managers are an important target market for active ETFs. By far the most popular product, JPM US Research Enhanced ESG ETF is present in 130 portfolios, including multi-asset funds from multiple providers (such as Erste Bank, Santander, and Generali) across various domiciles in Europe and Asia. In some cases, though, these products are used by other in-house teams, such as Fidelity's target-date range utilizing its research-enhanced lineup as core portfolio building blocks, or Pimco's funds leveraging the short maturity ETF for cash-management optimization.

Exhibit 7 Most Owned European Active ETFs

Name	Number of Portfolios Owning the Active ETF	Average Portfolio Weight
JPM US Research Enh Eq ESG ETF USD Acc	130	5.8
JPM Europe Rsrch Enh Eq ESG ETF EUR Acc	84	3.9
JPM Global Rsrch Enh Eq ESG ETF USD Acc	71	5.2
Lyxor Smart Overnight Return ETF C EUR	37	4.6
JPM Global EM Rsh Enh Eq ESG ETF USD Acc	35	5.3
JPM EUR Ultra-Short Income ETF EUR Acc	33	4.1
Fidelity Sust Rsh EnhPacexJpnEqETFUSDAcc	31	1.4
Fidelity Sust Rsh Enh Jpn Eq ETF JPY Acc	29	2.6
Pimco USD Short Mat ETF	21	3.8
Ossiam ESG Shiller BarclaysCAPE USETF1A$	20	2.6
HSBC Multi Factor Worldwide Eq ETF	19	6.5
Franklin Sustainable Euro Green Bond ETF	17	3.1
Franklin Euro Short Maturity ETF	15	3.9
JPM EUR CorpBd RshEnh ESG ETF EUR Acc	13	3.2
Fidelity Sust Rsh Enh EM Eq ETF USD Acc	11	5.4
JPM Japan Rsrch Enh Eq ESG ETF USD Acc	11	3.3
Invesco Quant Strats ESGGlbEqMFETFUSDAcc	10	4.6
Pimco Euro Short Mat ETF EUR Inc	9	2.1
Fidelity Sust Rsh Enh US Eq ETF USD Acc	7	18.7
JPM AC APAC exJPRshEnhIdxEq(ESG)ETF$Acc	7	0.9

Source: Morningstar Direct. Data as of March 31, 2024, based on most recently available portfolio data.

Equity: Young, Irish, and Shy

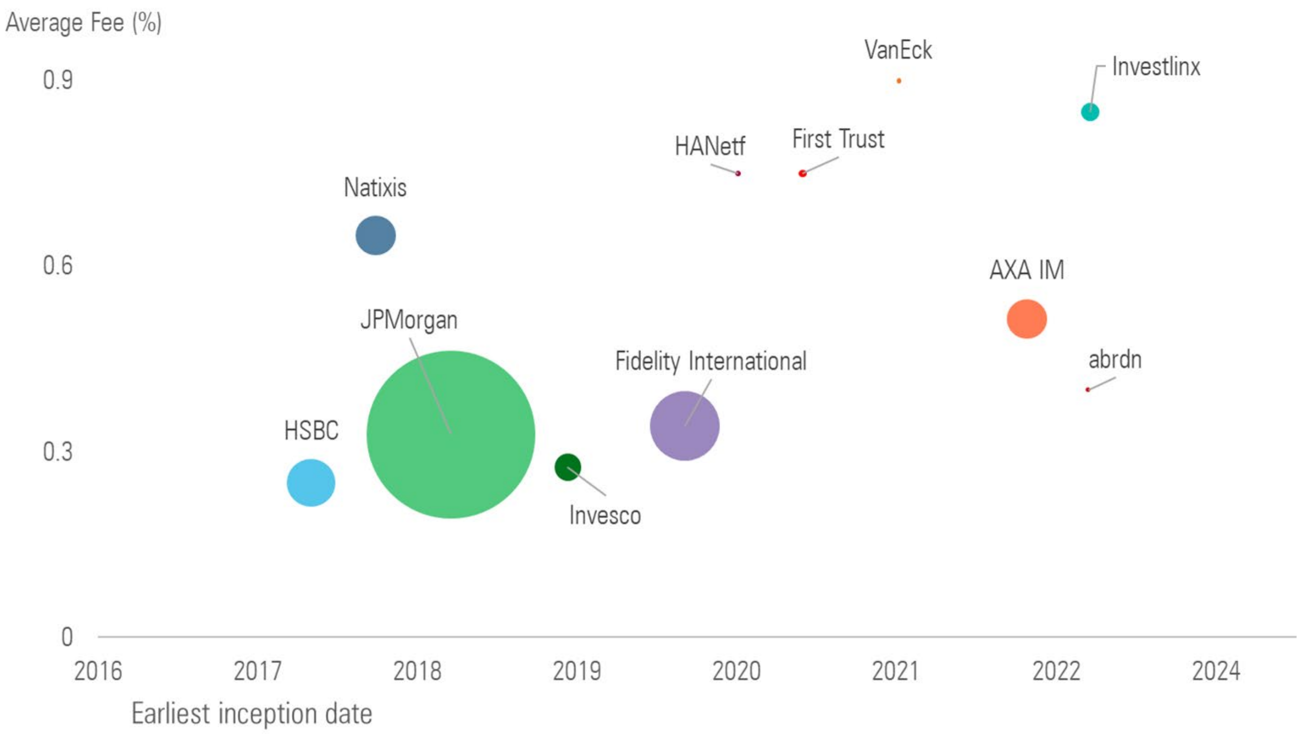
While in the US market high-conviction strategies don't fear the ETF structure, the European universe features much fewer high-octane, concentrated strategies. ARK's April 2024 debut in the UCITS market bucks this trend, yet thus far ARK seems to be the exception rather than the norm. In fact, the median European active ETF investing in equities held more than 150 individual stocks in its portfolio as of the end of 2023. (To put things in perspective, the median active fund in the global large-cap blend Morningstar Category held around 70 stocks.) Three fourths of the active ETFs were launched in 2020 or later, which makes for a still relatively young cohort. All equity vehicles are domiciled in Ireland, and the vast majority explicitly integrate ESG factors in their processes and are therefore tagged by Morningstar as sustainable investments.

The following exhibit shows how the market has evolved by mapping out the earliest active ETF inception date by fund company as well as the average fee across the fund range, with the size of each bubble representing the overall AUM across the respective lineup.

The market seems so far divided in two broad clusters. On one hand, a group of cheap, low-tracking-error products often intended to provide a broad, core exposure to the market segment: HSBC, JPM, Fidelity, and Invesco stand out in this area. JPM's and Fidelity's ranges, for instance, primarily consist of a range of region-specific, research-enhanced strategies that share several similarities, from the relatively low base fees to the benchmark-constrained portfolio construction approach. The tight constraints offer a less punchy entry point for investors and allow for greater scalability, whereas the low fees make it more competitive against both traditional active and passive propositions.

The second cluster includes more niche and expensive products that have mostly been launched in the last two years. These comprise several thematic strategies such as the AXA Biodiversity and Climate Equity strategies, as well as the style-focused JPM US Value and Growth ETFs.

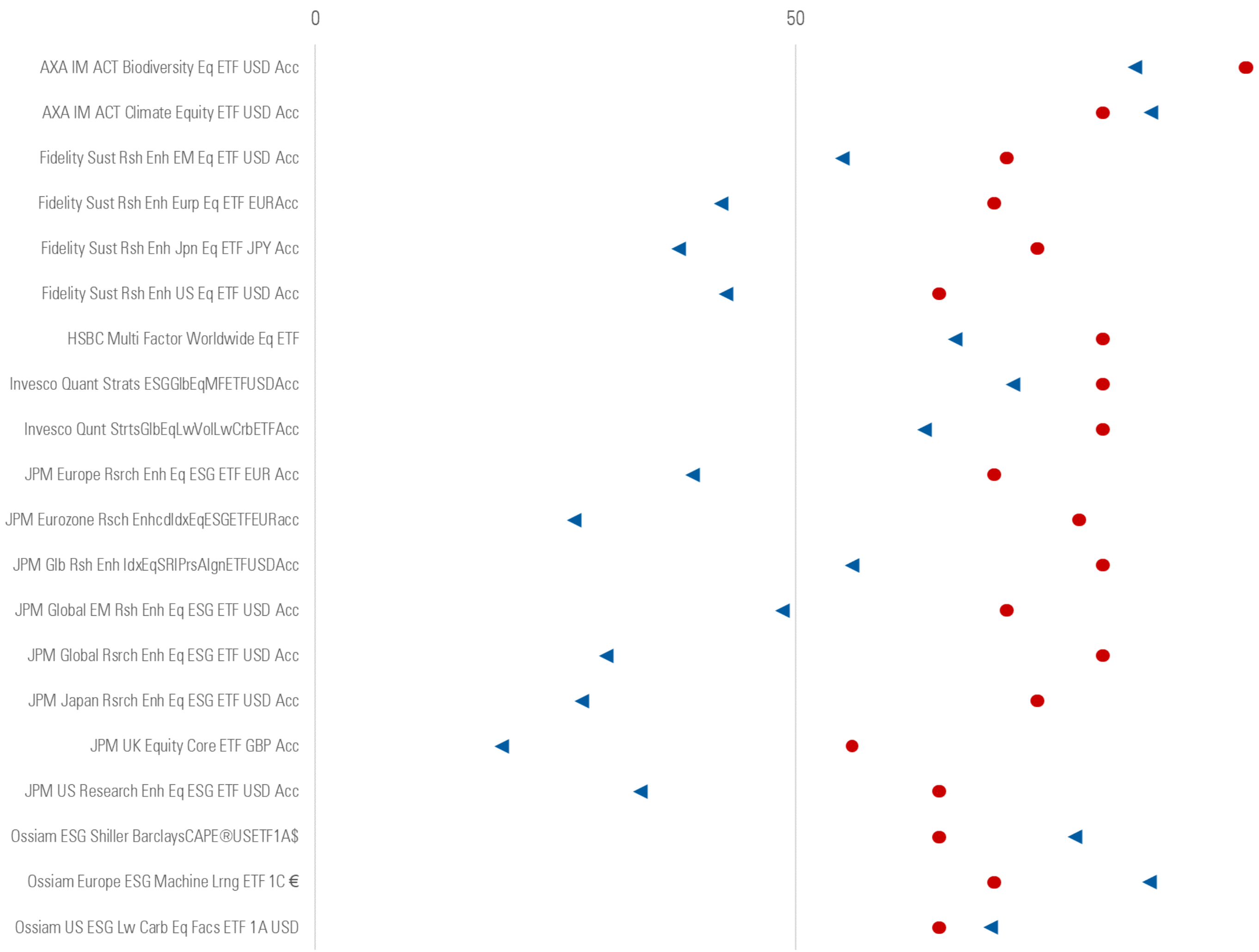
Exhibit 8 Active ETFs Earliest Inception Date, Average Fees, and Asset Size (Bubble) by Firms in the Equity Arena



Source: Morningstar Direct. Data as of April 1, 2024. Earliest inception date refers to the date when strategies became active as some vehicles were repurposed from passive ETF vehicles. Only live ETFs included.

It is also worth examining the average historical active share of the largest 20 equity active ETFs against a category-specific, representative passive ETF. This is depicted in the next exhibit, where each individual ETFs' active share, represented by the blue triangles, is compared with the median active share exhibited by active funds in the same category (the red dots), which helps contextualize active share according to the level that is most typical in the specific asset class. The data confirms that most strategies tend to be "shy active" and follow a more benchmark-aware approach than most active peers, as most of the blue triangles are located on the left of the red dots—with half of the ETFs in this sample displaying active shares of less than 50%. Unsurprisingly, thematic and more narrowly focused strategies tend to exhibit larger active share relative to the broad indexes used as yardsticks.

Exhibit 9 Active ETF Average Active Share (in Blue) vs. Peer Group Median's Active Share (in Red)



Source: Morningstar Direct. Data as of April 1, 2024. Peer group's active share represents trailing three-years average.

Allocation: The ETF Squared

Multi-asset investing is an area where lower-cost active ETFs can have a disruptive role, especially since so few traditional active managers manage to beat their own benchmark after fees (see this paper and this paper). Benchmarking multi-asset funds is a challenge in itself. There’s hardly a single, universally accepted, investable index, as active decisions cannot be escaped—from the asset split to the rebalancing frequency. For that reason, passive investing has historically represented a small niche in this arena, and active ETFs are thus a potential disruptor.

European multi-asset active ETFs essentially take the form of ETF squared—that is, ETFs of ETFs. The underlying ETFs are typically in-house, passive vehicles, with the typical active ETF holding anywhere from 10 to 20 strategies. The "ETF Squared" format gets around a significant challenge for asset managers: Multi-asset ETFs constructed using individual underlying securities such as stocks and bonds require tapping into both equity and fixed-income market makers to exchange ETF shares for baskets of underlying ETF securities. As such, the need to contract across multiple asset classes for creating and redeeming shares adds a layer of complexity that makes it difficult for market makers to arbitrage, resulting in potentially wider bid-ask spreads. An ETF of ETFs circumvents this difficulty by only trading in shares of the underlying ETFs.

Four major players now dominate this small field. DWS was the first entrant, offering two balanced active ETFs funds more than a decade ago. Then in 2020 came BlackRock (whose active ETF products were recently rebranded as iShares) and Vanguard. Their respective ranges share several similarities, offering a globally diversified, one-stop solution spanning multiple asset classes, with strategic asset-class splits in accordance with their target risk. Amundi essentially acquired the products in the Lyxor deal— as those were originally launched by Commerzbank's ETF arm ComStage.

The relative cheapness of the iShares and Vanguard ranges represents a major edge relative to traditional multi-asset funds and makes them potentially enticing for do-it-yourself investors. However, in many European countries, multi-asset funds are often the home turf of local players, heavily dependent on commission-based remuneration models. These firms have little incentive to endanger their existing fund range and the high costs they charge on active mutual funds. Indeed, the largest active multi-asset ETF in our cohort had less than EUR 600 million in assets under management at the end of March 2024, which is a long way from the largest open-end fund players in the field.

Exhibit 10 European Multi-Asset Active ETFs

Name	Morningstar Category	Inception Date	Fund Size (Mil)	Ongoing Costs (%)
Amundi Multi-Asset Prtf Defen ETF Dist	EUR Moderate Allocation - Global	March 7, 2018	25	0.38
Amundi Multi-Asset Prtf ETF Dist	EUR Moderate Allocation - Global	April 12, 2016	183	0.42
Amundi Multi-Asset Prtf Offen ETF Dist	EUR Aggressive Allocation - Global	March 7, 2018	19	0.49
Investlinx Balanced Income ETF	EUR Moderate Allocation - Global	Feb. 27, 2023	41	0.85
iShares Conservative Ptf ETF EUR Acc	EUR Cautious Allocation - Global	Sept. 8, 2020	16	0.26
iShares Growth Portfolio ETF EUR Acc	EUR Aggressive Allocation - Global	Sept. 8, 2020	54	0.28
iShares Moderate Portfolio ETF EUR Acc	EUR Moderate Allocation - Global	Sept. 8, 2020	35	0.27
Vanguard LifeStrategy 20% Eq ETF EUR Acc	EUR Cautious Allocation - Global	Dec. 8, 2020	60	0.25
Vanguard LifeStrategy 40% Eq ETF EUR Acc	EUR Moderate Allocation - Global	Dec. 8, 2020	125	0.25
Vanguard LifeStrategy 60% Eq ETF EUR Acc	EUR Moderate Allocation - Global	Dec. 8, 2020	341	0.25
Vanguard LifeStrategy 80% Eq ETF EUR Acc	EUR Aggressive Allocation - Global	Dec. 8, 2020	423	0.25
Xtrackers Portfolio ETF 1C	EUR Moderate Allocation - Global	Nov. 27, 2008	569	0.71
Xtrackers Portfolio Income ETF 1D	EUR Cautious Allocation - Global	Feb. 4, 2011	65	0.65

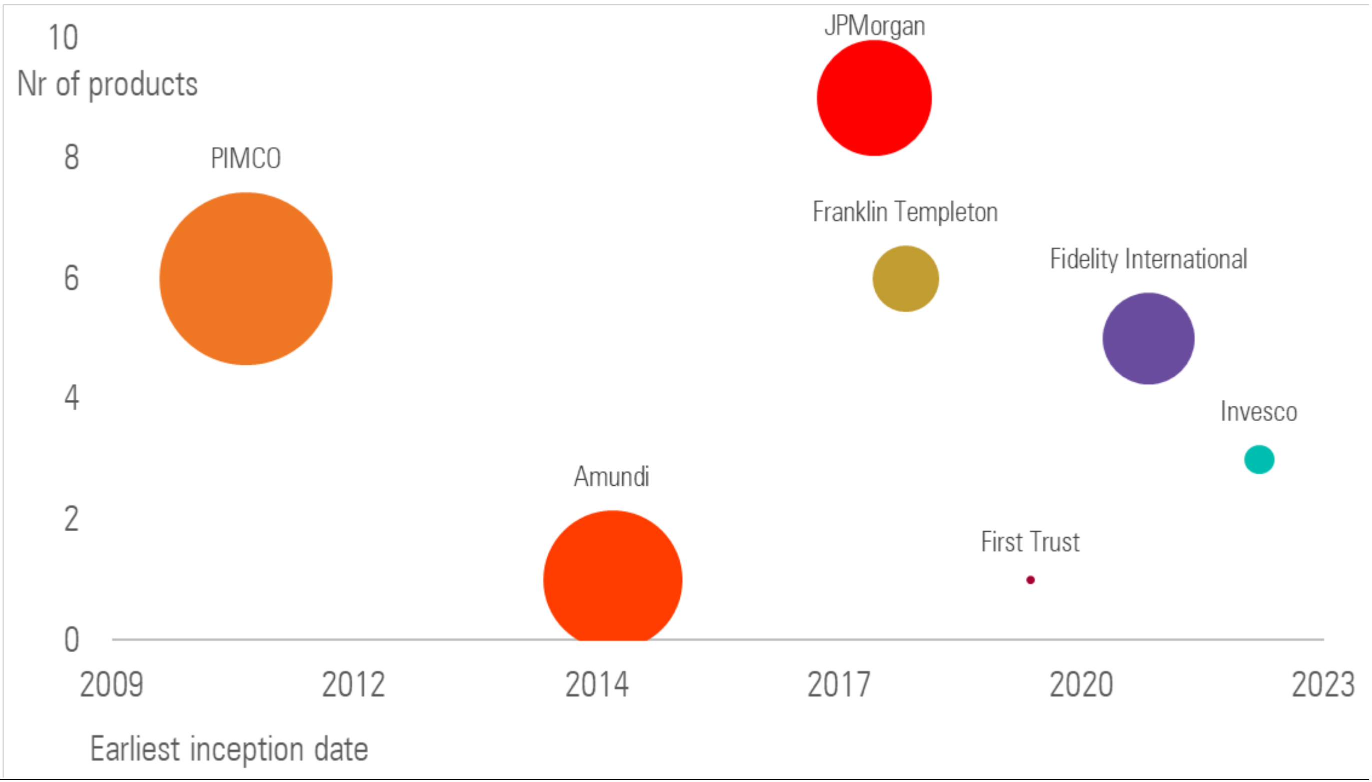
Source: Morningstar Direct. Data as of April 1, 2024.

Fixed Income: Short-Term Credit Reigns

Since active management as a whole tends to be more prevalent in the fixed-income arena, it's also no surprise that active ETFs first developed in this asset class, initially with a focus on the most liquid part of the universe: short-term bonds. Particularly in an environment of low (even negative) rates on the front end of the curve, active management held some promise for slightly better returns compared with a pure indexing approach. Even today, more than two thirds of fixed-income active ETF assets are invested in short-term strategies, and the menu only recently expanded to include other categories such as European corporate bonds or high yield. Additionally, strategies with an ESG focus are overrepresented in this cohort, a similar phenomenon to what we have observed in the equity space. Finally, there is a striking presence of multifactor corporate credit strategies, which take systematic exposure to factors like quality, value, momentum, size, and so on. These rules-based products sit somewhere at the confines of both active and passive management.

Overall, most of the assets in this cohort have accrued to existing bond behemoths Pimco, Amundi, and J.P. Morgan, suggesting that a successful prior track record in fixed-income strategies is key to scaling assets.

Exhibit 11 Fixed-Income Active ETFs Earliest Inception Date, Product Range, and Total AUM (Bubble) by Firm



Source: Morningstar Direct. Data as of April 1, 2024.

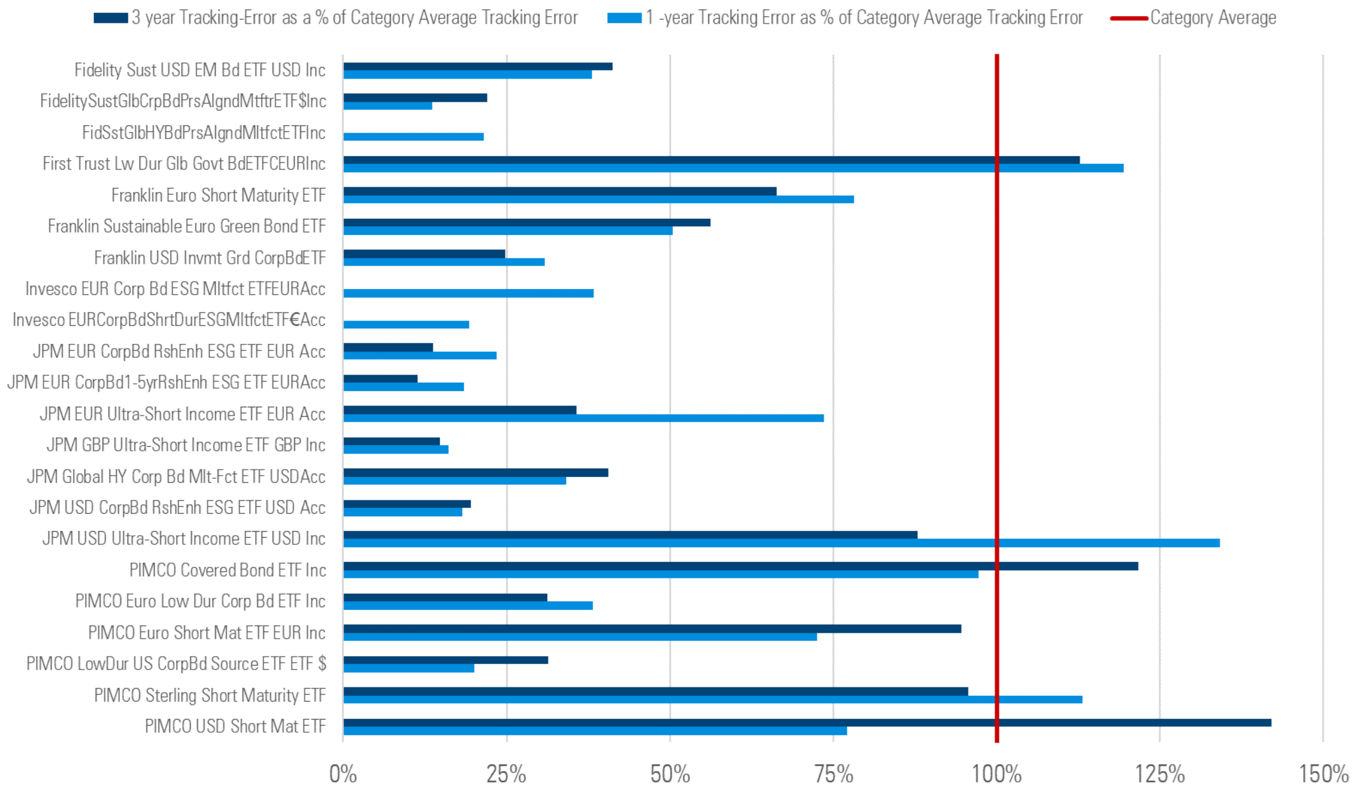
The key takeaway from our data is that active fixed-income ETFs also exhibit "shyness" in terms of active risk-taking. Active share analysis is not as straightforward in the bond universe, but looking at a strategy's typical tracking error to its stated prospectus benchmark can be an indication of the degree to which its managers are willing to deviate. The chart below takes each fund's one- and three-year tracking error (where available) versus its prospectus benchmark's and rescales it to the average tracking error of active open-end funds in its respective category. For example, Fidelity Sust USD EM Bd ETF's one-year tracking error of 1.66% is much lower than the one-year tracking error of the average fund in its global emerging-markets bond Morningstar Category (4.37%): The ratio of its tracking error to the category average tracking error is around 38%. Based on this metric, most active ETFs show a lower level of active risk than their active open-end fund counterparts. (Some exceptions are notable for funds that are an odd fit with their peer group, such as the Pimco Covered Bond ETF, which sits in the EUR corporate bond category but focuses specifically on covered bonds.)

Like in equities, high-conviction active ETFs are difficult to find. In many cases, the ETF format hosts a lower-alpha, lower-conviction version of an existing strategy from the same fund company. Fund name similarities can be misleading. For example, AXA IM US High Yield Opportunities (AHYU) leverages to an extent the strong bottom-up research conducted by the managers of the AXA WF US High Yield Bond fund (ISIN: LU0276015889, whose Process Pillar is currently rated Above Average by Morningstar analysts). But, despite including "opportunities" in its name, usually a sign of a higher-octane approach, the ETF's portfolio consists of almost 300 issuers—compared with less than 200 in the original fund. Meanwhile, its assets under management, at EUR 50 million currently, are only a fraction of the open-end fund's EUR 1.8 billion. Given the liquidity challenges inherent in the high-yield space, a more diversified approach is probably inevitable when choosing the ETF format, but that also implies that active ETF investors should probably moderate their excess return expectations.

Pimco's USD Short Maturity ETF (MINT) is also a more constrained version of Pimco GIS US Short Term Bond (IE00BMTRWY37): It steers clear of the non-investment-grade paper, non-US bonds, and currencies that its open-end counterpart occasionally uses. Despite this, Morningstar analysts have assigned Pimco USD Short Maturity ETF a High Process Pillar rating, as it features sufficient strengths to sit among our preferred options in its peer group.

Finally, fees range widely in this cohort, from 4 to 49 basis points per year, levels that are overall significantly lower than those of active open-end funds. At the cheapest end of the spectrum, J.P. Morgan's range of research-enhanced ESG European corporate bond strategies is priced more aggressively than many passive ETFs. The low-fee approach taken here is consistent with the funds' low alpha generation ambitions.

Exhibit 12 Average Active ETF One-Year and Three-Year Tracking Error as a % of Category Average Tracking Error



Source: Morningstar Direct. Data as of March 29, 2024

Mortality Looms

One persistent issue plaguing the active fund landscape is the large number of offerings that get liquidated or merged over time. This is usually a product of waning investor interest or because fund companies restructure their fund ranges, or in many cases, it is collateral damage when an asset manager encounters financial woes or merges with a competitor. Our data shows that in the global large-cap blend equity category, for example, only 35% of active funds survived (that is, were not liquidated or merged away) the trailing 15-year period through December 2023. By contrast, passive ETFs tend to have more staying power: 53% of them were still alive at the end of that same 15-year period. Other Morningstar Categories, such as global bond, illustrate the same pattern. Overall, these survival odds make passive ETFs more straightforward building blocks for long-term allocation portfolios.

Exhibit 13 List of Active ETFs Liquidated Since 2007

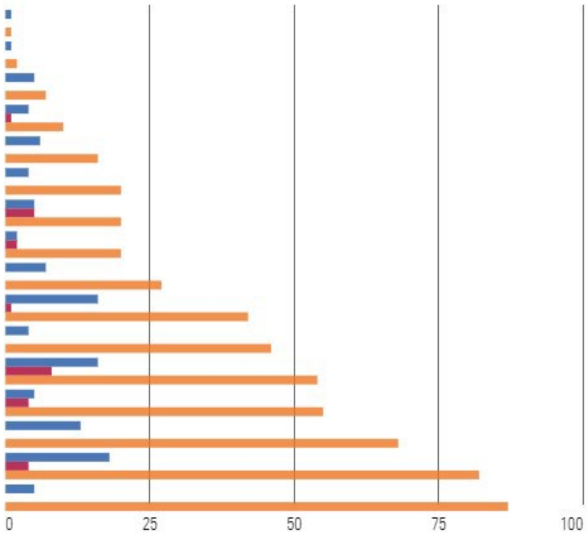
Name	ISIN	Global Broad Category Group	Inception Date	Obsolete Type	Obsolete Date	Total Ret % Rank Cat 1 Yr trailing before liquidation	Total Ret % Rank Cat 3 Yr trailing before liquidation
Alpha Dividende Plus ETF	DE000ETF7508	Equity	7/1/2016	Merged	12/11/2020	90	94
BayernInvest DE Msanleihen ETF AL	LU0903441706	Fixed Income	4/2/2013	Merged	8/3/2015	68	
BMO Enhanced Income Euro Equity ETF	IE00BF1K7917	Equity	7/7/2017	Liquidated	1/21/2020	33	
BMO Enhanced Income UK Equity ETF	IE00BF1K7800	Equity	7/7/2017	Liquidated	1/21/2020	62	
BMO Enhanced Income USA Equity ETF	IE00BF1K7792	Equity	7/7/2017	Liquidated	1/21/2020	51	
CBK Europe SectorTrend ETF I	LU0861096898	Equity	6/24/2013	Liquidated	4/21/2023	95	95
ComStage Alpha Dtschl Dividende Plus ETF	DE000ETF7516	Equity	12/14/2017	Merged	8/5/2020	89	
HSBC Economic Scale Worldwide Equity ETF	IE00BKZG9Y92	Equity	6/25/2014	Liquidated	9/21/2020	68	51
JB Smart Equity ETF Asia S-EUR	LU0747924560	Equity	3/30/2012	Liquidated	9/25/2015	51	45
JB Smart Equity ETF Emerg Mkts S-USD	LU0747924057	Equity	3/30/2012	Liquidated	9/24/2015	86	85
JB Smart Equity ETF Europe S-EUR	LU0747923752	Equity	3/30/2012	Liquidated	9/24/2015	35	12
JB Smart Equity ETF World S-USD	LU0747923083	Equity	3/30/2012	Liquidated	9/24/2015	60	42
JPM Equity Long-Short ETF USD Acc	IE00BF4G7308	Equity	11/8/2017	Liquidated	6/19/2020		
JPM Managed Futures ETF USD Acc	IE00BF4G7290	Alternative	11/8/2017	Liquidated	11/17/2020		
JPM RMB Ultra-Short Income ETF USD Acc	IE000RE0WX27	Fixed Income	3/1/2022	Liquidated	12/12/2023		
Lyxor ETF Wise Quantitative Strategy	FR0010540690	Equity	12/3/2007	Liquidated	9/4/2012	66	54
Nordea Global EM Equities UCITS ETF	FI4000064282	Equity	9/25/2013	Liquidated	10/14/2016	16	51
Nordea Stable Equities UCITS ETF	FI4000064274	Equity	9/25/2013	Liquidated	10/14/2016	9	4
Ossiam World ESG Machine Lrng ETF 1A EUR	IE00BF4Q4063	Equity	11/26/2018	Liquidated	4/20/2023		
Saturna Sustainable ESG Eq HANzero ETF	IE00BMGRZP89	Equity	7/7/2021	Liquidated	4/11/2023		
UBS ETF MAP Balanced 7 SF EUR A acc	IE00BTFR5140	Allocation	2/5/2015	Liquidated	6/21/2018	5	96
Vanguard Glb Liqd Fac ETFShrUSDAcc	IE00BYYR0D71	Equity	12/9/2015	Liquidated	2/26/2021	71	44
Vanguard Glb Min Vol ETFShr USDAcc	IE00BYYR0C64	Equity	12/9/2015	Liquidated	2/26/2021		
Vanguard Glb Momt Fac ETFShrUSDAcc	IE00BYYR0935	Equity	12/9/2015	Liquidated	2/26/2021	24	18
Vanguard Global Val Fac ETFUSDAcc	IE00BYYR0B57	Equity	12/9/2015	Liquidated	2/26/2021	84	86

Source: Morningstar Direct. Data as of March 29, 2024.

While the cohort of active ETFs in Europe is still too small to draw any definitive conclusions, it's fair to say that mortality isn't an uncommon scenario. Our data shows 25 active ETFs launched between 2007 and 2021 have already been merged or liquidated, an overall mortality rate of around 23%. On average, these ETFs were shut down three and half years after launch, with most products failing to reach critical mass (size over EUR 100 million) over their life span.

Exhibit 14 Number of European Active ETF Launches, Closures by Year

Year	Launched	Closed	Total as of Year End
2007	1	0	1
2008	1	0	2
2011	5	0	7
2012	4	1	10
2013	6	0	16
2014	4	0	20
2015	5	5	20
2016	2	2	20
2017	7	0	27
2018	16	1	42
2019	4	0	46
2020	16	8	54
2021	5	4	55
2022	13	0	68
2023	18	4	82
2024	5	0	87



Source: Morningstar Direct. Data as of March 31, 2024.

Similar to active open-end funds, these closures tended to affect ETFs that failed to attract meaningful assets, such as JPMorgan's RMB Ultra-Short Income ETF (launched in 2022, liquidated in 2023), and thus were unprofitable to maintain. They have also affected thematic strategies, such as Ossiam World ESG Machine Learning ETF (launched in 2018, liquidated in 2023), in a grim reminder of how difficult such niche strategies are for investors to use. Vanguard's global factor ETF range (launched in 2015) also stagnated for years at a subscale asset level, and poor relative performance for its global value and liquidity factor ETFs in 2020 might have accelerated their liquidation in 2021. Another example is HSBC's Economic Scale Worldwide Equity ETF (launched in 2014), which used countries' and regions' GDP-weighting instead of market-weighting. Interestingly, this ETF reached assets of EUR 900 million within one year after launch, making it the largest in our cohort (at peak). However, its value tilt was a drag on relative performance, and the fund was liquidated in 2020, right before the value style made a comeback.

In some cases, this also illustrates the difficulty of some fund companies to continue operating as ETF providers, with the cost and infrastructure that it entails. BMO, for instance, decided to withdraw from the European ETF market in 2020. Nordea also launched a small ETF range in 2013 in hopes of broadening the appeal of its active strategies across European borders—an experiment that proved to be too early and was abandoned in 2016.

Investors in active ETFs can mitigate this mortality risk in much of the same way as active investors more generally: by choosing established products in core, traditional asset classes, focusing on asset managers that are financially stable and have tended to manage their fund ranges responsibly, and avoiding funds launched on gimmicky themes or fads.

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