Inside First Trust ETFs

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What's Behind the Rise of Actively-Managed ETFs?

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Historically, the exchange-traded fund ("ETF") industry has been dominated by passively-managed (passive) investments, but over the past few years, actively-managed (active) ETFs have gained a foothold. One catalyst for this turn of events was the Securities and Exchange Commission's ("SEC") adoption of a new regulatory framework in 2019 (the "ETF Rule"), which made it easier for fund managers to launch active ETFs.[1] However, this doesn't explain the increase in demand for these ETFs, which occurred even as active open-end funds faced massive redemptions. Below, we discuss some of the factors that we believe have led to increased adoption of active ETFs, highlighting why we believe this trend is still in its early stages.

Fixed Income

Actively-managed fixed-income ETFs had $195 billion (13% market share) in assets under management ("AUM"), with trailing 12-month net inflows totaling $46 billion (23% market share), as of 3/31/24.[2] Interestingly, increased demand for active fixed-income ETFs materialized even before the ETF Rule was adopted in September of 2019. Over the three years ending on 9/30/2019, actively-managed ETFs accounted for 14% of fixed-income ETFs' net inflows.[3] Since then, that proportion (14%) has held steady.[4]

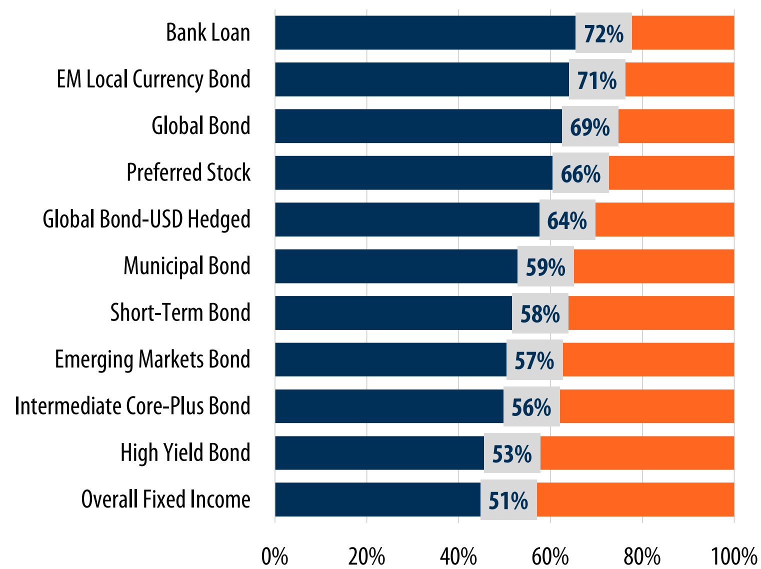
Truly Passive is Rare for Fixed Income

One reason for the early success of active management for fixed income ETFs may be that the traditional approach to passive investing—holding each security at approximately the same proportions as an ETF's underlying index—is quite rare for passive fixed-income ETFs, accounting for just 5% of assets.[5] Instead, most passive fixed-income ETFs seek to match the risk and return characteristics of a given benchmark by investing in a sample of its underlying securities. While there are practical reasons for this approach when it comes to fixed income, we believe sampling involves a series of active decisions about which individual securities to hold or avoid, which can sometimes result in undesired tracking error.

Performance Considerations

In our view, mediocre relative performance of many passive fixed-income ETFs is another key reason that demand for their actively-managed counterparts has increased. Overall, the average performance rank of passive fixed-income ETFs has been close to the midpoint of their respective categories over the past five years, but for several categories, the relative returns of passive ETFs have fared much worse (see nearby chart).[6] For example, the average return rank of passive ETFs in at least 10 fixed-income categories were higher than 50%, meaning that investors had a better-than-even chance of picking an active fund that outperformed the average passive ETF in that category.

Average Ranking of Passive Index ETFs: 5 Years (1% Best, 100% Worst)[6]



Past performance is no guarantee of future results.

The Importance of Active Risk-Management

Many of the fixed-income categories in which passive ETFs underperformed were those for which risk management is critical, in our opinion. For example, while managing credit risk may be beneficial for most fixed-income categories, we believe it's essential for those that focus on securities issued by below investment-grade borrowers, such as bank loan funds (a.k.a., senior loan funds) or high-yield bond funds. Similarly, while interest rate risk is a key driver of fixed-income returns in general, active managers in the preferred stock category may have added flexibility to address this risk, by increasing or decreasing exposure to fixed-rate, floating-rate, or fixed-to-floating rate securities. In our opinion, the ability to manage various dimensions of risk has been a key differentiator for active ETFs.

[1] The "ETF Rule" was adopted by the SEC in September of 2019 to modernize and standardize the framework for launching ETFs, including actively-managed ETFs.

[2] According to FactSet data, as of 3/31/24.

[3] According to Morningstar data, as of 3/31/24. Net asset flows measured for the 3-year period leading up to the adoption of the "ETF Rule" were from 10/1/2016 to 9/30/2019.

[4] According to Morningstar data, from 10/1/2019 to 3/31/2024.

[5] According to Morningstar data, as of 3/31/24.

[6] According to Morningstar data, as of 3/31/24. This chart shows the average performance ranking of passive fixed income ETFs from selected categories, from 4/1/19-3/31/24.

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Equity

Actively-managed equity ETFs had $381 billion (5.5% market share) in AUM, with trailing 12-month net inflows totaling $108 billion (21% market share), as of 3/31/24.[7] Unlike fixed income, the strongest inflows for active equity ETFs have come since the adoption of the ETF Rule in September of 2019. Over the prior three years, active ETFs accounted for just 1% of equity ETFs' net inflows; since then, the share of net inflows for active equity ETFs has risen to 12%.[8]

Flourishing Innovation Among Active Equity ETFs

In our opinion, one outgrowth of the ETF Rule has been a proliferation of new and innovative active equity ETFs. For example, a relatively new category known as "buffered ETFs" grew from $1.4 billion to $42.9 billion between 9/30/19 and 3/31/24.[9] Buffered ETFs generally provide exposure to the upside of a reference asset (usually a passive equity ETF or index), which is capped in exchange for a buffer against losses over a certain period. While these ETFs are actively-managed, their outcomes are generally pursued by investing in a series of options contracts linked to passive ETFs.

Another category of active equity ETFs that has attracted massive inflows over the past few years has been equity ETFs that seek to generate enhanced income by selling call options. Assets in active equity ETFs from Morningstar's "Derivative Income" category grew from $124 million to $55.4 billion between 9/30/19 and 3/31/24.[10]

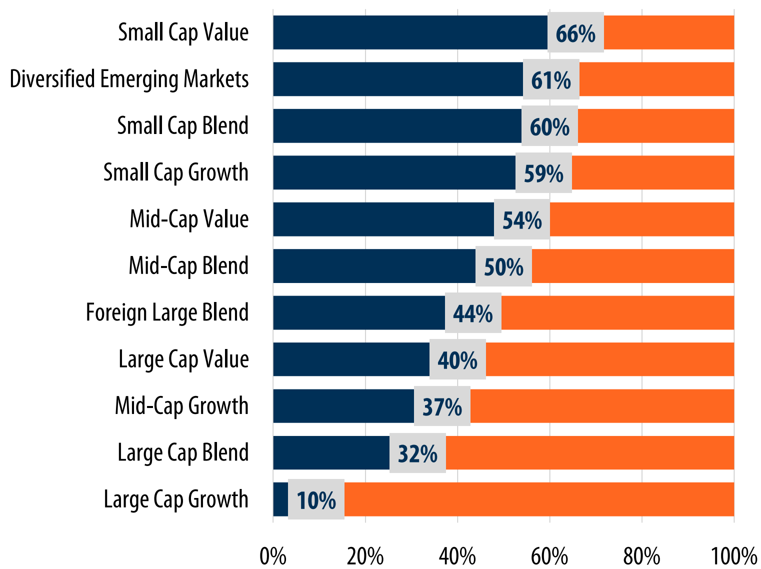
Tax-Efficiency

The potential for improved tax efficiency versus traditional open-end funds is another factor that has increased demand for active equity ETFs, in our opinion. This helps to explain why several fund managers have converted active open-end equity funds to ETFs over the past few years. In 2023, just 4.5% of active equity ETFs in Morningstar's "US Equity" fund category made a capital gains distribution, compared to 63% of active open-end funds from the same category.[11] Importantly, active equity ETFs were also generally more tax-efficient than passive equity open-end funds, 49% of which (in the US Equity category) made capital gains distributions in 2023.[12]

Performance Considerations

As was true for fixed-income ETFs, unexceptional performance for passive equity ETFs may be another reason that active equity ETFs have begun to capture market share. While passive ETFs from certain categories have produced better returns than most of their peers over the past five years, for several other categories, passive ETFs ranked worse than the midpoint of their respective peer groups (see nearby chart).[13]

Average 5-Year Return Rank of 3 Largest Passive ETFs by Category (1% Best, 100% Worst)[13]



Past performance is no guarantee of future results.

For example, passive small-cap ETFs (growth, value, and blend) and passive diversified emerging markets ETFs ranked notably worse than the midpoint of their respective peer groups. Conversely, passive large-cap ETFs (growth, value, and blend) ranked much better than the midpoint of their respective peer groups. In general, the data points to small- and mid-cap active managers outperforming more frequently than large-cap managers, over the last five years. Additionally, value managers tended to outperform their peer groups more frequently than blend and growth managers across each size. These trends may shift over time—as past performance is no guarantee of future results—but those seeking funds that have outperformed passive equity ETFs historically have numerous alternatives from which to choose.

The growth of active fixed-income ETFs and active equity ETFs followed slightly different paths, but both have gained significant market share over the past few years. While regulatory improvements have led to an increased supply of new and innovative active ETFs, we believe some of the key drivers of investor demand for these funds are a desire for better risk management, improved tax-efficiency, and the potential for outperformance. In our view, the growth of actively-managed ETFs may be just getting started.

[7]According to FactSet data, as of 3/31/24.

[8]According to Morningstar data, as of 3/31/24.

[9]According to FactSet data, as of 3/31/24.

[10]According to Morningstar data, as of 3/31/24.

[11]According to Morningstar data, as of 3/31/24.

[12]According to Morningstar data, as of 3/31/24.

[13]For this study, we compared the average 5-year performance rankings of the 3 largest passive ETFs tracking market cap weighted indices for each equity category. We did so to differentiate the performance of traditional passive equity ETFs from passive ETFs that track factor-based indices seeking to outperform traditional equity benchmarks.