Protecting the "secret sauce"

Blog

The actively managed ETF market in the US currently consists of over 260 ETFs that combine for roughly USD 77bn in assets. While the space continues to grow, it still only makes up 2% of US-listed ETF assets. Fixed income is the dominant segment accounting for 77% of assets.

I don't think it's a stretch to assume the main reason for the slower adoption of actively managed equity ETFs is the underperformance of actively managed equity funds. Another challenge is the availability of traditional, actively managed equity funds in the ETF space is more limited. One reason is many equity portfolio managers are concerned over the "front-running" of trades given actively managed ETFs have to disclose holdings on a daily basis.

There are a number of filings for nontransparent active exchange traded product structures that seek to block transparency (or preserve opacity for a more positive connotation) while capturing the advantages of the ETF wrapper around costs and tax efficiency. The first nontransparent active structure approved by the SEC was Eaton Vance's NextShares in November 2014 and the first NextShares product launched in February 2016. NextShares are a hybrid between an ETF and a mutual fund.

Earlier this week, the SEC approved another structure, ActiveShares from Precidian Investments. ActiveShares are ETFs. At a high level, the main difference between ActiveShares and traditional ETFs is there is one more layer to the creation/redemption process that keeps the portfolio's securities hidden. ActiveShares will have to disclose holdings on at least a quarterly basis, same as for mutual funds and NextShares. We think it's likely that products using the ActiveShares structure will be launched later this year.

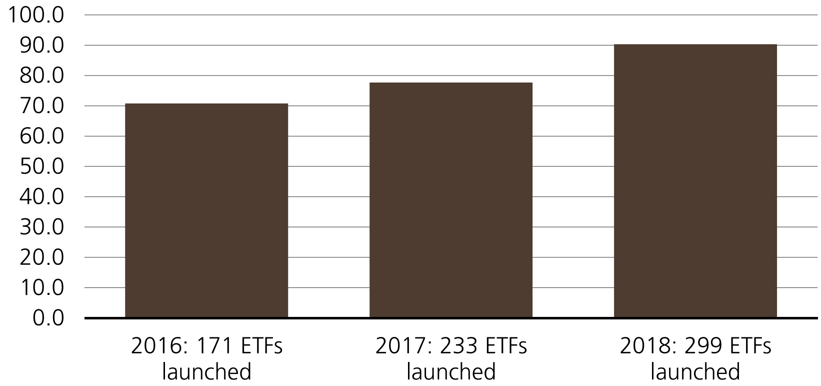
Both NextShares and ActiveShares are attempting to solve a problem for issuers. The end investor is not demanding less transparency from their investments. Based on what's happened with active equity mutual fund flows, they're also not demanding the traditional, actively managed exposure either. So there are hurdles for adoption. However, by making an investment more tax efficient and lowering costs, there are benefits for the end investor.

So will ActiveShares be successful?

To slightly modify a Rod Tidwell quote, "Show me the performance!" ETFs, mutual funds, ActiveShares, and NextShares are all just wrappers. Each has benefits and drawbacks. Outperform, and investors generally won't question the cost or the wrapper. My guess is that ActiveShares will have a similar experience to new ETF launches. Over the past three-years, more than 81% of the 700+ ETFs issued in the US have less than USD 100mn in assets. Some ActiveShares may be able to raise meaningful assets but there will likely be far more that do not. Successful launches will require both performance and distribution. As we've seen in the ETF space over the past years, having an established "in-house" asset base or a client partner as "ready-buyers" can improve the odds of success.

Fig. 1: Most new ETF launches have struggled to raise assets

% of US ETF launches that have less than USD 100mn in assets



Source: Morningstar Direct, UBS, as of 9 April 2019. Historical data does not include ETFs that have been liquidated.

David Perlman, ETF Strategist Americas, UBS Financial Services Inc. (UBS FS)

Appendix

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