Mixed forecast for active ETFs: Cerulli

By Editorial Staff *Thu, Dec 12, 2019*

ETF issuers are looking to develop more active products that can earn higher fees. Almost half of issuers say they are developing (20%) or planning to develop (27%) non-transparent active ETF products.

Non-transparent exchange-traded funds (ETFs) are gaining product development mindshare, but whether they prove an attractive distribution opportunity will depend on the products that firms choose to launch and the pricing strategies they pursue.

According to a new report from Cerulli Associates, *U.S. Exchange-Traded Fund Markets 2019: Expanding Beyond Passive*, the majority (80%) of ETF issuers estimate that non-transparent ETFs will gather between $1 billion and $100 billion by 2025, suggesting that these products will take time to gain traction.

The U.S. ETF industry continues to expand, but its growth rate has slowed. Assets grew at a compound annual rate (CAGR) of 15% over the five years ending in December 2018, but industry revenues grew only 11% annually on average over the same period.

Intense competition, particularly amongst the most commoditized products, has made launching passive ETFs less attractive to all but the largest firms. ETF issuers polled by Cerulli in 2019 were significantly more likely to report at least moderate impact on their firm’s margins due to industry fee compression (46% report moderate impact in 2019 vs. 25% in 2018).

As a result of both fee compression and product proliferation, ETF issuers are increasingly looking to develop more active products that can earn higher fee revenues. At the same time, traditional active managers are interested in entering the ETF landscape (active mutual funds overall have suffered outflows since 2015). But equity managers who want to conceal their holdings (to maintain strategy confidentiality) are wary of the transparency of the ETF vehicle.

Non-transparent ETF structures provide a solution for firms that want to offer active strategies in the ETF wrapper but not divulge holdings. According to Cerulli’s research, almost half of issuers state that they are currently developing (20%) or planning to develop (27%) non-transparent active ETF products. That would mean a momentous shift in a market where only about 2% of assets are currently actively managed.

Some of the largest asset managers are either signing non-transparent structure licensing agreements or launching their own. “Nontransparent active ETFs are a logical progression as the existing ETF market moves beyond passive exposures,” said Daniil Shapiro, associate director of product development at Cerulli Associates, in a release this week.

“It’s likely that more active products will provide a more lucrative battleground for ETF sponsors, with the average issuer reporting that they expect to earn a greater share of fees from more active offerings in several years,” he added.

Cerulli believes that non-transparent ETFs will gain traction, but that their adoption will be highly nuanced. Product choice and pricing will be the most significant challenges for asset managers to overcome. “Assuming that the non-transparent structures and associated infrastructure [support] their strategies, asset managers will have to decide whether their newly launched products should be clones, differentiated versions, or entirely different products when compared to their existing offerings,” according to Shapiro.

Concerns about over-saturating distribution partners and the cannibalization of existing products will affect their decisions. “Asset managers will find it difficult to offer their best products at an attractive price,” he said. “Low costs are a key success tenet for ETFs, so managers risk creating a self-fulfilling prophecy where launched products are slow to gain traction.”