Focus on Actively Managed ETFs: Expectations for Growth

By James McGowan, ETF Product Manager, J.P. Morgan

s the asset management industry evolves, innovative product options are being introduced to compliment traditional pooled vehicles. These rapidly emerging alternatives are influencing - and in some cases reshaping - the investment landscape. A forerunner in this race is Exchange-Traded Funds (ETFs) which are expanding individual investor access to asset classes and strategies once out of reach. ETFs allow investors to achieve asset allocation through portfolio diversification with lower costs, greater transparency and improved tax efficiency.

U.S. ETF assets have increased by 12 times over the past ten years, growing from \$88 billion in 2001 to \$1.2 trillion today. To put this in context, the current U.S. mutual fund market with over \$13 trillion is still the dominant form of investing in the U.S. However, the ETF market is rapidly growing with 44 investment advisors across 1,475 funds. New entrants are cautious given the majority of assets are controlled by the top three advisors. Nevertheless, ETFs have gathered nearly \$76 billion in new assets as of June 2012.

Industry research shows that looking forward; six trends will most likely support the continued growth of ETF assets:

- renewed focus on low investment
- a shift to fee-based advisory by financial advisors
- regulatory emphasis on transparency
- rising investor awareness of the product

- increased use by institutional investors
 - the ability to secure seed capital

It is also noteworthy that pricing pressure is increasing, with some of the latest broad-based ETFs charging 5bp expense ratios. At the same time, smaller players are designing specialized, innovative products that may find demand.

Alpha investors looking for greater than market returns could help recharacterize actively managed ETFs as the next mutual fund. With only 50 ac-

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tively managed ETFs listed in the U.S., representing over \$7bn in AUM, there is plenty of pent-up demand. New actively managed ETFs have been slow to come to market because of the long SEC approval process. The regulatory requirement for daily disclosure of portfolio holdings has skewed growth toward fixed income products which are more difficult to replicate and account for 75% of the AUM. A further challenge for newly launched actively managed ETFs is the need to be on the market for three years in order to be

eligible for Morningstar ratings. Nevertheless, the category is expected to grow with more than 34 new investment advisors having exemptive relief applications pending with the SEC. If active ETFs follow a similar acceptance as passive ETFs, it will likely motivate mutual fund managers to participate.

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