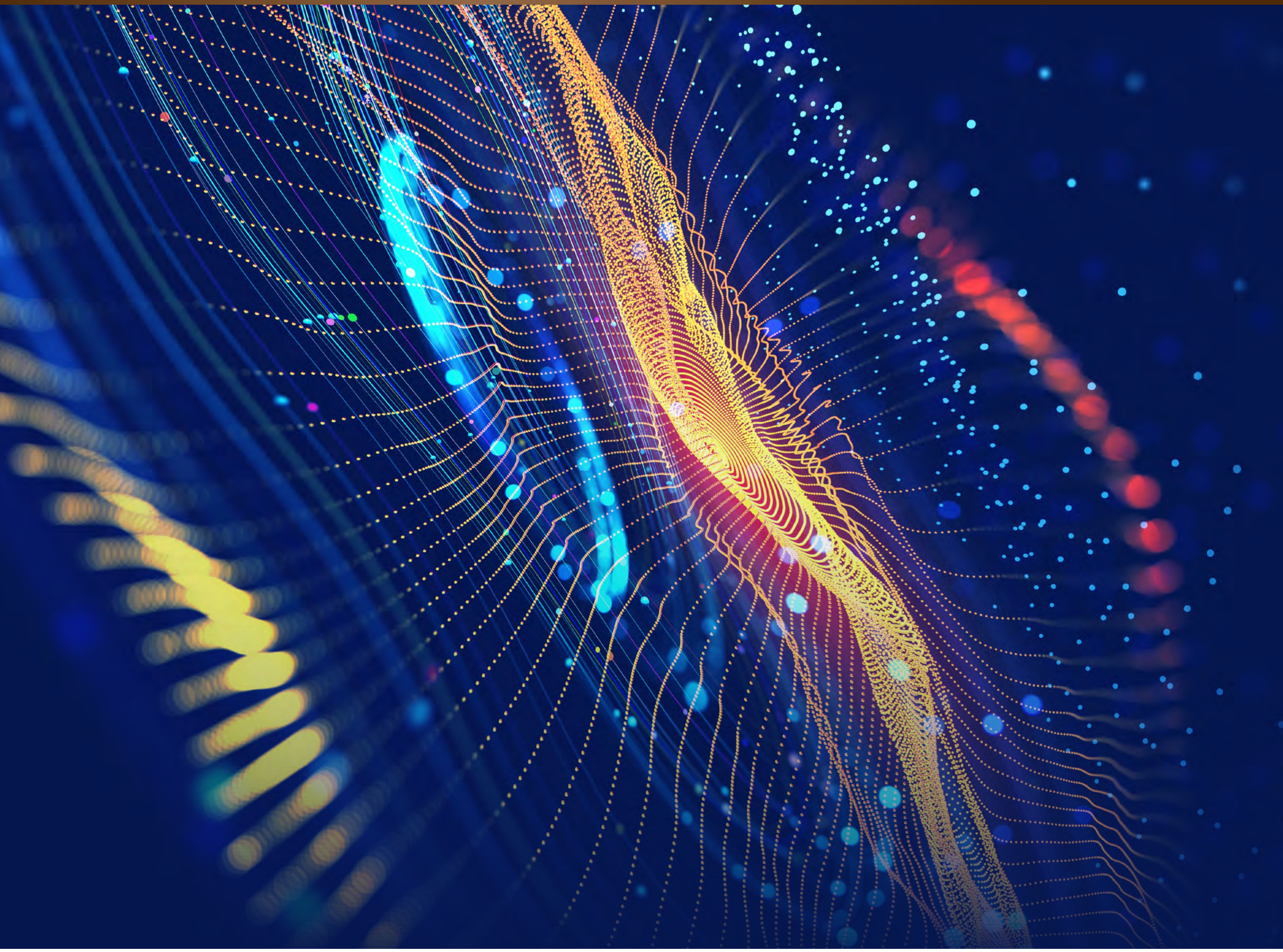
Amid Active ETF Rise, Issuers Seek to Meet Investors' Growing Needs

Asset manager considerations for building an ETF wrapper.



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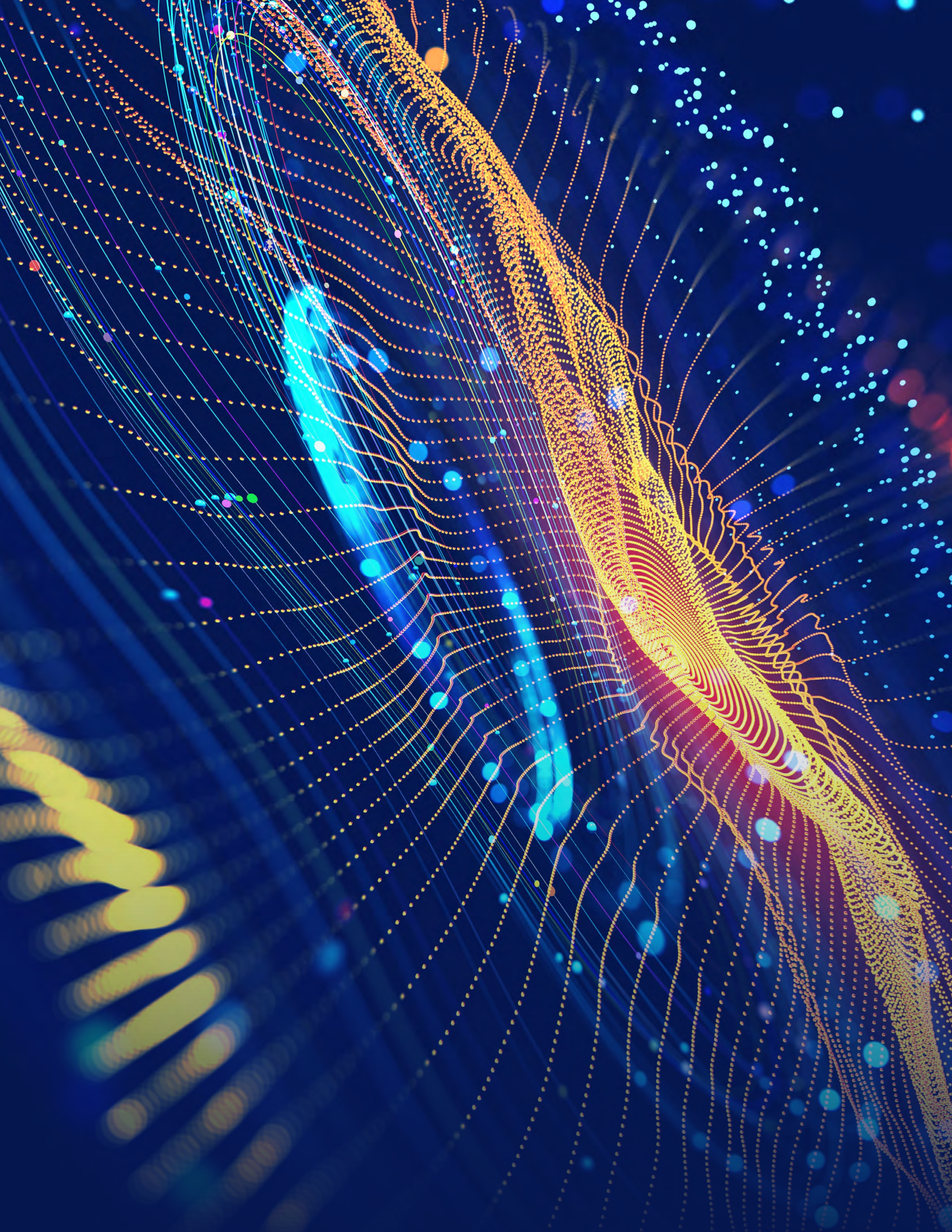


Standing out
from the crowd

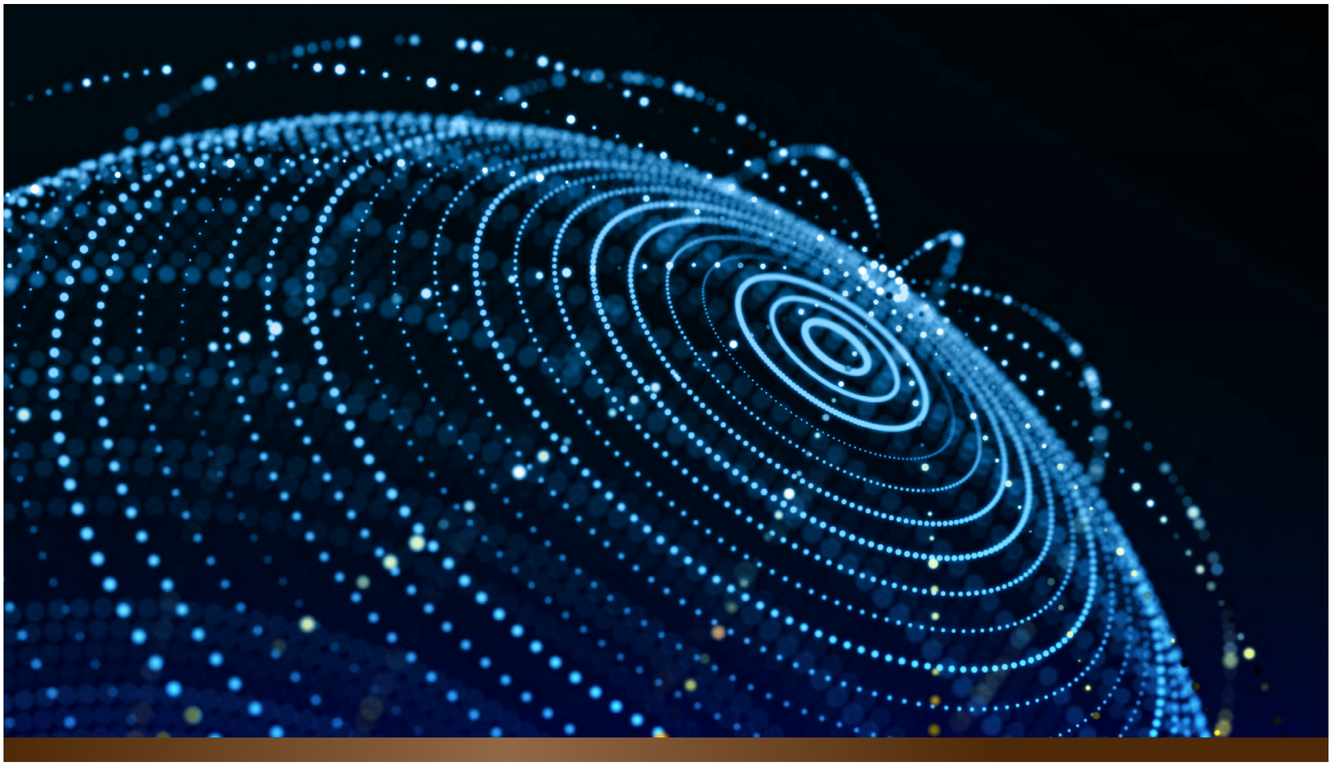
With consensus built around the merits of the exchange-traded fund (ETF) wrapper, there is a new shift emerging that requires issuers to leverage distinct investment strengths, assess unique distribution dynamics, and adapt to novel ecosystems.

The debate has shifted from “why” ETFs should be part of your fund line-up to “how” an organization should implement an effective ETF strategy. An ETF is a piece of technology that facilitates the broadening of an asset manager’s investment offering by providing a strategy across the primary and secondary markets. Among asset management firms that do not currently have an ETF business, a Blackwater survey reports 92% are planning to launch ETFs or undertake due diligence of the space within the next two years, up from 9% in 2021.[1]

So how do new entrants in this space differentiate themselves? Every asset manager needs to be prepared to respond to the ETF question of “how” as we begin to enter a new phase in the evolution of this maturing marketplace. For many issuers, the active ETF may be the right answer.

[1] *“What European Mutual Fund Managers Think About ETFs,” Blackwater, March 2024*

A complex ETF marketplace **is emerging**



Since their inception in North America in the early 1990s, ETFs have appealed to investors thanks to their simplicity, transparency, and inherent tax advantages.

This early era (ETF 1.0) embraced these products as passive, index-tracking vehicles offering relatively low fees, intraday trading flexibility, and daily portfolio visibility. The creation and redemption mechanism ensured that market makers would be incentivized to keep the price of the ETF in line with the value of its holdings. The products allowed both retail and institutional investors the opportunity to get exposure to large sets of assets with one trade. The rest of the world followed suit, with products launching in varying geographies soon thereafter.

By the mid-2010s, the ETF industry largely reflected passively managed, market-cap-weighted products, but a second transitional phase (ETF 2.0) began to emerge with the popularity of smart beta and factor-based products. These strategies sought to provide end investors with an incremental step that offered some of the benefits of active management (fundamental investing principles) while allowing newer ETF issuers an ability to differentiate themselves from a predominately market cap-weighted, incumbent crowd.

The Securities and Exchange Commission's 2019 passage of Rule 6c-11, the so-called "ETF Rule," was an inflection point. This reform leveled the playing field in the U.S. for new entrants by bringing consistency to market entry for fully transparent ETF portfolios. It also increased the access that fund managers had for the flexible and tax-efficient creation or redemption of ETF shares through the use of "custom in-kind baskets" within the primary market. The adoption of this basket mechanism further enabled the active investment process, igniting the active vs passive debate as well as whether this full transparency compromised the ETF portfolio's performance. Fears remained over whether competitors could trade ahead of asset managers given that they revealed their whole hand in an ETF wrapper.

It is at this time that high-profile active ETF stories dispelled broader market stigma around "alpha leakage" in portfolios requiring daily holdings transparency. While the option to launch a semi-transparent ETF in the U.S. existed, we saw the majority of active managers entering the ETF market with fully transparent products. In reality as was soon found out, the advantage is in the quantitative analysis, research techniques, portfolio construction, and market expertise, which is not given away simply by publishing the holdings on a daily basis.

By 2024, an exchange-traded product, originally passively managed and filled with vanilla asset classes (equities and basic fixed income), has increasingly developed into a sophisticated, fully actively managed portfolio containing exotic instruments (swaps, futures, synthetics, bank loans, and securitized products). The launch of crypto ETFs lends further credence to the applicability of the wrapper. This increased complexity brings both challenges and opportunity for newer issuers embracing the onset of this next phase in ETF evolution (ETF 3.0).

As actively managed ETFs rise in the U.S., and with Europe and Asia consequently positioned for growth, asset managers must effectively adapt to these evolving circumstances for a chance at capturing this opportunity with investors.

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Key considerations to **address**

It is critically important for asset managers to evaluate several essential questions and circumstances proactively when determining how to engage the active ETF marketplace effectively.

Establishing a thoughtful and organized approach ahead of time should help build a strong foundation for your organization. While we have seen a large number of traditional mutual funds and separately managed accounts (SMAs) converted to ETFs in the past two and half years, it is critical that the existing strategy be a successful one. Converting assets to an ETF is not a panacea to a poor performing strategy.

Distribution & marketing

Evaluate your investor base

- In the U.S., each investor channel (e.g., institutional, independent advisor, wire-house) can have different needs and appetites. Before launch, it is critical that managers evaluate their existing customers, (who they are, where they live, and what they buy) to determine if ETFs will be the right fit. Or if pursuing a new market, what will an ETF investment bring to the buyers that they cannot get already?
- Outside the U.S. and where the "retail investor" channel may be less mature, each country can have its own investment requirements, currency, language dynamics, and tax-reporting conditions, making distribution that much more complicated and fragmented. While the U.S. is a single market, regions such as Asia and Europe are fragmented with different buyer appetites and regulations in each country – this represents an added complexity that an asset manager needs to consider before launching an ETF strategy.

Motivate proactive behavior & co-locate ETF expertise

- It is important to encourage action from distribution teams, align incentive structures, and hold teams accountable for sales targets and outcomes.
- Building the ETF wrapper may be unfamiliar to some asset managers and require something of a learning curve, so proactive communication from ETF specialists is essential and access to ETF education is critical to enable progress, both inside and outside the firm.
- Hiring external ETF expertise to sell the product alongside the existing mutual fund range can be beneficial, as it ensures that the ETFs are front and center as opposed to an add on.

- Establishing a capital markets team within a particular region is critical for the success of an ETF product. Without an experienced capital markets resource, the success of an ETF product is significantly compromised.

Acknowledge a shift in culture while leveraging incumbent firm relationships

- Drivers that have led to successful inflows into the traditional mutual fund structure will likely be different than the drivers leading to successful ETF growth. Things like branding, advisor channels, and investor types can often be different than those of previous products. As mentioned prior, knowing your client base and appetite for an ETF solution is essential to any successful launch.
- Take advantage of legacy distribution tailwinds when appropriate, but do not allow a set point of view to discourage the adoption of emerging business models. Model portfolios, Turn-Key-Asset-Managers, Robo-Advisers, and self-directed brokerage accounts can all be factors in contributing to the success of an ETF.
- Regulation – such as Client Relationship Model 2 (CRM2) in Canada, Retail Distribution Review (RDR) in the UK, and the Markets in Financial Instruments Directive (MiFID II) across Europe – is focused on ensuring managers are selling the most suitable product to their clients. This, in turn, is likely helping with the growth of ETFs.

Product development & fund manufacturing

Lean into your investment identity

- Is there an existing brand awareness you can access? Think about your niche, and take advantage of the strengths the market will recognize, considering what is useful to both who is currently buying your products and who might in the future.
- Reinforce what makes your organization unique to customers and access existing, differentiated investment expertise when rolling out products.

Take a holistic approach to investment solutions

- Seek to complement existing fund options as appropriate. Think about client outcomes holistically, agnostic of wrapper type, and calibrate where ETFs are most suitable. Consider, for example, whether a particular portfolio is "model friendly" or a better fit for an SMA strategy.
- Determine if there are legacy fund products that could be strong candidates for an "ETF conversion." In non-U.S. domiciles, multi-share class fund structures are also becoming a prevalent option for issuers.
- There are currently more than 20 submissions to the SEC for an active ETF share class of a mutual fund that, if approved, may give another avenue for managers to offer successful mutual fund strategies within the ETF wrapper.

Assess the short term & long term, navigate between simplicity & complexity

- With product development becoming increasingly complex, and portfolios growing more sophisticated amid the active ETF rise, note that end-customers are still using ETFs to achieve simple outcomes and solutions.
- Be focused on your product aspirations and motives. Are you trying to catch a quickly emerging trend (thematic) or develop fund vehicles that round out core components of longer-term client portfolios? Both options might have merits depending on timing and context.

Key considerations to address (cont'd)

Operating model change & implementation process

Establish good governance & project management

- Identify internal talent to shepherd the project from inception to integration.
- Establish leadership and accountability for any project management needs, including escalation for the client, provider, and strategy.
- Ensure you understand the market appetite and have a clear directive.
- Lean on the right external partners with comprehensive experience to help facilitate your firm's success.

Balance between workflow consistency & flexibility

- Configure operations models so that you can potentially streamline activities while providing optionality and customization iteratively as your platform matures.
- Understand how your firm will adapt to novel ETF ecosystems (authorized participants, market makers), processes (basket creation and order management), and reporting demands (6c-11).

Implementation & integration processes should be malleable

- Seek guidance on operating model design from industry partners, and align to best practices on data management and workflows. As your organization scales its ETF lineup, it will be critical to have continuity of information. Although the differentiator is the ETF strategy, it is important to have the right operating model to support your strategy in order to increase the likelihood of success and client satisfaction while lowering the chances of operating risk concerns for failure. The differentiator is likely to be the ETF strategy not the operating model. Implementing a best practice, standardized ETF operating model can allow for scale and growth. Although the differentiator is the ETF strategy itself, implementing a best practice, standardized ETF operating model can allow for scale and growth.
- Roll out the types of portfolios and business models that will help your organization get off the ground first and then build more complexity and sophistication off of that foundation.

Partnership with **perspective**

Navigating the ETF marketplace can feel like a daunting task, but it does not have to be one.

It is important to create an organized and coherent roadmap to guide decision-making as conversations progress. Effective communication is paramount even as initial discussions start small within the organization. It is critical to align with the right partners who can assist in alleviating apprehension by seeing around new corners, helping to avoid roadblocks, and enabling positive outcomes.

Industry partners who can draw on unique business adjacencies across trading, primary market ETF origination, and operational asset servicing are likely better positioned to share valuable insights and provide iterative consultation. The close proximity of these interrelated activities is likely to allow organizations with a broad, holistic perspective to empower clients most effectively when engaging with this evolving marketplace.

Access to global expertise & resources **are essential**

Aligning your active ETF aspirations with reliable, strategic partners can provide the leverage and expertise you need at the onset of a platform launch and potentially allow for optionality down the road.

When selecting an ETF service provider to partner with, it is important to focus on the people, the expertise, and the technology that J.P. Morgan has across its global ETF servicing model.

To that end, J.P. Morgan's comprehensive global footprint continues to be committed to the enhancement and innovation of the exchange-traded fund industry. Having this broad, global reach helps us to empower clients by facilitating product development considerations, enabling portfolio liquidity and supporting evolving fund infrastructures. J.P. Morgan Securities Services supports more than 560 ETFs and $2.7+ trillion in ETF assets serviced globally across various investment domiciles and service delivery locations. This business is strengthened by leveraging the technology and proximity of a leading investment bank that also serves as an authorized participant and market maker for exchange-traded products around the world.

J.P. Morgan Securities Services

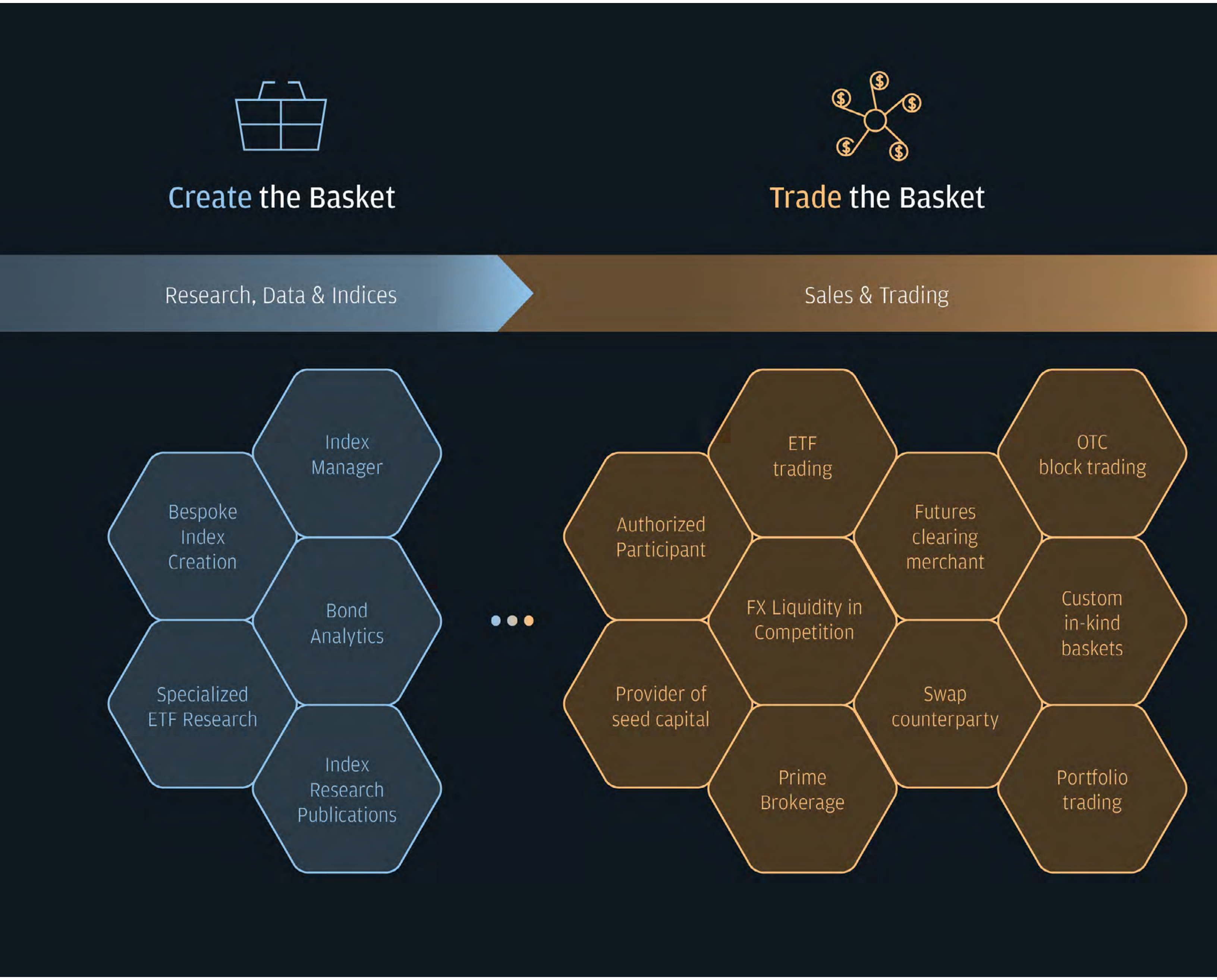
560+
ETFs supported

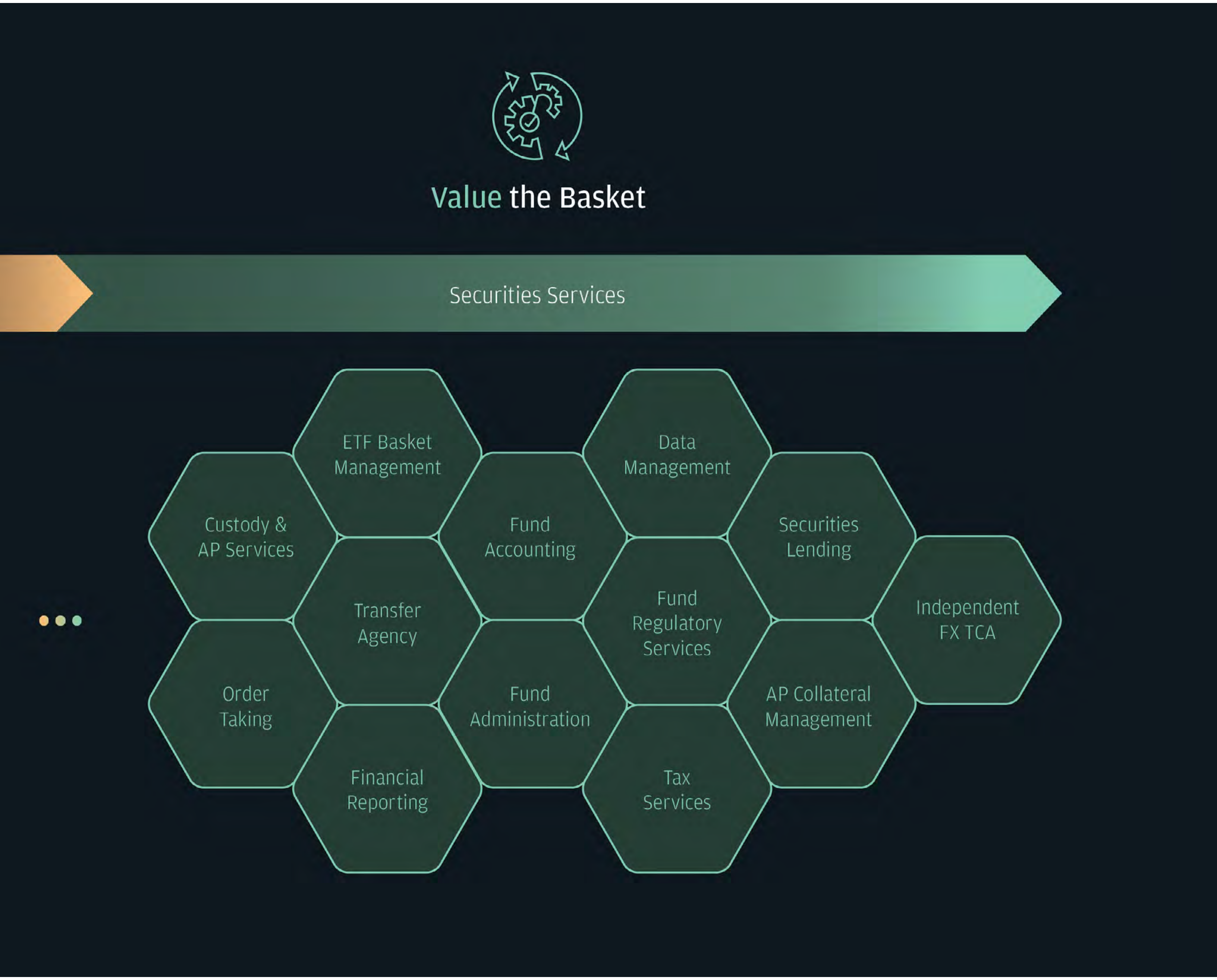
$2.7+ tn
in ETF assets serviced globally

Regardless of the role our businesses play, J.P. Morgan aims to support its client partners and deliver innovative solutions to improve investment outcomes, boost operating model scale, and help asset managers and investors reach their ETF goals.

J.P. Morgan teams provide capabilities across the end-to-end ETF lifecycle

ETF consultation providing solutions across the lifecycle




Value the Basket
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ETF Basket Management
Data Management
Custody & AP Services
Fund Accounting
Securities Lending
Transfer Agency
Fund Regulatory Services
Independent FX TCA
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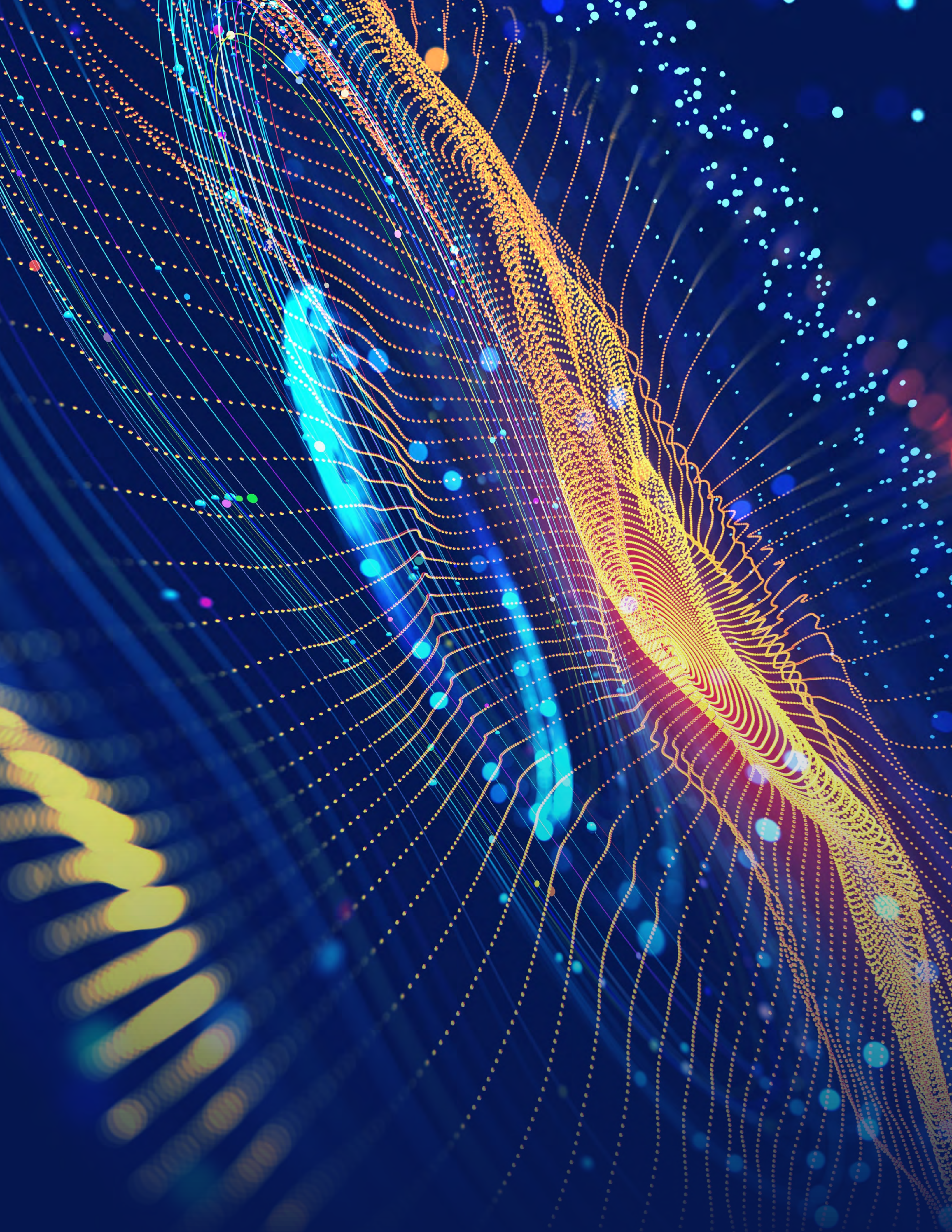
Fund Administration
AP Collateral Management
Financial Reporting
Tax Services



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