A bright future for active ETFs

August 25, 2022

We *have previously cautioned managers on sprinting headfirst into the active ETF market, which is much more complex than it appears. Those complexities notwithstanding, we remain (sensibly) bullish on the future of the Australian active ETF market.*

It has been a tough start to the year for ETFs (and for asset management in general), headline flows into ETFs to H1 CY22 were down ~23% period-on-period, with market volatility testing the nerves of many investors. However, looking beyond the headline numbers, there's still a lot to play for.

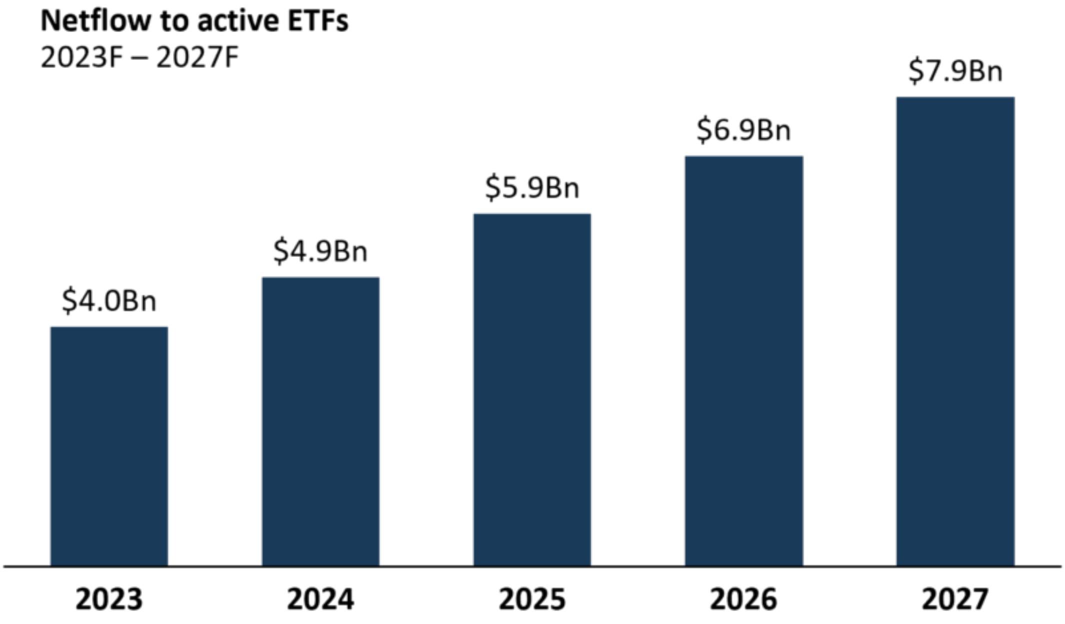
As we discussed in our previous article, the passive and smart beta markets in Australia are only contestable for a small few, and margin pressures make the proposition attractive for fewer still. Whilst this market still dominates in terms of flow and FUA, most of the competitive activity occurs in the active segment, which, save for one notable exception, has held up relatively well this year.

Active ETFs have a long way left to run

The active ETF market remains, and will remain, an (almost) entirely adviser led proposition. The flood of new entrants to this market and the advent of the dual listed/unlisted structure means that the decision on listed vs unlisted is increasingly driven by advisers' implementation preferences rather than any philosophical views on product structuring.

This loss of distinction between listed and unlisted in the advised market is going to see strong flows into active ETFs for the foreseeable future.

Exhibit:1 Forecast netflows into Australian active ETFs



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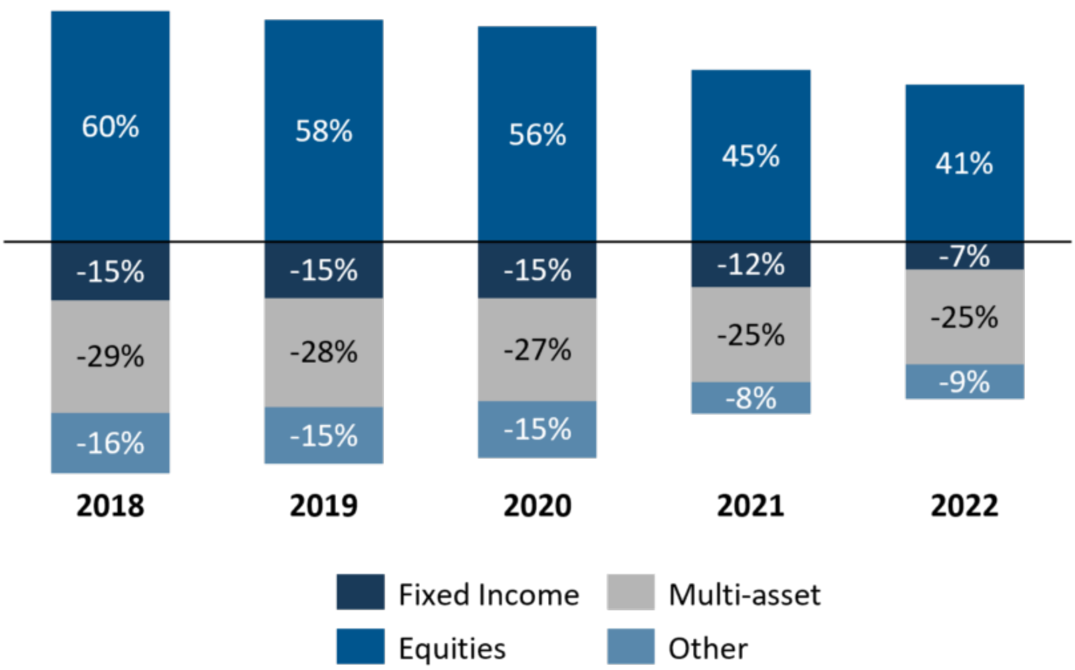
The key question for managers, as always, is “How do I best position myself for success”.

Firstly, where is the money going?

The loss of distinction between listed and unlisted offers some insights here. Over time, we’ve seen, and we will continue to see, the asset allocations of these markets converge.

Exhibit 2: Active EFT asset allocation relative to active managed funds, 2023F – 2027F



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There are a few takeaways here:

1. We have previously discussed why we are bullish on the medium term outlook for global fixed income market in the institutional space, and most of the arguments we made there hold true for the retail fixed income market more broadly. However, we see that the 'maturing' of the listed market's asset allocation will be a particular boon for well-placed fixed income managers.
2. The managed fund market currently has a ~25% allocation to (largely legacy) multi-asset products. These exposures are typically mass-market client dominated, and with the advice market continuing its shift toward HNW clients, we do not expect to see this replicated in the active ETF market.
3. Notwithstanding the convergence of allocations across these markets, equities will continue to take the lion's share flows for the foreseeable future.

So what can managers do to best position themselves?

This is an immature market with enormous growth potential and plenty of contestable flow to go around. That being said, this is a complex market with no guarantees of success, so here are a few key points which must be understood prior to diving into it:

1. **This is not a 'build it and they will come' market**: Behavioural shifts in the advice market are slow to eventuate and rarely happen on their own. Marketing mix and distribution capabilities need to be closely considered, distinct from unlisted offerings.
2. **This is not a market for B-grade product**: The active listed market is still novel for most advisers, and this novelty means that advisers are paying close attention to where and how they enter it – competitive positioning is key.
3. **This is a market that favours scale**: There is a sizable capital outlay required to establish the operating and distribution models required to participate successfully in this market. Once the infrastructure is in place, leverage it.

By Lachlan Reardon