Morgan Stanley
INVESTMENT MANAGEMENT

Active ETFs may Thrive even in Down Markets

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Amid growing demand for active management in volatile markets, the number of actively managed exchange traded funds (ETFs) has surpassed passive vehicles. Active ETFs have been rapidly flourishing since the Securities and Exchange Commission (SEC) modernized their regulation in 2019 by establishing a clear and consistent framework. The adoption of Rule 6c-11 was designed to facilitate greater competition and innovation in the ETF marketplace while creating more choice for investors. It also quickens the process for ETFs to come to market, sparing the time and expense of applying for individual exemptive relief. Moreover, actively managed ETFs offer potential benefits such as lower costs, tax efficiency and transparency, compared to traditional mutual funds, making them attractive to a broad range of investors.

In particular, fixed income ETFs are experiencing fast proliferation, fueled by their democratization and ability to offer investors diversified access to the bond market with liquidity and transparency. Fixed income ETFs may be more tax-efficient than holding individual bonds, and the unique structure and trading of ETFs in general may lead to fewer taxable events for investors. Since their launch in 2002 as passive vehicles with low fees, fixed income ETFs continue to expand to a wider audience with the benefits of active management. Even experienced investors seeking to add ETFs to their portfolio for the first time may be unaware of the potential benefits and how an experienced manager can help navigate the dynamic and quickly growing marketplace.

What are the "three T's" of ETFs?

The last five years have demonstrated the most significant expansion in the fixed income ETF market, as investors embrace three main characteristics: tax efficiency, transparency and tradability, making them potentially attractive investment vehicles now available to a greater range of investors.

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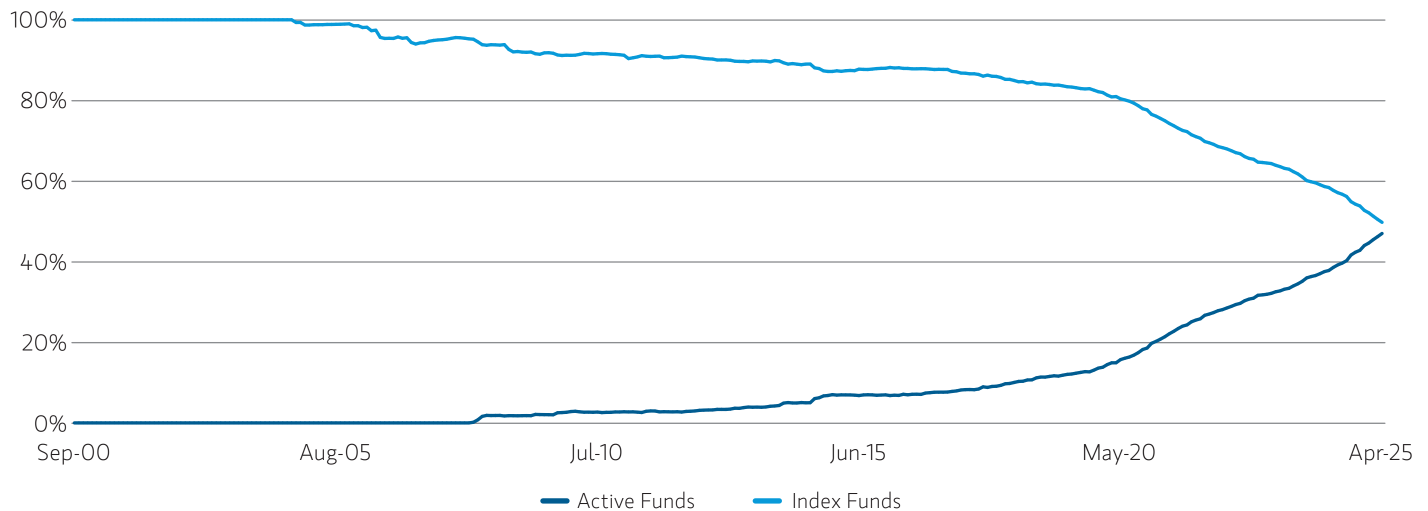
DISPLAY 1
Number of Active versus Index ETFS



Source: Investment Company Institute as of April 30, 2025.

TAX EFFICIENCY: ETFs may have lower tax implications compared to other investment vehicles, especially those with higher turnover of assets. ETFs tend to be more tax-efficient than mutual funds due to their unique structure. A mutual fund must sell its underlying securities to free up cash due to investor redemptions, which may generate more capital gains. Even if investors don't sell their own shares, they may be taxed on the capital gains the mutual fund generates.

Because ETFs trade over an exchange, shares are redeemed less frequently. ETFs may leverage an in-kind redemption process if they require investor redemptions, but they don't generally sell underlying securities while a significant group of investors are selling, bolstering tax-efficiency.

TRADABILITY: ETFs trade on exchanges, creating more trading flexibility than mutual funds. Investors can buy or sell ETFs throughout the day (just like equities), while mutual funds can only be bought or sold and are priced once a day at market close. As a result, ETFs are much more liquid than mutual funds, enabling investors to access the potential of market fluctuations or sell their shares at any time.

Active ETFs empower investors by giving them more control over their portfolios, as they can be used to diversify, provide exposure to specific asset classes or strategies or complement existing investment approaches.

As with stocks,[1] the minimum investment for an ETF is typically a single or fractional share, while mutual funds generally require a minimum investment of between $500 and $10,000, or higher. ETFs provide more flexibility for investors with real-time trading, similar to stocks, yet they may offer low expense ratios and fewer brokerage commissions than buying stocks individually.

TRANSPARENCY: ETFs offer investors detailed information on the underlying securities within the fund, offering more clarity than mutual funds which may be challenging to analyze. ETFs must disclose their holdings daily, while mutual fund managers must only disclose their holdings 60 days after the end of a quarter. This transparency provides investors with insight into a fund's exposure to sectors, industries, geographies and individual stock holdings, enabling them to make the most favorable portfolio allocations at any time.

Active ETFs outnumber passive vehicles

Signaling a seismic shift in the industry, active ETFs outnumber passive vehicles for the first time, as around 51% of nearly 4,300 U.S.-listed ETFs are now actively managed, according to Bloomberg. Active ETFs have more than doubled from just 23% in 2020, and asset managers continue to launch more new active products.

The $11 trillion U.S.-listed ETF market accounts for 10% of overall industry assets, doubling from a decade ago. Even as investors continue to embrace actively managed funds, Todd Sohn of Strategas told Bloomberg that many new entrants may not succeed.

[1] Diversification does not eliminate the risk of loss.

Sohn estimates that nearly half of the roughly 800 ETFs that focus on income, buffers or leverage have less than $50 million in assets.

Growth has continued since actively managed ETFs surpassed $1 trillion in total assets under management (AUM) in the U.S. on March 26, according to Bloomberg. The market could open more broadly if the SEC allows issuers to launch ETFs as a share class of mutual funds.

ETFs thrive in down markets

The ETF market experienced a major transformation in 2022, as actively managed ETFs gained market share and trading volume, even as the overall stock and bond markets declined.

The 2022 bear market may have been caused by high inflation, soaring interest rates and fears of a global recession, as well as Putin's escalation of the Ukraine invasion, snarling the supply chain.

The S&P 500 was down 18.1% in 2022, its worst year since 2008 and the fourth worst year since 1957, yet the number of ETFs blossomed as new participants clamored to enter the burgeoning marketplace.

The success of ETFs relies on an ecosystem of partners who trade and operate efficiently. Capital markets must collaborate with exchanges and liquidity providers, as well portfolio managers and custodians, to ensure that products are trading within an appropriate range to provide the best potential returns for investors.

BOTTOM LINE: Once viewed exclusively as passive instruments, active ETFs continue to attract new entrants in equities and fixed income. Investors seeking tax efficiency, transparency and liquidity may benefit from an experienced active manager who understands how to access the greatest potential benefits of the unique structure and trading of ETFs, especially in the fixed income universe.

Past performance is no guarantee of future results.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.

The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US.

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