

Marketing Material

## The Rise of Active ETFs: From Core to Conviction



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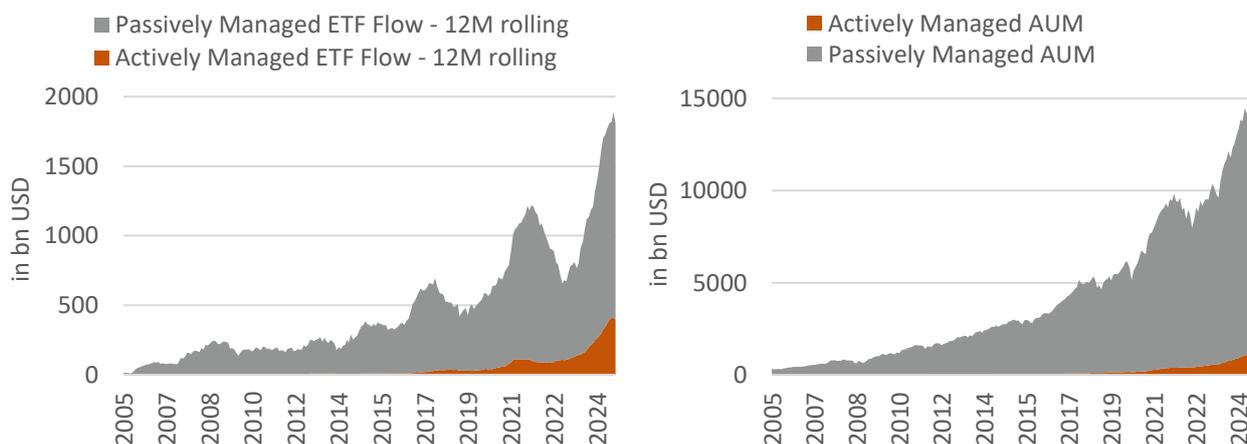
- Today's active ETFs are designed to integrate investment conviction into traditionally passive portfolios. They offer a diverse range of solutions, serving clear purposes: including traditional alpha signals, augmented outcome solutions, and niche market access.
- The European Active ETF adoption is accelerating, with assets under management surging 80% to \$53 billion in 2024. The bulk of those assets is managed in strategies with low active risk, making the institutional investors' appetite for more precise and risk-aware performance very clear.
- These low tracking error solutions, so-called Enhanced Active strategies, deliver capital-efficient exposure that sits between passive core and high conviction active and have the ingredients needed to help investors re-deploy risk budgets in core and multi-strategy portfolios.
- Enhanced Active delivers stable return per unit of risk without introducing significant volatility or drawdown risk. That makes them a natural anchor for every benchmark-aware investor, prioritising consistency rather than magnitude of excess returns.

# 1 / Active ETFs are transforming the ETF market

Are ETF markets indeed undergoing a profound transformation? To understand this, we first take a look at broader trends in U.S. and European ETF markets. For years, the landscape was defined around diversified, beta-centric strategies – products designed to track broad benchmarks with minimal deviation. Unsurprisingly, this entrenched the perception that ETFs and passive investing are interchangeable. But the ETF market is not undergoing its first evolution. Factor investing, more than 10 years ago, was arguably the first foray of active investments into ETFs, with systematic, fundamental strategies offered in rules-based ETFs already posing the question as to how such ETFs were still truly passive. Although recent estimates indicate that around 94% of global ETF assets remain in passive strategies<sup>1</sup>, the latest wave of innovation around actively managed ETFs – both in the United States and increasingly across Europe – challenges this view once more. Crucially, it underscores one core fact: the ETF wrapper is and always was strategy-agnostic. It can accommodate active or passive approaches, systematic or discretionary styles, and exposures that range from plain vanilla to highly specialised.

Following a multi-year expansion in the US, active ETFs are now steadily gaining traction on European exchanges. Structurally, they retain the key advantages of the ETF wrapper: cost efficiency, transparency, and liquidity. These attributes remain essential drivers of investor demand and were reaffirmed during recent periods of market stress. For example, amid heightened uncertainty around US trade tariffs in April 2025, ETFs accounted for 43% of total exchange volume in the United States, the second highest reading in the history of ETFs – highlighting investor preferences to use ETFs when liquidity and price discovery matters most<sup>2</sup>. In Europe, similar surges in ETF trading have been observed.

Figure 1: ETFs are on the rise – Global Inflow and Assets under Management (AUM) in USD



Source: DWS International GmbH, Bloomberg, using Bloomberg Intelligence fund classifications. As of May 2025.

For now, active ETFs remain in the shadow of their passive peers, which continue to dominate the ETF market (Figure 1). In the United States, the growing “passivation” has resulted in ETFs overtaking mutual funds as the investment vehicle of choice, with assets growing at a rate of over \$1 trillion per year. In Europe, ETF assets reached a record €2 trillion by end of 2024 and continue to expand at double-digit growth rates. While active ETFs remain at less than 10% of the size of the overall ETF market with assets of \$1 trillion, it is important to consider that this market share was earned within the last 5 years<sup>3</sup>.

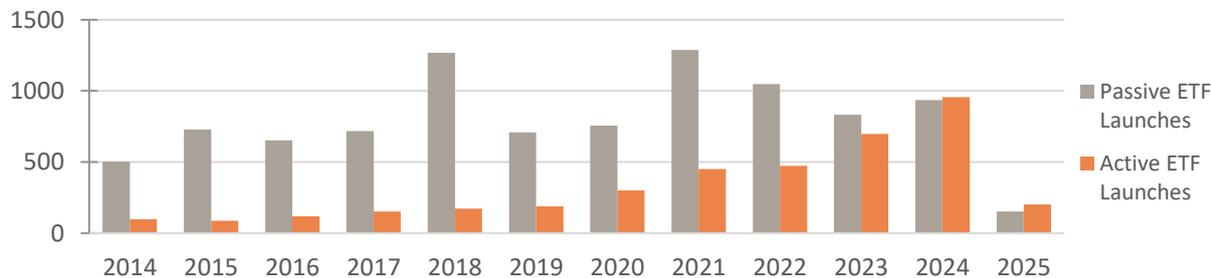
<sup>1</sup> Morningstar. (2024). Active ETFs in Europe: Small, Shy, and on the Rise.

<sup>2</sup> Bloomberg. (2025). Is This Capitulation? Frantic Trading Rockets ETFs to New Highs

<sup>3</sup> Source: Bloomberg, as of May 2025.

At Xtrackers, we view this growing versatility of ETFs as an opportunity to extend both the depth and breadth of the ETF product offering. As investor understanding and acceptance of active ETFs grows, and as product ranges become more sophisticated, these new dynamics can lay the foundation for a structural shift in European asset management.

Figure 2: Active ETFs overtake Passive ETFs by launch activity globally



Source: DWS International GmbH calculations, ETFBook, Bloomberg. As of 28/04/2025

The rise of the active ETF landscape also prompts a new classification framework based on strategic objectives, in short “purposes”, rather than solely by asset class. In Table 1 we categorise active ETF strategies into three dimensions – Alpha Signals, Augmented Outcome, and Market Access – to better reflect their varying investment rationale and role in portfolios. This reframing highlights how active ETFs can serve distinct purposes: seeking benchmark-beating returns, engineering specific risk/reward outcomes, or providing exposure to otherwise hard-to-reach market segments.

Table 1: Key purposes of active ETFs

	Characteristics	Role of Active Manager	Investment Rationale
<b>Alpha Signals</b>			
<b>Equities:</b> Enhanced Indexing, Traditional Active <b>Fixed Income:</b> Active	Seek to outperform their benchmark <b>Enhanced Indexing:</b> high diversification, tracking error (TE) <1.5%, factor tilts. <b>Traditional Active:</b> concentrated, high-conviction, TE >2%.	Determines and translates alpha signals (quant, fundamental) into portfolios. Manages tracking error and risk alignment.	Capture alpha while staying within tracking error budgets. Suitable for investors with manager conviction and controlled risk appetite.
<b>Augmented Outcome</b>			
<b>Derivative Income</b> (Call overwriting) <b>Structured Outcome</b> (Buffer)	Outcome-engineered strategies using derivatives. E.g. call overwriting for income, or buffered ETFs for downside protection.	Actively rebalances derivatives positions to maintain targeted buffers.	Targeted risk/reward profiles (e.g. volatility reduction, income generation). Suitable for income-seeking or risk-sensitive investors.
<b>Market Access</b>			
Focus on <b>less-liquid</b> or <b>index-inaccessible</b> segments.	Examples: Thematics, frontier debt, CLOs, EM small caps.	Navigates illiquid, opaque, or inefficient markets. Selects securities and manages liquidity risk.	Grants access to specialised markets. Requires higher due diligence due to complexity, potential liquidity mismatch, and manager dependence.

Source: DWS International GmbH, May 2025

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## Alpha Signals: Outperformance-Focused Strategies

Alpha Signal strategies encompass active ETFs aiming to beat a standard benchmark through superior security selection, factor positioning, or tactical insights. These strategies leverage the portfolio manager's skill to generate alpha, at times against pre-defined level of active risk. Such ETFs can be placed along a continuum of tracking error versus core benchmarks, from modest deviations (enhanced indexing) to high-conviction, stock-picking portfolios:

- **Enhanced Indexing (Research-Enhanced or Quantitative Active):** This sub-segment involves rules-based or model-driven portfolios that closely resemble a broad index but incorporate active tilts. Typically holding a large number of securities and targeting a low tracking error (TE) (e.g. 1%–1.5%), these ETFs harvest factor premia or follow fundamental signals to incrementally improve on the index return. The approach builds on the success of strategic beta ETFs (now over \$2 trillion in AUM globally<sup>4</sup>) in delivering factor-driven returns at low cost but adds a layer of discretion to respond to changing market conditions. Unlike traditional passive smart-beta ETFs, which tilt toward factors but can be rigid, enhanced index strategies retain a degree of human oversight and adaptability. Managers use fundamental research or quantitative models to adjust weights and avoid pitfalls of a purely mechanical indices, while maintaining risk controls to limit unintended sector or country biases. This marriage of active insight with passive discipline has proven appealing to investors and the majority of European active equity ETFs follow this paradigm.
- **Traditional Active & High-Conviction Strategies:** At the other end of the spectrum, some active ETFs adopt a fully active, stock-picking approach more akin to a traditional mutual fund. These funds hold a lower number of positions (often around 50–150 stocks in equity portfolios) and as a result see widened tracking error versus core indices in excess of 2%, driven by meaningful active share. This high-conviction style caters to investors who trust the manager's ability to outperform via stock selection and are willing to tolerate greater risk in pursuit of higher alpha. While historically less common in Europe's ETF market, there are signs of growth in this segment.

## Augmented Outcome: Tailoring Risk and Return Profiles

Augmented Outcome strategies encompass active ETFs that seek to modify the payoff profile of an investment, targeting specific risk or income rather than simply maximising raw performance. These ETFs use active management – often in the form of derivatives overlays – to deliver features like downside protection, volatility reduction, or enhanced income. The focus is on achieving investor objectives like capital preservation or yield generation by augmenting traditional equity or bond return stream. Two prominent examples are:

- **Defined-Outcome / Buffer Strategies:** These active ETFs utilise option contracts to buffer the downside for a reference index over a set period, financing the protection by capping the upside. For instance, a fund might guarantee the first 10% of losses are buffered (not borne by the investor) over an annual outcome period, in exchange for limiting upside participation. The manager actively structures and rebalances a portfolio of option spreads to maintain the promised protection levels and caps. Since their debut, defined-outcome ETFs have gained traction, appealing to investors who seek a measure of downside protection against market declines. Notably, these ETFs are starting to compete on territory long dominated by structured products, with the advantages of daily liquidity and transparency.
- **Defined-Income / Option Overlay Strategies:** Another growing subset of outcome-oriented ETFs are those that pursue enhanced income through call overwriting (buy-write strategies). These funds fully invest in an index and actively sell call options to generate option premium income. The result is an income-focused return profile: the premiums collected boost distributions, resulting in yields above the underlying dividend index yield. The sold calls also mean the fund sacrifices some upside if the market rallies. This strategy tends to lower volatility and drawdowns as the collected call premiums provide a cushion against losses. Active management is needed for the calibration and management of the option overlay – managers decide on strike levels, maturities, and how much of the portfolio to overwrite. This can suit investors prioritising steady income and mild downside mitigation over maximum growth.

<sup>4</sup> Source: Based on Bloomberg classifications, as of May 2025

## Market Access: Niche and Specialised Exposure Strategies

The Market Access category of active ETFs is characterised by a focus on niche, hard-to-reach, or less efficient market exposures. These strategies are less about beating a broad index and more about providing access to segments of the market that are not easily accessed via standard index ETFs. Often, the underlying markets are illiquid, highly specialised, or lack investable benchmarks or indexable data, creating an opportunity for active management to add value through selective exposure. Broadly, this category includes thematic ETFs targeting specific sectors or trends and funds investing in complex assets, for example in credit or alternatives. Key examples include:

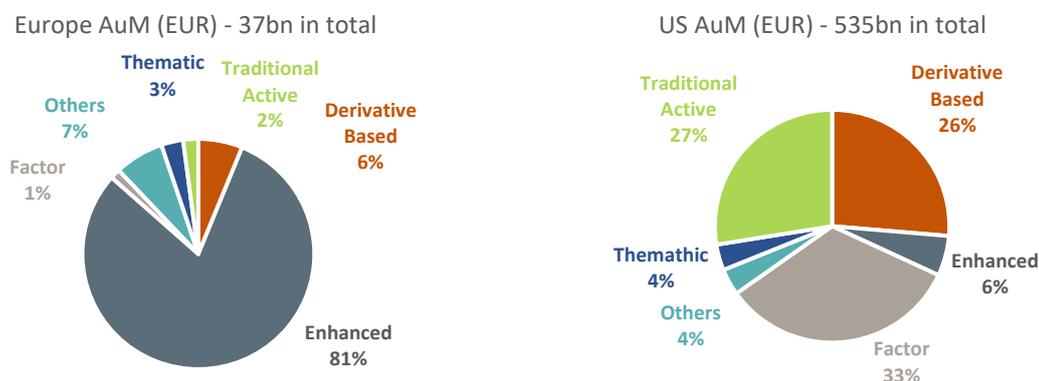
- **Thematic and Sector-Focused Active Strategies:** These funds focus on a particular investment theme or sector that may lie outside the mainstream indices. Examples range from themes like artificial intelligence to specialised sectors like cybersecurity or natural resource equities. Active thematic ETFs have gained traction as a way for investors to express high-conviction views on structural trends with the ETF convenience, but with an expert guiding portfolio construction. These funds naturally complement passive index-based sector ETFs; for example, an actively managed artificial intelligence ETF can coexist with a passive fund, giving investors a choice between a concentrated, best-ideas approach and a broad basket, often selected on very different metrics.
- **Complex and Alternative Strategies:** This second major subset encompasses fixed-income or alternative asset classes that are not well-served by traditional indices. Collateralised Loan Obligations (CLOs) are a prime example – these securitised loan portfolios offer floating-rate yields. While pure passive ETFs were held back by the complexity of selecting and trading individual, investable CLO tranches, active ETFs are opening the door for a broader range of investors to gain exposure to assets that were once the domain of institutions and hedge funds. However, investors must be aware of the risk-return trade-off: these ETFs often carry higher fees, elevated market risk, and embedded liquidity transformation – a situation where the underlying assets of an ETF are thinly traded and/or structurally complex. An ETF may always be at least as liquid as its underlying holdings – but in these cases, that minimum level of liquidity may not satisfy all investors.

## 2 / The way ahead for European Active ETFs

Having set the global context, we now turn to the European market, where a distinct set of regulatory and structural dynamics have shaped a different path for active adoption. Using the above framework to classify active ETF strategies, and focusing specifically on equity exposures, key regional distinctions emerge versus the U.S. market:

- Enhanced active strategies dominate the European landscape, accounting for roughly 80% of active equity ETF assets – in stark contrast to the U.S., where they represent just 6–7% of the active ETF market.
- The remaining 20% of the European market is almost evenly divided between Derivative-Based, Traditional Active, and Thematic strategies. While small in AUM terms, these categories are growing and increasingly reflect European investors' interest in outcome-based and thematic allocations.
- In contrast, U.S. investors show a clear preference for factor, derivative-based, and traditional active strategies, with relatively limited uptake of enhanced or benchmark-constrained approaches. Thematic ETFs also remain a relatively small share of U.S. active equity ETF assets.

Figure 3: Regional differences in Active Equity ETF preferences



Source: TrackInsight, Bloomberg, DWS International GmbH classifications, only considering equity ETFs, April 2025

These regional differences are not simply a function of timing or product availability. Most important are differences in the regulatory regime, investor base and differences in taxation schemes. The following provides the most essential points

### Difference #1: Regulatory Landscape

The rapid growth of active ETFs in the United States has been significantly influenced by regulatory reforms, most notably the SEC's Rule 6c-11, often coined the "ETF Rule". Introduced to modernise the ETF landscape in 2019, this rule has provided issuers with greater flexibility and accelerated market entry by eliminating previous barriers. It streamlined disclosure requirements and levelled the playing field between fully transparent actively managed ETFs and index-based ETFs. Moreover, the SEC enabled the emergence of semi-transparent ETFs, which deviate from the traditional requirement of daily holdings disclosure<sup>5</sup>. These ETFs operate under various models in the U.S., but their defining feature is the protection of portfolio details, typically revealing holdings less frequently to shield proprietary strategies. These regulatory shifts spurred a surge in the supply of active ETF strategies. From less than 200 US active ETFs, the universe now exploded to over 1400 different US Active ETFs<sup>6</sup>.

In contrast, Europe has historically restricted such semi-transparent structures under the UCITS framework, which prioritises transparency and investor protection. However, a notable shift occurred recently when Luxembourg's

<sup>5</sup> DWS. (2024). Yes, Virginia, there are Active ETFs...

<sup>6</sup> Source: Bloomberg, as of May 2025

regulator signalled a relaxation of these rules. Updated guidance now permits actively managed UCITS ETFs to disclose their full portfolio holdings as infrequently as once a month, with a maximum lag of one month, provided managers justify the frequency and balance it against the need to safeguard proprietary information<sup>7</sup>. Additionally, Luxembourg has eliminated subscription taxes (*taxe d'abonnement*) for active ETFs, a move that reduces costs for the fund issuer and aligns with passive ETFs. Ireland, Europe's leading ETF domicile, followed suit in April 2025.

Ireland has also adapted its regulatory stance to encourage growth. The Central Bank of Ireland has approved the creation of ETF share classes within existing mutual funds, a structure previously underutilised due to naming conventions. Recent convergence with Luxembourg's approach, which allows the "UCITS ETF" identifier at the share class level rather than mandating it for the fund – further simplifies the launch of listed share classes<sup>8</sup>.

Together, these developments in Luxembourg and Ireland have reduced deterrents for asset managers considering active ETF strategies. With fewer regulatory and cost-related obstacles, Europe may see an increased proliferation of active ETFs. Despite these developments the role of semi-transparent ETFs remains marginal. In the U.S., semi-transparent ETFs make up of 1.5% of the total Active ETF assets under management and also European launches so far favoured full transparency<sup>9</sup>.

### Difference #2: Investor Base

Another standout driver for the rapid and successful rise of Active ETFs in the U.S. is the participation of retail investors in the ETF market. In the U.S., the investor base is increasingly balanced, with professional/institutional clients accounting for approximately 60% of the market and retail clients comprising the remaining 40%. This contrasts with Europe, where the ETF market split has historically leaned toward institutional investors at 75%<sup>10</sup>. It is no surprise that institutional-grade solutions are focal points of past and present product development.

In Europe this dynamic, however, is shifting. A growing number of retail clients are entering the ETF market, driven by digital trading platforms and a preference for cost-efficient investment vehicles. The rise of retail investors is proving to be a pivotal force in the broader adoption of ETFs, including active strategies. These investors are self-directed and source investment insights from websites and social media rather than from traditional financial advisors. Complementing this trend is the proliferation of ETF-based saving plans, a phenomenon most prominent in Germany. These plans allow retail investors to systematically invest small amounts over time, further embedding ETFs into the financial habits of younger generations. As retail investors grow in importance, their preferences will shape the future of Europe's active ETF landscape, pushing managers to innovate and cater to this evolving demand.

### Difference #3: Tax Considerations

In addition to differences in regulation and market structure, a major factor for the rise of Active ETFs in the U.S. is their tax "efficiency" compared to mutual funds, largely due to in-kind redemption mechanisms enabling managers to potentially offset certain capital gains. For many investment applications, this makes ETFs the preferred wrapper in the U.S.. Direct mutual fund conversions hence explain the majority of the active ETF growth observed.

In Europe, the tax advantage of ETFs over mutual funds is less pronounced. However, Irish-domiciled ETFs offer a different, and potentially significant, tax edge: a potentially lower withholding tax on U.S. dividends. Given the high weighting of U.S. equities in global benchmarks this dividend-related benefit is meaningful for European investors and not available in many established mutual funds.

Taken together, these trends explain why active ETFs may be one of the clearest areas where European ETF markets differ significantly from their U.S. counterparts, but this might change in the future, given the changing regulatory landscape and evolving investor base in Europe.

<sup>7</sup> See also ETF Stream [Luxembourg regulator to relax transparency requirements for active ETFs](#)

<sup>8</sup> [Central Bank of Ireland confirms that ETF share classes may be established within non-ETF UCITS](#) | Commercial Law Firm | Dillon Eustace

<sup>9</sup> ETFBook, DWS International GmbH calculations, as of May 2025

<sup>10</sup> See also EFAMA. (2023). [Asset Management in Europe and 2025 ETF Trends: Shaping market growth and innovation](#) | EY - Global

### 3 / The Quest to Enhance the Core

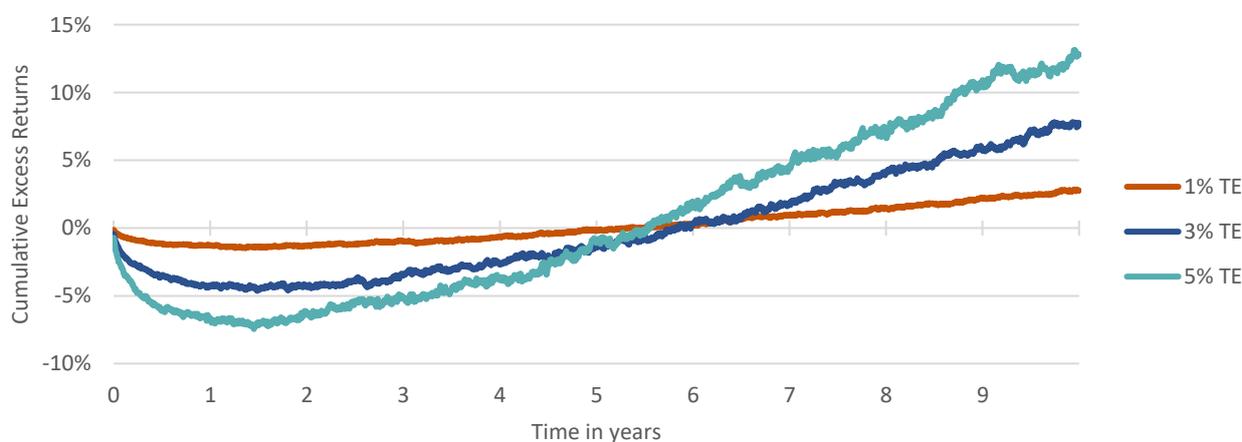
With these fundamental regional differences in mind, we shift the focus to the segment that underpins much of Europe’s active ETF growth: enhanced active. This category seeks to apply alpha forecasts paired with measured active risk to generate excess returns relative to a benchmark – without straying far from the index’s composition. This disciplined approach to putting an active risk budget front and centre might seem unconventional for many investors who would typically focus on absolute returns. However, on closer inspection, these strategies are valid core complements for many types of investors. We expect enhanced active solutions to become a major counterweight to the growing “passivation” of core portfolios in the years to come. After years of moving closer to benchmarks, investors are increasingly expressing interest to move beyond pure passive allocation and enhanced active is a natural stepping stone for this. While the offering in this segment is diverse and their exact analysis goes beyond the scope of this paper, the following explores their theoretical and practical attractiveness by looking at three key insights that can guide implementation:

#### Insight #1: Active risk should be deliberate, efficient and aligned with portfolio constraints

The prevalent use of broad market-based indices as benchmarks for institutional investors underscores their central role in both fixed-income and equity portfolios, the increasing share of passive solutions in investor’s portfolios is underpinning this trend. But this raises a critical question: why do institutional investors exhibit such preference for passive solutions and hesitate to include higher-tracking-error strategies that entail greater active risk? One perspective to address this question lies in analysing the fair expectations of benchmark underperformance associated with varying levels of tracking error. After all, the assessment of manager skill is an ex-ante exercise. Investors can use past excess returns and past benchmark deviations (active risk) as means to estimate the manager’s efficiency. The key metric for this is the Information Ratio (IR), which measures returns vs benchmark per unit of active risk. For investors that are benchmark-focused, the tracking error however remains an important consideration. To explore this, we simulate in cumulative excess returns of hypothetical portfolio managers, each with identical management skills (Information Ratio = 1), across tracking error levels of 1%, 3%, and 5%.

Figure 4: Strategies with identical Information Ratios can have different downside risks

1<sup>st</sup> percentile of simulated cumulative excess returns of three strategies for different Tracking Error levels



Source: DWS International GmbH calculations, past performance, actual or simulated, is not a reliable indicator of future results. As of 28/04/2025  
The simulation assumes that excess returns follow a random walk, with a drift parameter to reflect the expected active returns and volatility derived from the tracking error.

It should not come as a surprise that the risk of underperformance is proportional to the tracking error. To illustrate the potential risks, we plot in Figure 4 the first percentile of the simulated cumulative excess returns, representing an unlikely and highly adverse outcome, which investors remain mindful of. While acknowledging the limitations

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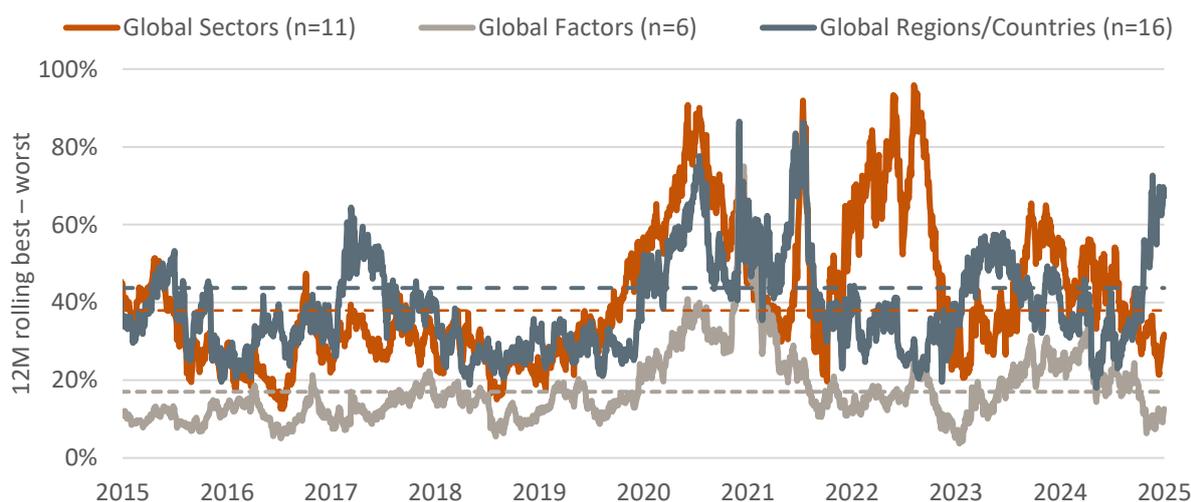
of such a simulation, this approach effectively highlights a key argument: higher-tracking-error strategies expose investors to significant short-term underperformance risks. For instance, at a tracking error level of 5%, the worst 1% of cumulative excess returns, depicted by the light blue line, underperformance versus the benchmark may hit 7.5% within the first couple of years of investment. Looking at the other side of the spectrum, a strategy with just 1% tracking error will have a much lower risk of underperforming the benchmark, illustrated with the orange line. The worst 1% of cumulative excess returns declines only down to -1.5%. In practice, returns are rarely linear and hence the underperformance risks may compound if they coincide with drawdowns. This has become a key reason why institutional investors favour low-tracking-error strategies overall, prioritising consistency rather than magnitude of excess returns.

Another way to frame this is to recognise that many institutional investors today are constrained not only by a tracking error budget, but also by facing a tracking difference threshold – a hard cap on how far portfolio performance may deviate from the benchmark. Larger tracking error budgets do not just increase the expected returns – they also widen the tails of the distribution of possible outcomes. This makes both overshooting and undershooting internal performance targets more likely, increasing the probability that a fund will miss its stated objective.

The heightened interest in balancing tracking risks however extends beyond mere governance considerations. Elevated market volatility and increasing dispersion have served as a stark reminder to investors of the significant risks associated with running sector, factor, regional, or idiosyncratic risk exposures. Figure 5 illustrates the dispersion metrics investors observe across key portfolio construction lenses, plotting the best versus worst rolling performance in each category (sector, factor, region). Utilising these building blocks to overweight or underweight versus the benchmark, for example via smart beta or simple sector ETFs has become a prominent trend. Over the past five years, increased volatility among these, however, has heightened the risk of investors being caught off guard by market movements when implementing static or dynamic portfolio tilts themselves.

Figure 5: Dispersion across key investor building blocks – Sectors, Factors and Regions

Rolling 12-month total return difference between best and worst performing building block within category



Source: DWS International GmbH calculations, based on MSCI indices, past performance, actual or simulated, is not a reliable indicator of future results. As of 28/04/2025

**Insight #2: Strategy selection and allocation should be driven by their risk-efficiency**

Having established their overall tracking error budget, investors face a crucial decision regarding strategy selection. The rise of passive investing has led to the widespread adoption of barbell-style allocations, where pure passive strategies are combined with high-conviction active approaches. However, investors may want to reassess this approach.

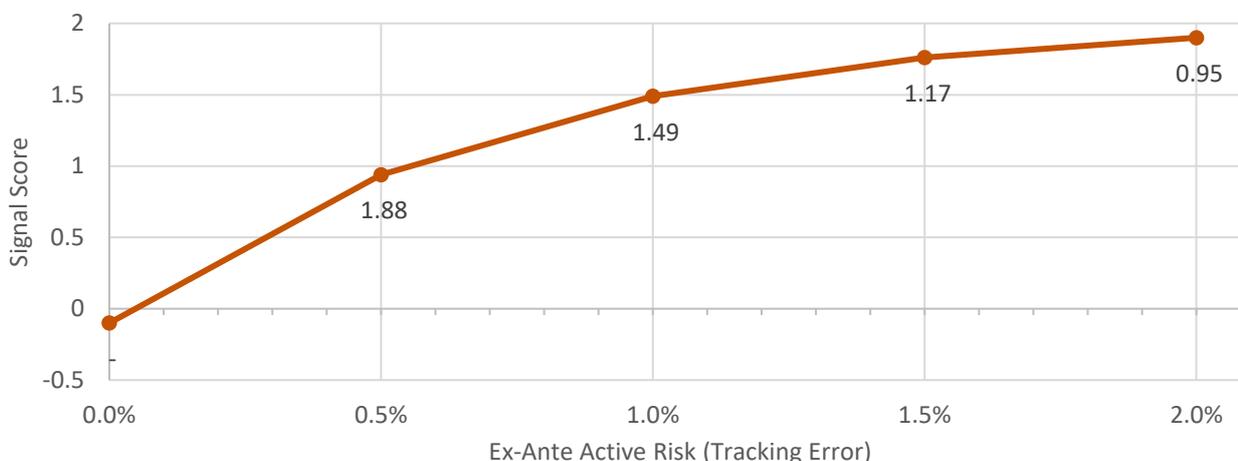
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When allocating capital to active strategies within a benchmark-aware framework, the objective is not to maximise absolute returns, but rather to optimise the use of active risk to generate consistent, repeatable value-add per unit of deviation. In this context, tracking error functions as a scarce resource that must be allocated with discipline across competing alpha signals. The Information Ratio serves as the key metric in this process, capturing the fundamental trade-off. It provides a crucial measure of risk-adjusted alpha, quantifying how effectively active skill is translated into benchmark-relative performance. Importantly, this relationship typically exhibits non-linear characteristics. While larger benchmark deviations allow for higher potential excess returns, the marginal benefit of additional active risk typically declines as the risk budget expands. This occurs because early increments of active risk tend to tilt to high-conviction, high-signal positions, without excessively leaning into idiosyncratic risks.

To illustrate this steeper return-to-risk trade-off, we consider a stylised optimisation using the MSCI World Index. Each security is assigned a conviction score (ranging from -2 to +2), representing a manager's proprietary alpha forecast. An optimiser then constructs portfolios that maximise signal alignment for a given tracking error budget. The resulting frontier, plotting signal strength against tracking error, is upward sloping but concave. This has important theoretical implications, which more often than not also translate into investment practice: Risk-adjusted performance, as measured by the Information Ratio, tends to be highest at lower tracking error levels, where active weights are most aligned with high-conviction views and implementation costs are relatively low. Enhanced active strategies operating in the tracking error range to 1.5% are a preferred building block. Their controlled tracking error profiles also support stronger alignment with institutional governance and benchmark-relative constraints.

**Figure 6: When implementing a view, investors face decreasing returns to risk**

Based on MSCI World and randomly assigned conviction score from -2 to +2, then using Bloomberg PORT to maximise the score for a given level of TE



Source: DWS International GmbH calculations, based on MSCI World composition. As of 28/04/2025

So, is the answer simple? If enhanced active strategies deliver the highest expected Information Ratio, should investors allocate exclusively to it? Not quite. While enhanced strategies can offer compelling risk-adjusted returns, concentrating the entire risk budget in a single strategy overlooks two key realities: forecast uncertainty and diversification benefits. As we have assumed in Insight #1, even the most efficient strategy can, at least temporarily, underperform. And allocating across multiple sources of (not-perfectly correlated) alpha sources can improve overall portfolio stability.

For investors with a fixed tracking error constraint efficiency therefore comes not just from selecting higher Information Ratio strategies, but from sizing them correctly. Concentrating all risk in a single strategy may look optimal ex-ante. A better outcome often comes from blending complementary strategies, each risk-weighted in line with its Information Ratio.

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This principle applies equally within the enhanced active segment itself. Investors today face a growing set of implementation styles – from dynamic multi-factor models to bottom-up fundamental insights – all delivered within a benchmark-aware framework. While grouped under the same label, enhanced strategies differ meaningfully in signal sources, portfolio construction, and risk profiles. This can create particular diversification benefit.

### Insight #3: Enhanced active strategies are a tool to bridge gaps between Core and traditional alpha allocation

Returning to the full portfolio context, investors therefore have good reasons to combine alpha strategies. However, due to the properties of enhanced indexing, once onboarded, they often justify sizeable allocation multi-strategy portfolios. The below illustrates this by means of a stylised portfolio construction example where three strategies are available to the investor:

Table 2: Choice of three different assets for equity portfolio construction

Strategy	Excess Return (%)	Tracking Error (%)	Information Ratio
Passive	0.00	0.05	0.00
Enhanced Active	1.26	1.80	0.70
High Conviction	5.25	7.50	0.70

Source: DWS International GmbH, for illustrative purposes only. May 2025

Importantly the two active strategies – Enhanced Active and High Conviction – are assumed to exhibit the same Information Ratio of 0.7 – signifying identical levels of manager skill in their given risk envelope. We also assume a return correlation of 0.5 between the active strategies to reflect different management approaches and sources of alpha generation. We then employ mean-variance optimisation to build the most efficient portfolio and compare it to an investor who has disregarded the enhanced indexing category before.

Table 3: Benchmark-aware investors can often improve traditional “barbell”-allocations

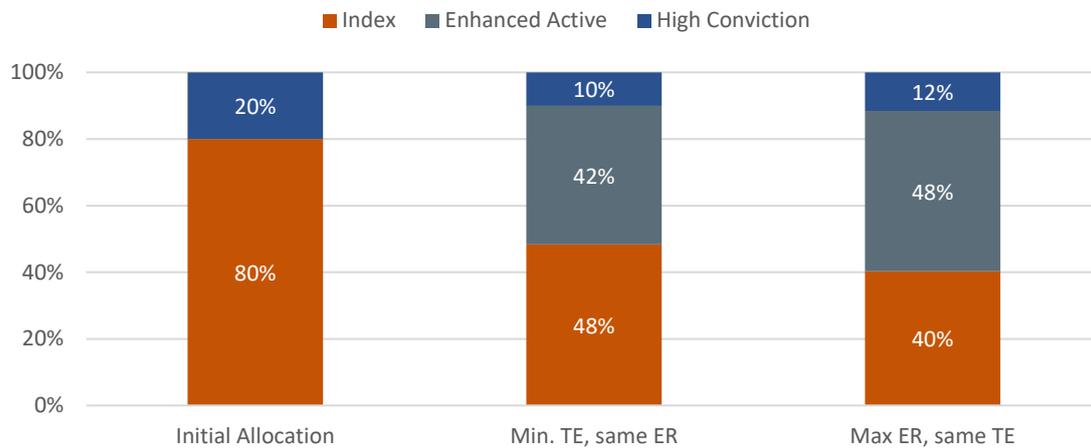
Portfolio Characteristics	Initial Allocation	Min. TE, same ER	Max. ER, same TE
Excess Return	1.05%	1.05%	1.21%
Tracking Error	1.50%	1.30%	1.50%
Information Ratio	0.70	0.81	0.81

Source: DWS International GmbH, for illustrative purposes only. May 2025

This additional room for portfolio design offers clear benefits to the investor as the efficiency of capital allocation can improve. For example, using the above assumption, the active risk of the portfolio could be reduced by 20 basis points (from 1.50% to 1.30%) without sacrificing expected return. This is achieved largely by reallocating toward enhanced active, which now comprise 42% of the portfolio. Alternatively, return-seeking investors could increase expected return for the same level of tracking error.

**Figure 7: Sizeable allocations to benchmark-aware strategies can be optimal for investors**

Optimized portfolio allocations, starting from an initial allocation that disregards the enhanced indexing category.



Source: DWS International GmbH, for illustrative purposes only. May 2025

The consistent conclusion across this illustrative example is clear: even when all strategies are equally efficient, enhanced strategies receive a disproportionately high allocation due to their capital efficiency. They deliver more stable return per unit of risk without introducing significant volatility or drawdown risk – making them a natural anchor for any benchmark-aware portfolio.

Over the past decade, much of institutional portfolio construction was defined by aligning portfolios with preminent benchmarks. Today that mindset is evolving. With disciplined risk budgets investors increasingly aim to move beyond benchmarks – not by abandoning them but by optimising with their constraints. Enhanced strategies in an active ETF wrapper can offer a compelling middle ground: the capital efficiency of passive, paired with precision and intentionality of active allocations.

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## Related reading

- CFA Institute Research Foundation (2024). Smart Beta, Direct Indexing, and Index-Based Investment Strategies: A Framework.
- DWS. (2024). Yes, Virginia, there are Active ETFs...
- EFAMA (2025). The Rise of Active ETFs in Europe – A Short Overview.
- Financial Times (2025). Traditional Index Trackers Shunned in January US ETF Flows.
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- Morningstar (2024). Morningstar's Guide to U.S. Active ETFs.
- Morningstar. (2024). Active ETFs in Europe: Small, Shy, and on the Rise.

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