How Beta Investors Keep Alpha Under Control

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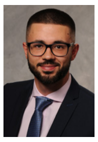

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Active ETFs are redefining the parameters of modern portfolio construction, offering solutions to the challenges faced by institutional investors. While it is easy to get lost in the rapidly expanding array of active ETFs, when investing in them European institutional investors have remained firmly anchored near core allocations around established benchmarks such as MSCI World and Europe. This preference for opportunities with less active risk is not a reflection of conservatism or lack of innovation, but rather a rational response to the structural constraints they face.

Today, the actively managed equity ETF market in Europe is valued at €38 billion, and if growth rates persist, it may exceed €50 billion by year-end. Within this market, there are three main types of solutions. Alpha-focused active ETFs, that aim to generate excess returns by a range of methods – from leveraging systematic factor exposures to high-conviction selection. Outcome-oriented strategies focus on reshaping the distribution of returns, offering solutions that can enhance income or reduce volatility through options-based overlays or payoff engineering. Additionally, a new cohort of access-oriented active ETFs is emerging, providing scalable exposure to market segments not well served by traditional benchmarks.

So far Europe's institutional investors have focused on a subset of alpha-focused strategies, particularly those offering tightly controlled active risk versus core benchmarks, typically between 100-150 basis points. While systematic active strategies that have long catered to this role, the ETF wrapper provides new opportunities to integrate these strategies into portfolios, as intraday liquidity and daily transparency of holdings expand the spectrum of applications. Based on our experience, there are three key drivers for this growing preference.

The Role of Dispersion

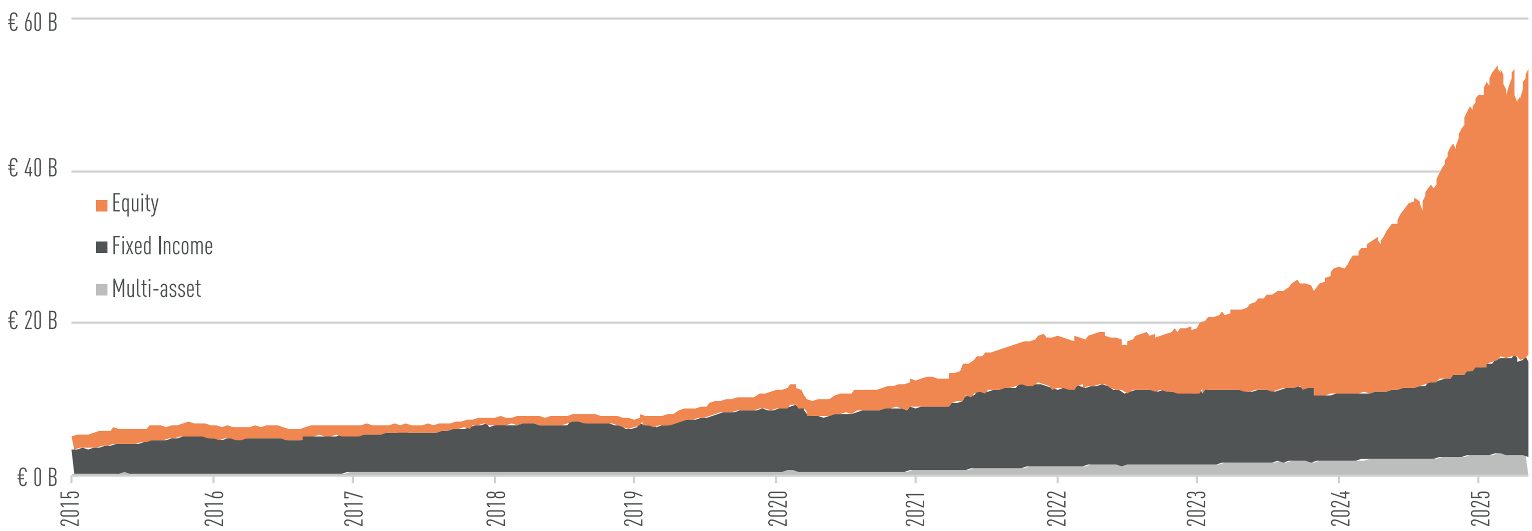
The rise of the "Magnificent 7", (the end of) "US exceptionalism", the European "GRANOLAS", and the China "Tech 8" are all symptoms of a growing cross-sectional dispersion in sectors, factors, regions, and single stocks. Widened differentials between top and bottom performers create opportunities but also raise the risks of unbounded active strategies. As dispersion remains a dominant theme, the value of a risk-managed implementation grows, making the alignment of portfolios with the core increasingly appealing.

The Role of Institutional Constraints

Globally, investors are navigating increasingly codified rules around benchmark adherence, and risk attribution. For many asset owners, the benchmark is not simply a reference—it is the foundation of performance reporting, and the accessibility of beta has narrowed the margin for deviation, particularly among regulated pools such as insurance capital, corporate pensions, and public sector funds.

Larger active risk budgets also do not just increase 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. Within this context, strategies that can deliver modest

Figure 1: European Active ETF Assets under Management growth driven by Equity



Source: ETFBook and Xtrackers calculations, as of 09/05/2025.

Xtrackers by DWS

but consistent excess returns without breaching those limits are structurally advantaged.

Efficiency at the Core

Overlaying these forces is a deeper change in how capital is allocated. Institutional portfolio construction is increasingly guided by risk efficiency (information ratio), not just absolute return potential. In this framework, strategies that offer a higher return per unit of active risk become more scalable in the portfolio. Between two strategies with the same risk efficiency, investors then choose the lower active risk option. This role of sizing the allocation opportunities properly is increasingly important.

The below illustrates this by means of a stylised portfolio construction example where three different equity strategies are available to the investor and mean-variance optimisation is used to embed an exemplary enhanced active strategy with a moderate risk profile into the portfolio. This additional building blocks allows the construction of portfolios, that either have lower risk or higher expected returns due to the high degree of capital efficiency of these strategies.

The example also illustrates that they are also not displacing passive exposure, nor are they competing with high-octane alpha funds—instead, they are helping investors fill the space between benchmark replication and unconstrained risk. After a decade of growing "passivation" via the ETF wrapper, this might be a useful evolutionary step in implementation.

Figure 2: Enhanced indexing is a key tool to bridge the gap between Core and traditional alpha allocations

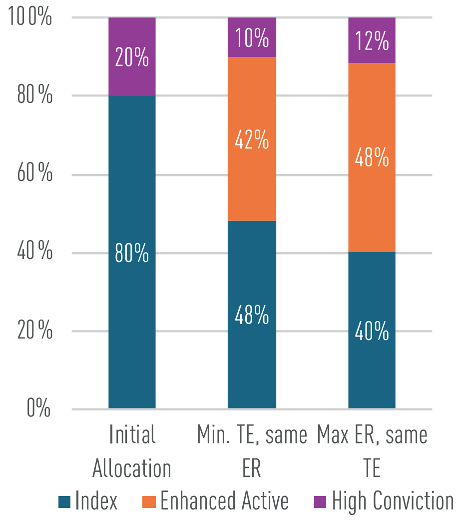
Choice of three different assets for equity portfolio construction

Strategy	Excess Return (%)	Tracking Error (%)	Information Ratio
Passive	0	0.05	0
Enhanced Active	1.26	1.8	0.7
High Conviction	5.25	7.5	0.7

Benchmark-aware investors can often improve traditional "barbell"-allocations

	Initial Allocation	Min. TE, constant ER	Max. ER, constant 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

Efficient portfolio allocations



Source: DWS International GmbH, for illustrative purposes only. Enhanced active and high conviction strategies are assumed to exhibit the same Information Ratio of 0.7. We also assume a return correlation of 0.5 between the Enhanced Index and the high conviction. We then employ long only mean-variance optimisation to build the most efficient portfolio. Forecasts are based on assumptions, estimates, opinions and hypothetical models that may prove to be incorrect.