Insights

FTSE Russell

Trends and outlook for smart beta

Insights from the 2017 FTSE Russell global smart beta survey[1]

Smart Beta indexes and their associated investable products have upended conventional understanding of terms like active, passive, alpha and beta and transformed the investment landscape in profound ways that are still being digested by the market. For four years FTSE Russell has documented this transformation through its global smart beta survey of institutional asset owners. The 2017 survey results reinforce many trends observed in previous surveys and signal some new directions.

An overall assessment of the survey results is provided by Rolf Agather, managing director of research:

> *"The trend observed over the past three years of increasing global growth and adoption of smart beta indexes continues in 2017. It is clearly not a fad, but now widely recognized as a meaningful set of new tools."*

We will drill down on some of the more interesting aspects of the survey and provide our perspective on the outlook for the future.[2]

Trend rates of growth in smart beta – who and where

As in past years, the 2017 survey sample included a wide range of decision makers from across a broad spectrum of assets under management (AUM) and at a variety of stages in their evaluation of smart beta. Almost 200 asset owners responded. We divided the respondents into three AUM tiers: 19% were under $1billion, 34% were $1billion to $10billion, and 47% were over $10billion. Regionally, the respondents were drawn from North America (43%), Europe (32%), Asia Pacific (19%) and other regions (5%) and have an estimated total AUM of over $2 trillion.

[1] For the full report: http://www2.londonstockexchangegroup.com/Smart-Beta-Results-2017-Home-Page

[2] Data included in this Insights is sourced from the surveys undertaken in each of the four years from 2014 to 2017, as indicated in the relevant section and exhibit.

The organizational range of respondents was a fairly even mix of corporate (26%), government (23%), non-profit and university (13%), union & industry pensions (11%) and other (27%). The institutional plan type was led by defined benefit (55%), followed by defined contribution (36%) and endowments & foundations (18%).

The global adoption rate of smart beta has steadily climbed to 46% in 2017. European asset owners have consistently had the highest rates of smart beta adoption over the four years of the survey (60% in 2017), followed by Asia-Pacific (48%) and North America (37%).

Regarding AUM tiers, the sharpest jump in adoption percentage was in the midsize $1billion to $10billion range: 32% in 2016 to 57% in 2017. This is even higher than the top AUM tier asset owners, which past surveys showed were the earlier adopters. This result squares with our own experience in talking to asset owners. Large pension funds showed the most interest early on, often adopting alternatively-weighted index-based strategies such as fundamental or equal weighted investable products as complements to their cap weighted passive investment strategies. Midsize and small pension funds have taken longer to get comfortable with the smart beta concept. As we shall see, the rise of factor investing has helped stimulate the smart beta movement.

Exhibit 1. Global smart beta adoption rates

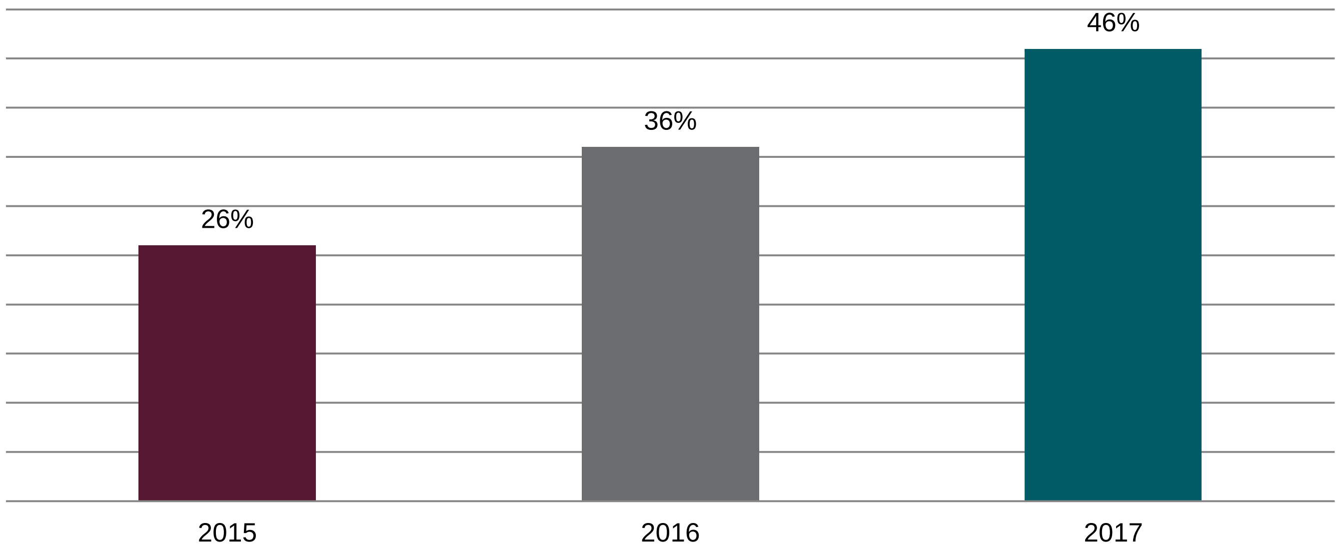
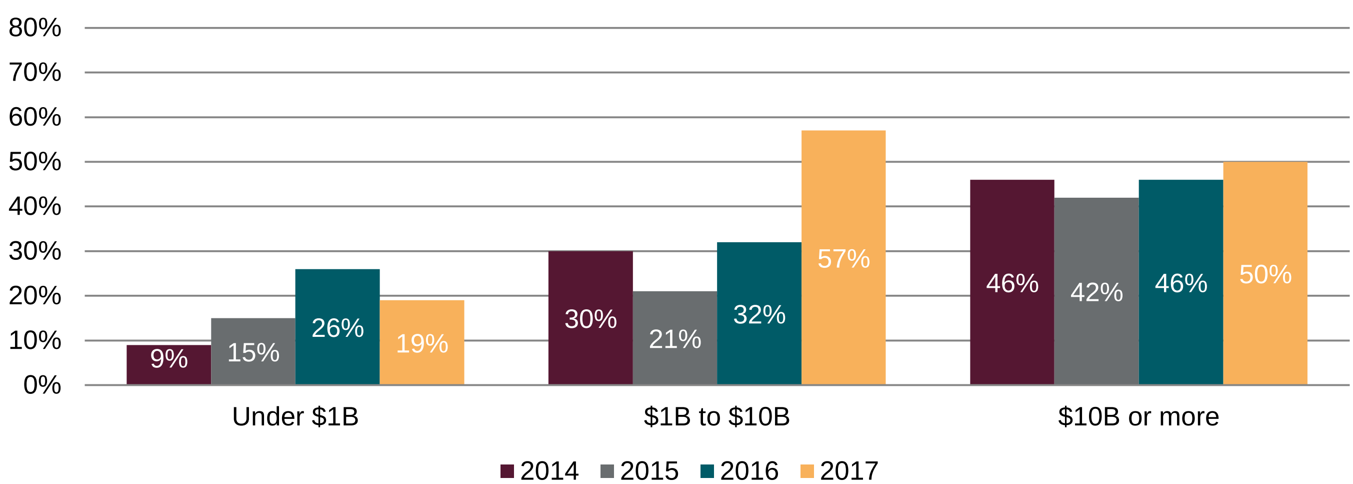


Exhibit 2. Smart beta adoption by asset size

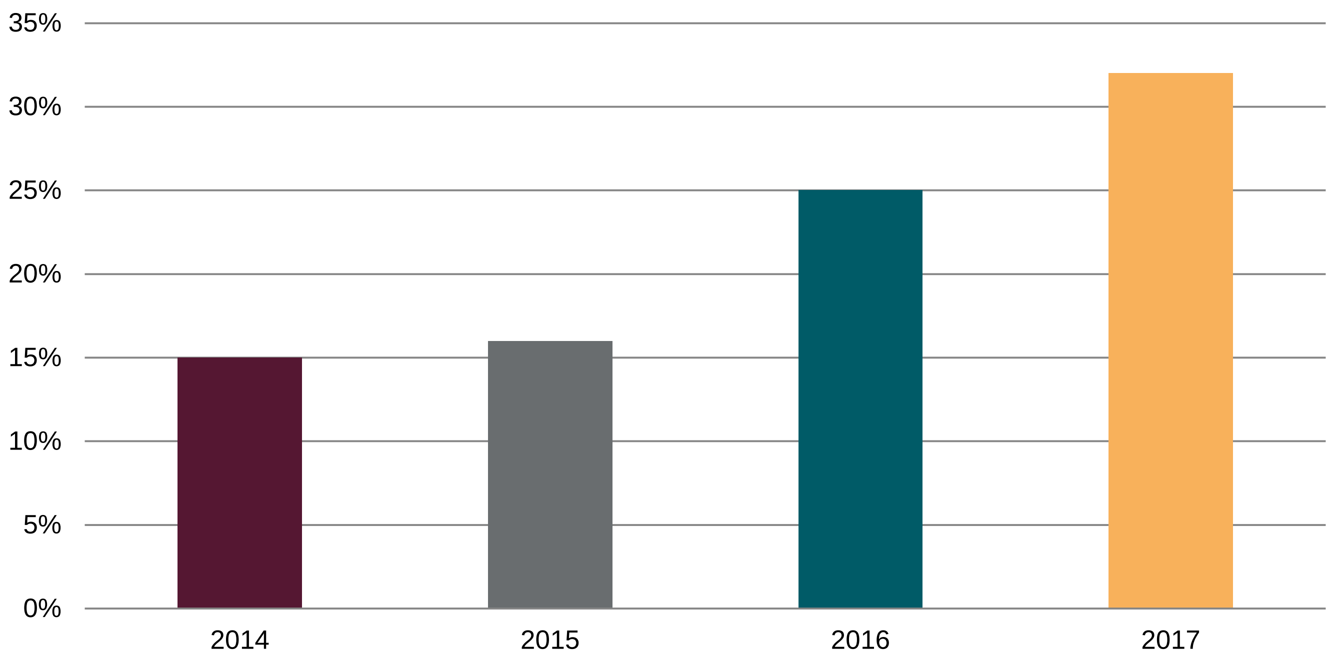


Getting to the "why" of smart beta

There is much debate in the industry about how smart beta might fit into a portfolio, so it is always interesting to see how it is perceived by the owners of those portfolios. Every year of the survey "risk reduction" and "return enhancement" have been the top answers to the question regarding investment objectives in evaluating smart beta strategies. "Improve diversification" has always finished a solid third.

But a strong trend in "cost savings" as an investment objective has made it a close fourth choice. In an era of increased emphasis on fee budgets for defined benefit (DB) plans and a focus on providing the end investor with good value for money for defined contribution (DC) plans, an increasing number of asset owners are seeing smart beta as a useful tool to hold down costs. We can see that in the responses to the question, "Where are funds coming from in your smart beta allocations?" In total, 69% indicated the money came out of either active strategies (34%) or a combination of active and passive strategies (35%). This result corresponds to the many reports we have all seen about the simultaneous decline in active assets and increase in passive assets, including smart beta allocations. To be sure, some of that shift in assets is due to disappointment in active asset performance, but cost is top of mind for many asset owners today.

Exhibit 3. Cost savings as an investment objective of smart beta



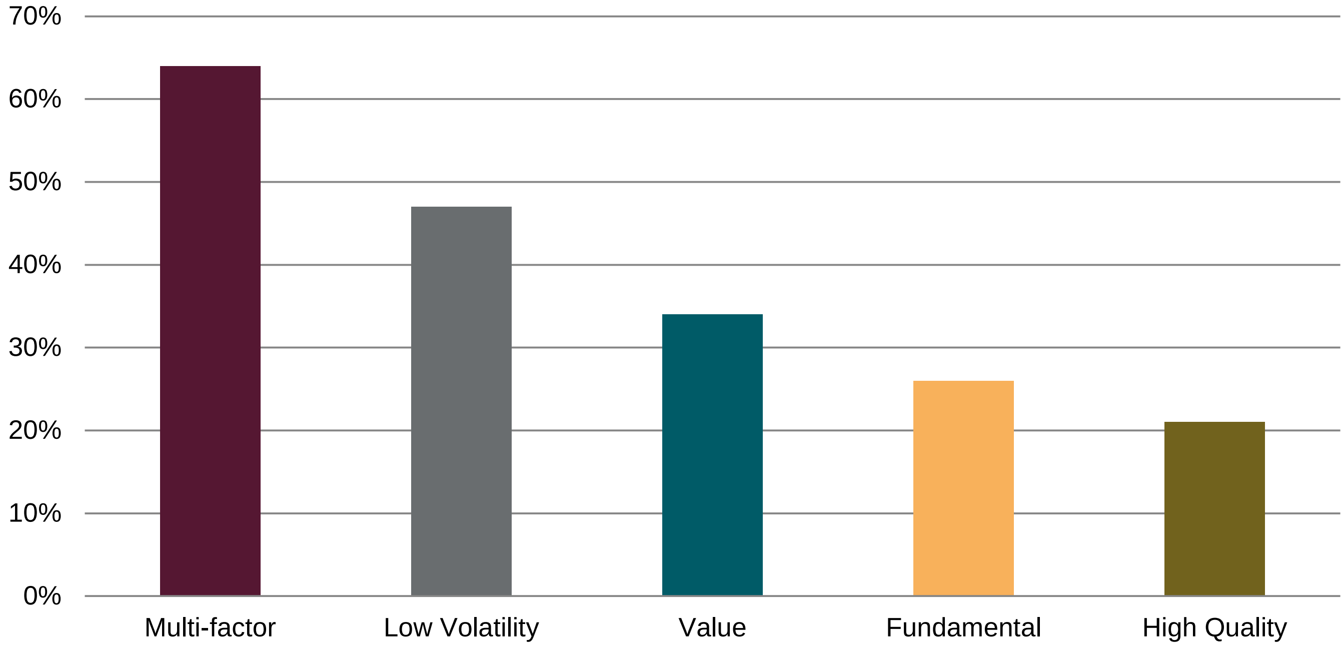
Source: FTSE Russell, Smart beta: 2017 global survey findings from asset owners. Results from question: "What investment objectives initiated evaluation of smart beta strategies?" Multi-pick; Segment = Have a smart beta allocation, evaluated and decided not to implement, currently evaluating smart beta.

Equity smart beta strategies – a shifting landscape

The term "smart beta" has always encompassed a variety of investment strategies. FTSE Russell classifies these various approaches into two broad categories of smart beta indexes: alternatively-weighted and factor indexes. In the early days of smart beta, most smart beta allocations were to alternatively-weighted strategies based on fundamentally-weighted and equal-weighted indexes, plus single factor indexes like low volatility and value.

More recently, factor investing has become a mainstream concept, and factor analysis has taken an equal place next to traditional asset allocation analysis for many asset owners. This has led to a dramatic uptick in interest in multi-factor index-based strategies. Among those asset owners who have smart beta allocations, multi-factor combinations now top the league table with 64%. That's up from 20% and fourth place just two years ago.

Exhibit 4. Top five smart beta strategies—2017



Source: FTSE Russell, Smart beta: 2017 global survey findings from asset owners. Results from question: "What type of smart beta strategies are you currently using?" Multi-pick. Segment = Have a smart beta allocation.

Our view is that the trend toward multi-factor index-based strategies appears likely to continue. Amongst asset owners who have adopted a smart beta strategy within the last two years, 71% have employed a multi-factor combination. Moreover, 74% of asset owners who are currently evaluating smart beta strategies are focused on multi-factor combinations.

Fixed income and smart beta – a future trend

This year, questions about fixed income and smart beta were included in the survey to serve as a baseline for future surveys. We did not expect there would be much adoption or even evaluation of fixed income smart beta because of the absence of generally accepted investment themes that have been proven over a market cycle, not to mention a dearth of investable products. Our expectation was accurate: only 7% indicated any kind of fixed income smart beta allocation with 73% indicating no plans to even evaluate a smart beta fixed income strategy over the next 18 months.

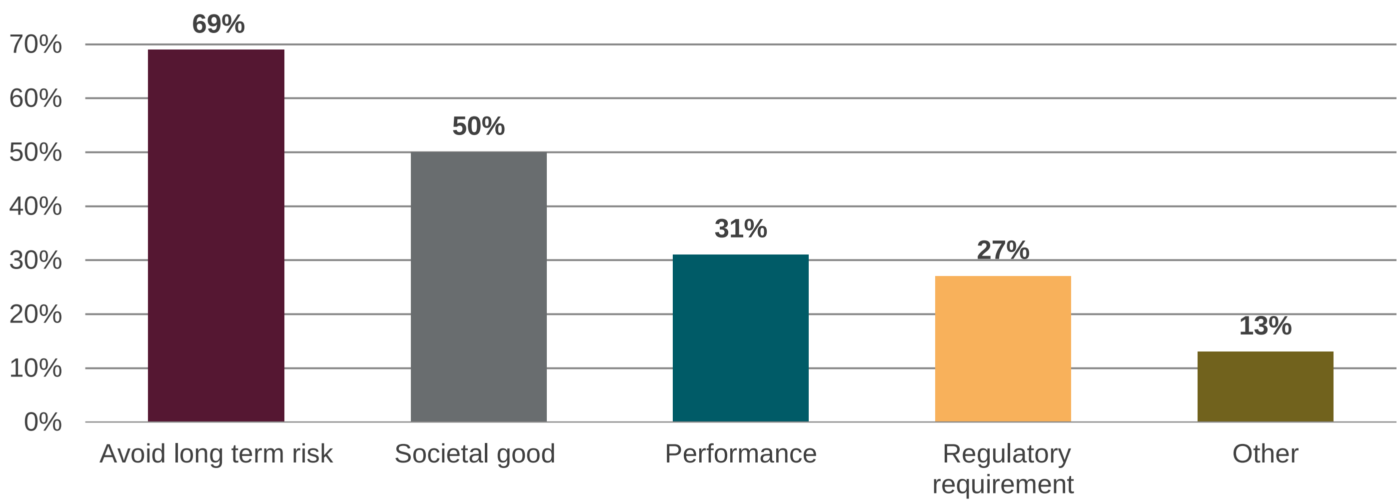
There's an old adage that everything about fixed income is harder than equities. Certainly there is a higher bar for analytical tools and analyst expertise to make sense of the complexities of that market. That is why FTSE Russell is excited about the announcement that London Stock Exchange Group plc is to acquire The Yield Book and Citi Fixed Income Indices, and the expert staff of analysts that come with them. Going forward, we will be looking to leverage that expertise into both fixed income and multi-asset smart beta indexes.

ESG and smart beta – a natural pairing?

Environmental, social and governance (ESG) investing (also known as socially responsible investment, SRI) has been gaining visibility for quite some time amongst institutional asset owners. For the first time, this year the survey contained questions about applying ESG considerations to smart beta. The interest is measurable, with the most coming from European asset owners – 60% said they will be applying ESG considerations to their smart beta strategy – while it is only 20% in North America. Also the greater interest is with larger plans, those greater than $10billion. An interesting result is that the primary motivations for using a smart sustainability strategy are investment-led rather than regulatory or social/ethical.

The notion of integrating ESG with smart beta is relatively new. Two trends that have helped are, on the one hand, a movement within ESG investing away from negative screens, and, on the other hand, the rise of factor investing within smart beta. Negative screens are increasingly seen as “throwing the baby out with the bathwater” and more recent thinking is to use ESG information on individual companies to tilt the capitalization weights up or down depending on a quantitative score. This melds naturally with the multi-factor methodology of tilting capitalization weights toward a desired factor exposure. FTSE Russell has already constructed a multi-factor climate-risk-aware index that tilts equity weights toward both factor and climate aware exposures simultaneously.

Exhibit 5. Motivations for applying ESG considerations to a smart beta strategy



Source: FTSE Russell, Smart beta: 2017 global survey findings from asset owners. Results from question: “What is your motivation for applying ESG considerations?” Multi-pick. Segment = Have a smart beta allocation OR are currently evaluating smart beta strategies OR are planning to evaluate smart beta strategies in the next 18 months AND anticipate applying ESG considerations to a smart beta strategy.

Outlook

A happy customer is a repeat customer. When asked how satisfied asset owners are with their smart beta strategies, 51% replied they were either satisfied or very satisfied. Only 2% reported to be dissatisfied. So perhaps it is no surprise that 76% of those who currently have a smart beta allocation are contemplating further allocations. Of those that do not have a current smart beta allocation but are contemplating one, 52% expect to make an allocation. Even amongst asset owners who currently have an allocation to smart beta but are not contemplating any more, 80% expect to retain their current allocation. All indicators are for continued growth in smart beta allocations. We expect the bulk of new growth to continue to be in the application of multi-factor and, increasingly, multi-factor–ESG strategies. But one shouldn’t overlook the “classic” strategies based on fundamental-weighted and equal-weighted indexes which will continue to appeal to asset owners with a contrarian bent.

Success in the institutional space usually leads to interest in the retail space, which we have already seen through the various advisor channels. There has been a tremendous growth in ETF products tracking smart beta indexes, making allocations to client portfolios easy to implement. Perhaps even more than in the institutional space, the advisor space has been under pressure to lower the costs to the end investor by avoiding added fees from active managers. Smart beta ETFs provide a compromise where active fees are avoided but an active strategy is still in place, albeit passively managed based on transparent index rules and methodology.

Finally, some asset owners are already conducting extensive due diligence on a smart beta index-based vehicle, and the underlying index provider, just as they would so for a new active manager appointment. As smart beta index-based strategies become more central to portfolio construction, the question of due diligence will need to be more rigorously addressed across asset owners and retail investment advisors.

For more information about our indexes, please visit ftserussell.com.

About FTSE Russell

FTSE Russell is a leading global index provider creating and managing a wide range of indexes, data and analytic solutions to meet client needs across asset classes, style and strategies. Covering 98% of the investable market, FTSE Russell indexes offer a true picture of global markets, combined with the specialist knowledge gained from developing local benchmarks around the world.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. $12.5 trillion is currently benchmarked to FTSE Russell indexes. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create investment funds, ETFs, structured products and index-based derivatives. FTSE Russell indexes also provide clients with tools for asset allocation, investment strategy analysis and risk management.

A core set of universal principles guides FTSE Russell index design and management: a transparent rules-based methodology is informed by independent committees of leading market participants. FTSE Russell is focused on index innovation and customer partnership applying the highest industry standards and embracing the IOSCO Principles. FTSE Russell is wholly owned by London Stock Exchange Group.

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