Insights

Five-year trends and outlook for smart beta

Insights from the 2014-2018 FTSE Russell global smart beta surveys[1]

This is the fifth year of the FTSE Russell smart beta global asset owner survey. This milestone presents an opportunity to look back and reflect on how smart beta indexes and their associated investable products have evolved and transformed the investment landscape.

Over these five years we have interviewed hundreds of asset owners globally managing over $10 trillion of assets. The 2018 survey results reinforce many trends observed in the previous four years and signal some new directions. An overall assessment of the five-year survey results is provided by Rolf Agather, managing director of research:

> *"The trends observed over the past five years of increasing global growth and adoptions of smart beta indexes show every sign of continuing. Smart beta is now widely recognized as a meaningful set of new tools with great potential for helping market participants achieve their goals."*

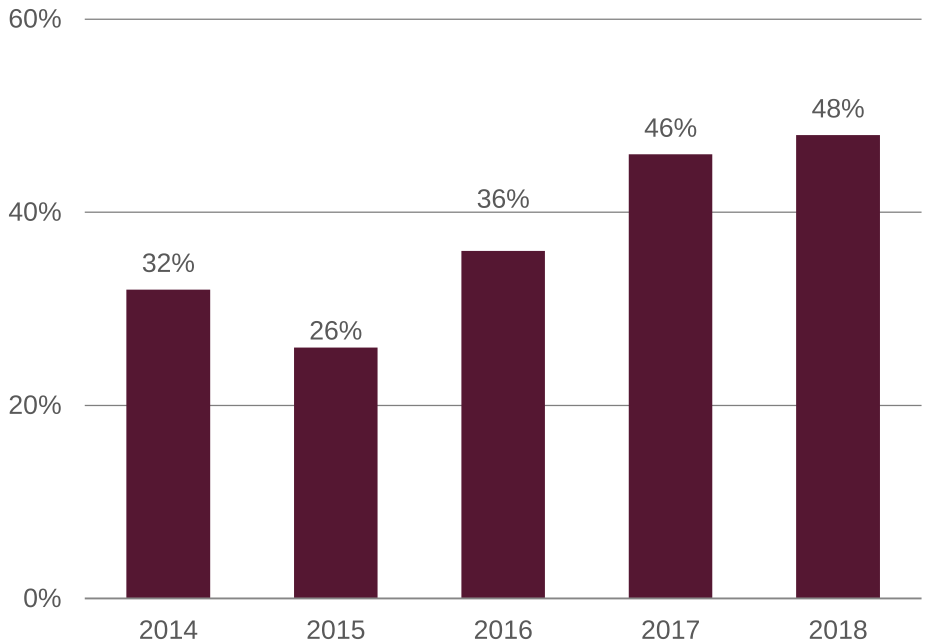
In this paper, we will drill down into some of the more interesting aspects of the survey results over the past five years and add to it complementary market data. We will also provide our perspective on the outlook for the future.

[1] For the full report visit http://www2.londonstockexchangegroup.com/Smart-Beta-Results-2018-Web.

Overall growth trends of smart beta indexes and products

Smart beta adoption rates have reached a record high of 48% according to the 2018 global survey findings. That becomes 91% if we add to that those who have evaluated or plan to evaluate a smart beta allocation. Only 9% of 2018 respondents have no current allocation and don't plan to evaluate smart beta in the future, compared to 25% in 2014.

Exhibit 1: Existing allocations to smart beta

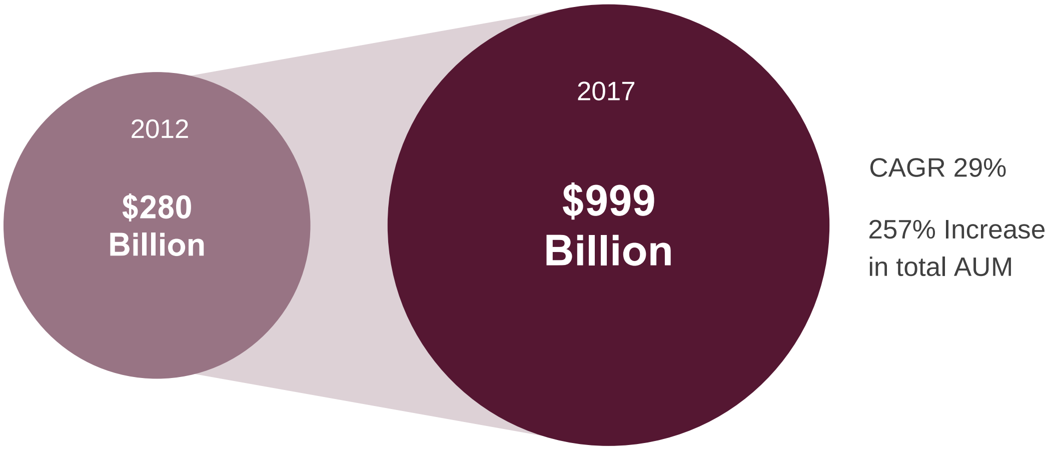


Source: FTSE Russell. Global smart beta surveys of asset owners, 2014, 2015, 2016, 2017, and 2018.

Available market data reinforces the trend we see in the surveys. According to Morningstar, smart beta assets under management (AUM) grew from $280 billion in 2012 to $999 billion at the end of 2017–a total increase of 257% over the five year period from 2012-2017 (CAGR 29%).[2] These figures include all public vehicles, such as mutual funds and ETFs, covering both the institutional and retail markets.

[2] Morningstar as of December 31, 2017. Please see the end for important legal disclosures.

Exhibit 2: Global smart beta AUM



Source: Morningstar as of December 31, 2017. Please see the end for important legal disclosures.

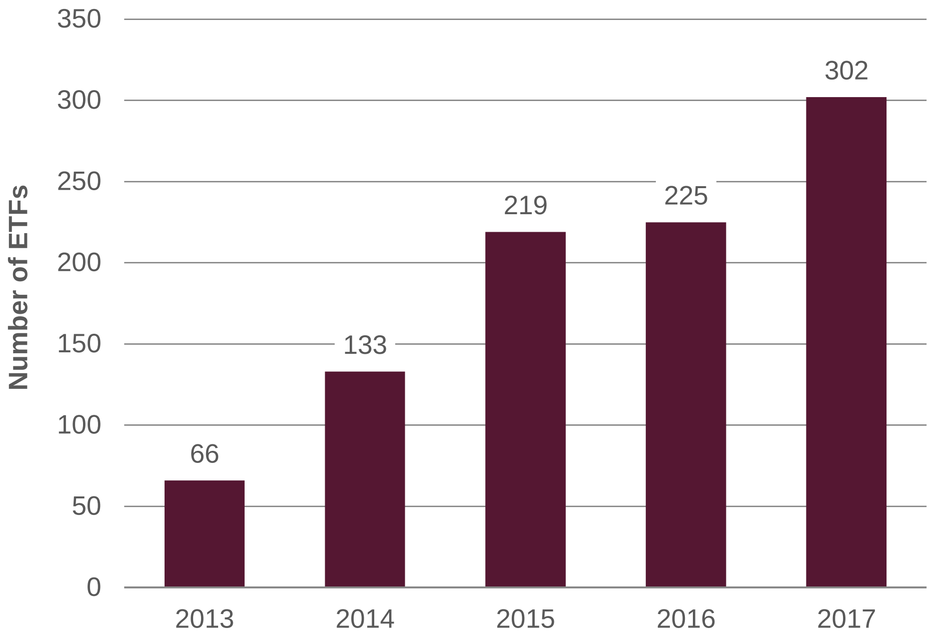
A large part of the smart beta AUM growth has been through ETF vehicles. This year, ETFs were the top survey response (51%) to the question of what vehicle is preferred for tactical smart beta allocations. Internal management (33%), separate accounts (27%), and mutual funds (16%) made up the bulk of the other responses.[3] These results relate to tactical implementation only. For strategic allocations, separate accounts were the most preferred vehicle with 46% of respondents.

Smart beta ETFs have grown in AUM. Morningstar reports $813 billion AUM in smart beta ETFs as of March 30, 2018.[4] Using a different database, ETFGI estimates that smart beta ETF AUM is up to $676 billion globally as of March 2018.[5]

Perhaps even more significant is the growth in the number of products. The lack of “off-the-shelf” products had been an impediment to adoptions in past years. But not so now: from 2017 to 2018, “increased off the shelf product availability” as an incentive to re-evaluate leapt from 8% to 56%. This parallels new product creation. Exhibit 3 plots new ETF creation according to Morningstar, and these figures do not include new mutual fund products.

[3] This was a multi-pick question and many respondents selected more than one preferred vehicle.
[4] Morningstar as of March 30, 2018. Please see the end for important legal disclosures.
[5] ETFGI as of March 30, 2018.

Exhibit 3: New smart beta ETF launches



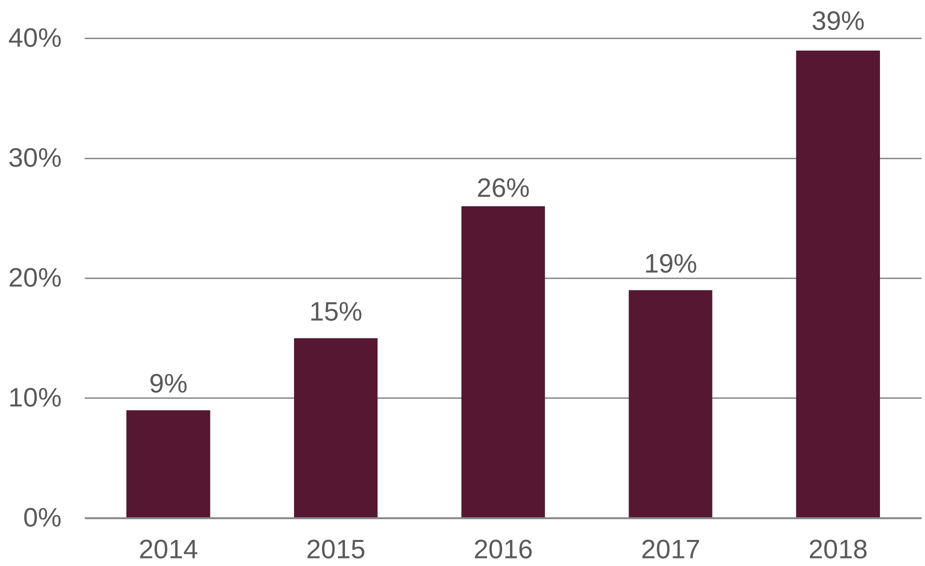
Source: Morningstar as of December 31, 2017. Please see the end for important legal disclosures.

Five-year trends in smart beta adoption by asset size and region

As in past years, the survey sample included a wide range of decision makers from across a broad spectrum of AUM levels and at a variety of stages in their evaluation of smart beta. We divided the respondents into three AUM tiers: under $1 billion, $1 billion to $10 billion, and over $10 billion. In the 2018 survey, 39% of respondents with less than $1 billion AUM had smart beta adoptions, 43% with $1 billion to $10 billion had adoptions and 56% of respondents with AUM over $10 billion had adoptions.

The most notable five-year trend in adoption of smart beta by asset size was in the smaller asset owners, with less than $1billion in AUM. From 2014 to 2018 the adoption rate rose from 9% to 39%. This is in line with our experience that the smaller AUM segment of the market was initially the least comfortable with smart beta concepts. Smaller asset owners do not have deep research departments and tend to rely more heavily on the recommendations of consultants than larger funds do. With notable exceptions, consultants as a whole were skeptical of smart beta four or five years ago, concerned that it might be a fad that they should steer clients away from. Today, it is fair to say that the bulk of the consultant community has concluded that smart beta is not a fad, but rather a useful set of tools that can be used to help their clients achieve their goals. Their positive recommendations have been one of the drivers in the sharp increase in adoptions in this market segment.

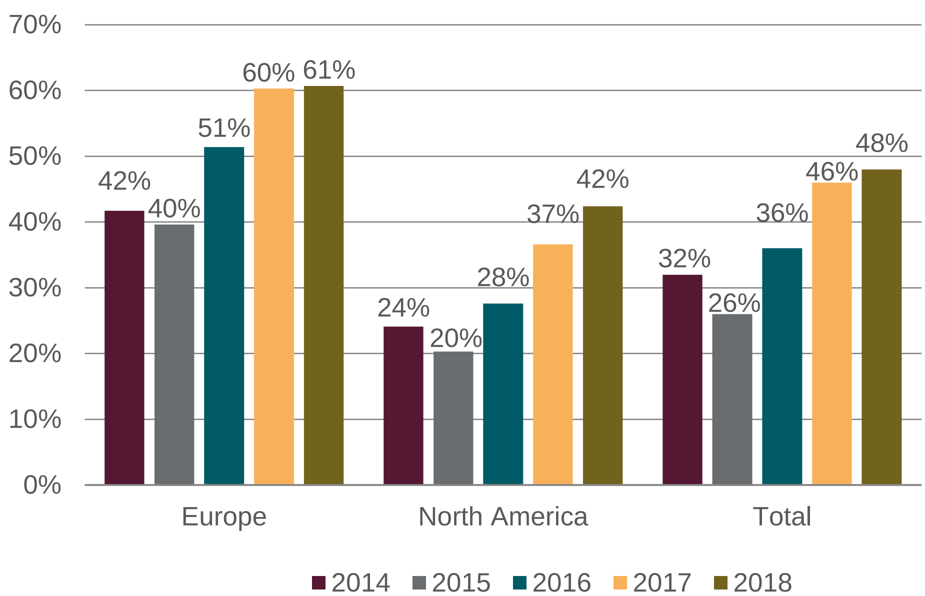
Exhibit 4: Adoption rate of asset owners with less than $1 billion AUM



Source: FTSE Russell. Global smart beta surveys of asset owners, 2014, 2015, 2016, 2017, and 2018.

A comparison of smart beta adoption by region shows that Europe's adoption rate has been consistently higher than in North America. The higher adoption rate in Europe may be in part driven by a wider disillusion with active management in Europe following the global financial crisis. As well, regulatory agencies in the EU and UK have been more insistent than in the US about reducing costs in pension schemes. Those differences may be narrowing as the North American adoption rates have been increasing at a faster pace in the last couple of years.

Exhibit 5: Smart beta adoption by region



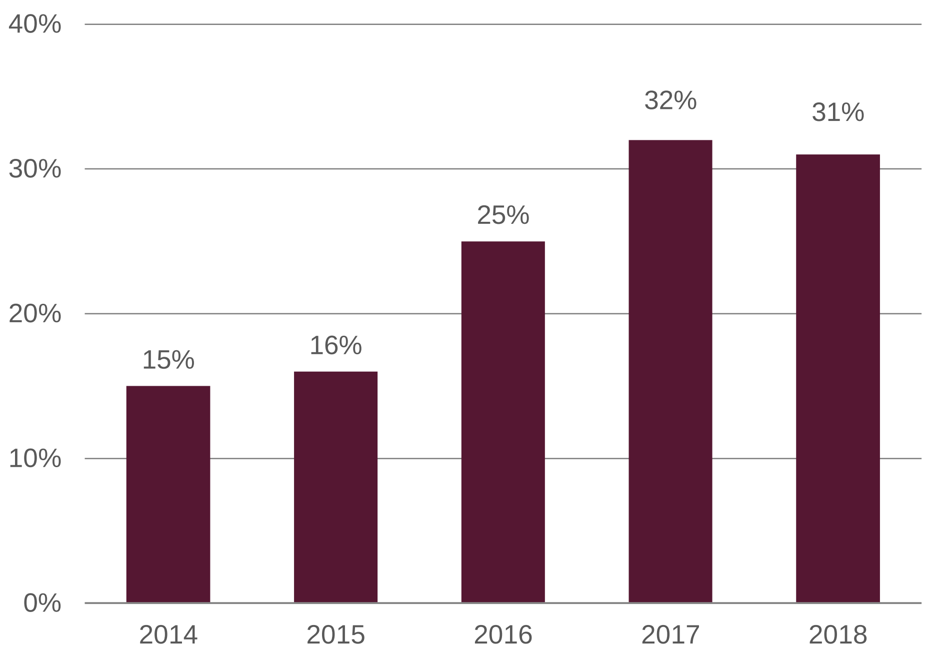
Source: FTSE Russell. Global smart beta surveys of asset owners, 2014, 2015, 2016, 2017, and 2018. Sample sizes for Asia-Pacific and Other regions were too small to break out separately. Those regions are included in the totals.

Trends in the objectives of smart beta

Every year of the survey we have asked asset owners who have evaluated smart beta what investment objectives motivated them. The results in 2018 were mostly in line with past surveys. The objectives of "risk reduction" and "return enhancement" vied for the top two responses, with "improve diversification" a solid third.

There has been a notable trend in "cost savings" as an investment objective, which is the fourth ranked objective. Increased emphasis on fee budgets in defined benefit plans and costs to participants in defined contribution plans has fueled some of the moves to smart beta strategies. Of course, whether smart beta allocations actually reduce costs depends on one's starting point and how allocations are funded. Those who are thinking of shifting funds from actively-managed funds to smart beta strategies will likely see a cost reduction. But those who are thinking of changing allocations from cash or low-cost market beta products to smart beta products may see costs increase. For them, return enhancement and risk reduction may be the dominant motives. This is possibly why cost savings does not rank higher than fourth as an overall objective.

Exhibit 6: Cost savings as an investment objective of smart beta

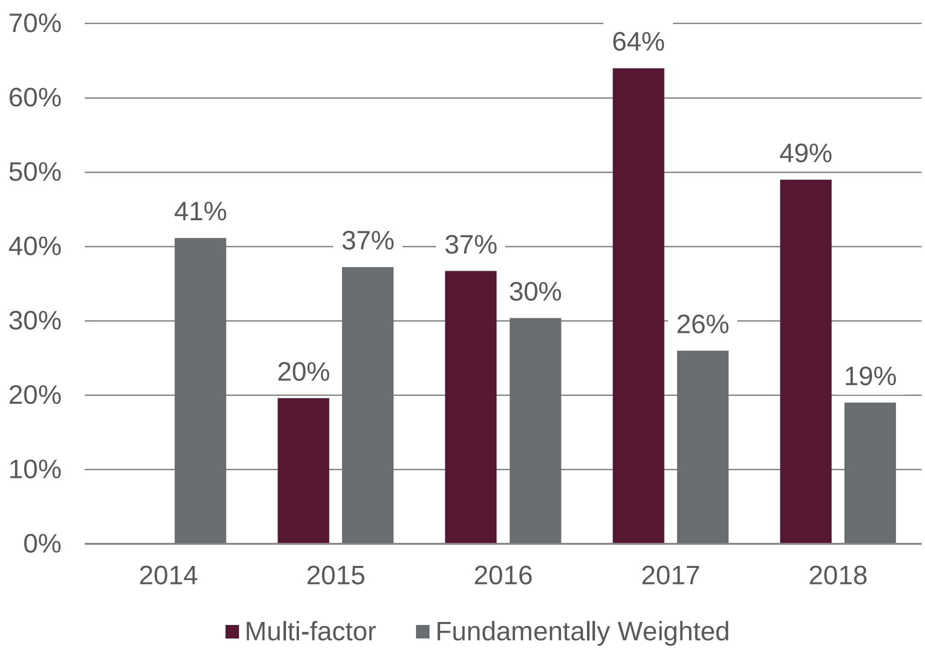


Source: FTSE Russell. Global smart beta surveys of asset owners, 2014, 2015, 2016, 2017, and 2018.

Highly variable trends in equity smart beta strategies

Fundamentally-weighted indexes are alternatively-weighted indexes that replace market capitalization weights with alternative measures of company size. Introduced in 2005, they first brought the concept of smart beta indexing to industry-wide attention. In product life cycle terms, investable products based on fundamentally-weighted indexes were already past the new-entrant-high-growth stage and well into a more mature growth stage when the first survey was launched in 2014. The survey documents the steady decline in respondents' adoption of these products over the five year period (Exhibit 7).

Exhibit 7: Contrasting trends on smart beta adoptions



Source: FTSE Russell. Global smart beta surveys of asset owners, 2014, 2015, 2016, 2017, and 2018. "Multi-factor" was not included as a selection in the 2014 survey.

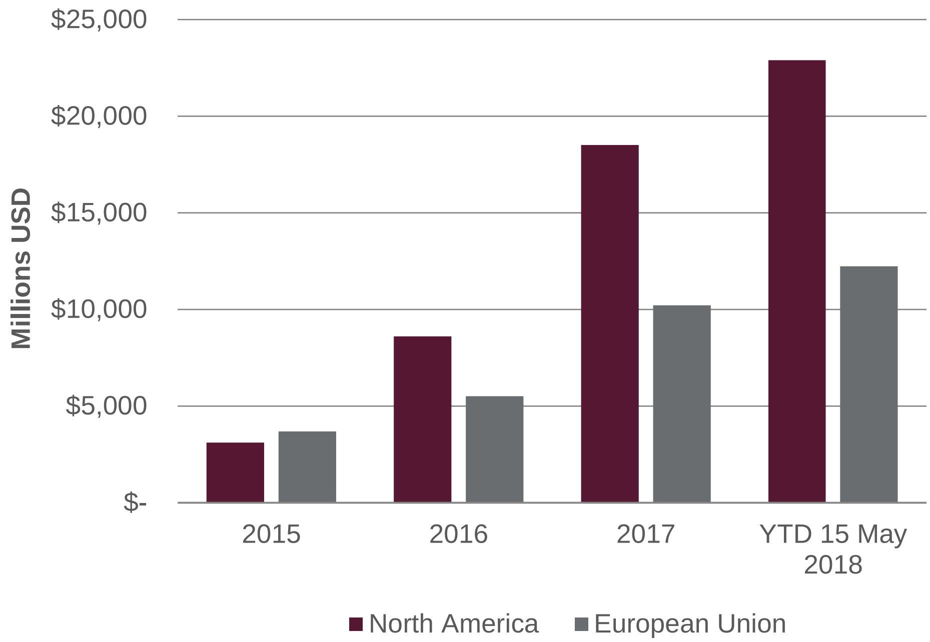
The survey results may overstate the trend in fundamentally-based products, however. ETFs based on fundamentally-weighted indexes are still the largest in number of all smart beta ETFs and the AUM has steadily grown, just not as rapidly as the AUM of other smart beta ETFs. Inflows to ETFs tracking fundamentally-weighted indexes accounted for 69% of all smart beta ETF inflows in 2014, but that dropped to 59% in 2017.[6] This paints a picture of slower but not negative growth.

By contrast, products based on multi-factor indexes are surely in a high growth stage. We didn't even include "Multi-factor" as a selection when we launched the first survey in 2014 as it seemed like a small blip on industry radar. Exhibit 7 shows the rapid rise of adoptions of products based on multi-factor indexes.

[6] Source: ETFGI as of March 31, 2018.

At 49%, it now has the highest adoption rate of all smart beta strategies. According to ETFGI, ETF products based on multi-factor indexes have grown from 144 with AUM of $25 billion as of September 2015 to 423 with $70 billion AUM as of March 2018.[7] Exhibit 8 shows additional AUM data from XTF broken down by region.

Exhibit 8: Multi-factor ETFs



Source: XTF as of May 15, 2018. Please see the end for important legal disclosures.

An indication that the contrasting trends will likely continue can be seen in the responses of those who have had a smart beta allocation for less than two years. Of those respondents with new allocations, 87% have allocations to a multi-factor product and only 13% have an allocation to a fundamentally-weighted product.

Products based on single factors have a longer history than multi-factor products. The largest adoptions of single factor products have been based on low volatility and value factors. They rank second and third, respectively, in overall adoption rates after multi-factor. But the adoption rates of both have declined in the past year. This may be due in part to the challenging performance of these two factors over the past two years, bringing home the argument that single factors have highly cyclical return patterns and that a multi-factor approach may provide less volatility.

[7] Source: ETFGI as of March 31, 2018.

Fixed income smart beta strategies – still in its infancy

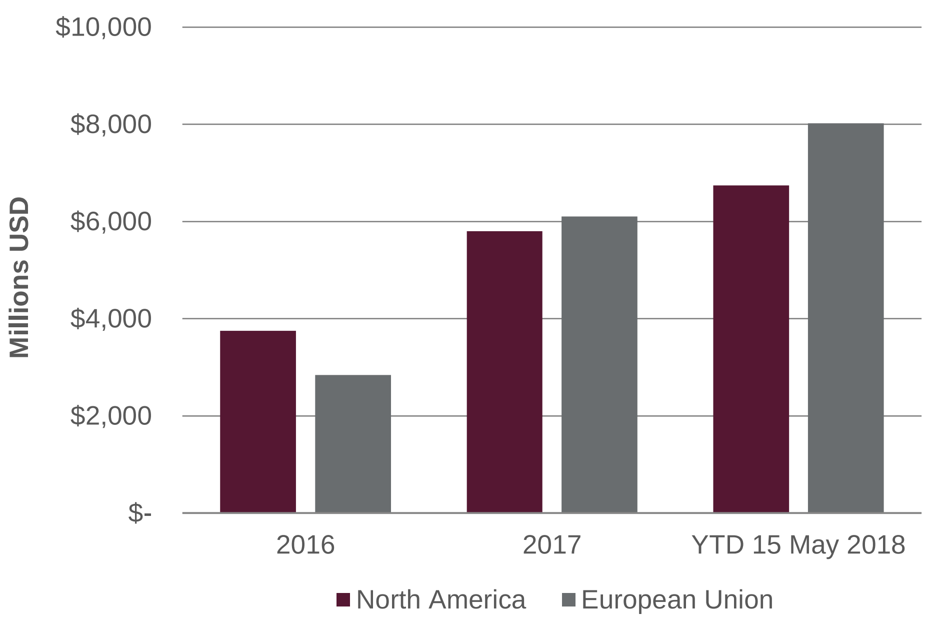
We have only been asking questions about fixed income smart beta strategies for the last two years. The results for 2018 are not dramatically different than for 2017. Slightly fewer respondents indicated that they have no plans to evaluate fixed income smart beta strategies, 61% in 2018 compared to 66% in 2017. And slightly more respondents indicated that they have made a fixed income smart beta allocation, 9% in 2018 compared to 7% in 2017. But neither of these differences is statistically significant.

Respondents were asked, "What are the primary reasons you have not yet evaluated fixed income smart beta strategies?" A wide range of reasons emerged, from a lack of belief in the investment merit, to lack of research resources, to lack of product choice, to lack of consultant recommendations. There was no one dominant response. The selections "Other" and "Don't know" garnered 39% of the responses. It is clear that fixed income smart beta is still in its infancy. Going forward, education will be most needed as well as a range of new products that address specific investor needs.

The pairing of smart beta and ESG

Environmental, social and governance (ESG) investing (also known as socially responsible investment, SRI) has been gaining visibility and AUM for quite some time amongst institutional asset owners. Exhibit 9 shows the dramatic growth of ETFs based on ESG considerations for North America and Europe since 2016. Of course this is only a partial accounting as it does not include mutual funds, separate accounts, and internal management, but it does identify a clear trend.

Exhibit 9: Environmental, Social and Governance ETFs

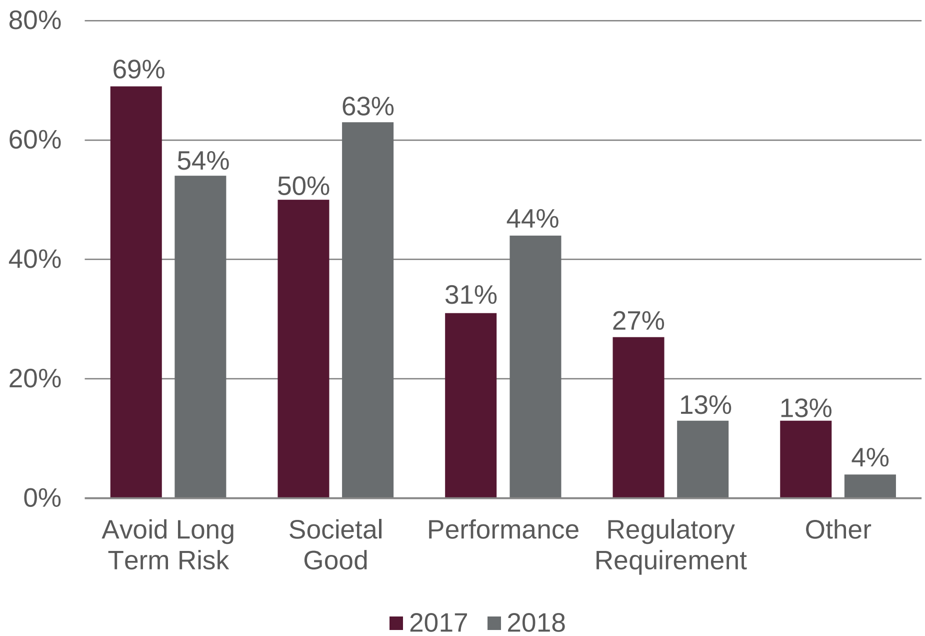


Source: XTF as of May 15, 2018. Please see the end for important legal disclosures.

The notion of integrating ESG with smart beta has been gaining momentum. Two trends that have helped are, on the one hand, a movement within ESG investing away from exclusionary screens, and, on the other hand, the rise of factor investing within smart beta. Exclusionary 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.

For the second 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–55% said they will be applying ESG considerations to their smart beta strategy–while it is 25% in North America, up from 20% last year. Also, the greater interest is with larger plans, those with greater than $10 billion AUM. Exhibit 10 shows a consistent motivation over the past two years: the two primary considerations for using an ESG strategy with smart beta emphasize both risk management and social-ethical concerns.

Exhibit 10: Motivations for applying ESG considerations to a smart beta strategy

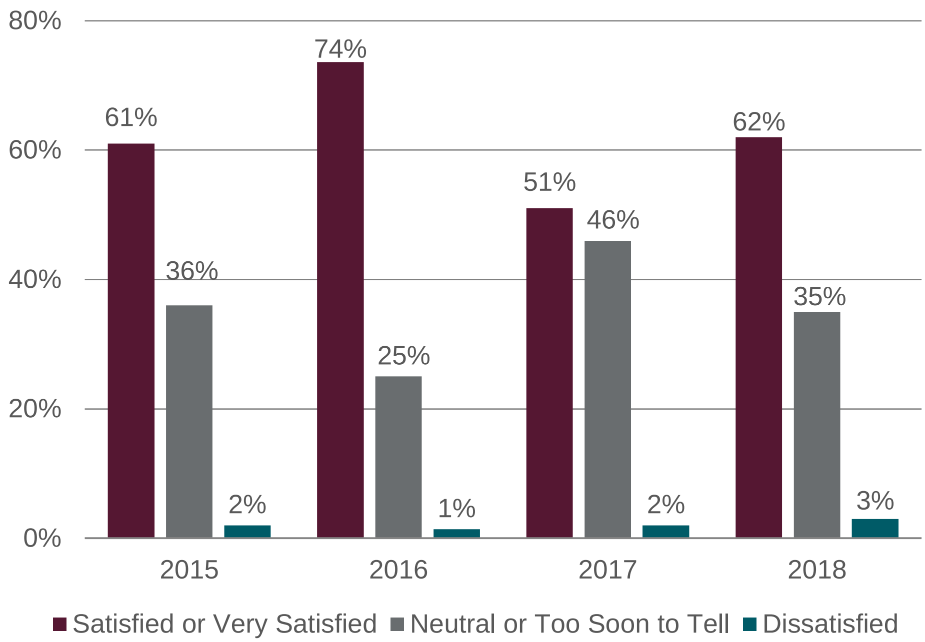


Source: FTSE Russell. Global smart beta surveys of asset owners, 2017 and 2018. Totals may not add to 100% due to rounding.

Outlook

Investor satisfaction is a key indicator of future growth. By that measure, the outlook for smart beta strategies is bright, as Exhibit 11 shows. When asked how satisfied asset owners are with their smart beta strategies, the response of satisfied or very satisfied has steadily ranged from 51% to 74% over the past four years. Only 1-3% reported dissatisfaction. So perhaps it is no surprise that in the 2018 survey, 60% of those who currently have a smart beta allocation are contemplating further allocations. We expect a large share of new growth to continue to be in the application of multi-factor and, increasingly, multi-factor–ESG strategies. Nearly 40% of global asset owners anticipate applying ESG considerations to a smart beta strategy in the next 18 months.

Exhibit 11: Satisfaction with smart beta strategies



Source: FTSE Russell. Global smart beta surveys of asset owners, 2015, 2016, 2017, and 2018. The question was not asked on the 2014 survey. Totals may not add up to 100% due to rounding.

Finally, while five years of the survey shows a strong growth in adoption, educational shortfalls remain. To the question, “What barriers to equity smart beta allocation and/or implementation do you perceive?” the number one response (45%) was, “How to determine the best strategy or combination of strategies for my portfolio.” This result points to the need for an ongoing education program and the promotion of innovative thinking. FTSE Russell is very active in this process of client engagement.

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FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. 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.

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EMEA
+44 (0) 20 7866 1810

North America
+1 877 503 6437

Asia-Pacific
Hong Kong +852 2164 3333
Tokyo +81 3 4563 6346
Sydney +61 (0) 2 8823 3521