Insights

FTSE Russell

How are institutions using smart beta?

Smart beta is a rapidly expanding category of the global asset management sector. But how are asset owners evaluating and using smart beta? In this FTSE Russell *Insights* we summarize key findings from the recent FTSE Russell smart beta surveys.

What is smart beta?

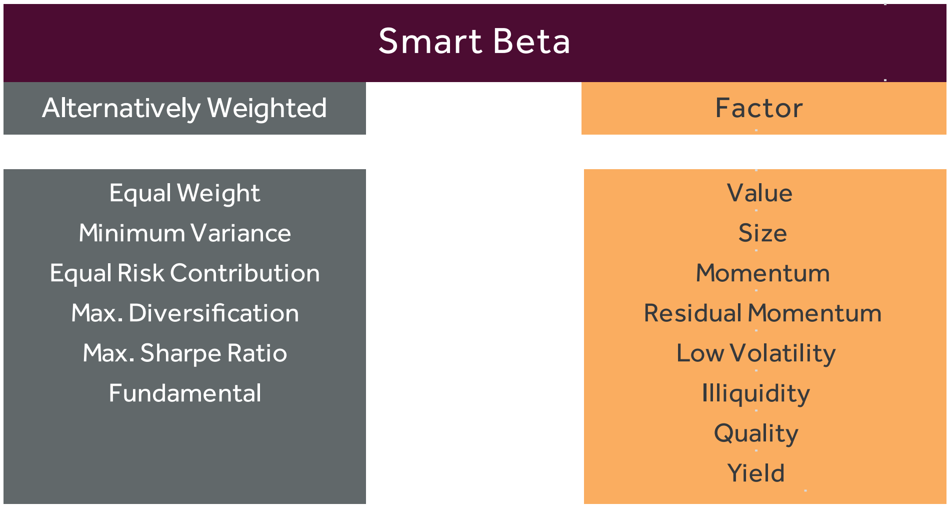
Smart beta is a term that covers a wide range of systematic, index-based investment strategies in the equity markets and, increasingly, in other asset classes. Smart beta indexes generally depart from the standard index construction methodology of weighting constituents by their market value (capitalization).

FTSE Russell defines smart beta as encompassing two types of strategy:

- Alternatively weighted indexes, designed to address perceived concentration risks in capitalization-weighted indexes or reduce volatility;
- Factor indexes, designed to replicate factor risk premia in a transparent, rules-based and investable format.

There is an overlap between these two categories: alternatively weighted indexes have factor exposures. However, these exposures may not be stable over time and are a by-product of the index design, rather than the index's primary objective. Factor indexes, in contrast, specifically target factor exposures as their primary objective.

Types of smart beta strategy



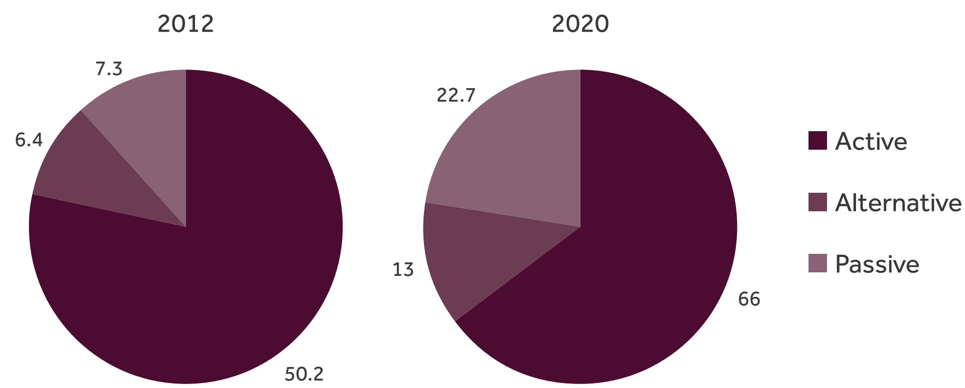
Index and smart beta usage accelerates

Smart beta usage is difficult to measure both because of a lack of consensus over terminology and because a lot of the early adopters have been large, sophisticated asset owners, such as self-managed pension schemes and sovereign wealth funds, who are typically not subject to mandatory reporting requirements.

Nevertheless, there is abundant survey and forecast evidence of accelerating usage of index-based smart beta approaches.

According to consultant PWC[1], passive, index-based strategies are likely to double their share of worldwide assets under management between 2012 and 2020, trebling in US dollar terms.

Forecast global AUM by strategy type (US$trn)



Source: PWC, "Asset Management 2020: A Brave New World"

PWC forecasts that "the growth of passive strategies will also be fuelled by new innovations in this space, such as factor investing – factor investing will 'cross over' from the realm of active managers, through highly sophisticated institutional passive investors, and into the mass-market retail space".

[1] http://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf.

Invesco Powershares conducted a survey[2] in 2014 among 112 wholesale and institutional investors in Europe, with 61% of respondents saying they intended to increase their use of smart beta index products and only 1% expecting a decrease.

Consultant Spence Johnson released a study[3] in 2014 in which it forecast a more than threefold increase in European smart beta assets under management between 2013 and 2018, from €78 billion to €297 billion.

FTSE Russell smart beta surveys

In early 2015 FTSE Russell surveyed 214 institutional asset owners across North America (61%), Europe (26%) and in other regions of the world (13%), collectively responsible for an estimated US$2 trillion in assets under management.

The survey[4] was designed to ask these institutional investors about their current and planned usage of equity smart beta strategies. The survey respondents shared information on which strategies they preferred, what concerns about smart beta they might have, whether they preferred multiple or single smart beta strategies, their planned holding periods and their preferred means of implementing smart beta.

The 2015 survey was conducted as a follow-up to a similar survey, conducted by Russell Indexes in 2014, focusing on 181 asset owners in Europe (52%) and North America (48%).

Large European asset owners stand out as smart beta adopters

Among asset owners in North America and Europe, large European investors stand out as the main early adopters of smart beta strategies.

According to the FTSE Russell 2015 smart beta survey, 68% of the European asset owners surveyed with over US$10 billion in assets under management already have a smart beta allocation. By contrast, only 27% of North American asset owners surveyed with over US$10 billion in assets under management have a smart beta allocation (although a further 30% of North American asset owners said they are either currently evaluating smart beta or intend to do so in the next eighteen months).

Interest in smart beta usage driven by both return and risk considerations

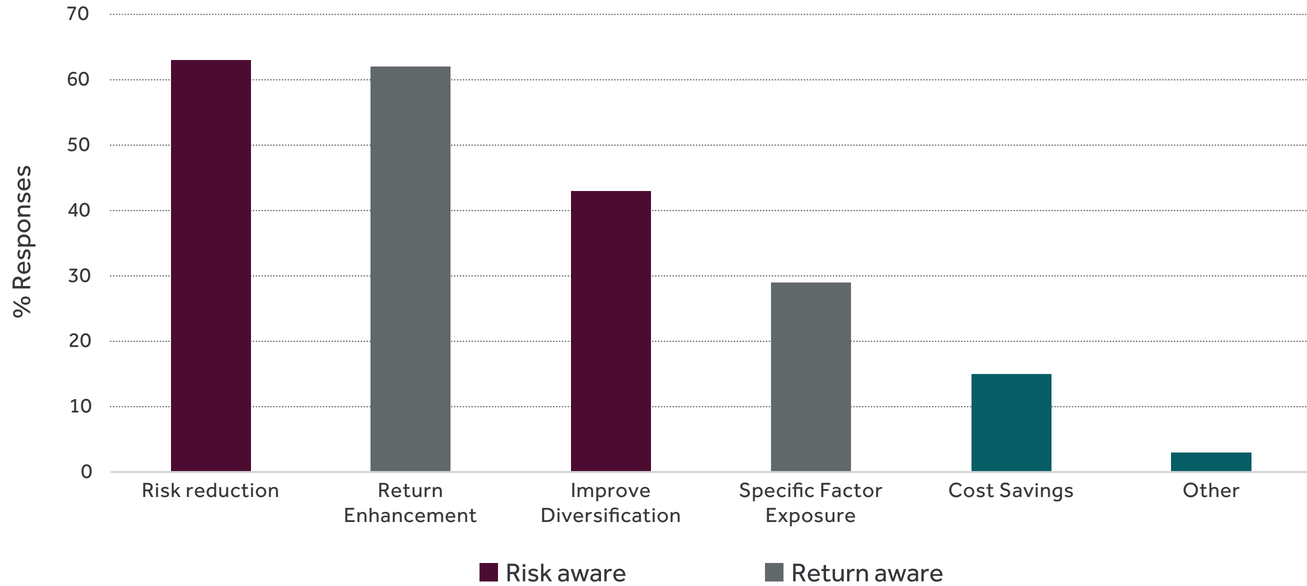
The FTSE Russell surveys reveal that interest in smart beta among asset owners has been driven both by risk considerations (such as a wish to reduce index-level risk or to improve levels of index diversification) and a desire to enhance return through exposure to factor risk premia.

[2] Invesco Powershares: "Index Investing and Smart Beta in Europe 2014"

[3] Spence Johnson: "Deeper Perspectives—Smart Beta", April 2014

[4] See http://www2.londonstockexchangegroup.com/2015-global-smart-beta-survey-results

Smart beta index interest both risk-aware and return-aware



Source: Russell smart beta survey 2014. Asset owners who declared themselves as currently evaluating smart beta, having evaluated and decided not to implement, or having a smart beta allocation, were asked: "What investment objective initiated your evaluation of smart beta strategies?"

Preferred smart beta strategies vary by region

Asset owners in different geographical regions have evaluated or are currently using different types of smart beta strategy. Among investors worldwide, low volatility and fundamental strategies are the most popular smart beta approaches. These categories of smart beta have the advantage of simplicity in construction, an intuitive investment approach and relatively long live track records.

There are clear regional differences in the extent to which individual smart beta indexes have been evaluated or adopted. For example, maximum diversification, a risk-oriented approach that aims to maximize the diversification ratio of the index (the weighted average of constituent volatilities divided by the index volatility) has so far seen greater take-up in continental Europe and Canada than in the US and the UK.

These regional distinctions highlight the lack of standardization in a rapidly growing market.

Regional smart beta preferences

	US	Canada	UK	Europe ex-UK	Focus of strategy
Low Volatility	54%	86%	55%	81%	Return/Risk
Fundamental	61%	29%	90%	59%	Return
Quality	32%	43%	30%	44%	Return
Maximum Diveresification	11%	36%	20%	41%	Risk
Risk Parity	25%	50%	40%	37%	Risk
Momentum	25%	29%	15%	26%	Return
Equal Weight	25%	29%	40%	44%	Risk
Defensive	36%	21%	25%	22%	Risk
High Dividend	21%	29%	40%	41%	Return
Other	4%	7%	5%	11%	?

Source: Russell smart beta survey 2014. Asset owners who declared themselves as currently evaluating smart beta, having evaluated and decided not to implement, or having a smart beta allocation, were asked: "What smart beta strategies have you evaluated or are you currently evaluating?"

Smart beta allocations come from both active and passive assets

Smart beta can be seen as the new generation of passive management, embedding strategies within a rule-based, objective index, enabling market participants to use the index both for benchmarking purposes and as the basis for creating index-linked investment products.

Some of the initial interest in alternatively weighted indexes came from a risk perspective, with investors keen to address perceived concentration risks in capitalization weighted indexes. However, there has been increasing interest in smart beta as a source of factor-related returns.

For example, in an influential 2009 paper[5] examining the historical track record of the Norwegian Government's global pension fund, Professors Ang, Goetzmann and Schaefer concluded that a significant proportion of the long-term performance of the fund could be attributed to its exposure to various factors. The authors recommended that the pension fund consider obtaining long-term exposure to systematic factor returns by means of a lower-cost, passive implementation of such an approach.

According to the FTSE Russell 2015 smart beta survey, asset owners are funding or considering funding smart beta strategies from both active and passive portfolio allocations.

[5] http://www.regjeringen.no/upload/fin/statens%20pensjonsfond/rapporter/ags%20report.pdf

Source of smart beta allocation

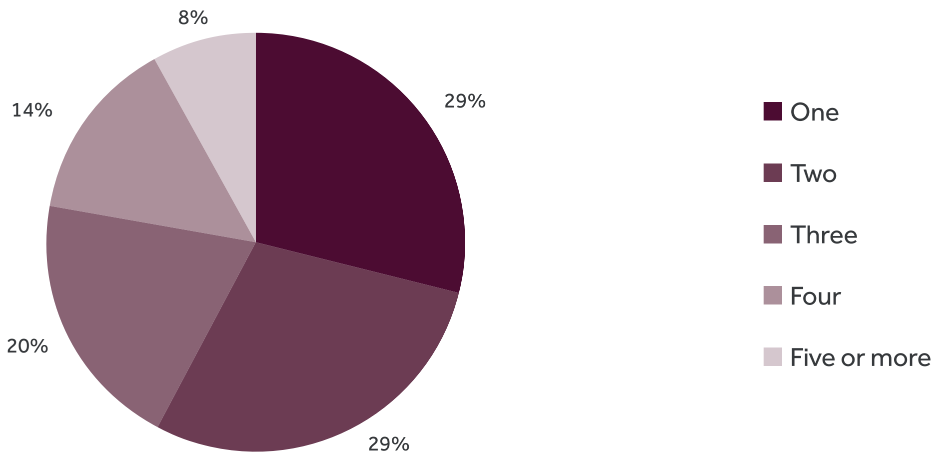
Which allocations are you evaluating for use, or using smart beta strategies as part of?	Total	Have smart beta allocation	Currently evaluating smart beta
Active equity allocation	22%	24%	19%
Passive equity allocation	21%	29%	10%
Active and passive equity allocation	47%	40%	58%
Neither; it should be considered a new asset class	9%	7%	13%

Source: FTSE Russell, *Smart beta: 2015 global survey findings from asset owners*. Asset owners responding were those with a current allocation to smart beta or those currently evaluating smart beta.

Combining smart beta strategies

Among asset owners with a current allocation to smart beta, the 2015 FTSE Russell smart beta survey revealed that over 70% were using two or more strategies.

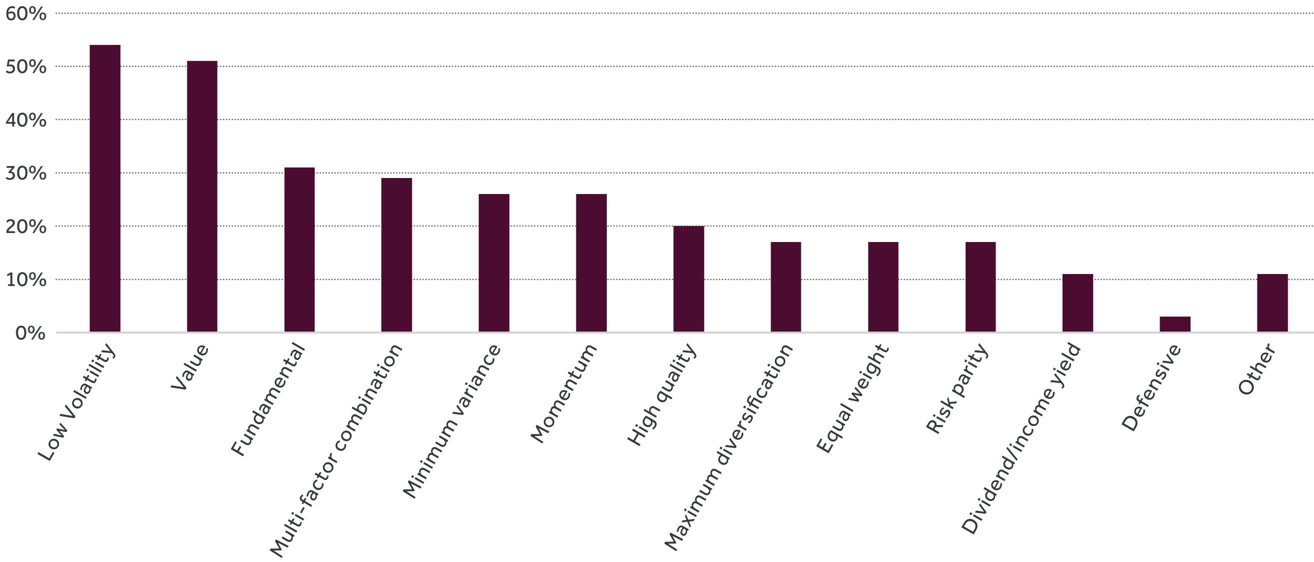
Number of strategies used



Source: FTSE Russell, *Smart beta: 2015 global survey findings from asset owners*. Asset owners responding were those with a current allocation to smart beta

Among asset owners using two or more smart beta strategies, the most popular strategies were low volatility (54%), value (51%) and fundamental (31%), findings broadly consistent with the 2014 survey.

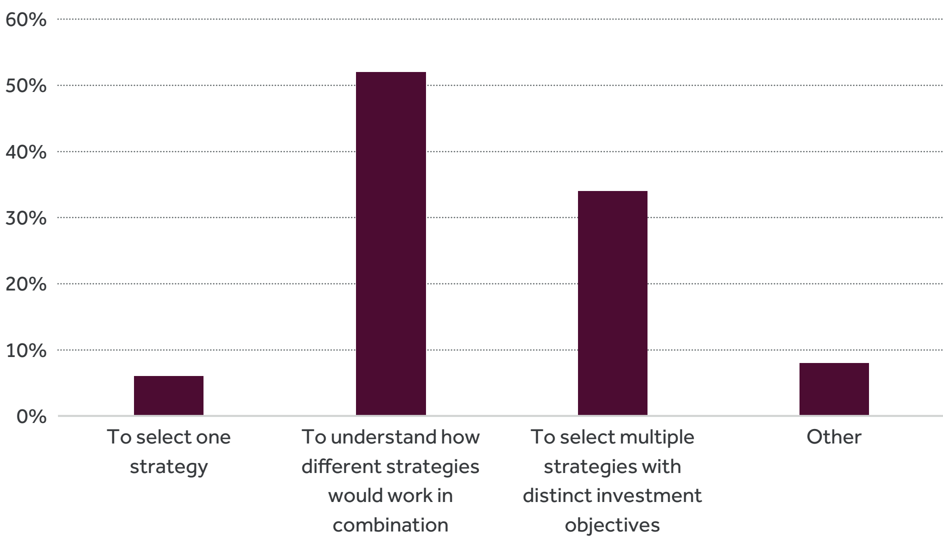
Which smart beta strategies are being combined?



Source: FTSE Russell, *Smart beta: 2015 global survey findings from asset owners*. Asset owners responding were those with a current allocation to smart beta and using two or more strategies

For asset owners evaluating multiple smart beta strategies, the most popular primary goal was to understand how different strategies would work in combination.

Primary goal of asset owners evaluating multiple strategies

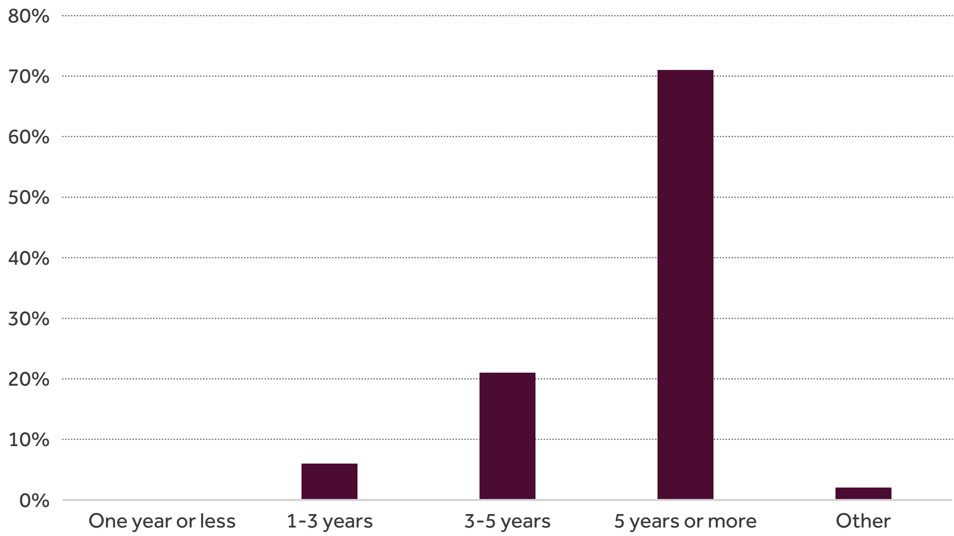


Source: FTSE Russell, *Smart beta: 2015 global survey findings from asset owners*. Asset owners responding were those with a current allocation to smart beta, those evaluating smart beta and those having evaluated and decided not to implement, and evaluating more than one strategy. Respondents were asked: "Which statement best reflects your objective of evaluating multiple strategies?"

Most smart beta allocations are strategic

Respondents to the FTSE Russell 2015 smart beta survey gave a clear indication that their current or possible future smart beta allocations are strategic, rather than tactical: 71% of those surveyed expect to hold their smart beta strategies for five years or more.

Expected holding period for smart beta



Source: FTSE Russell, *Smart beta: 2015 global survey findings from asset owners*. Asset owners responding were those with a current allocation to smart beta and those currently evaluating smart beta. Respondents were asked: "How long do you expect to hold your smart beta strategies to achieve your investment objectives?"

The uses of smart beta

The responses given by institutional investors and asset owners to the FTSE Russell smart beta surveys reveal the following:

- Smart beta usage is accelerating, with large European investors notable by their early adoption rate
- Interest in smart beta has been driven relatively evenly by risk and return considerations
- Though low volatility and fundamental strategies are the most popular worldwide, preferred smart beta strategies vary considerably by region
- Allocations to smart beta come from both passive and active portfolio assets
- According to the 2015 survey, over 70% of respondents with a current allocation to smart beta are using two or more strategies
- Smart beta investors have a long-term outlook: over 70% of those evaluating or using smart beta have a planned holding period of more than five years.

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