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A regular analysis of strategic issues in the institutional investment business

# Deeper Perspectives

## Smart Beta - Our fastest growing MI segment

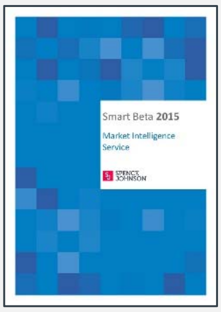
*The rapid expansion of the Smart Beta market in 2014 makes it the fastest growing market segment covered by Spence Johnson's Market Intelligence Service*

The 32% growth in the European Smart Beta market in 2014 supports Spence Johnson's predictions regarding the significant opportunity that this market represents for today's asset management community.

In this Deeper Perspectives we explore some of the early findings from our upcoming 2015 Smart Beta report. We show how the shape of the market's growth suggests demand in the European Smart Beta market is being shaped by a broader range of forces than a simple quest for greater cost reduction.

Although cost reduction continues to play an important role in driving demand for Smart Beta products, we show how, in certain segments of the European Smart Beta market, it is being outstripped by other key demand drivers such as improvements in return, improvements in diversification and risk reduction.

This edition of Deeper Perspectives shares some findings from our 2015 Smart Beta Market Intelligence report:

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Spence Johnson provides five research-based services to asset management and insurance companies. Our clients use us to help them identify or retain clients in five key sectors within their institutional investment businesses

# European smart beta market grew by 32% in 2014

The growth in the European fund-based smart beta market in 2014 supports the predictions Spence Johnson made in our 2014 report that this market represents a significant growth opportunity for asset managers over the next five years.

In our 2014 report we predicted that the European fund-based smart beta market would continue to represent a significant opportunity for asset managers over the coming years.

The size of this opportunity was underlined by our prediction that the market would grow at an annual rate of 31% over the five years from 2013-2018 (which remains one of the largest annual growth predictions we have ever made in our reports).

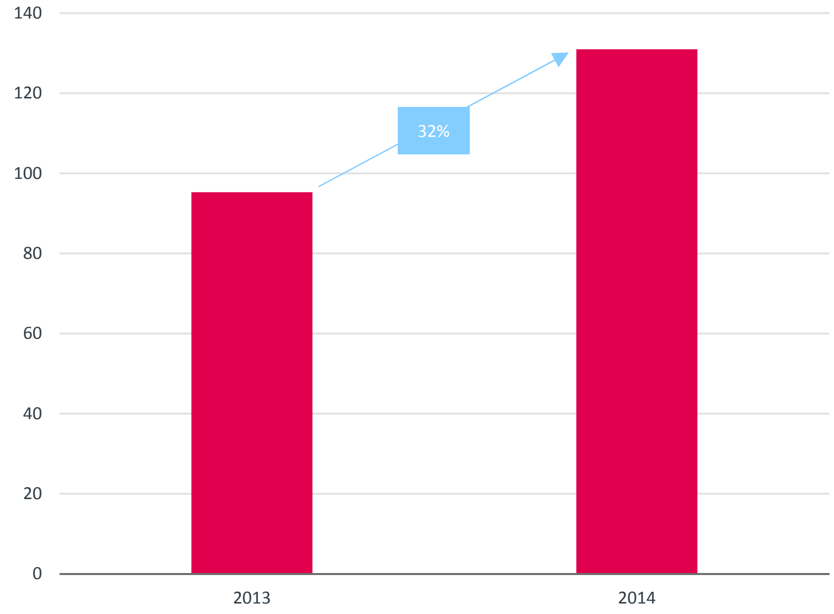
The 32% growth in the European fund-based smart beta that this year's analysis suggests actually occurred in 2014 appears to strongly validate our hypothesis, confirming our view that the opportunity in this market remains significant.

As shown in the lower of the two charts much of the growth in the market continues to be focused on equity smart beta products, although bond smart beta also showed a strong growth over the year (albeit off a much lover base).

The growth of the bond market is not as strong as we expected, suggesting investors continue to struggle with the greater complexity and smaller product set on offer in the smart beta bond space.

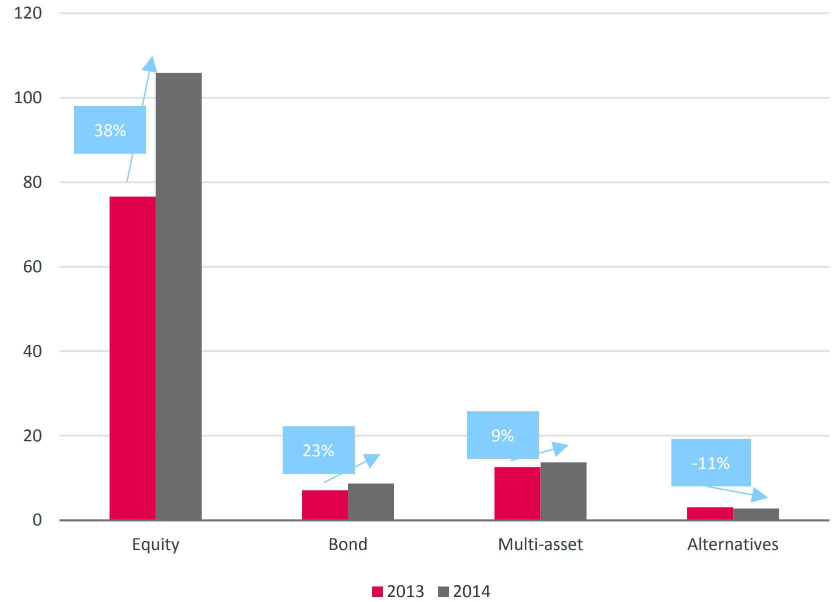
Smart beta products focused on 'alternative' asset classes actually declined slightly over the year, reflecting the continued difficulties asset managers face in designing products for this space.

Smart beta total market growth 2013-2014
(€bn)




Source: Spence Johnson analysis, CAMRADATA, Morningstar

Smart beta total market growth 2013-2014
By asset class (€bn)




Source: Spence Johnson analysis, CAMRADATA, Morningstar

# There are 3 approach and 2 product types in SB

The overall 'smart beta' label belies the diversity of product and approach types that the label is applied to. These product differences reflect the diversity of the demand profiles of the institutional and retail investors that are driving the rapid growth of this market.

Our segmentation of the smart beta market reflects the wide range of providers offering both different investment approaches and different types of smart beta product within the European smart beta market. We continue to classify the market in terms of 3 main approaches that asset managers can take when constructing Smart Beta products:

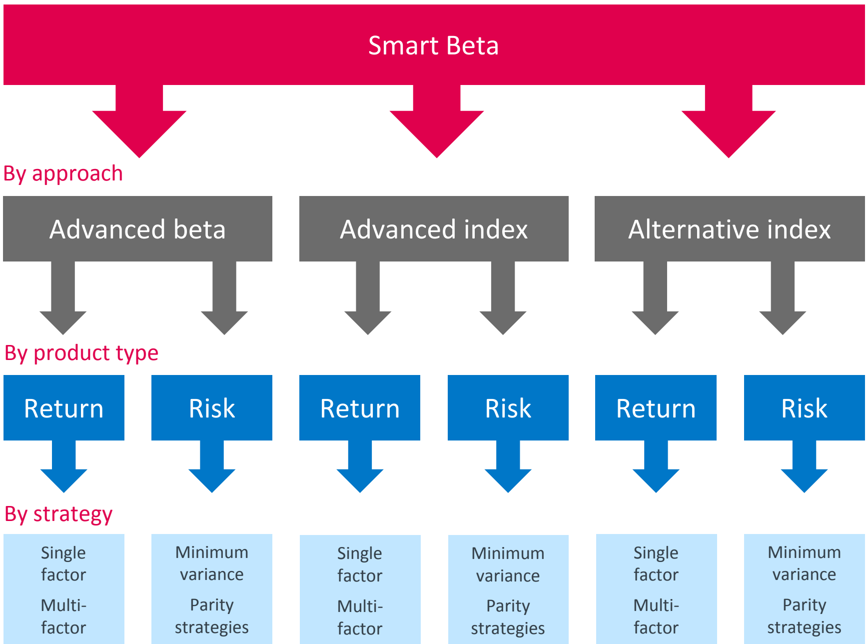
1. **Advanced beta –** a wholly asset manager-led approach, often close in design to traditional active 'quantitative' strategies where investment teams will review and evolve investment process rules them over time to ensure their continued efficacy. In addition systematic processes are often overlaid with more qualitative/ fundamental inputs and portfolio rebalancing also tends to be more dynamic than index-led approaches
2. **Advanced index -** rules-based indices designed in-house by asset managers. Investment process rules tend to be fully published, giving high levels of transparency, but reviewed more actively than is common in alternative index approaches. The in-house design and more 'active' elements of these approaches can result in higher costs.
3. **Alternative index –** these approaches are based on asset manager replication of third-party indices (making them low cost) . Rules tend to be fixed and published with limited evolution, thereby offering the highest transparency levels.

The products themselves can be classified as either:

1. **'Return' products –** where the objective is to offer investors enhanced returns through exposure to market 'factors' (such as value, growth or momentum) that academic studies have claimed offer higher returns over the long term. These 'return' smart beta products are offered as two main strategy types a) ***single factor*** or b) ***multi-factor*** strategies
2. **'Risk' products –** which do not explicitly target enhanced returns, instead their objective is to offer better risk-adjusted return through volatility reduction and diversification. Risk Smart Beta products can also be grouped into two main strategy types: either a) ***minimum variance*** or b) ***parity strategies***

Smart Beta market map

By approach, product type and strategy




Smart Beta individual strategy examples

By product and strategy type

| **Product type** | **Return Smart Beta** | | **Risk Smart Beta** | |
|---|---|---|---|---|
| Objective | Enhanced return<br>Factor exposures | | Volatility reduction<br>Diversification | |
| **Strategy type** | **Single factor** | **Multi-factor** | **Minimum variance** | **Parity strategies** |
| Individual strategy examples | • Momentum<br>• Value/Fundamental<br>• Growth<br>• Quality<br>• High dividend yield<br>• Equal weight<br>• GDP weight | | • Low volatility<br>• Minimum volatility<br>• Minimum variance<br>• Managed volatility | • Equal risk<br>• Risk parity<br>• Maximum diversificat ion |

Source: Spence Johnson analysis

# SB demand driven by more than just cost savings

Although cost reduction has been a major driver in the growth of the smart beta indices, the continued strong growth in the often more costly advanced beta market supports survey evidence that lowering costs is not the primary focus of many smart beta investors

Our analysis of the 2014 growth of the different approaches to managing smart beta products shows the two largest parts of the market (advanced beta and alternative index funds) grew at the same rate.

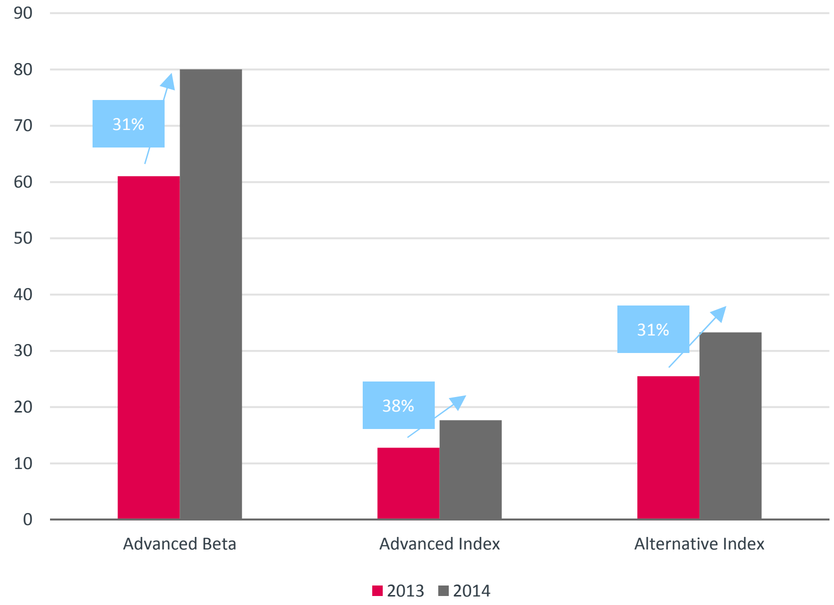
Although our current estimates suggest that only around 40% of this growth was generated by new flow (compared to 60% of the growth in the alternative index market), it nonetheless points to a continued strong demand for more sophisticated advanced beta (and indeed advanced index) solutions amongst European investors.

This suggests that, although cost reduction continues to play an important role in driving demand for smart beta products, other drivers such as improvements in return and diversification and reduction in risk often outstrip cost reduction as key drivers of demand in the certain segments of the smart beta market.

This hypothesis is supported by the results of the FTSE Russell 2015 Global Smart Beta survey, which focuses mainly on large US and European institutional investor attitudes towards smart beta products. As the chart on the right shows, for over 50% the institutional clients that took part in the survey, the return enhancement and risk reduction characteristics of smart beta investing were the main drivers of their interest in these products. Just 16% of respondents chose cost savings as the investment objective that initiated their interest in smart beta strategies.

Smart beta total market growth 2013-2014

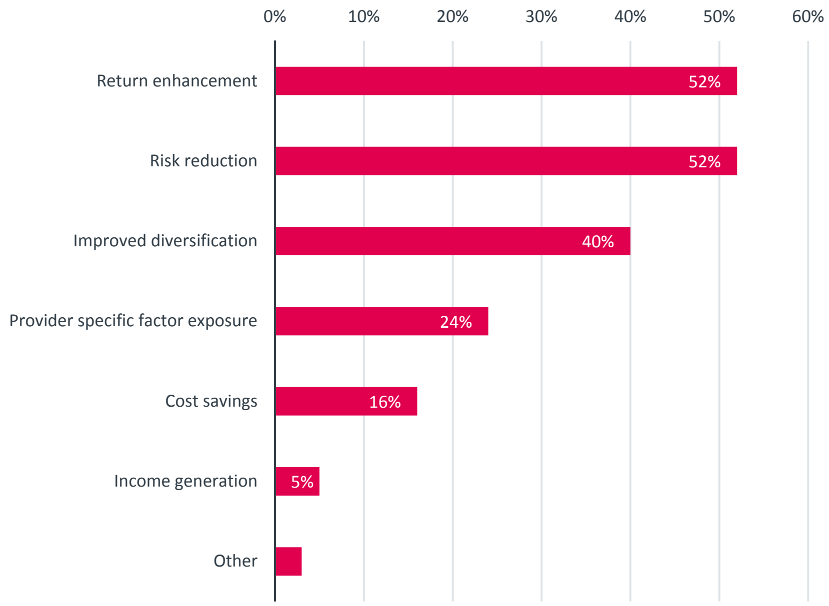
By approach type




Source: Spence Johnson analysis, CAMRADATA, Morningstar

Investment objective that initiated the evaluation of smart beta strategies

% respondents




Source: Spence Johnson analysis, CAMRADATA, Morningstar

# Risk SB products grew faster than Return SB

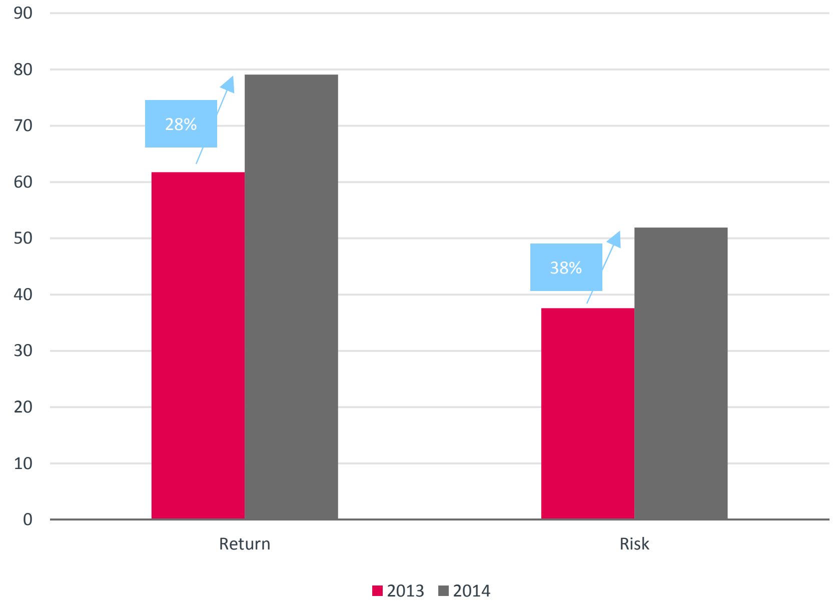
## Again this growth was in-line with our 2014 predictions, and further reinforces the extent to which European investors are looking to smart beta solutions for the risk reduction and diversification benefits that they offer

Risk smart beta grew by 38% over the course of 2014. Although return smart beta products grew at a rate of just 28% they continue to dominate the market, with just under 60% more assets under management than risk smart beta products.

Looking below the top-line numbers, however, it is clear that minimum variance products accounted for much of the growth within risk smart beta. While we have not yet been able to identify the precise reason for the strength of demand for minimum variance as opposed to risk parity products, we suspect part of the reason is that relative simplicity of minimum variance and low volatility strategies when compared to many risk parity may mean these products appeal to a broader audience of investors.

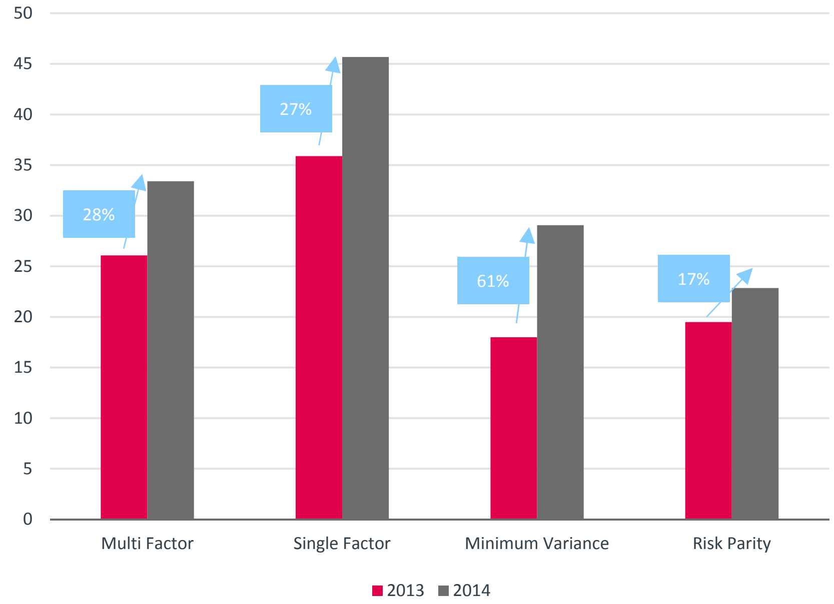
In part the slower growth in risk parity solutions also reflects the weaker than expected demand for smart beta multi-asset strategies (which account for a significant proportion of the risk parity approaches identified by this report). Feedback from our work in the European pensions space suggests that the lack of demand for multi-asset products is in part a reflection of the fact that many European investors, especially amongst large institutional clients, continue to manage asset allocation in-house rather than relying on third-party funds to do this.

Smart beta total market growth 2013-2014
By product type




Source: Spence Johnson analysis, CAMRADATA, Morningstar

Smart beta total market growth 2013-2014
By strategy type




Source: Spence Johnson analysis, CAMRADATA, Morningstar

# Risk SB growth driven by existing SB investors

The latest FTSE Russell survey shows risk smart beta is more frequently held by those investing in multiple smart beta solutions, strongly suggesting that it is existing rather than new smart beta investors that are behind the strong growth of the risk smart beta market

Evidence from FTSE Russell's 2015 Smart Beta Global Survey shows investors with only a single smart beta product in their portfolio are most likely to invest in return-based smart beta products using fundamental, value or equal-weight investment strategies. Less than 20% of those with just a single smart beta allocation reported investing in risk smart beta products. This strongly suggests that new entrants to the smart beta market are most attracted to the return-enhancing smart beta products, whose investment strategies are often simpler to understand and explain.

The fact that low volatility risk smart beta products topped the list of product types for those with multiple allocations to smart beta strongly suggests that it is amongst more sophisticated investors/those with more mature smart beta portfolios that demand for these risk smart beta products is greatest.

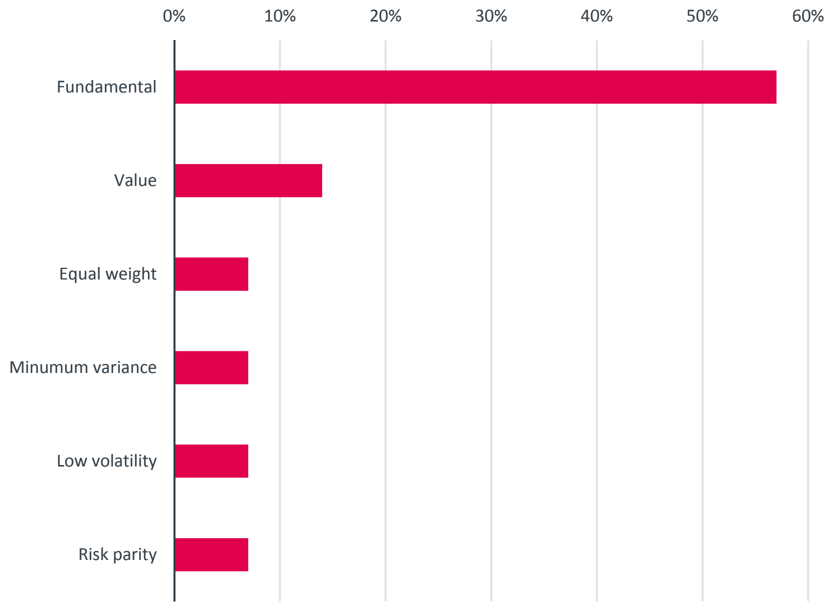
Looking at these results alongside the strong growth in risk smart beta products in 2014 suggests demand for risk smart beta is being fuelled by investors with well establish smart beta portfolios.

By extension the evidence also suggests that the new entrants to the smart beta market account for a larger proportion of the growth in return smart beta products than they do in risk smart beta products.

The evidence also points to yet another dimension of demand in the smart beta market, which suggests asset managers need to consider carefully where potential investors are in their smart beta 'journey' when considering which products are likely to appeal to them.

Products used by institutions who have invested in just one smart beta strategy

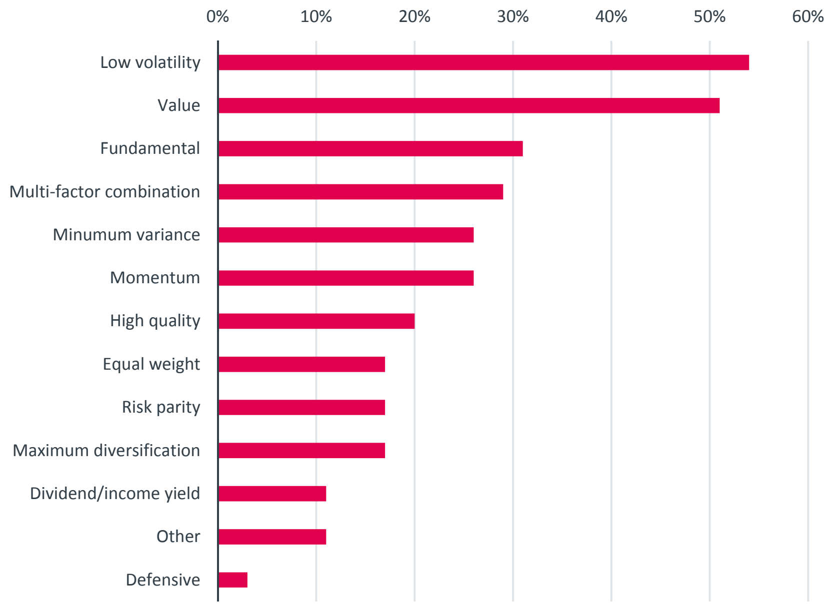
% respondents with allocation a single SB product using each SB product type




Source: SB167 (FTSE Russell)

Products used by institutions who have invested in multiple smart beta strategies

% respondents with allocation to multiple SB products using each SB product type




Source: SB167 (FTSE Russell)

# Previous editions

Previous editions Available from http://www.spencejohnson.com/

June 2015- Number 28-Targeting growth markets in European Institutional
we project future annual growth rates in institutional assets varying from -0.5% to 31%.

June 2015 – Number 27 - Opportunities in insurance asset management
The search for yield in a low interest rate environment and regulatory pressure are driving outsourcing opportunities

March 2015 - Number 26 - Excellent Client Management Provides Tangible Added Value
In this edition Spence Johnson reveals what it is that makes for excellence in client management.

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We look at how asset concentration and distribution issues are related in Europe.

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As with target date funds, master trusts also offer a less intermediate channel than those for more traditional trust or contract-based schemes, especially in the large scheme sector.

November 2014 - Number 23 - European growth opportunities for US asset managers
The European Institutional market is a market going through transformation. As this transformation takes place, we have identified 3 growth opportunities that US managers could take advantage of.

October 2014 - Number 22 - Opportunities in a transformed market
Retirement Income is now predominantly an investment based fund market. Both the life & pensions and asset management sectors are facing major challenges to protect and grow their strategic interests in this £1.7 trillion opportunity.

September 2014 - Number 21 - Solutions will win in the end game
Not only will the specialist third party asset manager share be greatly reduced but the source of assets greatly changed. Specialist providers in the future will look to solutions providers for nearly 40% of their assets.

May 2014 - Number 20 - DGFs still room for new players
The speed of adoption by DB schemes witnessed in 2013 was much faster and more significant that expected. The market grew by £10 billion from this source in 2013, off a previously estimated base of only £30 billion.

April 2014 - Number 19 - Smart Beta the new alternative
Alternative index product flow is estimated to be largely from UK clients, unlike flows into advanced beta and advanced index products which are estimated to emanate more from European clients.

December 2013 - Number 18 - The three spirits of pensions, past, present and future
In this holiday edition of Deeper Perspectives we evoke the Three Spirits of Pensions – Past, Present and Future – to enlighten and inspire our readers about the exciting world of pension investment.

November 2013 - Number 17 - New opportunities for asset mangers in workplace pensions
In this new edition of Deeper Perspectives we make four predictions of the future of workplace pensions that could have a significant impact on your strategic planning today.

October 2013 - Number 16 - New opportunities emerge in Insurance Asset Management
We describe how the management of insurers' general accounts is a growing and changing revenue opportunity for European asset managers

June 2013 - Number 15 - Growth of US OCIO reveals one clear winner
We share some high level findings of our OCIO Market Intelligence report, and we describe one very clear winner emerging in this market