The Evolution of Smart Beta ETFs

Smart Beta ETFs Poised for Growth Among Institutions

COGENT RESEARCH
A division of Market Strategies International

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Introduction

Prior to the introduction of smart beta ETFs, institutional decision-makers including public and private pensions, endowments and foundations and Registered Investment Advisors (RIAs) who manage institutional assets had to choose between market cap-weighted indexes and higher-cost actively managed funds. Today, these institutional decision-makers can add a growing category of ETFs to their toolbox: smart beta ETFs. These smart beta or rules-based ETFs seek to achieve specific investment objectives – such as limiting volatility or generating income – by employing a fundamental or factor-driven weighting methodology. The category has become an increasingly attractive alternative to market cap-weighted ETFs by delivering many of the same benefits of traditional ETFs, particularly lower costs in comparison to actively managed funds.

Thanks to their flexibility, transparency, and ease of implementation, smart beta ETFs have experienced tremendous growth over the past year and are now being used by 1 in 4 institutional decision-makers. Additionally, over one-quarter (29%) of the U.S. ETF industry's equity net flows in 2013 went into smart beta ETFs, even though this category represents just 19% of assets in the ETF industry.*

To better understand the growing smart beta ETF trend, Cogent Research, on behalf of Invesco PowerShares, recently conducted research among institutional decision-makers, including institutional investors and RIAs serving institutional asset managers. The results provide key insights into current usage and perceptions regarding the smart beta ETF category, including:

- Why and how are institutional decision-makers using this type of strategy?
- What are the attitudes of current users and non-users about smart beta ETFs?
- Which type of smart beta ETF is most widely used?
- What are the major barriers to acceptance of these strategies?
- What are the primary evaluation and selection factors when choosing a strategy?
- How is utilization of smart beta ETFs expected to grow over the next few years?

Smart beta ETFs have become an increasingly attractive alternative to market cap-weighted ETFs by delivering many of the same benefits of traditional ETFs, particularly lower costs in comparison to actively managed funds.

* Bloomberg LP, December 31, 2013

Part of a Growing Category

Institutional decision-makers are increasingly turning to the broader ETF category for a number of reasons, including lower costs, access to specific asset classes or market sectors, and flexibility in investment strategy implementation. As proof, more than one-third of institutional decision-makers allocate, on average, more than one-quarter of their total assets to the ETF category. As shown in EXHIBIT A, market cap-weighted ETFs continue to be the most widely utilized ETFs – accounting for three-quarters of the total assets allocated to the category. However, nearly one-quarter (24%) of institutional decision-makers currently make use of smart beta ETFs, a number that's expected to rise.

Despite increased awareness and rising interest, smart beta ETFs are still relatively new for many institutions and are not universally understood to the extent of traditional market-cap weighted ETFs. This is evidenced by the fact that the majority of professionals using these funds have only done so for an average of less than three years.

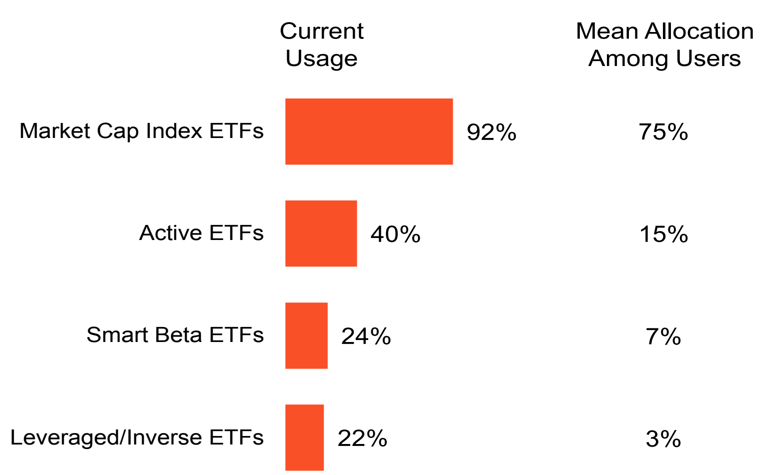
However, most institutional investors and RIAs have a basic understanding of how these funds differ from other ETFs, as shown in EXHIBIT B. Most industry professionals recognize that smart beta ETFs are not tied to market capitalization and that they feature predetermined rules, quantitative approaches and underlying methodololgies developed with a specific objective, such as reducing volatility. The distinction between smart beta ETFs and actively-managed ETFs can be somewhat blurred at times as some institutional decision-makers believe there is an active component to smart beta ETFs.

Why are some institutional decision-makers advocating use of smart beta ETFs while others show hesitation to use them? As shown in EXHIBIT C, the primary reason institutional professionals use smart beta ETFs stems from their belief that these funds generally outperform the market. In addition, these ETFs provide investment professionals a more efficient means for diversifying their portfolios and reducing overall portfolio volatility – a growing mandate among many institutional investors today.

Those who haven't yet incorporated smart beta ETFs into their strategies cite a general lack of familiarity, above all else, as the reason why they have yet to use these products. This is not uncommon for any new product category, particularly one that incorporates a more sophisticated methodology. Currently, one-third (34%) of institutional decision-makers are unfamiliar with smart beta ETFs, a hurdle the industry will have to overcome to increase acceptance and usage. Secondary reasons for not using this fund category include a lack of track record and a preference for active management – the second being a major barrier to adoption for the broader ETF category overall.

EXHIBIT A

ETF CATEGORY USAGE AND ALLOCATION



Nearly one-quarter (24%) of institutional decision-makers currently make use of smart beta ETFs, a number that's expected to rise.

The primary reason institutional decision-makers use smart beta ETFs stems from their belief that these funds help manage volatility, increase diversification, and access enhanced risk-adjusted returns.

EXHIBIT B

HOW INDUSTRY PROFESSIONALS DEFINE SMART BETA ETFS (TOP 10)

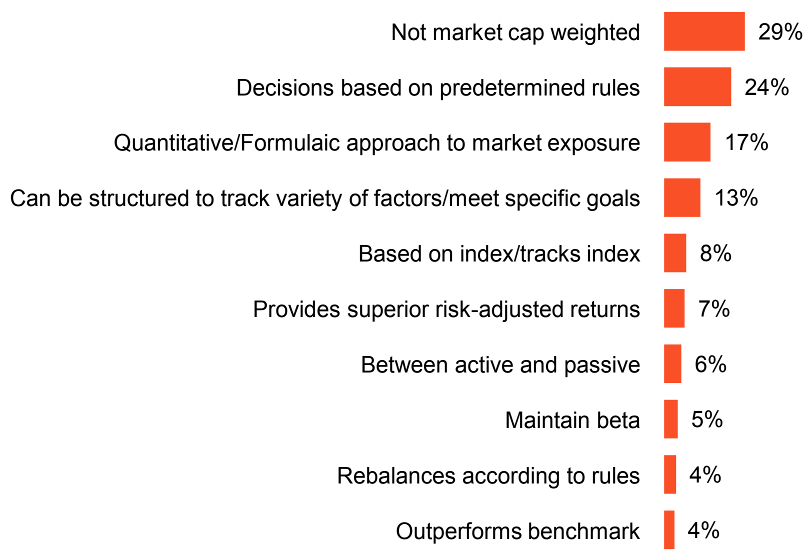
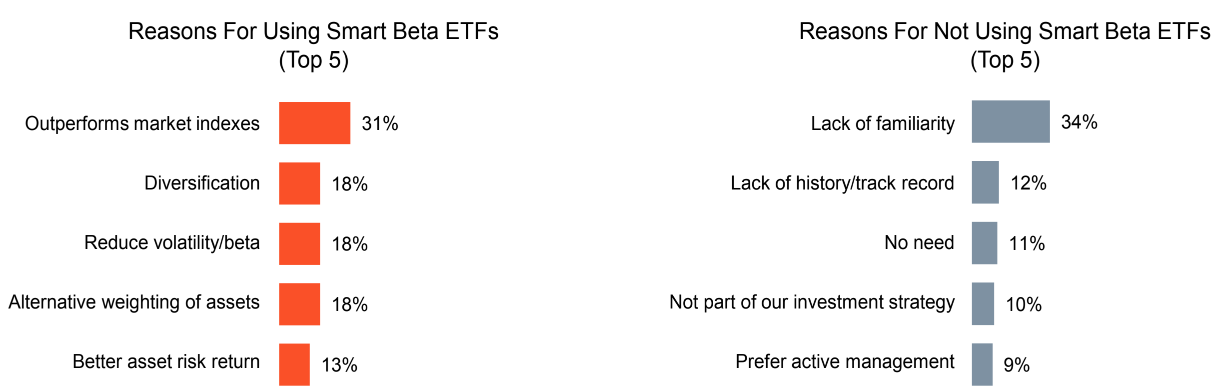


EXHIBIT C

REASONS FOR USING AND NOT USING SMART BETA ETFS



A Strong Growth Forecast

Overall, institutional use of the ETF category in general is expected to increase as more institutional professionals become familiar with these vehicles and the role these funds can play in re-balancing their portfolios and managing risk. In fact, nearly six in ten (59%) institutional decision-makers expect to increase their use of the broader ETF category over the next 12 months, while just 2% expect a decrease in usage (as shown in EXHIBIT D).

Perhaps more noteworthy, the smart beta ETF category is poised for the greatest growth relative to all other ETF categories over the next 3 years. In fact, over half (53%) of institutional decision-makers expect to increase their use of smart beta ETFs, while less than half (48%) project they'll make heavier use of market cap-weighted ETFs. (as shown in EXHIBIT E). In addition, nearly half (46%) of those not currently using smart beta ETFs say they are at least somewhat likely to add these funds to their toolkit within the same time period. This anticipated shift from market cap-weighted to smart beta funds is a sign that institutional decision-makers might be looking for more tactical strategies to address their evolving investment objectives in today's volatile and uncertain economic climate.

The smart beta ETF category is poised for the greatest growth relative to all other ETF categories over the next 3 years.

EXHIBIT D

EXPECTED CHANGE IN ETF USAGE (WITHIN NEXT YEAR)

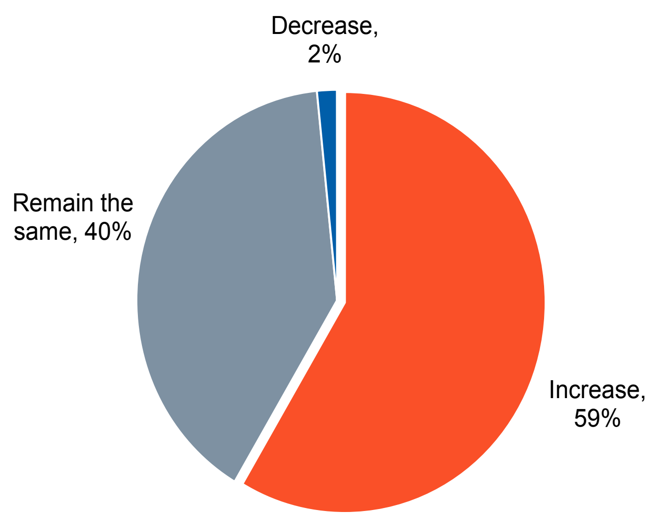
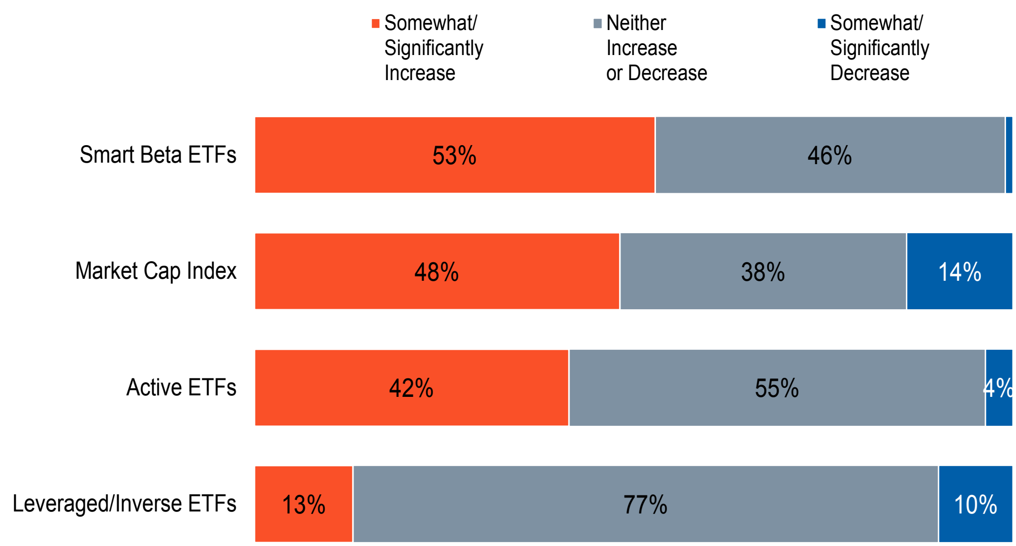


EXHIBIT E

EXPECTED CHANGE IN USAGE OF VARIOUS ETF CATEGORIES (WITHIN NEXT 3 YEARS)



Recognizing Multiple Benefits

The primary reason among institutional decision-makers looking to start using smart beta ETFs is the ability to make tactical adjustments to their asset allocation strategy – followed closely by several other important factors (as shown in EXHIBIT F). However, different aspects of this fund category appeal to institutional investors compared to RIAs. Institutional investors cite access to higher beta strategies and reducing fees as top motivators for using this type of fund while RIAs are more interested in making tactical adjustments to their asset allocation, reducing portfolio volatility, accessing specific markets/ sectors and harnessing ETF tax efficiency.

Differences in perceptions of the smart beta category also exist between institutional investors and RIAs not currently utilizing smart beta ETFs. Overall, almost half (49%) feel that these funds are an effective tool for managing portfolio volatility; however, institutional investors are more likely to agree that these types of funds are a great low-cost option, offer better value for the money as compared to market cap-weighted ETFs and are an ideal tool for building a portfolio (as shown in EXHIBIT G).

Once institutional decision-makers start using smart beta ETFs, they recognize the value they provide. Among professionals using this fund category, seven in ten (70%) feel they effectively manage portfolio volatility (compared to 49% of non-users) and nearly the same proportion (68%) feel smart beta ETFs provide better risk-adjusted returns than market cap-weighted ETFs (compared to 31% of non-users).

Compared to institutional investors, RIAs are more interested in using smart beta ETFs to make tactical adjustments to their asset allocation, reduce portfolio volatility, access specific markets/sectors and harness ETF tax efficiency.

EXHIBIT F

PRIMARY REASONS TO START USING SMART BETA ETFS (AMONG NON-USERS)

	All Institutional Decision Makers	Institutional Investors	RIAs
To make tactical adjustments to asset allocation	42%	36%	47%
To access higher beta strategies	40%	49%	32%
For portfolio completion	40%	39%	41%
To reduce portfolio volatility	39%	24%	53%
To reduce expenses/fees	37%	46%	29%
To access specific markets and/or sectors	34%	27%	41%
To harness ETF tax efficiency in taxable plans	12%	0%	24%
To leverage long/short ETF applications	9%	12%	6%
To execute fixed income and credit adjustments	5%	6%	3%
To participate in securities lending	0%	0%	0%
Other	5%	6%	3%

EXHIBIT G

ATTITUDES TOWARD SMART BETA ETFS (AMONG NON-USERS)

% Somewhat/Completely Agree

	All Institutional Decision Makers	Institutional Investors	RIAs
Rules-based/smart beta ETFs can be used to manage portfolio volatility	49%	51%	48%
Rules-based/smart beta ETFs offer embedded risk management controls and features	33%	37%	29%
Rules-based/smart beta ETFs can provide better risk-adjusted returns relative to market cap ETFs	31%	33%	29%
I anticipate allocating more of my institutional assets/fund assets to rules-based/smart beta ETFs in the future	28%	29%	27%
Rules-based/smart beta ETFs can offer the best combination of low cost, and market outperformance	25%	38%	12%
Rules-based/smart beta ETFs provide much better value for the money compared to Market Cap Index ETFs	13%	22%	4%
Rules-based/smart beta ETFs are ideal portfolio building tools	12%	19%	4%
I prefer to use rules-based/smart beta ETFs over market-cap weighted ETFs when it's applicable	10%	12%	7%
Rules-based/smart beta ETFs are my preferred ETF portfolios	1%	1%	1%

Decision-Makers High on Low Volatility

Within the smart beta ETF category, low volatility funds have experienced the greatest growth in 2013: an impressive 99%.* This trend is expected to continue as two-thirds (67%) of institutional decision-makers not currently using smart beta ETFs indicate they are likely to use low volatility funds moving forward (as shown in EXHIBIT H). As discussed, the need to manage volatility has become more important in recent years and is likely driving this trend. High dividend and fundamentally weighted ETFs are also likely to experience increased flows over the next three years as sizeable proportions of institutional professionals indicate they are likely to incorporate these ETFs into their portfolios moving forward (46% and 34%, respectively).

To date, institutional decision-makers have primarily been using smart beta ETFs in equity asset classes while usage is relatively lower in fixed income and alternative asset classes (as shown in EXHIBIT I). These are two areas in which institutional decision makers have historically utilized more actively-managed funds; however, as product development increases, institutional professionals will continue to see new products emerge in these areas.

Smart beta ETF providers should take note that the evaluation and selection process related to smart beta ETFs is somewhat different than for traditional, market cap-weighted ETFs. While the fees/fee structure continues to be the most important criterion, the ETF's underlying methodology becomes significantly more important, given the more sophisticated underlying methodology of smart beta ETFs. There is a greater need for transparency and education regarding the composition of the fund, something ETF providers should be prepared for when positioning smart beta ETFs.

Institutional decision-makers have multiple provider choices when selecting smart beta ETFs. However, Invesco PowerShares stands out as an industry leader in terms of number of product offerings, assets under management and brand recognition. Almost one-third of institutional investors and RIAs mentioned Invesco PowerShares when asked to name a provider of smart beta ETFs.

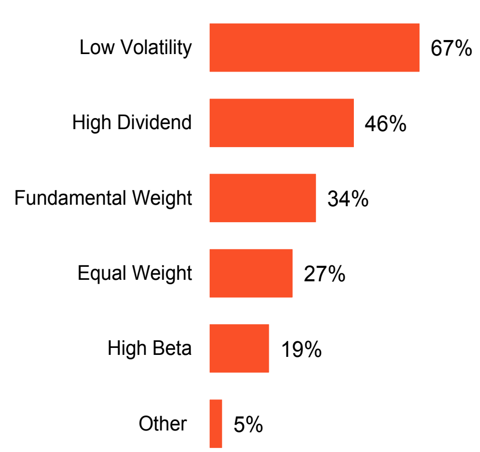
Interestingly, the actual provider of the ETF is not a key factor in the selection process (as shown in EXHIBIT J); however, several firms have emerged as leaders in this new category of smart beta ETFs. While nearly one-third of institutional decision makers agree that Invesco PowerShares is a leader in the smart beta ETF category, institutional decision-makers who are already using the category have an even stronger impression of the PowerShares brand. As shown in Exhibit K, nearly three-quarters (72%) of users agree Invesco PowerShares offers truly innovative ETFs and over half agree Invesco PowerShares is a leader in the category, offers a breadth and depth of ETF offerings and is a product and service innovator.

Two-thirds (67%) of institutional decision-makers, not currently using smart beta ETFs, indicate they are most likely to use low volatility funds moving forward.

EXHIBIT H

LOW-VOLATILITY FUNDS SHOW GREATEST GROWTH (AMONG NON-USERS)

Anticipated Use Over the Next 3 Years



* Bloomberg LP, December. 31, 2013

EXHIBIT I

SMART BETA ETFS WIDELY USED IN DOMESTIC EQUITY CLASSES

	Overall Allocation	Market Cap Index	Smart Beta	Leveraged/ Inverse	Active
U.S. public equities	37%	85%	79%	60%	54%
U.S. fixed income	24%	51%	32%	36%	35%
Non-U.S. public equities	14%	56%	53%	12%	32%
Other alternatives	8%	14%	17%	24%	18%
Cash/cash equivalents	6%	20%	2%	0%	8%
Real estate [including REITs]	4%	35%	11%	21%	18%
Non-U.S. fixed income	4%	25%	21%	5%	23%
Real assets/commodities	3%	35%	23%	17%	21%

EXHIBIT J

FEE SELECTION IS MOST IMPORTANT IN FUND SELECTION

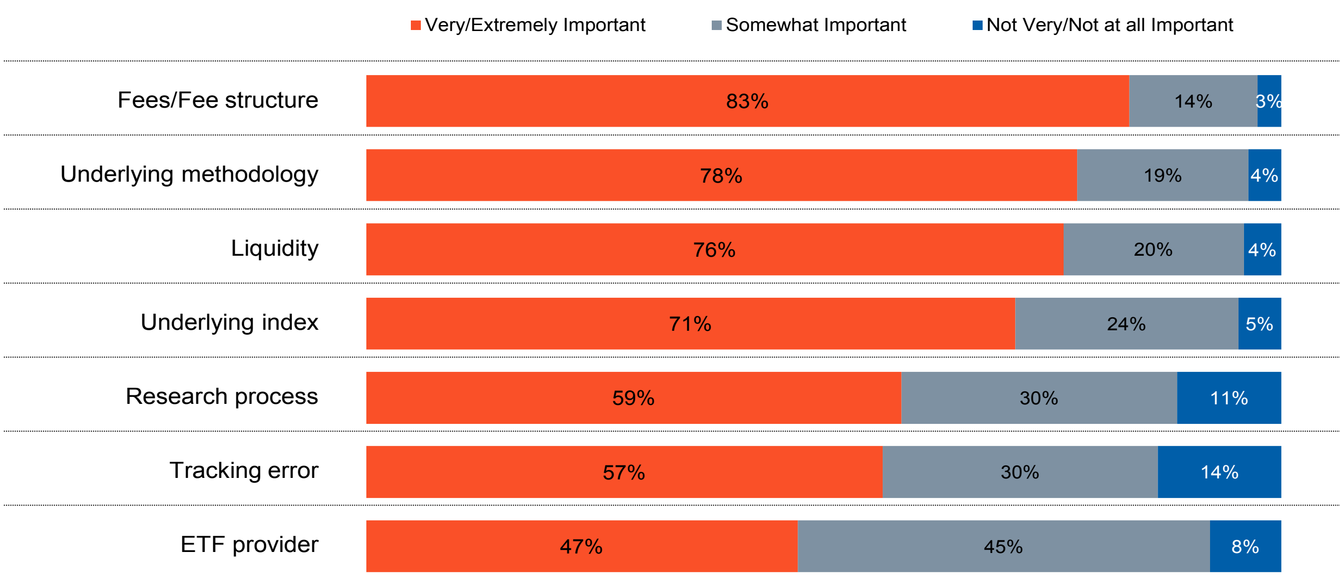


EXHIBIT K

INVESCO POWERSHARES BRAND ASSOCIATION (TOP 2-BOX DESCRIPTION)

	Smart Beta ETF Users	Smart Beta ETF Non-Users	Difference
Offers truly innovative ETFs	72%	37%	+35
Leader in the 'Smart Beta' ETF category	59%	22%	+37
Offers a breadth and depth of ETF offerings	62%	41%	+21
Is a product and service innovator	62%	42%	+20
Has a deep understanding of global markets	44%	36%	+8

Invesco PowerShares stands out as an industry leader in terms of number of smart beta product offerings and assets under management to date.

Conclusion

Nobody would argue that smart beta ETFs have supplanted other categories of ETFs, and they probably won't in the near future. However, this emerging fund category gives institutional decision-makers a powerful "middle ground" between actively-managed ETFs and those that are market-cap weighted. As a supplement to other investment strategies, smart beta ETFs are an effective tool for institutional investors and RIAs seeking better risk-adjusted returns and lower costs amid volatile market conditions. While growth is expected to continue for the smart beta ETF category, providers will need to take into account the primary drivers of adoption and address the potential concerns if they plan to grow their business moving forward.

About the Study

The data contained within this analysis was collected between September 5 and October 2, 2013. A 15 minute online survey was administered to nearly 200 institutional decision makers, including pensions, endowments/foundations, non-profit institutions, mutual funds, as well RIAs who manage institutional business. All institutions had at least $20 million in assets and allocated at least 1% of their assets to ETFs. Institutional RIAs had at least $25 million in assets under management–a portion of which was managed on behalf of institutional investors.

Invesco PowerShares is not affiliated with Cogent Research, a division of Market Strategies International. Cogent Research is an independent full-service market research provider, specializing in wealth management and financial services market research and consulting. Cogent Reports was hired by Invesco PowerShares to conduct the research used in the creation of this white paper. Participants were not made aware of Invesco PowerShares' involvement in this research initiative.

Glossary

Beta is a measure of risk representing how a security is expected to respond to general market movement.

Liquidity is characterized by a high level of trading activity and is a measure of the degree to which an asset or stock can be bought or sold in the market without affecting it's asset price. Assets or stocks that can be easily bought or sold are known as liquid assets.

Smart Beta represents an alternative and section index based methodology that may outperform a benchmark or reduce portfolio risk, or both. Smart beta funds may underperform cap-weighted benchmarks and increase portfolio risk.

Standard Deviation measures a fund's range of total returns and identifies the spread of a fund's short-term fluctuations.

fund's short-term fluctuations components are weighted according to market capitalization. Index value can be calculated by adding the market capitalizations of each index component and dividing that sum by the number of securities in the index.

Non-Market Cap Weighted assign weights to stocks based on factors other than market capitalization in an attempt to reduce the risk of overexposure to a certain sector or group of stocks.

Quantitative Weighted a type of rules-based index in which individual components are weighted according to a variety of factors, such as volatility and momentum, in an attempt to generate excess return.

Transparency ETFs disclose their holdings daily.

Volatility the annualized standard deviation of index returns.

Risk Information

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There are risks involved with investing in ETFs, including possible loss of money. Index-based ETFs are not actively managed. Actively managed ETFs do not necessarily seek to replicate the performance of a specified index. Both index-based and actively managed ETFs are subject to risks similar to stocks, including those related to short selling and margin maintenance. Ordinary brokerage commissions apply. The Fund's return may not match the return of the Index.

Investments focused in a particular industry are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

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Cogent Research helps clients gain clarity, obtain perspective and formulate direction on critical business issues. Founded in 1996, Cogent provides custom research, syndicated research products and evidence-based consulting to leading organizations in the financial services, life sciences and consumer goods industries. In May 2013, Market Strategies International acquired Cogent Research. In the next few months, the syndicated research products you know and love will become Cogent Reports. Rest assured, we will continue to deliver data-driven solutions and strategies that enable clients to better understand customers, define products and shape market opportunities in order to increase revenues and grow the value of their products and brands.

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