etfexpress special report
www.etfexpress.com
December 2018

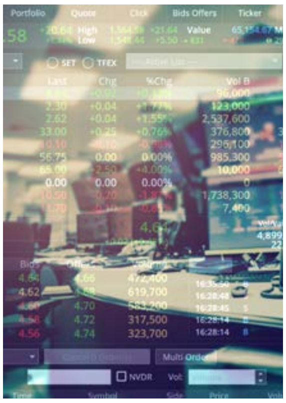
Smart Beta 2018

Smart beta receives academic treatment

Investors look for low volatility in tricky markets

Minimum variance strategy gets its 'day in the sun'

In this issue...



etfexpress

Publisher

Managing Editor: Beverly Chandler, beverly.chandler@globalfundmedia.com
Contibuting Editor: James Williams, james.williams@globalfundmedia.com
Online News Editor: Mark Kitchen, mark.kitchen@globalfundmedia.com
Deputy Online News Editor: Mary Gopalan, mary.gopalan@globalfundmedia.com
Graphic Design: Siobhan Brownlow, siobhan.brownlow@globalfundmedia.com
Sales Managers: Simon Broch, simon.broch@globalfundmedia.com;
Malcolm Dunn, malcolm.dunn@globalfundmedia.com;
Sales Manager, Property Funds World: Matthew White, matthew.white@globalfundmedia.com
Marketing Administrator: Marion Fullerton, marion.fullerton@globalfundmedia.com
Head of Events: Katie Gopal, katie.gopal@globalfundmedia.com
Chief Operating Officer: Oliver Bradley, oliver.bradley@globalfundmedia.com
Chairman & Publisher: Sunil Gopalan, sunil.gopalan@globalfundmedia.com
Photographs: Shutterstock
Published by: GFM Ltd, Floor One, Liberation Station, St Helier, Jersey JE2 3AS, Channel Islands
Tel: +44 (0)1534 719780 **Website:** www.globalfundmedia.com

Smart beta ETFs begin to impact on active funds

By Beverly Chandler

Smart beta data from ETF data provider ETFGI reveals that assets invested in smart beta ETFs and ETPs listed globally reached a new high of USD687 billion, following net inflows of USD9.15 billion and market moves during September.

Smart beta fills the investor's need for targeted investment outcomes, as revealed by the contributors to this year's Smart Beta Special Report from Global Fund Media.

Other research from Moody's published in its latest report on ETFs and passive funds predicts that in Europe, ETF growth will propel European passive funds towards 25 per cent market share by 2025.

The Moody's report describes the ETF as a viable tactical tool for implementing short- to medium-term views.

"Investors can use sector and geography focused ETFs for directional thematic trades, both long and short. With the increasing size and granularity of the ETF market, institutional investors including hedge funds are also increasingly using ETFs to assume risks previously taken via futures and OTC derivative products. Unlike futures or swaps, which may require additional operational hurdles and portfolio management expertise, ETFs enable portfolio managers to easily adjust their portfolio exposures so as to mitigate major risk factors, including equity, credit and interest rate risks. This allows them to quickly adjust their investment exposure."

Moody's notes that active asset managers are also increasingly using ETFs as part of

traditional and multi-asset portfolios to build flexible, liquid, cost-efficient solutions.

The firm writes that there is growing demand for fixed income ETFs, as well as for thematic ETFs, such as those that take environmental, social and governance (ESG) issues into consideration.

"While most of the flows go to plain vanilla ETFs, demand is also growing for 'multi-factor' or 'smart beta' ETFs. These funds follow an index, but rely on multiple factors – such as quality and value – and incorporate decision-making processes to actively adjust the level of exposure to different factors and betas. Multi-factor ETFs are more research intensive, and often compete directly with traditional mutual funds," Moody's writes.

This month has also seen new research from the Lyxor Dauphine Research Academy that reveals that the introduction of passive funds has helped investors by increasing competition in asset management.

In 2018, the Research Academy focused on the relationship between passive and active management, specifically looking at what role the growing passive space has left for active managers. The research from Cao, Hsu, Xiao and Zhan found evidence that the introduction of passive funds has increased competition, revealing that the increasing availability of smart beta funds is forcing active managers to demonstrate that they can deliver true alpha in order to continue to gather flows.

Academic institution the EDHEC-Risk Institute announced the results of the 11th EDHEC European ETF and Smart Beta and Factor Investing Survey, recently as well. This study is conducted as part of the Amundi research chair at EDHEC-Risk Institute on 'ETF, Indexing and Smart Beta Investment Strategies'.

This survey, conducted since 2006, is designed to provide insights into European investors' perceptions, practices and future plans in the domain of ETFs and Smart Beta.

EDHEC-Risk writes that this year, the survey also included a special focus on Smart Beta product development, considering specific client demand in the fixed income field.

The survey reveals that since 2006, the increase of the percentage of respondents using ETFs in traditional asset classes has been spectacular: in 2006, 45 per cent of respondents used ETFs to invest in equities, compared with 92 per cent in 2018.

About two-thirds of respondents (67 per cent) used ETFs to invest in Smart Beta in 2018, a considerable increase compared to 49 per cent in 2014 and respondents most frequently used Smart Beta/Factor-Based exposures to harvest long-term premia (as opposed to tactical use), the survey found.

Despite this strong motivation, more than 80 per cent of respondents invest less than 20 per cent of their total investments in Smart Beta and Factor investing strategies.

The survey found that 50 per cent of investors still plan to increase their use of ETFs in the future despite the already high maturity of this market and high current adoption rates. Top concerns for the respondents are the further developments of Ethical/SRI ETFs, emerging market equity and bond ETFs and Smart Beta ETFs, including multi-factor and smart bond indices.

EDHEC-Risk writes that respondents showed a significant interest for Fixed Income Smart Beta solutions and plan to increase their investment in it, but they do not consider there to be enough research in the area. The development of new products corresponding to these demands may lead to an even wider adoption of Smart Beta solutions, the Institute says.

Commenting on the study, Professor Lionel Martellini, Director of EDHEC-Risk

Institute, said: "ETFs are increasingly regarded by institutional asset owners as key investment vehicles in the implementation of strategic asset and factor allocation decisions. The new frontier now is the development of meaningful smart factor investment solutions in the fixed income space. More academic research is needed in this area, which has become one of the main areas of focus for EDHEC-Risk Institute."

More research published in this last quarter, came from Jason Hsu and John West from Research Affiliates and was provocatively entitled: 'The Biggest Failure in Investment Management: How Smart Beta Can Make It Better or Worse'.

Here the pair posited that the negative gap between investor returns and fund returns is the biggest failure in investment management - with alpha only a sideshow.

They write in their paper: "If we extrapolate the investor returns gap to smart beta strategies, poor client timing will completely negate the potential for positive excess returns. The client service model for smart beta strategies needs to be radically different from other types of strategies to produce better investor outcomes."

Their paper concludes that the gap between dollar-weighted and time-weighted returns–the investor returns gap–is a substantially larger figure, and therefore a greater cause of concern for investors, than underperformance versus a benchmark.

"The investor returns gap means that even for asset managers skilled enough to produce alpha, chances are their clients won't be able to fully capture it in their own portfolios because of the clients' investment timing decisions. For this reason, we call the investor returns gap the biggest failure in the investment industry.

"At the end of the day, for investment professionals to successfully deliver on their mission to clients, they must help them earn a positive dollar-weighted alpha over time. This means not only must investment professionals design strategies with robust sources of return and implement them in a cost-effective manner, they must also strive to help clients understand how to stay the course by understanding the styles in which they choose to invest."

The Research Affiliates study found that many high-tracking-error smart beta strategies may actually exacerbate the investor returns gap, especially if noisy short-term performance is sold to trend-chasing clients.

"The investor returns gap of nearly 2 per cent will wipe out the majority of smart beta strategies' long-term returns. But we're optimistic. We believe this cycle can be broken. Robust, academic-quality research and efficiently designed products are important, but no longer enough. To avoid the biggest failure in investment management, we must embrace a new conversation." ■

Discover the route to low cost ETFs

Core ETFs for a third less on average

With TERs from just 0.04% our Core ETFs are the lowest cost portfolio building blocks in Europe, a third less than the rest[1].

Providing quality without compromise, our Core ETFs cover mainstream exposures, are physically replicated, and avoid securities lending.

The original pioneers

LyxorETF.co.uk/ReduceCost

LYXOR etf

SOCIETE GENERALE GROUP

[1]Source: Lyxor International Asset Management. Based on the average TER reduction across 16 Lyxor Core ETFs. *Fees data from Bloomberg as of September 2018

Investors look for low volatility in tricky markets

Interview with Adam Laird

Adam Laird, head of ETF strategy, Northern Europe for Lyxor reports a sea change in investors' use of smart beta ETFs in the last year. Lyxor currently manages around EUR3 billion in smart beta funds – just less than 5 per cent of its assets. Flows have been steady across 2018, with a sizable uptick in smart beta flows in Q3, along with rising market volatility – bringing Europe's smart beta inflows over EUR4.6 billion.

"The most important thing is that this year has seen a real resurgence in interest for low volatility strategies," Laird says. He believes that, because of the market environment, everyone is more concerned about risk to their portfolios going forward.

"We have had a decade now of very strong growth in the equity markets," Lairds says. "Everything has been well protected but we have seen market dips in the US and a lot of investors are worried about the future – worried about protecting their assets.

"For a long time, everyone enjoyed the upside but there is a real recognition at the moment that good times can't go on forever and that we need to be more cautious with our portfolios."

Laird reports that caution is across the board with all types of ETF investors but that he has observed that it's particularly true for wealth managers and private banks because individual investors are jumpy.

"The retail market has been forecasting the next crash for years, investors don't like to lose. This presents a puzzle – do you stay invested and wait for the crash? Or move to cash and lose out on returns?" says Laird "There's risks on both sides – nobody can time the markets"

The consequence is that Lyxor has seen an increase in demand for minimum volatility ETFs. The construction means that investors can retain 100 per cent of their investment in equities but at the same time the portfolios

Adam Laird, head of ETF strategy, Northern Europe at Lyxor

"For a long time, everyone enjoyed the upside but there is a real recognition at the moment that good times can't go on forever and that we need to be more cautious with our portfolios."

are constructed so that they are less volatile than a standard index.

Laird says: "We have seen a lot more investment in those ETFs, particularly as these strategies now have a track record with many having been around for over five years so they have proven themselves in the smaller market downturns in the last 12 months."

Lyxor's US Equity Low Volatility ETF has been particularly popular. It is designed to take into account the overall risk in the portfolio and buy complementary shares so that while each individual company might be volatile the portfolio has offsets within it to overcome that.

The example Laird gives it that the portfolio might offset oil price change by holding oil companies alongside car manufacturers. When the oil price is high and oil shares are going up this can offset the drop in the car manufacturers.

"The index does this mathematically – looking at correlation between share prices rather than individual company profiles." Laird says. "The results show that this really works. In Q3, the Lyxor FTSE USA Minimum Variance ETF reduced risk by 16.9 per cent compared to the standard FTSE USA index."

As a secondary consideration the index emphasises diversity. "Nobody wants to minimise volatility but end up with a super-concentrated portfolio. Spread your eggs amongst many baskets." ■

Minimum Variance has its 'day in the sun'

Interview with Inderpal Gujral

Inderpal Gujral, head of product at STOXX, has seen recent market volatility shining a bright light onto their range of Minimum Variance Indices, designed to reduce risk by attempting to minimise the variance (and thus volatility) of a portfolio.

STOXX offers two versions of their minimum variance indices: constrained and unconstrained. The range was launched more than six years ago but has seen its most popular period in the last two years, with assets managed globally against STOXX min var indices exceeding USD1 billion.

Gujral explains that minimum variance tends to perform well in a market environment that is witnessing volatility.

"The STOXX USA benchmark index had outperformed the min var version during the year by nearly 4 per cent over the summer. Now, the min var version is ahead of the benchmark by 4 per cent due to reversals in the stock markets over the recent six to eight weeks of slightly volatile returns, coming on the back of a 10-year bull run, with almost a straight line of performance in equity markets," Gujral says.

Creating the minimum variance index range depends on an examination of correlations and co-variances between each pair of stocks, in order to estimate how they are expected to behave relative to each other.

"The min var approach is rooted in Markowitz investment theory, and looks at the correlations and co-variances between each pair of stocks to put together a portfolio that has a minimised expected variance.

"You take the overall portfolio which is the benchmark and add a constraint that the min var version should have 30 per cent of the constituents plus other optimisation approach limits."

Inderpal Gujral, head of product at STOXX

Unique to STOXX is a further filter which involves looking at the factors' exposures of the min var portfolio and setting a threshold for those to remain within a certain range of the benchmark.

This means that the min var version will likely have similar attributes to the benchmark as well as achieving the objective of having minimum variance.

The min var approach is popular with a broad cross section of clients from traditional ETF product users who use it as an alternative to typical beta products, to institutions who perhaps see it as complementary to standard market cap weighted exposures.

"We think it is very useful in structured products where in order to create capital protected products, the min var index offers a cheaper solution than otherwise would be the case," Gujral says.

He argues that min var investing is not smart beta in its truest sense. "We have positioned the min var not as a form of smart beta alternative that are typically unsuitable for standalone allocations but used mostly as building blocks within a broader portfolio. Min var portfolios conversely, provide investors with a complete portfolio management strategy allocating optimally to reduce risk."

"It's quite easy to see it being used to represent US exposure in place of a typical US ETF which captures the market cap weighted index," he says.

The STOXX Global 1800 min var index (USD Gross Return) between end 2009 and 2018 went up nearly 236 per cent cumulatively with an annualised volatility of 8.7 per cent, whereas the benchmark went up 217 per cent with a 13.3 per cent volatility.

"Over a wider time frame you get this kind of out performance with a lower volatility," Gujral says. ■