Exchange traded funds

A useful route to passive investment?

In conversation:

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A useful route to passive investment?

Exchange traded funds (ETFs) experienced record growth last year as some $338.3bn flowed into the strategies throughout 2014. This total represented a year-on-year increase of 36.1%, while December alone saw a new monthly record inflow of $61.5bn.

This soaring demand was met with innovation from providers as around 200 new ETFs entered the market last year – a 30% jump on 2013.

ETFs' low cost passive exposure to indices has proved popular for investors looking for exposure to niche asset classes or asset classes not accessible via pooled funds. Use among investors varies with some using ETFs for tactical exposure to express a view on a market and others using them as strategic buy-and-hold investments. According to research by independent research and consulting firm ETFGI, 47% of institutions said they held ETFs for more than two years.

But despite last year's stellar growth, it seems that, anecdotally, widespread use of ETFs among UK institutional investors is yet to really take off. One of the biggest hurdles for trustees to overcome is a lack of understanding about these products that prevails among certain trustee boards.

Another barrier to entry is overcoming regulatory requirements, such as the need for funds to be authorised to trade listed instruments as well as concerns over the tax framework around ETFs. Elsewhere for bigger funds, ETFs are not always the cheapest route to passive exposure because they often have the clout to negotiate lower fees on direct passive mandates.

Until fees really come down and the tax issues are addressed then some UK pension funds will remain hesitant when it comes to investing in ETFs.

This roundtable brings together a panel of asset owners, consultants and managers to debate the issues around accessing ETFs, including how they are being used in portfolios, the development of smart beta strategies and some of the barriers to entry.

Sebastian Cheek
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Ana Harris

"Firms are using ETFs to promote new ideas as they are easier and more cost-efficient to get off the ground. Even if a lot is linked to passive and smart or advanced beta, there is still a lot in cap-weighted products." Ana Harris

It was a record-breaking year for ETFs in 2014; some £338.3bn was put into ETF strategies, with £61.5bn in December alone. Almost 200 new ETFs were launched in 2014 – a 30% jump on 2013. What has driven such big inflows?

Deborah Fuhr: ETFs have become popular as asset classes and markets have expanded. Many don't have the expertise or time to research them all. It's also difficult to find managers that consistently deliver alpha despite paying higher fees, so people are combining active and where they can find it, getting alpha, with low-cost beta where they can't. ETFs have become a tool that helps investors do their job. Fees have come down and the number of products has increased significantly. Meanwhile, the cost of other products has gone up and the array of futures is pretty limited. They can be used very short-term, as part of a transition or they can be used tactically, because there's news breaking in your field and you need to react without changing an external mandate. Increasingly, we're seeing many institutional investors – including pension funds – use ETFs as long-term holdings.

Our research shows 47% of institutions that talked about their use of ETFs said they held them for more than two years. The review of ETFs being UCITS is quite helpful. There's been an awareness of what they are and how they work that wasn't there a few years ago.

The reality is most of them are pretty simple. Some are excited about 'smart beta', but don't like the term because it implies doing market cap is not smart. I don't buy that view, but academic research shows using factor products over the long run delivers better returns than market cap.

We're working on some new research on that area, and we would say that the assets in that category,

James Waterworth

“Smart beta straddles what would be traditionally defined as active and passive. Active gives an improved risk-return profile and traditional passive a more systematic, rules-based index, with lower costs.” James Waterworth

last year, increased by about 30%, and market cap only increased by about 14% within the equities base. Not everything that’s not market cap is smart; so, if you think about a price index, we would say that’s not a smart strategy, so I think we have to be careful when we describe what smart is. Saying it’s anything that’s not market cap is not a good definition, either.

Jane Welsh: We see ETFs as one of a number of tools for getting exposure to passive. For most clients, there are more tax-efficient or lower-cost ways of getting exposure to either market cap passive, smart beta, or whatever you call it.

Our clients have made relatively limited use of ETFs to date; not because of any philosophical dislike, but they’re big enough to negotiate a lower fee, and maybe go into a more tax-efficient vehicle. We see them used for transitions and by non-pension fund clients who can’t access some of the most tax-efficient vehicles around. The US and UK pension fund industry is looking at them, but until the fees really come down, and tax issues are addressed, may not make major use of them.

Ana Harris: We don’t see institutional investors using ETFs much, but it’s changing. Sometimes, they don’t have the internal infrastructure which allows them to invest directly, so they need more administrative help to be able to invest in ETFs and would prefer vehicles that are more tax efficient. I’ve seen more interest in ETFs driven by passive; or sometimes niche asset classes or asset classes that are not accessible via pooled funds, or even in segregated mandates.

There is a lot of innovation in the market, much from the ETF space. A lot of firms are using ETFs to pro-

mote new ideas as they are a lot easier and more cost-efficient to get off the ground. Even if a lot is linked to passive and smart or advanced beta, there is still a lot in cap-weighted products.

Fuhr: It depends on the size of investment and time horizon. Pension funds over £100m with a time horizon of a year or more will then use a segregated account.

Deon Dreyer: Another element on the pensions side is that education is required to get the number of pension trustees in a position to make an informed decision. This takes quite a long time for them to start embracing all these new opportunities.

Welsh: And confusion about the regulations – in the UK pension funds have to be authorised if they're going to trade in listed instruments and for some, that's an additional barrier to buying ETFs. It's possible you can get your custodian, or one of your existing asset managers to handle the trading on your behalf, but it's just an extra barrier to overcome.

John St Hill: As investors become more focused on matching their liabilities, so the number and range of risks which are available in the ETF space is increased, it has become possible for asset owners to actually target specific risks, which they either want to gain exposure to, or which they want to hedge. To some extent, I think that has probably helped drive some of the work in the industry.

How are you using ETFs at the Pension Protection Fund?

St Hill: We use them sometimes to gain exposure to particular areas of the marketplace. We also use them, on occasion, to implement specific types of medium-term view, which we think are likely to be either risk-reducing, or generate returns.

Dreyer: From a consultant side, it's interesting; the pension schemes that have been using primarily passive have been looking to utilise either smart beta or ETFs to generate an additional level of alpha, but they're still really wedded to passive, so it's halfway between passive and active. Whereas, those that have embraced active are looking a lot more for the risk mitigation, and the risk limitation, especially with the advent of diversified growth funds now being able to target particular risks; it has become quite interesting to us.

Deborah Fuhr

Welsh: From our client base, it's those who can't get exposure to ideas through a more efficient pooled vehicle, or we've got clients who have had enough of a particular active manager. Most of our clients are not tactical: most are long-term investors, and not trying to do some of the things that you're clearly trying to do in ETF, so there's a limited use.

Harris: There are as many different uses as investors, but given just the innovation and vehicles, it sometimes takes a bit of time for investors to learn the different possibilities and the different combinations.

St Hill: We regard ETFs as vehicles for implementing our views. For any systematic strategy, broadly speaking, you can buy a total return; you can buy into a passive fund, or you can buy an ETF. The key is choosing the best vehicle for the time horizon and type of exposure we want.

Fuhr: When pension funds have different plans running, they might replicate what they do in segregated accounts through ETFs for the smaller plan, particularly when looking to put money into real estate or private equity. Some of the larger pension funds decide they want to manage tactical exposure, say, to US sectors, and so because there are no futures, or other things easily to use, and the fees in these products have come down, you can see through regulatory filings that some of the larger sovereign wealth funds have actually been using ETFs to do that.

Welsh: But with a longer time horizon there are other more efficient vehicles out there.

How much of this money flowing into ETFs is institutional and is it for the long term?

Fuhr: It's easier to get data on who owns US-listed ETFs and in 2013, 56% of all assets in US-listed ETFs were held by institutions in 42 different countries around the world. Some of it is quite long-term, because it's been there for a long time, others tactical, and if it's transition, it's not going to show up in these reports. Requirements around reporting ownership of European-listed ETFs is not very robust, so it's harder to get good data.

The challenge in the UK is many pension funds don't buy and sell securities, so using ETFs becomes a bit of a challenge. They also feel that ETFs are more of a retail product.

Dreyer: We have seen some interest in defined contribution (DC), with the default fund and charge cap on that. If you didn't want pure passive exposure, smart beta while eking out additional levels of alpha without necessarily having to pay the fees can come in under the cap.

Welsh: It's an obvious tool for DC, but it's been difficult to get ETFs onto a DC platform because of the constant pricing. Platforms want something that's priced at a particular time of the day and are reluctant to add more to the DC platform, anyway, because it adds to cost for them.

Dreyer: It's a great opportunity, in theory, but hasn't materialised yet.

James Waterworth: That will change and in the UK providers are working together to influence the platforms. It is a very suitable tool, but it is down to infrastructure.

John St Hill

ETFs have the benefit of trading through the day like a stock, whereas platforms are used for trading traditional pooled index funds that have a single NAV. For ETFs, some costs are externalised – such as brokerage – so these are the sorts of things issuers are working together on to influence the platforms.

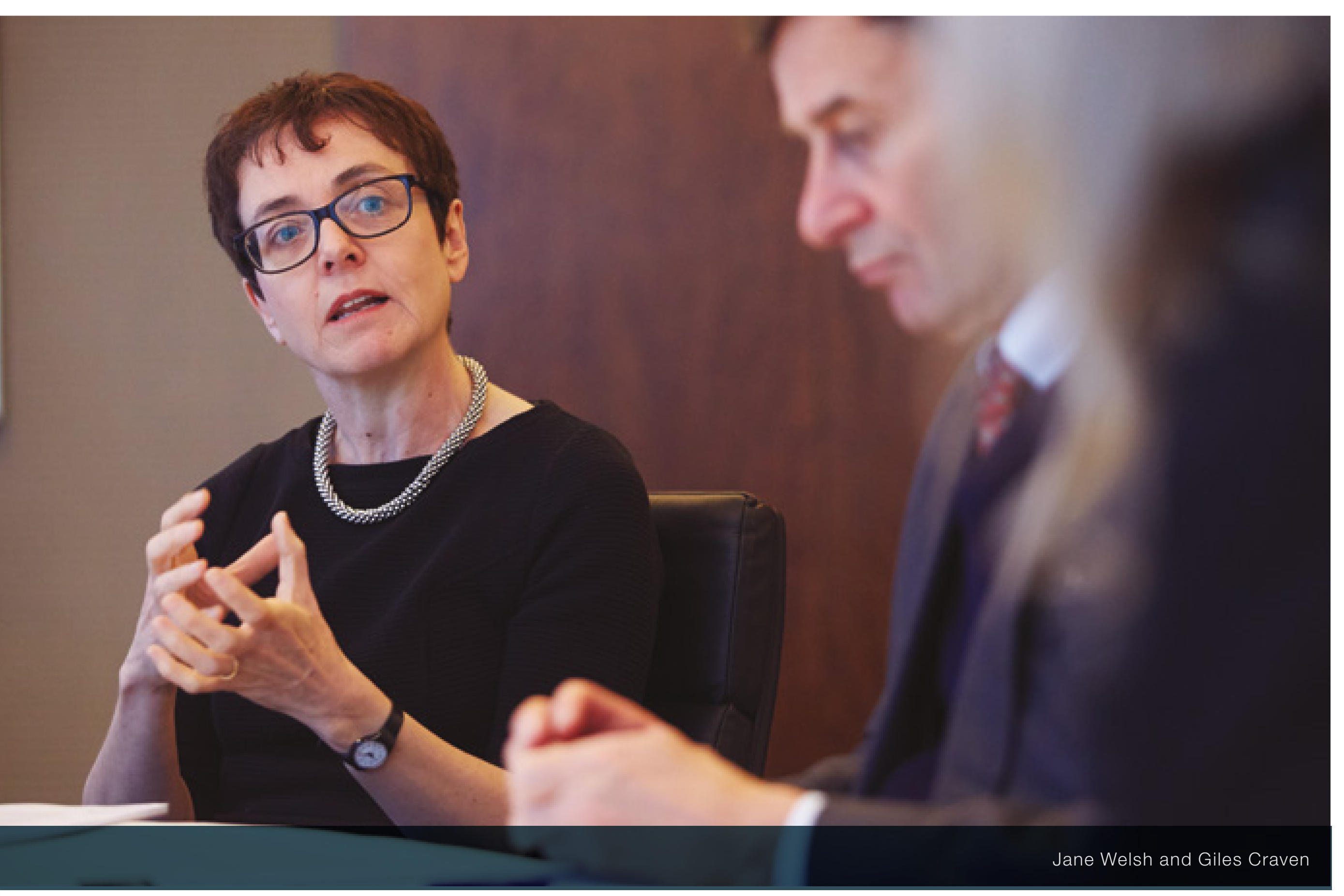
Does the Waterways scheme use ETFs, Giles?

Giles Craven: No. We take a lot of advice from consultants, and they don't mention them. Trustees struggle enough to learn about LDI, though I recognise ETFs would offer something but at the moment, trustees are trying to understand other, more pressing issues.

Harris: What will happen next, in terms of risk mitigation and reorganisation of pension funds? I guess that's where smart beta and advanced beta comes next after LDI and restructuring of portfolios?

Craven: Once they've modelled LDI, they've got a destination in mind, and a new set of issues come into play about how the plan is governed on the road to an explicit destination.

I don't see it coming into play there, either, because the big issues trustees are getting to grips with in terms of governance are quite often fiduciary management. We're talking big fixed income stuff and trus-


Jane Welsh and Giles Craven

tees have got to learn to understand it. One way of doing it – almost by proxy – is with fiduciary management, but they must get comfortable with that as a concept first, which can take a long time.

For the limited time available to help trustees understand their evolving role and responsibilities, I don't see ETFs getting in there either. That is in terms of mature DB schemes. There are a lot of other institutional investors who don't have trustees to keep up to speed on this. It's meat and drink to professional portfolio managers, but traditional, English, mature DB plans have other, bigger fish to fry.

Dreyer: As liabilities are influenced primarily through interest rates and inflation, those are the largest risks facing DB pension schemes and trustees need to be mitigated, so that has to be their first focus.

Fuhr: ETFs are actually a component of most funds. Last year, there were 3,590 institutions in 52 countries that used ETFs and there were 6,480 mutual funds. Quite often, people don't know that they actually do use them, and that is increasing.

Harris: Using ETFs to equitise cash is an option for us. As futures costs go higher, we are looking at it continuously and assessing it. We always try to keep cash to a minimum, and that may have happened already, especially on more liquid asset classes. But there's still a lot of use in futures to overlay the cash.

Waterworth: In some cases, futures are now more expensive than ETFs, so while futures are free – in the sense that there is no total expense ratio – futures have become more expensive, because of implied negative repo.

Subsequently, what we've seen is some shift towards ETFs on a case-by-case basis. Secondly, the order of magnitude of products available are tremendously more varied via ETFs, whereas there are only 20 or so liquid futures contracts in the world. You can pick and choose, and really target a specific exposure when you are equitising cash.

Craven: In traditional DB plans, trustees and consultants are quite brand-driven in buying their index funds. These are low-cost trusted brands. What goes on under the bonnet there, they're frankly not too

concerned about, because they trust the brand, and it's perfectly possible that this is happening within these funds. A trustee would be entirely comfortable with that because with the help of his consultant he wanted exposure to the US equity market, so he bought a US index fund of a brand he trusted, and didn't really need to know all the stuff that was going on underneath. That's a comfortable and hygienic way for conventional DB pension plans to use ETFs and they wouldn't really understand they were using them.

St Hill: The bid/ask spread is tighter in US volatility ETFs than US volatility futures. For the nearby volatility futures contract the spread is 48 basis points whereas for the short-term volatility ETFs it's around 29 basis points – practically half the cost. There are other issues in the volatility space, but in terms of a pure cost of trading bid – ask spread versus price – then it's much cheaper to trade ETFs.

We've already mentioned smart beta, but how will that develop?

Welsh: We originally thought that the move into smart beta would come from traditional passive because

we perceived problems with traditional market-cap indices, but I don't think that's what's happened. People have been looking at their active managers and considered that some of the ways they're adding value actually come from factor exposures they could get much more cheaply through an alternative or smart beta. This is particularly true among the fiduciary clients we have. Globally, clients are very interested in these strategies.

Harris: We've seen people trying to diversify passive and cap-weighted exposure, but also from active if they have managers overlapping in certain factor exposures that can now be accessed more cheaply and easily – and perhaps with more certainty of outcome – through a passive strategy. That could be in an ETF, a segregated mandate or a pooled fund.

St Hill: It's important to understand not only the factors that you're getting exposed to, but also the construction of indices if it's something like low volatility indices. You can't just look at the factors, because sometimes, the construction can completely overwhelm the factor effect.

Waterworth: Smart beta aims to straddle the middle ground between what would be traditionally be defined as active and passive. An active exposure would give you an improved risk-return profile, whereas passive in its traditional definition is more of a systematic, rules-based index, and with the benefit of lower cost versus active. An ETF or an index-based smart beta strategy will track the index it is designed to. The issue here is one of due diligence on the index, both from investors, but also the index provider and ETF issuer in the design of the index. ETFs would have to go one step past an index fund in the sense that they have the additional liquidity intra-day, so the design of the index is imperative with smart beta ETFs.
Welsh: Smart beta strategies can be compelling for institutional investors, though I do have some concerns about them. Do people really understand what the outcomes could be, and the journey they might experience along the way? These strategies will perform very differently from market cap, and I'm not always sure that investors going into these strategies fully appreciate that. You don't have to worry about capacity with pure market cap, but something like low volatility or min vol: they can be quite high turnover

"You don't have to worry about capacity with pure market cap, but something like low volatility or min vol: they can be quite high turnover strategies, and capacity, therefore, is something to be concerned about." Jane Welsh

strategies, and capacity, therefore, is something to be concerned about.
Waterworth: We've found clients more comfortable with a synthetic replication methodology, because the trading and rebalancing costs can be absorbed by the swap, whereas if it's a physically replicated ETF, you have a high turnover strategy such as momentum on using, for instance, UK equities where you would incur 50 basis points of stamp duty every time you buy and sell their stock. If you have a monthly or quarterly rebalancing, the performance of the ETF versus the index won't necessarily match that and you

will get drift due to the design of the index, the rebalancing frequency, and the replication methodology, whether it's physical or synthetic.

Harris: For investors in more mature DB plans that still, in terms of a governance structure, have the market cap-weight as a reference, you'd not shrink too far away from it. It really depends on the governance structure, because tracking error can be quite high, and it might happen that, for certain investors, smart beta can't fit within how they see the world and how they allocate around that benchmark of reference. It provides options, but it may not end up being available or something everybody can tap into.

St Hill: Implicit in what you say is the assumption that the reference benchmark for the client should be a cap-weighted index. If you really understand your liabilities, you should identify the benchmark which you think will best enable you to match the risk of those liabilities.

The PPF switched from a cap-weighted index to a low-volatility index for the equity exposure because it offered a better match for our target risk and return levels. Our active managers have found the low volatility index to be a much more challenging, but ultimately, the liabilities should drive your choice of benchmark. This may not always be the cap-weighted index.

Harris: That is a challenge, and cap-weighted is not always the best benchmark, but it's still fairly widely

Giles Craven

"We delegate authority to act, but that's all; we can't get rid of the responsibility. There's a limit to what we can understand and absorb and I have MNTs who don't want to be trustees in the first place." Giles Craven

Deon Dreyer

used as a reference, and so any deviations can be challenging. Whether value, low volatility, or quality, these are long-term investments, so there will be periods where versus cap-weighted will be challenging and they will underperform.

St Hill: But trustees cannot delegate accountability; all you can delegate is the execution of the strategy that you put in place. Whether you choose cap-weighted, low-volatility, or something else, as a trustee, you are responsible for providing benefits to your members.

Trustees are accountable for the returns, and just because a manager is making the decisions doesn't remove the trustees' responsibility to act in the best interests of their members, and to make informed and considered decisions about how their agents should act on their behalf.

Craven: That's what we do every day. We don't currently use smart beta, but that's probably because I am still struggling to understand it myself, and our consultants haven't proposed it.

We do regular market cap indexing with a brand that we understand and the trustees are comfortable with. We delegate authority to act, but that's all; we can't get rid of the responsibility.

But there's a limit to what we can understand and absorb. I have member-nominated trustees who probably don't want to be trustees in the first place, but get selected, and you can't take them beyond where they're comfortable. You could try, but it would be wrong if you tried.

St Hill: This may seem controversial. If you went into a hospital, with tightness in your left shoulder, and you were short of breath, and the senior consultant prescribed aspirin on the grounds that it was easier to explain then you probably wouldn't consider that good advice.

Your consultant should ensure you are in the best position to understand the decisions you've got to make. If they have to explain it in different ways, that's what you're paying them for. As an industry, we pay consultants a lot of money, and we should insist we get value for money.

Craven: Of course, but if the education hasn't happened, the investment doesn't happen. We spend the little time we have on the priorities. I'd hate for you to think that I'm suggesting consultants don't spend enough time, but if we don't spend enough time on something, we won't do it. It's as simple as that.

St Hill: I completely agree with the rationale of prioritisation. We use consultants – probably to a lesser extent than a typical fund – but we drive them to make sure that they are delivering value for us. It's incumbent on trustees to do that, because otherwise you're not making the best use of resources.

Dreyer: DB schemes have to generate a level of return in excess of the liabilities. Even a small improvement in that means a better position from a funding perspective, so they can de-risk their portfolio quicker, and ultimately, that leads to benefits for the members. Any opportunity where that can be achieved should be presented to the trustees, and then they can make a decision on that basis.

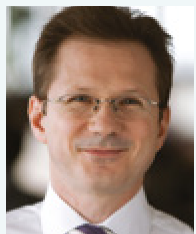
Welsh: There's more scrutiny of active management these days and that is leading to discussion about the alternatives across all asset classes. We're even seeing almost hedge fund factors being captured via smart beta strategies and people are focused on value for money.

St Hill: That's a really excellent point, and one of the threats to the hedge fund industry comes from ETF space. Asset owners shouldn't pay two and 20 for a hedge fund product that they could replicate using ETFs for less than 100 basis points flat.

Dreyer: One thing which wasn't really anticipated but has been really beneficial for the pension fund industry, was the success of diversified growth funds and the education which was required to get trustees to make an informed decision has meant trustees have focused not purely on the return but on the composition of the risk within the construction of the portfolios, leading onto factors, and how that level of return is delivered from a risk perspective. That has been beneficial to the industry.

Risk factor investing explained

By Thierry Roncalli, head of quantitative research, Lyxor Asset Management



As risk factor investing grows in popularity, there's a risk of getting lost in the "zoo" factor. In this Expert Opinion Thierry Roncalli, head of quantitative research at Lyxor Asset Management, explains the concept of risk factors by distinguishing between facts and commonly held fictions about factor investing.

Risk factors help us to understand the market

Risk factors help explain systematic return patterns in the equity market and in other asset classes. In traditional finance theory, such as the Capital Asset Pricing Model (CAPM) set out by Treynor, Sharpe and others in the 1960s, there is a single equity market risk premium, measured by beta. This risk premium compensates investors for holding equities rather than less risky assets. An investor can capture the equity market risk premium by holding the market portfolio of stocks. But since CAPM was introduced, researchers have put forward convincing evidence that there are other systematic sources of return in the equity markets than simply the market beta. These alternative return premia, or risk factors, include those relating to stocks' size, their valuation, their momentum and their historical riskiness.

Smart beta = market beta + alternative risk premia

Factor investing means the attempt to capture particular factor risk premia in a systematic way, for example by building a factor index and replicating it, or by constructing a portfolio that gives exposure to a range of risk factors. The objective is to combine factors to enhance the long-term performance of portfolios.

Factor investing is a subset of smart beta

Factor investing, including factor indices, are part of the smart beta trend. But smart beta goes beyond factors. Smart beta indices include all indices that depart from the traditional method of weighting components by their market capitalisation—companies' individual stock market footprint. Equally weighted, minimum variance indices, maximum Sharpe ratio and equal risk contribution indices are all part of smart beta. Many of these index approaches have factor "tilts" but they are a by-product of the index design. In contrast, factor indices are those that are designed intentionally to capture a specific risk premium as value, size, low volatility, quality or momentum.

Factors and active management

Factor investing has attracted a lot of interest because the past performance of traditional active managers seems to be due in a large extent to exposure to particular risk premia. Evidence shows that the average active manager has had long-standing exposure to particular factors as size and momentum. For example, an influential study of the past performance of the Norwegian Government Pension Fund, published in 2009, depicted that almost all of the performance of the fund's external managers, across both equities and fixed income, could be explained by factor "tilts". This observation raises an important question. If a fund's performance can be attributed in large part to a combination of

return factors, why not seek to replicate the factors in a systematic and low-cost way? We are seeing a lot of interest in doing just this via smart beta indices and ETFs. Despite the role of active investors, this type of fund management will always play an important role. But active managers should be rewarded for taking truly idiosyncratic risks.

Don't get lost in the factor zoo

In their influential 1992 paper, "Common Risk Factors in the Returns on Stocks and Bonds", Eugene Fama and Kenneth French showed that, in addition to the market risk premium, two other factors relating to firms' size and to value help to explain stock returns, which researchers have then provided evidence for the existence of other factors, including momentum, low volatility and quality. Momentum is a well-documented tendency for persistence in stocks' price returns: stocks that have recently outperformed tend to continue to do so for some time. The low volatility factor is a return stream associated with less risky stocks and the quality factor represents the performance of a subset of more defensive stocks. To avoid getting lost in the factor zoo – so as not to be misled by spurious correlations – we think that there should be solid empirical evidence for the existence of a factor and that there should also be some theoretical justification for its existence.

Lyxor's five-factor framework

Lyxor's equity market factor framework focuses on those alternative risk premia that have solid theoretical support and which are backed by empirical evidence. The framework has five components: in addition to the Fama-French factors of value and size we include momentum, low volatility and quality.

The explanatory power of factors varies

When compared to traditional market beta, the ability of alternative factors like value and size to explain market returns is not fixed. Our research suggests that the ability of individual factors to explain stock returns probably moves in a 5-10 year cycle and, over time, reverts to the mean. Importantly, collective power of factors also varies. Since 2005, the combined impact of the Fama-French value and size factors on the US equity market was lower than in the 2000-2005 period. Value and size stocks moved very much in unison during the period after the dot-com bubble burst. These observations suggest that it makes sense to diversify across factors in a portfolio.

Allocating equally across factors can give powerful results

One of the principal reasons for the rising interest in factor investing is that diversifying across factors appears to give more powerful results than diversifying in the traditional way, by asset class, because of the lower correlations we observe between factors. When asset allocators consider how much of their portfolios to devote to equities and bonds they usually start with quite distinct return and risk forecasts for these two asset classes, leading to a variable equity/bond allocation for investors with different risk appetites. This type of forecasting exercise, which is not easy, is even more difficult for factor returns. On the next page we show the return and risk characteristics of five world factors and we compare them to the MSCI World Net Total Return Index. All the factor indices produce higher Sharpe ratios than the market portfolio, but note that the returns of the individual factor indices are within a range of just over 3% a year.

10-year risk/return profiles of factor indices

	Value	Quality	LowVol	Size	Momentum	Index
Return	13.14%	11.32%	11.32%	13.96%	10.70%	9.16%
Vol	17.58%	11.99%	14.59%	20.30%	17.17%	16.84%
Sharpe	0.64	0.78	0.68	0.5	0.51	0.43
TE	10.92%	11.83%	4.67%	7.10%	7.55%	–
IR	0.33	0.17	0.54	0.62	0.19	–
DD	-64.85%	-37.99%	-55.19%	-62.55%	-57.58%	-57.82%
WM	-19.35%	-7.35%	-19.34%	-23.89%	-16.96%	-18.96%

Source: Bloomberg, July 2014. Factor index returns are based on existing indices. Past performance is not a reliable indicator of future returns. Return=annualised return, Vol=annualised volatility, Sharpe=Sharpe Ratio, TE=Tracking Error, IR=Information Ratio, DD=Maximum Drawdown, WM=Worst Month.

In fact a simple approach to factor allocation—equal-weighting—has a lot of benefits. Our calculations show that for this period equal weighting produced better returns than other, more complex approaches to allocation, such as equal risk contribution, volatility weighting or minimum variance.

Factors should be used sensibly

Factors can be a powerful tool to represent in a systematic way how the equity market's returns are produced. They are having a major impact on how investing and asset allocation are done. But factors need to be used consciously and carefully, with full knowledge of their characteristics.

Moving from theory to practice

Investors may feel lost when confronted with 250 risk factors. They are required not only to understand the characteristics of each factor but also how to combine them in a portfolio. And to move from theory to practice, factor investing demands both technical expertise and experience. It's also natural to question whether factors should be used as part of a strategic allocation or to take more tactical investment positions. To help answer such questions, together with my co-author Zélia Cazalet I have recently written a paper entitled "Facts and Fantasies About Factor Investing". We take a holistic view of risk factors to demonstrate certain factors' persistence and to suggest how to allocate between them in portfolios.

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* Source: Lyxor - AuM as of October 31st, 2014 - Equivalent to EUR5.6bn, liquidity-YTD average daily volume EUR39M.
** AuM as of October 31st, 2014 - Equivalent to EUR38bn.

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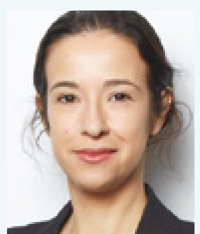
Advanced beta has come of age

By Ana Harris, portfolio strategist – global equity beta solutions & Antoine Lesné, head of ETF sales strategy EMEA, State Street Global Advisors



Advanced beta is changing the way investors look at investing, and 2014 was the year it really came of age. Investors have realised that they no longer face a binary choice between active and passive in the equity space: there is a third way that can overcome the shortcomings of weighting indices by market capitalisation, and increase returns over the long-term. Not surprisingly, therefore, a growing number of European funds want to make room for alternative exposures by reallocating from their cap-weighted and active funds.

Most advanced beta strategies play on long-standing empirical evidence that shows that greater risk-adjusted returns can be earned over the long-term by targeting factors such as valuation, volatility, size, momentum, or quality. The 'value premium', which was famously highlighted by Fama & French in their study comparing the returns on high and low book-to-market ratio stocks, refers to the greater risk-adjusted returns on value stocks over growth stocks.

Being price driven, traditional cap-weighted indices give the most exposure to overvalued stocks – which is particularly unattractive if you are, say, a value investor who thinks the stock market is near an all-time high, or an asset allocator trying to avoid overvalued shares when making a long term investment decision. Weighting by capitalisation also means that the biggest investments in some markets end up being in larger, more mature companies, rather than smaller companies with greater growth prospects.

Since we launched the world's first dividend paying ETF in 2011, the SPDR US Dividend Aristocrats UCITS ETF, dividend-based strategies have become one of the most popular advanced beta strategies, and have not shown signs of slowing down in a market environment where investors are starved for yield. Low-volatility strategies are also increasing in popularity. By weighting indices according to volatility of the underlying stocks rather than their capitalisation, low-volatility strategies may provide some protection against market downturns. What makes them one of the most popular advanced beta strategies is that they could generate higher returns than cap-weighted strategies over the long-term - the so-called 'low volatility premium' – besides being up to 30% less volatile than the broader market. This is naturally appealing when markets become more uncertain.

In Europe, the move away from cap-weighted indices was set in train some time ago. Institutions in the Nordic countries and the Netherlands may have been the early adopters, but the UK is rapidly catching up. The majority of European fund selectors may already use ETFs to gain exposure to advanced beta strategies, but the impact recent market moves have had on the risk-reward profile of numerous asset classes, has only fuelled further interest.

In a survey conducted last year, Longitude Research showed that two-thirds of respondents agreed that advanced beta was a viable alternative to active management. By combining strategic and

tactical allocations to advanced beta strategies, they can build cost efficient portfolios and more easily manage their risk/return profile. That is why we have seen such demand in Europe, where the number of advanced beta SPDR ETFs, and the assets under management, have more than doubled in the last three years. Recent additions to our range include eurozone low volatility and global dividend aristocrats ETFs.

Fixed income advanced beta: the final frontier

While advanced beta equity strategies have flourished, it is still early days for fixed income approaches. However, in recent years the bond landscape has changed significantly in terms of sovereign risk and yield, with core 10-year bond yields remaining close to historical lows, while fiscal discipline, bond investor-friendly ratio scored weighting and fixed income factor-based investing are all contributing to a new appetite for innovation among fixed income investors. The timing seems ripe, therefore, for fixed income advanced beta strategies to step up. But what factors should investors take note of when considering an index approach?

Firstly, to help define allocations and assess performance, investors often use indices. But, are existing fixed income indices truly aligned with investors' objectives? Asset owners, for example, build their fixed income portfolios around their sensitivity to interest rates, inflation and yield. This approach should lead investors to look deeper into the factors that make up fixed income beta.

For example, exposure to interest rates and high liquidity are historically linked to market confidence and economic indicators such as growth and inflation. Therefore the risk premium required for government or sovereign debt by investors is traditionally lower than for other fixed income sectors.

However, the eurozone crisis exposed the potential impact of a loss of market confidence in governments' ability to repay their debt and fixed income indices exhibited much higher volatility than expected. Since the objective of allocating to government bonds is to provide interest rate exposure in a liquid manner, it makes sense to expressly incorporate these elements — liquidity and focused interest rate exposure — into the construction of the index.

The sovereign bond market can be viewed as a continuum that has been traditionally divided into two worlds: developed and emerging. Recent economic developments and the improving state of certain emerging markets have led to a revision of this split. Although markets in general have remained turbulent, some emerging market countries are beginning to look like safer bets than certain developed countries. On the other hand, certain government bonds can exit indices, following a downgrade, and not find a place in the traditional universe of government bond indices. The risk profile of these countries has materially changed but they could still remain interesting investment opportunities. Over time their credit risk, rather than interest rate risk, can dominate.

Investors wishing to allocate primarily to interest rate risk and find liquid exposures will find that developments in the index universe recently burgeoned. We would caution that indexes with different construction criteria will not necessarily eliminate all risks that investors are not fully comfortable with. It is necessary to know if index construction rules are aligned with investor's risk appetite.

An advanced beta approach, therefore, based on countries' attitude towards debt (using debt-to-GDP) and also focusing on the countries' ability to service debt that could be an interesting way to lower the potential downside risk linked to a confidence crisis. Such exposure could be accessed through newly developed fixed income ETFs, and with innovation in this area likely set to increase, investors in coming years could look forward to a whole new set of opportunities.

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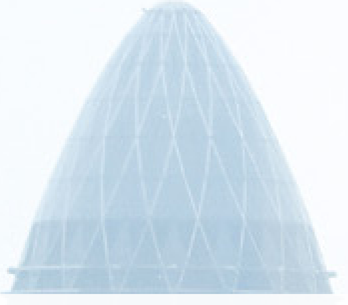

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