Spotting Passive Investment Trends: The EDHEC European ETF Survey

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Outline

• The Survey: A Unique Source of Insights
• ETF Usage: Trends and Drivers
• Smart Beta ETFs: Views and Challenges
• The Survey: A Unique Source of Insights
• ETF Usage: Trends and Drivers
• Smart Beta ETFs: Views and Challenges
A Decade of Surveying the ETF Landscape

Overview of **EDHEC-Risk Institute’s ETF Surveys** since 2006

<table>
<thead>
<tr>
<th>Year</th>
<th>Nb of ETF users surveyed</th>
<th>ETF AUM (Europe, bn USD)</th>
<th>Survey’s Special Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>112</td>
<td>71</td>
<td>core/satellite allocation</td>
</tr>
<tr>
<td>2008</td>
<td>111</td>
<td>132</td>
<td>inverse/leveraged ETFs</td>
</tr>
<tr>
<td>2009</td>
<td>360</td>
<td>143</td>
<td>ETFs in the global financial crisis</td>
</tr>
<tr>
<td>2010</td>
<td>192</td>
<td>227</td>
<td>dynamic risk budgeting</td>
</tr>
<tr>
<td>2011</td>
<td>174</td>
<td>274</td>
<td>risks of ETF replication methods</td>
</tr>
<tr>
<td>2012</td>
<td>212</td>
<td>308</td>
<td>perceptions on ESMA guidelines</td>
</tr>
<tr>
<td>2013</td>
<td>174</td>
<td>395</td>
<td>use of smart beta ETFs</td>
</tr>
<tr>
<td>2014</td>
<td>188</td>
<td>433</td>
<td>equity factors</td>
</tr>
<tr>
<td>2015</td>
<td>180</td>
<td>461</td>
<td>information needs for smart beta</td>
</tr>
</tbody>
</table>
Potential for Unique Insights

• Access to differentiated information from investors:
  – how ETFs fit into their investment process
  – how they evaluate these instruments
  – how ETFs compare to competing instruments

• The survey allows obtaining forward-looking information:
  – future plans of investment professionals
  – their outlook on industry developments
Scope of the 2015 Survey

• Conducted among investment professionals
  – from September to October 2015
  – by online questionnaire

• The 219 respondents together have at least €3.1 trillions of AUM.
  – 59% of respondents have AUM > €1bn
  – 33% of respondents have AUM > €10bn

• Respondents span 25 European countries
  – 41% are from the UK or Switzerland
Main Activity of Respondents’ Institution

- Main focus on institutional investment management

Asset owners (i.e. pension fund, insurance company)
Other institutional investment managers
Private Wealth Management
Other
Function of Survey Respondents

- Main focus on investment decision makers
• The Survey: A Unique Source of Insights
• ETF Usage: Trends and Drivers
• Smart Beta ETFs: Views and Challenges
Key results on trends and drivers

• The survey explores investors’ views and uses of ETFs, and comparisons with other indexing products.

• Persistent trends:
  • ETFs make up an increasing proportion of portfolio holdings and satisfaction has remained at high levels
  • Investors recognize the high quality of ETFs when compared to competing indexing vehicles.
  • Investors have a positive outlook on their use of ETFs

• Drivers of ETF demand:
  • Cost considerations appear to be the main drivers behind increasing ETF allocations.
  • ETFs are seen as a substitute both for active management and other passive products.
  • Smart Beta ETFs have become a key driver for demand more recently
Percentage of total investment in ETFs

- ETFs make up an increasing proportion of portfolios }

Among users of ETF for the respective asset class
Satisfaction rates with ETFs

• Stable & high satisfaction rates for liquid asset classes
• ETFs in less liquid categories show lower and less stable satisfaction levels (hedge funds, infrastructure)
High perceived quality of ETFs compared to competing indexing vehicles

<table>
<thead>
<tr>
<th>Quality Score (scale: 1,2,3)</th>
<th>ETFs</th>
<th>Futures</th>
<th>TRS(*)</th>
<th>Index Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>2.43</td>
<td>2.81</td>
<td>1.78</td>
<td>2.30</td>
</tr>
<tr>
<td>Cost of liquidity</td>
<td>2.23</td>
<td>2.66</td>
<td>1.71</td>
<td>2.11</td>
</tr>
<tr>
<td>Other cost</td>
<td>2.35</td>
<td>2.62</td>
<td>1.80</td>
<td>2.11</td>
</tr>
<tr>
<td>Tracking error</td>
<td>2.39</td>
<td>2.61</td>
<td>2.40</td>
<td>2.28</td>
</tr>
<tr>
<td>Product range</td>
<td>2.66</td>
<td>2.03</td>
<td>2.00</td>
<td>2.01</td>
</tr>
<tr>
<td>Transparency</td>
<td>2.40</td>
<td>2.70</td>
<td>1.80</td>
<td>2.27</td>
</tr>
<tr>
<td>Minimum subscription</td>
<td>2.78</td>
<td>2.21</td>
<td>1.63</td>
<td>2.34</td>
</tr>
<tr>
<td>Operational constraints</td>
<td>2.59</td>
<td>2.22</td>
<td>1.53</td>
<td>2.32</td>
</tr>
<tr>
<td>Regulatory regime</td>
<td>2.48</td>
<td>2.38</td>
<td>1.69</td>
<td>2.41</td>
</tr>
<tr>
<td>Tax regime</td>
<td>2.21</td>
<td>2.34</td>
<td>2.00</td>
<td>2.24</td>
</tr>
<tr>
<td>Control of counterparty risk</td>
<td>2.15</td>
<td>2.52</td>
<td>1.65</td>
<td>2.35</td>
</tr>
<tr>
<td>Average score</td>
<td>2.42</td>
<td>2.46</td>
<td>1.82</td>
<td>2.25</td>
</tr>
</tbody>
</table>

This table indicates the average scores which ETFs, futures, TRS and index funds received from respondents based on the eleven criteria. For each particular quality, grade 1 to 3 were given for answers of poor to very good and the average score was calculated based on the number of responses who have answered that question. (*) Total Return Swaps
Positive outlook on future use of ETFs (I)

- Percentage of investors planning to **increase** their use of ETFs, and of other indexing products
Positive outlook on future use of ETFs (III)

- Percentage of investors planning to **decrease** their use of ETFs, and of other indexing products

![Graph showing percentage of investors planning to decrease their use of ETFs, Futures, Total return swaps, and Index funds over the years 2006 to 2015.]
Motivations for increasing the use of ETFs

- Cost is the main motivation to increase ETF allocation
- Performance is also a driver, perhaps related to evidence on active management (Barras et al, 2010; Fama-French, 2010).

More than one response could be given.

![Motivations for increasing the use of ETFs](image_url)
ETFs as a substitute for active management

• The use of ETFs as low cost tools may be seen as a response to the increase of asset management fees (see Malkiel, 2013).
• The Survey: A Unique Source of Insights
• ETF Usage: Trends and Drivers
• Smart Beta ETFs: Views and Challenges
Key results about smart beta ETFs

• Smart beta ETFs are another key driver for ETF demand
  – Investors show wide agreement with research results on the benefits of smart beta

• However, investors face important challenges when trying to evaluate such offerings
  – **Resources:** Investors allocate few resources to the evaluation of cap-weighted indices, and even fewer to the assessment of smart beta
  – **Access to information:** There is an important gap between investors’ information requirements for smart beta and accessibility of information from providers
Smart Beta ETFs: Use and satisfaction

- A recent trend: Increased use and strong satisfaction with smart beta ETFs
Views on Smart Beta ETFs

- Investors show agreement with research results on the benefits of smart beta:

1. Diversification across several weighting methodologies allows risk to be reduced and adds value. Agree: 79% Disagree: 21%
2. Smart beta indices allow the concentration of cap-weighted indices in very few stocks or sectors to be avoided. Agree: 81% Disagree: 19%
3. Smart beta indices allow factor risk premia such as value and small cap to be captured. Agree: 87% Disagree: 13%
4. Smart beta indices provide significant potential to outperform cap-weighted indices in the long term. Agree: 75% Disagree: 25%
More Transparency Needed for Smart Beta ETFs

- Respondents increasingly agree that smart beta indices require full transparency on methodology and risk analytics.

![Bar chart showing percentage distribution across strongly agree, agree, disagree, and strongly disagree categories for 2014 and 2015.]
Lack of resources to assess smart beta

- Investors allocate most resources to the appraisal of active managers, fewer resources to the evaluation of cap-weighted indices, and smart beta.
Strong requirements for equity factors

- Strong academic grounding of premium required
- Implementability is also a key requirement

Importance of Requirements (scale: 1 to 5)

<table>
<thead>
<tr>
<th>Description</th>
<th>Importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explained as rational risk premium (risk that the factor pays off badly in bad times)</td>
<td>3.73</td>
</tr>
<tr>
<td>Premium documented in extensive empirical literature</td>
<td>3.63</td>
</tr>
<tr>
<td>Factors easy to implement with low turnover and transaction costs</td>
<td>3.63</td>
</tr>
<tr>
<td>Related to firm fundamentals</td>
<td>3.03</td>
</tr>
<tr>
<td>Explanation as an “anomaly” allowing rational agents to profit from irrationality of others</td>
<td>3.02</td>
</tr>
<tr>
<td>Related to macroeconomic variables</td>
<td>2.68</td>
</tr>
</tbody>
</table>

Average across answers on a scale from 0 (not important) to 5 (absolutely crucial)
### Smart Beta ETFs - Information requirements

<table>
<thead>
<tr>
<th>Information</th>
<th>Long term performance and risk (&gt;30Y)</th>
<th>Recent performance and risk (10Y)</th>
<th>Sensitivity of performance to market conditions</th>
<th>Datamining risk</th>
<th>Transaction costs</th>
<th>Factor exposures</th>
<th>Transparency on portfolio holdings over backtest period</th>
<th>Sensitivity of performance to strategy specification choices</th>
<th>Liquidity and capacity</th>
<th>Index construction methodology</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.47</td>
<td></td>
<td>3.02</td>
<td>3.16</td>
<td>2.68</td>
<td>3.35</td>
<td>3.81</td>
<td>3.81</td>
<td>4.16</td>
<td>3.91</td>
</tr>
<tr>
<td></td>
<td>3.02</td>
<td></td>
<td>2.07</td>
<td>3.16</td>
<td>3.82</td>
<td>3.01</td>
<td>4.03</td>
<td>4.06</td>
<td>4.12</td>
<td>4.28</td>
</tr>
</tbody>
</table>

On a scale from 0 (not important) to 5 (crucial) and on a scale from 0 (difficult to obtain) to 5 (easy to obtain), respectively.
Information requirements

• A general tendency is that importance scores exceed ease of availability scores!

• The two items that are judged to be the least easily available are also judged to be highly important
  • holdings over the back-test period
  • data-mining risks

• On the contrary, performance and risk information is judged to be moderately easily available an also moderately important.

• The results suggest that investors do not believe that information considered important for assessing smart beta strategies is made available to them with sufficient ease.
  • Below, we explicitly analyse the gap between information requirements and ease of access to information
## Smart Beta ETFs - Information accessibility

- Important gap between investors’ requirements and accessibility of information from providers.

<table>
<thead>
<tr>
<th>Information</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transparency on portfolio holdings over backtest period</td>
<td>1.87</td>
</tr>
<tr>
<td>Datamining risk</td>
<td>1.75</td>
</tr>
<tr>
<td>Sensitivity of performance to strategy specification choices</td>
<td>1.36</td>
</tr>
<tr>
<td>Index construction methodology</td>
<td>1.21</td>
</tr>
<tr>
<td>Sensitivity of performance to market conditions</td>
<td>1.13</td>
</tr>
<tr>
<td>Liquidity and capacity</td>
<td>1.07</td>
</tr>
<tr>
<td>Factor exposures</td>
<td>0.90</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>0.66</td>
</tr>
<tr>
<td>Long term performance and risk (&gt;30Y)</td>
<td>0.55</td>
</tr>
<tr>
<td>Recent performance and risk (10Y)</td>
<td>0.19</td>
</tr>
</tbody>
</table>

The gap is computed as the difference between the score of information importance and the score of information accessibility.
Conclusion: Demand Drivers and Challenges

- Respondents show a positive appreciation and outlook on ETFs as low-cost indexing instruments
  - Cost considerations appear to be the main driver behind increasing ETF allocations.
  - Other motivations: performance, transparency, and liquidity

- Respondents show pronounced interest in smart beta ETFs and strongly appreciate potential benefits
  - 75% of respondents think that smart beta indices provide significant potential to outperform cap-weighted indices in the long term

- However, investors face several challenges when evaluating smart beta products
  - Lack of resources allocated to smart beta assessment
  - Difficulty of access to information
References


