Deeper Perspectives

Smart Beta: multi factor vs alternative index

2015 saw strong growth in both multi-factor strategies and alternative index approaches as the battle between low cost targeting of individual factors and the lower governance approach of hiring managers to actively manage factor exposure began to heat up.

In this Deeper Perspectives we explore some of the findings from our 2016 Smart Beta report. Multi factor emerged as a key new driver of growth in 2015, growing 33% over the year, as investors turn to these strategies to help solve selection challenges in a smart beta market with an increasingly bewildering range of individual factor options.

Meanwhile alternative index approaches continued to grow faster (17% vs 10%) than the more sophisticated advanced beta approaches, suggesting that the allure of capturing long term factors through lower cost smart beta strategies remains strong.

Smart beta growth reflects a face-off between more ‘active’ multi-factor strategies and more ‘passive’ alternative index approaches.

This edition of Deeper Perspectives shares some findings from our 2016 Smart Beta Market Intelligence report:
2015 growth came from min var and multi factor

In 2015 the growth of European smart beta assets was driven by a 33% rise in multi-factor strategy assets and a 17% rise in alternative index approaches. Minimum variance strategies also posted strong gains of 26% while growth in single factor strategies was largely flat.

Index-led approaches grew faster in 2015 compared to advanced beta, albeit from a lower asset base. As the top graph shows, both alternative index and advanced index approaches grew at 17% over the course of 2015, whereas advanced beta approaches grew at a rate of 10% in the same period.

When looking at the growth of different smart beta strategy types, however, an even greater contrast emerges. Whereas multi-factor and minimum variance grew at 33% and 26% respectively during 2015, the assets invested in the other strategies remained largely flat. Indeed the combined growth of multi-factor and minimum variance accounted for 90% of the total European smart beta growth in 2015.

Reasons given for the continued growth in minimum variance approaches (which include low risk strategies) include the strong performance they have registered in choppy markets where other smart beta strategies have fared less well.

On the other hand, the reasons given to Spence Johnson by market participants for the rise of multi-factor investors are twofold. Firstly, it offers greater diversification benefits than investing in a single factor approach. Secondly, and perhaps more importantly, is that it removes the need for investors to choose which of the growing number of factors they are being offered to include in their portfolio. By choosing multi-factor approaches they can reduce the governance burden involved in choosing and monitoring a range of single-factor approaches and instead outsource this decision to a third party (namely the asset manager). Feedback from the market suggests this is one of the key drivers behind the shift away from single factor and towards multi-factor approaches (especially amongst some of the smaller institutional investors in the market whose governance resources tend to be more limited).
Smart beta market will grow to €474bn by 2020

We predict that the overall smart beta market in Europe will grow by 16% annually to €474bn in 2020, with 71% of this growth driven by inflows into the market.

We continue to predict strong growth in the European smart beta market driven by a number of factors including increased interest in multi-factor approaches and the continued popularity of low volatility approaches (which performed strongly in 2015).

As in previous reports our growth estimates have been constructed by combining the 2015 flow estimates for each of the twelve market segments (e.g. advanced index multi-factor) with assumptions for the growth of each of these flows over time.

The flow growth assumptions are based on our analysis of the historical growth of flows into these products combined with qualitative input on future market growth from our wider research, interviews with market participants and the survey data presented in this report.

In estimating the element of growth driven by future investment/market return we have used conservative assumptions in line with the long-term market returns generated by equity, bond, multi-asset and alternative asset classes. Indeed we have slightly lowered the equity market investment growth assumptions this year (from 7% per year to 5% per year) to reflect reductions in the long-term capital growth assumptions in 2016 from the likes of Willis Towers Watson, BlackRock and JPMorgan.

Readers of previous reports will notice that we have slightly lowered our forward-looking growth estimates from 21% per year in last year’s report to 16% in this year’s report.

In part this reflects the broader slowdown we have witnessed in the smart beta market growth over the past year. In part this is caused by the fact that the additional segregated assets that our 2016 Smart Beta Survey enabled us to uncover increased the asset base of the market to a larger extend than it did the flows that the market is generating. A larger starting market figure combined with flow estimates that grew by a proportionally lesser amount has slightly dampened our forward-looking forecasts.

2015-2020 estimated overall European smart beta market growth

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<th>(€bn)</th>
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<tbody>
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<td>2015</td>
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<td>2020</td>
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Source: Spence Johnson analysis

2015-2020 estimated overall European smart beta market growth

By source of growth (€bn)

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Source: Spence Johnson analysis
Lower cost index SB will continue to drive growth

Index smart beta is generally cheaper than the more ‘active’ advanced beta approach for both institutional and retail/wholesale investors. The main price distinction is within the smart beta index space, which is significantly cheaper for institutions.

Our model continues to predict that overall growth in the smart beta market will be driven by uptake in the more recently developed advanced index and alternative index approaches. The assets in these products are expected to grow at an annual rate of 23% for advanced index approaches and 21% for alternative index approaches from 2015 to 2020.

The rapid growth in these approaches to smart beta will continue to put cost pressures on the more advanced end of the smart beta market as our analysis continues to show that smart beta index approaches offer investors access to market factors at a considerably lower cost than more advanced beta approaches. As shown in the lower graph the weighted average net expense ratio we have calculated for alternative index funds in our sample is 26bps for institutional share classes compared to 77bps for advanced beta approaches.

The slower growth predicted for advanced beta approaches continues to reflect the fact that these approaches exist in the more mature end of the European smart beta market (with a European institutional investors making up the majority of investors in these products). Despite this, our model still suggests uptake of advanced beta products will be significant. In particular this growth is likely to be driven by the development of multi-factor approaches that seek to remove the governance challenges of smart beta from investors and which are less easily replicateable using index methodologies.

2015-2020 estimated overall European smart beta market growth

Average retail annual net expense ratio 2015 (weighted by share class assets)

Source: Spence Johnson analysis

Institutional annual net expense ratio per smart beta approach

Average institutional annual net expense ratio 2015 (weighted by share class assets)

Source: SJ analysis, SJ European Smart Beta Survey 2016, Morningstar
Alternative index: outsourcing investment design

The rise of alternative index smart beta has given rise to investment models that effectively sees large providers of these strategies outsourcing investment design to third parties and focusing instead on investment implementation and distribution challenges.

The graphic on the right is designed as a simple illustration of how the role of the asset manager evolves at three key stages of the smart beta investment process (design, construction and implementation), depending on the which of the three main approaches to smart beta investing the manager has chosen to adopt:

1. **Advanced beta** – tend to reflect the more ‘traditional’ design approaches of active quantitative strategies. The in-house research or investment team design the investment rules (based on in-house or external academic research etc.). The rules are then used to construct portfolios and back-tests which result in a final portfolio that is then implemented through a traditional trading model.

2. **Advanced index** – products designed as indices rather than traditional portfolios with fixed and published rules. As with advanced beta the design process is undertaken by in-house teams who also implement the final portfolio based on the index. Index construction, however, is often handled by a third party index provider, who constructs indices using the rules developed by the manager and also acts as a third party ‘verifier’ of the investment design.

3. **Alternative index** – in this model smart beta index design and construction is handled by third parties, with the only role for asset managers being implementing a fund based on the finalised and published index that the third party index supplier produces. In a model reminiscent of the way big pharma works (where R&D is often outsourced to smaller biotechs) this model can be seen as a way for larger asset managers to outsource their investment design/development functions and position themselves as implementers and distributors of smart beta fund products.

‘Although we have the ability to build fundamental indices, ‘in-house’ clients are demanding independence of the index calculator from the asset management.’

**Product Specialist, Alternative Index Provider**

Advanced beta approaches

**Product structure**

- **Design:** Investment rules
- **Construction:** Portfolio
- **Implementation:** Fund

*Typical product example: Quoniam Equity MinRisk Global*

Advanced index approaches

**Product structure**

- **Design:** Index
- **Construction:** Index
- **Implementation:** Fund

*Typical product example: Ossiam iStoxx Europe minimum variance*

Alternative index approaches

**Product structure**

- **Design:** Index
- **Construction:** Index
- **Implementation:** Fund

*Typical product example: L&G FTSE RAFI All World 3000 Index*

![Diagram of investment process with notations for elements provided by fund manager and third party.]

Source: Spence Johnson analysis
Risk and return smart beta to grow 16-17% a year

This year we predict that risk and return smart beta will grow at broadly similar rates, with risk smart beta growth driven by growth in annual growth of 20% in minimum variance and return smart beta growth driven by 24% growth in multi-factor.

A major change in our predictions in this year’s report is that we are now predicting that return-focused smart beta will grow at a similar rate (16% vs 17% per year) as risk-focused smart beta.

As noted elsewhere in this report as smart beta products have proliferated and the number of factors available to clients has grown uptake of single factor products has slowed (especially in the advanced beta space) as clients take longer to consider which factors to select for their portfolios.

This issue is especially acute for smaller institutional clients who, unlike larger institutions, may not yet have smart beta investments and who often have less governance resources available to conduct length/complex due diligence processes.

As the difficulties of choosing the ‘right’ factors has increased, therefore, so has interest in multi-factor products where managers have the freedom to make the decision regarding which factors to over/underweight on behalf of clients.

As a result of these qualitative observations, as well as die to a growing flows trend visible in the flow data, this year multi-factor approaches have emerged as the fastest growing part of the smart beta market (although the 24% per year growth we are predicting is only slightly ahead of the 18% per year growth we predicted last year).

In the risk-focused space we continue to see strong growth in minimum variance products (which include low risk approaches). Recent launches of low cost minimum variance ETFs and index funds, however, combined with evidence of support for these strategies from retail/wholesale intermediaries such as financial advisers and private banks, lead us to believe that growth in this market will be particularly driven by alternative index approaches and by retail/wholesale and smaller institutional investors (many larger investors already have significant holdings in low volatility/minimum variance approaches).

Parity strategies and single factor strategies will grow the slowest (both at a predicted at 12% per year) but we still believe that single factor approaches will be the largest segment of the market in five years time (albeit with a higher proportion of single factor assets being in alternative index products than today).

Source: Spence Johnson analysis, Morningstar
Chart ref: 84

2015-2020 estimated overall European smart beta market growth
By strategy type (£bn)

Source: Spence Johnson analysis
Chart ref: 85
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