Index Investing

Views on Index Investing from the UK Wealth Market

October 2017

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1. Foreword

Background to this report

The market for index products has exploded in recent years, but there is little information on how the UK wealth market use index products and why. We aim to fill this gap by sharing insights gleaned from investors themselves. Our research consisted of two interview programmes, one quantitative and one qualitative. The people with whom we spoke work for organisations who together advise or manage over £4.5 trillion on behalf of retail clients.

The quantitative component involved phone interviews with 105 financial advisers, wealth managers and private bankers who make use of index investments within portfolios on behalf of retail clients (referred to as study participants in this report). We show their answers in the statistics throughout this report. We screened study participants in order to ensure all make use of index products. We screened out 47 investors, suggesting 1 in 3 investors may not make use of index products.

The qualitative component involved 30 face-to-face interviews with financial advisers, wealth managers and private bankers (referred to as "interviewees" in this report) which allowed for a richer discussion about their views on index products and other market trends. The perspectives they shared provide colour to the statistics and give examples of how and why investors are using index products and reacting to changes in the industry. This is KPMG's inaugural report on the use of index products by these investor groups – we would welcome your thoughts and feedback on our findings.

We are thankful to BlackRock who contributed to the funding of this research. For the avoidance of doubt, the views contained herein are those of KPMG and BlackRock did not have editorial oversight.

Tim West
Partner
Head of Asset Management Consulting
KPMG

2. Executive Summary

Firms' use of index products varies a great deal

- The use of index products varies greatly. Investors report that index products can account for anywhere from 1-2% to 70-80% of portfolio value
- Financial advisers are the most likely investor type to invest more than 20% of a typical portfolio in index products. Wealth managers were the least likely to have this high a proportion of a portfolio invested in index products
- 30-40% of a multi asset portfolio held in index products appears to be a natural limit for many investors

Investment performance is a key driver of use

- Index products are seen as a cheap, liquid and fast way to achieve a desired exposure to an asset class
- The majority of investors reported investment performance as being a key factor in their use of index products. This is particularly true in equities, with US equities being a widely discussed example
- Investors are increasingly looking beyond equities and are using index products to gain exposure to other asset classes. A majority of investors use index products for some fixed income exposure; a sizeable minority do so for commodities
- Total cost of ownership is an important consideration when picking an index product, but investors appear to place greater focus on performance and efficient index tracking
- Investors focus on understanding index construction to make sure a product is the best way to gain a desired exposure. Cost then becomes a key consideration in the sense that investors look to maximise net returns

Many investors share similar product preferences and scepticism about factor investing

- ETFs are the most commonly used index products, with a significant number of investors also using index mutual funds. For many this is driven by what their investment platform allows access to; more sophisticated investors make rigorous cost comparisons between index product types
- A sizeable minority of investors use Smart Beta products, and are enthusiastic about the benefits it can bring. The remainder need to see more real world track record, with many comfortable with the academic theory but sceptical about the proliferation of new product

Index product use is likely to increase

- Investors with a heritage in active management tend to make limited use of index products. This looks likely to persist in the short term. Amongst investors who invest less than 10% of their AuM in index products, almost three-quarters said they do not expect their usage to change in the next two years
- Existing index product proponents will drive increased usage. Of those who invest more than 10% of AuM in index products, 50% plan to increase their allocation in the next two years
- Fee pressure is a significant factor supporting increased use, as well as a relentless focus on investment performance. Private bankers, wealth managers and financial advisers all cited fees as the most common reason they planned to increase index product allocations

Investors have strong, if varied preferences on what they value from providers

- Scale and product breadth are important considerations in the choice of index product providers, particularly for larger investors, who may value providers who can act as 'one stop shops' for all their index product needs
- Generally, interviewees in research teams felt they were well served with little desire for much contact, but would value being engaged earlier in the product design process
- Willingness to participate in education initiatives, particularly for relationship managers, was also seen as very valuable, and something providers should do more of

3.

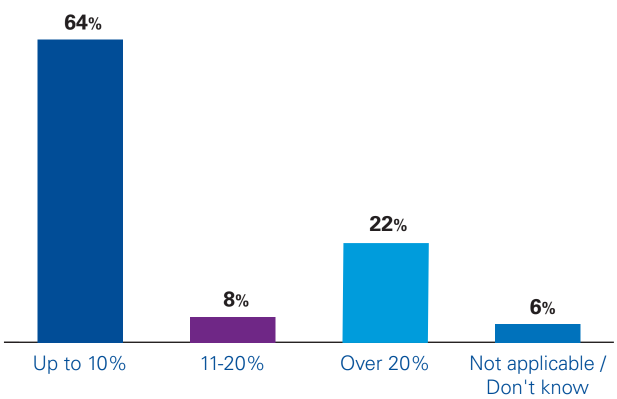
Use of index products set to increase as key drivers of usage will persist

Our research shows that the extent to which investors use index products varies greatly. Some interviewees have as little as 1-2% of an investment portfolio in index products. One financial adviser we spoke to said he invests as much as 70-80% of a portfolio in index products.

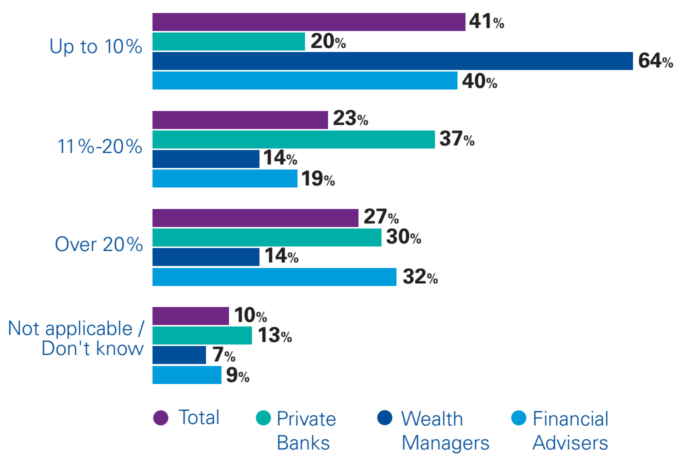
Study participants most commonly report investing less than 10% of a typical portfolio in index products. This varies somewhat between investor types. Wealth managers appear to use index products least. Private bankers and financial advisers report a more even spread of concentrations of index products. Our interviews with market participants indicate that 30-40% of a portfolio held in index products appears to be a natural ceiling for many investors.

We found a sizeable minority of firms which offered portfolios featuring 100% index products, most of whom are private banks or financial advisers. These portfolios account for a minority of these organisations' AuM (two thirds said fewer than 10% AuM are invested in index-only portfolios), but interviews suggest this share will increase. Interviewees said they target less wealthy clients with these portfolios. Some interviewees also said they like index-only portfolios because clients find them easy to understand. One financial adviser told us "the advantage is that when they watch the news on television and see the performance of the FTSE100 index, they will know what their investment has done."

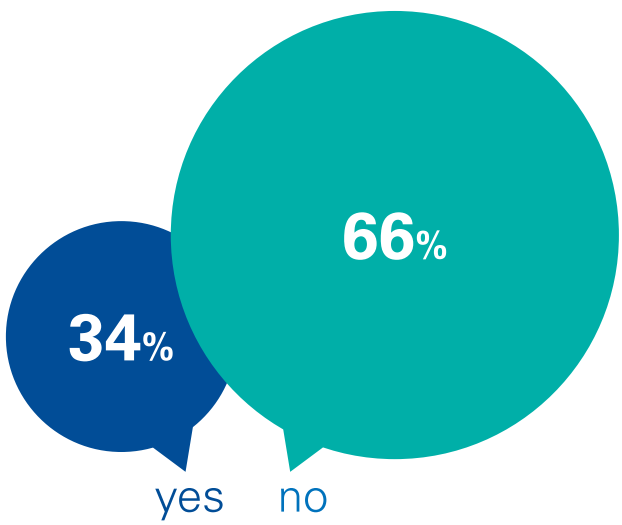
And what proportion of client AuM are in index-only portfolios?



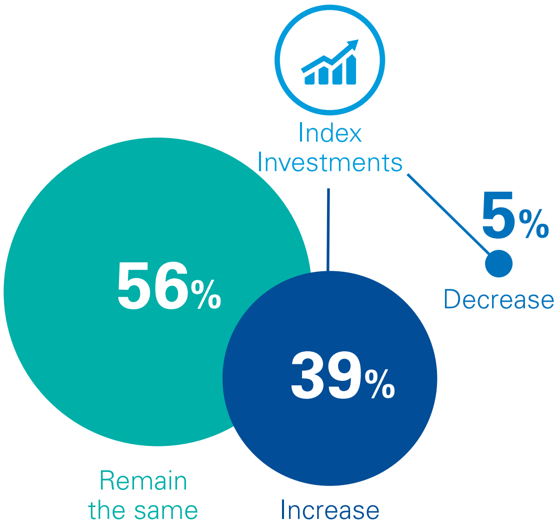
What proportion of a typical client portfolio is in index products?



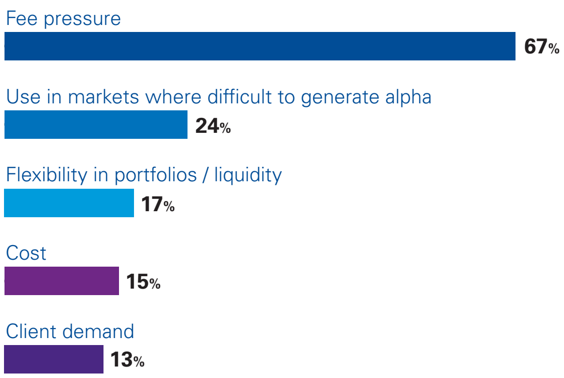
Do you have any portfolios that are made up of only index products?



How do you expect your use of index investing to evolve over the next 2 years?



Which of the following would you say are the main reasons for this change?



> **We used to see some markets as more efficient than others, so used active managers in emerging markets for example. Now we think that index investing is better for all equity markets.**

Director of Advisory
Financial Adviser

Investors with a heritage in active management or stock-picking tend to make limited use of index products. This looks likely to persist in the short term as investors back themselves to continue identifying alpha opportunities. One wealth manager said he feels that "there are pockets of opportunity to exploit; we think it is relatively easy to identify good active managers, and our performance has reflected that." Amongst study participants who invest fewer than 10% of their AuM in index products, only 20% said their use will increase. Almost three-quarters said they do not expect their use of index products to change in the next two years.

> *Consensus across our research showed that zero use of index products is not a good idea. Even ardent supporters of active investment recognise the benefits tactical allocations to index products can bring, even if proportion of AuM is small.*

Many investors are, however, using index products in place of active management in a greater number of markets, which will support future growth. Current proponents of index investing will play a key role. 50% of study participants who invested more than 10% of their AuM in index investments planned to increase their allocation over the next two years.

Fee pressure and cost are two key and intertwined drivers of increased use. Cost pressure arises from investors' focus on controlling spend on investment solutions. This is a particularly noticeable factor amongst financial advisers. Many report aiming to keep total costs below 2%. Use of low cost index products helps financial advisers achieve this while maintaining margins in other parts of the value chain. This helps explain why 44% of financial advisers who use them report that over 20% of their Assets under Administration is in index-only portfolios.

Pressure on the fees clients pay for investment management or advice can come from either investors or their clients. Our research suggests that fee pressure from clients is not driving index product usage. As we note in chapter 7, few investors cite client preference as a key driver of their use of index products.

4.

Centralised and decentralised firms value different product and provider attributes

Investment processes range from very centrally-led, to ones which give portfolio managers a great deal of flexibility. Firms appear to be quite evenly split along this spectrum. Where they fall on that spectrum has implications for how they use index products and what they want from providers.

At one extreme, firms centrally specify model portfolios at holding level and give Relationship Managers (RMs) no flexibility. At the other extreme, RMs are left to build their own portfolios to a target risk profile. Those occupying the middle ground offer RMs a panel of instruments and an asset allocation.

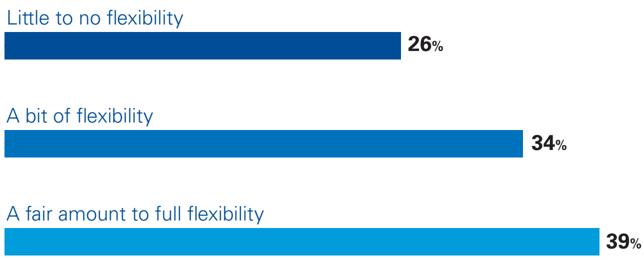
Centralised firms tend to have an Investment Strategy team who decide on asset allocation and security selection. A Portfolio Implementation team might then execute against the Strategy team's allocations. Investment Strategy teams expect to have good relationships with product providers. If large enough, they expect providers to be responsive to their new product development needs. Large, centralised investors often have very large individual order sizes. This means they tend to focus more on index fund size and liquidity, and value primary market access.

Decentralised firms might have an approved product or provider panel, and give RMs more flexibility in selecting investments. These firms want to see more educational outreach from providers. They want providers to help their RMs understand the benefits of using different products. This is particularly true of firms with regional presences outside of London. They value providers who go out to the regions to engage with and educate their RMs.

Within panels, many firms approve an index investing provider's whole fund range, meaning RMs have to choose between several similar instruments to gain index exposure to e.g. the S&P 500. It is not always clear how they make these choices, or that clients get consistent and best outcomes from this.

> *Too much choice is not a good thing: having five different S&P 500 trackers is redundant. Investors are better-served by having a definitive view on which product is best*

How much flexibility does your firm's relationship managers have regarding individual discretion over portfolios?




17%
20%
7%
15%
16%
25%
Top sales by region
North America
Europe
Asia

5.

How investors deploy index investing: Strategic and tactical approaches are common

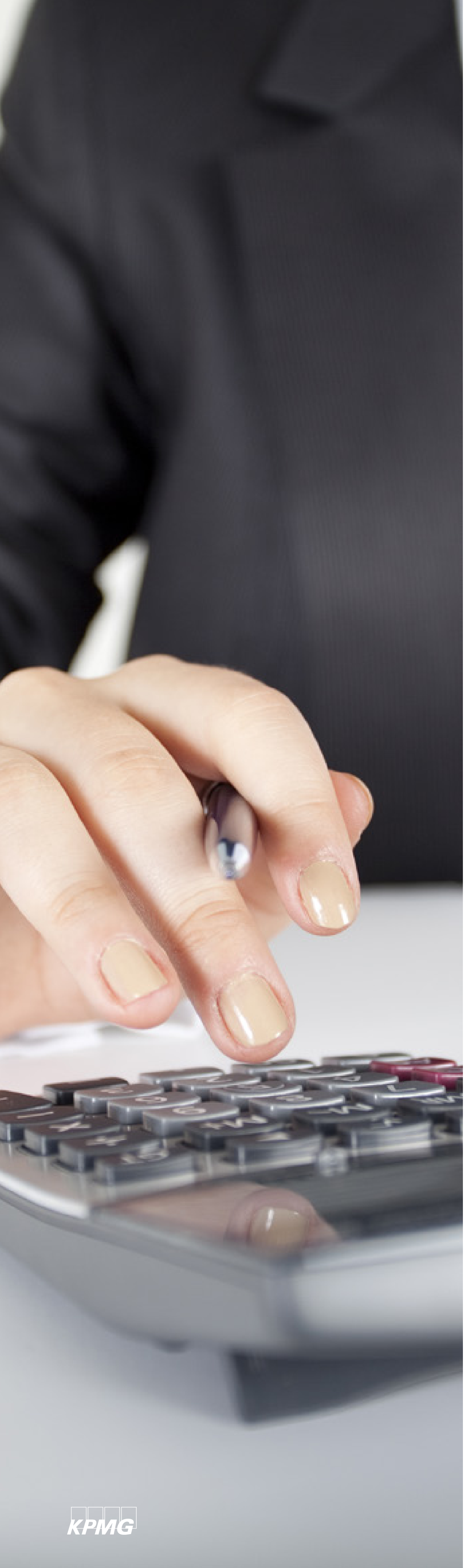
Our research indicates that most investors are happy combining active and index products to deliver the best performance outcome for a portfolio. Our survey confirmed this, with 54% saying investment performance is an important influence on their use of index products – the most out of all options given. Investors use index products to deliver better investment performance in two ways: strategically and tactically.

Investors use index products strategically where they believe active managers do not deliver sustainable alpha, or otherwise believe they are unable to identify active managers who do so. This is particularly the case in large liquid equity markets, with US equities cited as an example by many interviewees.

Interviewees who use index products tactically do so as a cheap, liquid and fast way to achieve a desired exposure. Tactical use of index products tends to fall into one of two categories. Some investors temporarily allocate cash to index products whilst waiting to identify and allocate to an appropriate active manager. Other investors use index products to gain a desired exposure when they believe their desired holding period does not justify selecting an active manager.

> **"I can press a button and get exposure now, not 24 hours later because I'm waiting for a deal to get done."**
>
> Head of Research
> UK Wealth Manager

[1] Please see chapter 7 for more information on drivers of index product use.



6.

Wealth managers are increasingly comfortable looking beyond equities in their use of index investments

Investors use index products where they believe usage will enhance net returns. This is particularly evident in equities, where active managers might not be able to generate sustainable alpha in many markets. One adviser explained that they use index products anywhere "we don't expect outperformance and don't want a style tilt."

Interviewees did note some concerns with features of equity index products. One financial adviser called them "Blood Hound Funds" which might sniff the market all the way up, but equally will follow the market all the way down. One wealth manager told us that he doesn't like market cap-weighted products since "big companies aren't necessarily the safest." This has parallels to concerns raised about the weighting of bond indices we note below.

Fixed Income

Investors also believe that active outperformance opportunities are limited in parts of fixed income (typically for inflation linked gilts or TIPS and short duration). For inflation-linked securities, wealth managers like being able to invest in one product which gives them exposure to a range of durations rather than having to buy individual securities.

Financial advisers made greater use of fixed income index products than both private bankers and wealth managers. This may be down to a preference amongst private bankers and wealth managers to invest in bonds directly, which is a capability not available to most financial advisers.

Many investors seem comfortable using active management for longer-duration fixed income assets. One adviser noted that "we think active does better than index over the long term." This could be because fund managers have a better opportunity to demonstrate skill in security selection over a longer time horizon. Investors may also have fundamental concerns about the appropriateness of fixed income index construction methodologies as a benchmark for real money investors.

> *The most sophisticated investors decide on their desired exposures first. They then identify which way to get that exposure will deliver the best net return. Sometimes this leads to selecting an active manager, other times an index product. One private banker told us: "we consider the likelihood of consistent relative outperformance by top quartile active managers versus their costs, and compare that with the expected outcomes of a passive approach."*

In which asset classes do you use index products?

Equity	94%
Fixed income	60%
Commodity	31%
Property	8%
Other	8%

Our research found demand for more innovative ways to weight fixed income index products. Some interviewees noted the perversity of weighting credit or government bond indices to the most indebted companies or countries, which can lead to adverse consequences for investment performance. More indebtedness is of less concern if a country has high GDP or a large tax base – two factors for which fixed income indices could better reflect in index construction.

Commodities

A sizeable minority also see value in using index products as a way to access commodities. Investors like using Exchange Traded Funds (ETFs) or Exchange Traded Notes (ETNs) as a viable way to gain relatively direct exposure to risk factors like gold or oil prices. Notably, commodity index investments are the exception to a general preference for physical index products (more on this in the next chapter). One investor noted that "full replication can work against you" in commodities and many preferred synthetic products.

Property

A small number of investors use property index products. There could be latent demand from investors who might like to gain index exposure to property but worry about fundamental issues of using a liquid security to track a highly illiquid underlying asset. Some investors called on providers to develop new product to address this issue. One investor noted that he liked iShares' Property ETF because it "combined REITs and gilts to provide investors exposure to real estate risk but without the liquidity constraints of physical."

> **Cost headline is important but not everything… Getting the right index for the exposure we want is the most important thing.**
>
> Head of Global Investments
> Global Private Bank

7.

Cost is important when selecting a product, but not as important as value for money

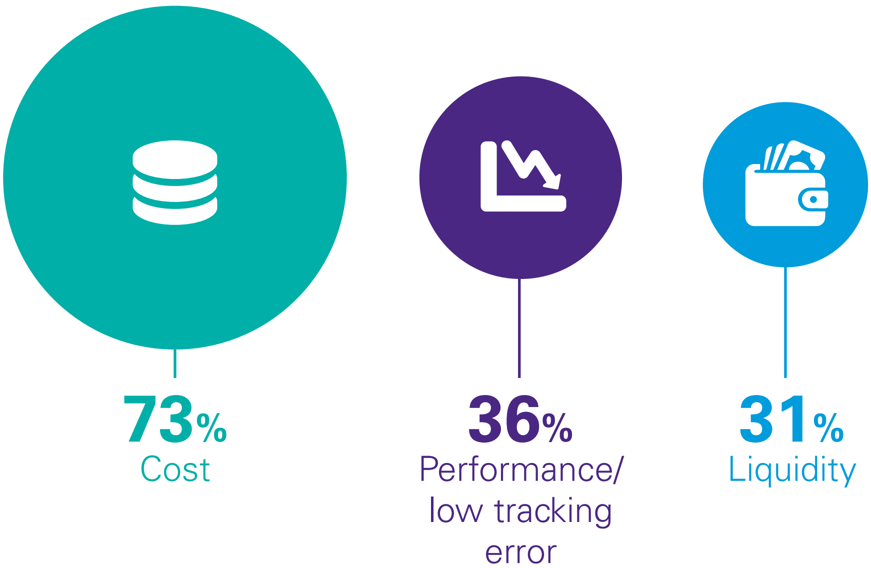
We found two distinct approaches to product selection. Some investors are focused on bottom up product selection on a case by case basis, seeking to pick the best product irrespective of provider.

Other investors would have a panel of approved providers, and would then pick products from providers on that list. This is not to say that investors won't look elsewhere. As one private banker told us, "If it is available from an existing product provider, we look at that product first. If it doesn't meet our requirements, we'll look at a new provider." Please see chapter nine for more information on considerations for selecting a provider panel.

Product selection criteria

Although cost is by far the most commonly cited reason to pick a particular index product, most interviewees we spoke to said understanding index construction is their starting point for making sure a product is the right way to gain a desired exposure. Investors need to understand both index constituents (to whom the index offers exposure) and index methodology (how the index weights those constituents). Investors need to understand exactly what they are getting with a particular product. For example, if an investor wants exposure to the pharmaceuticals sector, it's not enough to just buy an ETF with 'pharma' in the name. Are the underlying assets big pharma companies? Mostly biotech stocks? Or a mixture of the two?

What are the top three factors which lead to you selecting a particular index vehicle?



Index

Investors rightly view cost as an important component of their decision but many recognise that product pricing is not the be all and end all of product selection. Many investors select the right product and only worry about price as the tie breaker if there is more than one comparable product. One adviser told us that getting the right index is so important that "if we want a specific index for investment reasons, that will trump price." Another said that "we don't think about cost, except in the sense of only caring about net returns."

More sophisticated investors (across all segments) are more likely to make this finer distinction about net returns over headline cost. A more nuanced view of net returns incorporates factors like tracking error, liquidity and all-in costs over the investment's holding period.

Desire for low tracking error is universal, and considered both over long time periods and also in different market regimes. Sophisticated investors sometimes unpick structural performance drivers of different ETFs accessing the same market, with some going as far as to create long/short trades to generate returns from these differences.

Liquidity

Liquidity is also a consideration for many investors. Focus depends on investors' size. Larger investors who trade with providers' capital markets desks might focus both on primary market liquidity as well as how fund size and secondary market volumes impact liquidity. One private banker at a universal bank noted that if one of their Discretionary Portfolio Managers needed to do a trade, "we could potentially crush the market with a big order."

Other investors focus on secondary market liquidity, particularly if they use index products tactically (which means they benefit from the ability to quickly enter and exit a position). These investors are willing to pay a premium for this benefit.

Total Cost Ownership

Many investors look beyond headline price to look at the Total Cost of Ownership (TCO) over a given holding period, accounting for ongoing charges and entry and exit costs. Please see the pull-out box on TCO for more detail.

Physical versus Synthetic

We see widespread preference for (and often insistence on) physical replication to avoid counterparty risk: as one financial adviser said "in a black swan event [synthetic exposure] could bring huge consequences. It's not worth it for 2 basis points (bps) in savings."

For commodities, however, replication preferences varies. Some think physical replication is too costly and might even work against the investor in instruments like oil ETFs. Gold is an exception – "we're buying it for insurance, so no sense in then using a derivative that may not pay off when you most need it."

Stock Lending

Some interviewees indicate they are willing to buy synthetic products. Where this is the case, they specified they need to completely understand the approach (not least so they can explain it to clients). Many also insisted that any swaps used in synthetic replication be fully collateralised. Other investors feel they could get comfortable if they understood the benefits and risks better. A wealth manager said that "if the product providers could present reports to prove the better performance, that would give us more confidence [in using synthetics]."

> *Being totally cost-led is counterproductive: good investment outcomes are unlikely if products are picked exclusively on price. More sophisticated investors instead focus on performance net of fees*

Most investors also expressed a preference for full replication over portfolio sampling, but there is not widespread in-depth understanding of why this is preferable.

Views on stock lending are mixed. One private banker called it a "pretty standard and vanilla market activity." Another noted he was open to it, but would first have his fund research team diligence the stock lending approach to get comfortable with the level of risk. One wealth manager noted that she doesn't like stock lending because in times of market stress, counterparty risk can be greater than that of synthetic products. She explained that whilst swap counterparties are mostly bulge bracket banks, stock lending counterparties are more likely to be networks of hedge funds that could unravel in a black swan event.

Some investors think revenue sharing arrangements can improve. One said that while he appreciated that funds have costs to run the security lending activities and it is fair to share profit, he wanted more transparent disclosure of the revenue/profit coming from security lending.

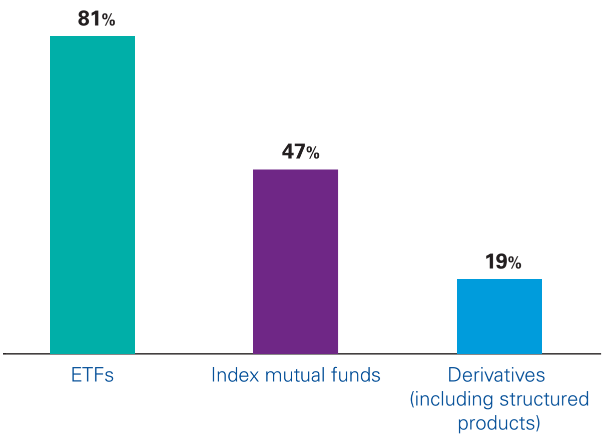
Vanguard are seen favourably as they give all stock lending profit back to investors, even if it is unclear what this means in terms of the revenue split. This distinction between revenue and profit is somewhat lost on most investors, who instead reported they liked Vanguard's approach of "giving 100% back to customers." Investors generally thought that revenue sharing overly favoured providers. A 70/30 split tilted towards investors was cited as a fair divide.

Product preferences by investor type

ETFs are far and away the most popular index product in our survey. Every private banker surveyed uses them. 86% of wealth managers uses them. Only two thirds of financial advisers use them. This still seems high given the drawbacks advisers face with the use of ETFs.

Financial advisers are the only investor type who make more use of index funds (70% of participants do) than ETFs. We discuss the barriers financial advisers face in using ETFs in the next chapter.

Which instruments do you use to access index investments?



Private bankers display the greatest variety in product use, with a substantial minority using index funds, derivatives or structured products.

Wealth managers report the most concentrated use of ETFs. A small minority make any use of index funds or derivatives. Given wealth managers we interviewed reported central trade sizes that can go into the hundreds of millions of pounds, they benefit from the greater liquidity and tradability ETFs can offer. Investors who trade in these sizes may also be more focused on managing counterparty risk. Investors looking to minimise counterparty risk might be less comfortable with the use of derivatives and structured products.

A minority of firms also use structured products to achieve core beta exposure, but this approach is not generally popular. Structured products can offer helpful downside protection or leverage to upside returns. Wider use may be limited by the fact that these features are not always made available to retail investors with a reasonable and fair pricing of risk. Concerns over cost and suitability probably also play a role, particularly for financial advisers. Fewer than 10% of financial advisers make use of structured products.

Almost half of the private bankers surveyed use derivatives or structured products. This could be due to a sophisticated client base more cognisant of the benefits these products can bring. A factor may also be private bankers' access to investment banking colleagues' structuring and sales skills.

ETF and Index Mutual Fund cost is more than headline price

There are a number of factors which investors cited as contributing to greater usage of ETFs over other products like index funds. We elaborate on these in TCO: The devil is in the detail in the box to the right, but it is particularly worth highlighting the sometimes fine distinctions investors make to unpick why an ETF might cost less than an index fund or vice versa.

Some investors note they prefer ETFs because headline costs are lower. Larger investors like that they can negotiate price with mutual fund providers, whilst they have to be price-takers with ETFs.

The most sophisticated investors shared remarkably nuanced views on the benefits and disadvantages of choosing between an index fund and an ETF.

TCO: The devil is in the detail

Total cost of ownership (TCO) of entry costs, ongoing charges, and exit costs. Simple on the face of things, but some investors display a great deal of subtlety in unpicking the detail of TCO.

In short, the general consensus is that index mutual funds (IMFs) can have higher entry and exit costs (through dilution adjustments) whilst ETFs have higher ongoing charges. This means that if you are investing over a holding period greater than 12-18 months, IMFs likely offer better value. Shorter-term investors may prefer using ETFs, particularly because intra-day tradability can support optimal timing of entry and exit.

Entry costs for IMFs typically entail some form of dilution adjustment to ensure market spreads are borne by the new investor in the fund only. ETF entry costs consist of Stamp Duty and paying the bid-offer spread. Paying the offer price and then marking at the bid-offer midpoint can cause an instantaneous paper loss. In practice, well-traded ETFs should have a tight enough spread such that this cost is lower than the IMF's dilution adjustment, and for some products (e.g. fixed income) the ETF can be more liquid than the underlying.

Exit costs work in a broadly similar manner, although without Stamp Duty.

Whilst in practice IMFs are slightly cheaper for providers to manage than ETFs, lower IMF pricing is more a function of providers being able to discount price to large investors. All ETF investors pay the same ongoing cost irrespective of size. Larger investors can negotiate the ongoing price of an IMF based on allocation size. For big firms with allocations in the order of £1 billion, providers are willing to charge as low as a few bps for access to large liquid index mutual funds.

8.

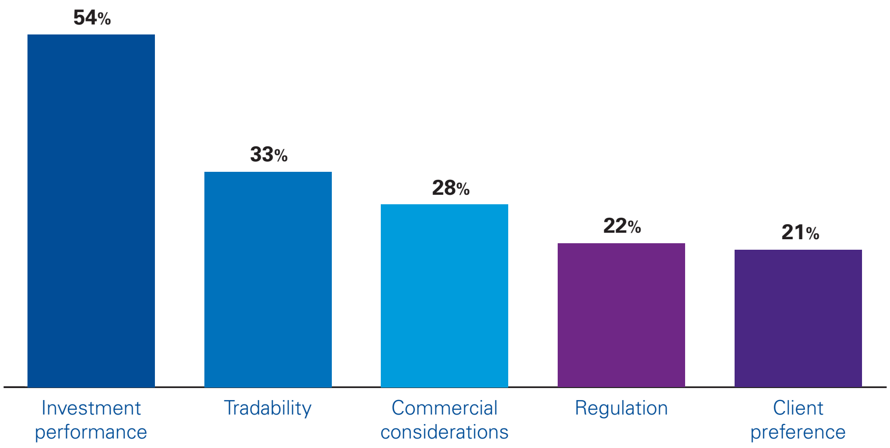
Investment performance is a key driver of index product use. Wider availability of index mutual funds could support future growth

In big liquid asset classes, it's hard to convince me that an active manager is going to beat the benchmark after fees.

Head of Global Investment Group

Global Private Bank

Would you rate the following factors as important in influencing your use of index products in general?



Drivers

The overriding driver of use is investment performance. Growth in the range of index products available has supported potentially better investment performance in a wider number of markets. Product innovation has led to features which investors particularly value, such as currency-hedged products. This trend is beneficial to both providers and their clients, and would accelerate with more collaboration in new product development.

Some investors express frustration that whilst products are proliferating rapidly, they tend to be ETFs and not more widely available mutual funds.

Some investors particularly value the tradability of ETFs, and are willing to pay a premium for it. One wealth manager told us "we don't mind if costs are occasionally higher because we prefer the intraday tradability."

Private bankers particularly value tradability, perhaps because they have operating platforms which allow them to execute through the day. Many financial advisers and wealth managers are limited to platforms with minimal ETF functionality which only trade at end of day.

The significant fall in index product prices now means even a small allocation to index products can have a material impact on total cost. These types of commercial considerations are particularly important to financial advisers given the fee pressure they feel.

Interestingly, not many participants said regulation was an important influence on their use of index products. We were able to unpack this a bit more in interviews. It appears that increased use of index products is a second order impact of regulation. Regulations like RDR and MiFID II are resulting in greater fee transparency, which leads investors to look for ways to reduce costs. Switching from an active into an index product can help achieve this goal.

Amongst interviewees, financial advisers feel that RDR has contributed to a market-wide focus on reducing costs. Most feel that this is driven by adviser firms themselves reacting to the regulation, rather than any particular pressure from customers. Financial advisers' focus is on demonstrating suitability (cost being an important factor), and constructing portfolios accordingly.

Interviewees in discretionary fund management or private banking feel that on the whole they have been less impacted by RDR, but expect MIFID II to have a far-reaching impact on their business. Many feel the regulation will lead to increasing price transparency and consequently greater client scrutiny of the underlying portfolio and costs. Some investors expect that this will ultimately result in more use of index products. Others feel this may in fact lead to a return to greater use of direct investments in portfolios.

Client preference is notably not considered important to use of index products. This is particularly true for financial advisers who instead focus on cost and fee pressure. A greater number of private bankers think client preference is important, perhaps because their more sophisticated client base are more aware of index products and their benefits.

Barriers

Decreased product charges have benefited investors, but this is not the whole story for all. For larger houses, ETFs tend to be more expensive than the price for which they can procure a mutual fund equivalent.

For those with smaller clients, the often high individual share prices of ETFs is a barrier. Lack of fractional share availability inhibits smaller investors' and regular savers' use of ETFs. Given the share price of some ETFs, this is potentially an issue even for portfolios worth several £100,000s. One financial adviser wanted to see purchasable units of under £20. Another was emphatic: "I understand iShares has a pilot program for buying fractions of ETFs with Ascentric. All UK platforms need to do the same."

The benefit of ETF intra-day tradability is not available to most platform investors, who bear the higher costs of a benefit they can't access. Many platforms also don't allow ETF use in Discretionary Fund Management (DFM) portfolios (or charge a significant amount for it), further restricting ETF use amongst advisers and for wealth managers with platform propositions.

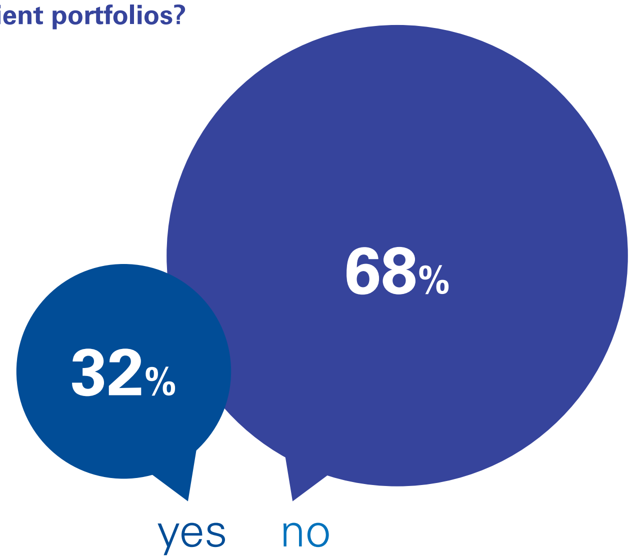
Providers also don't always match competitors' price cuts. This may be a result of their recognition that customers are likely to be sticky, particularly where they are reluctant to crystallise a portfolio's capital gains. Vanguard's mutual status is seen as a major plus in this regard. Given the cost of switching, investors like the certainty that lower costs will be passed onto customers. One investor said that being a mutual gave him "the confidence that Vanguard price has dropped every year, and will continue to lead the market lower."

Whilst this may not inhibit use of index products overall, it will be a barrier to switching. This is particularly the case in very low-priced index products. Switching costs (including taxes on crystallised capital gains) will likely outweigh the benefits of accessing lower prices. One interviewee felt that a 30bps price difference covered the cost of switching. This will be increasingly hard to achieve given that many index products now cost under 20bps.

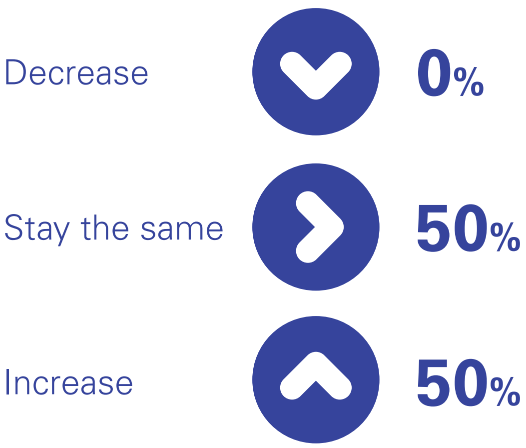
9.

Smart Beta and factor investing: More data and education needed

Do you use Smart Beta or factor investing in client portfolios?



How do you expect your use of Smart Beta or factor investing to change over the next 12 to 18 months?



A sizeable minority of investors make some use of Smart Beta or factor investing, although typically this is a small part of their client portfolios. These investors like the ability to express a view on style or factor through an index investment. One wealth manager explained his organisation liked using factor investing "for areas where we see no skill but want the style flavour – US equity income is a good example." This sentiment is broadly reflected in investors' preferred factors. These are either fundamental factors through which investors could focus on a desired exposure (e.g. value, growth, size/small cap), or a style investors could target without paying active-level fees (e.g. income, minimum volatility).

Whilst it's early days, investors who currently use Smart Beta and its ilk appear to like what they're seeing. Half of those who use Smart Beta say they expect to increase allocations to Smart Beta or factor investing product over the next 12 to 18 months.

The two out of every three investors who don't currently use it might need more convincing; most said that they are unlikely to start using Smart Beta products in the next 12-18 months. Smart Beta still seems to be something they get in theory but are sceptical of in practice. Scepticism about the benefits of factor investing comes in a number of forms.

While providers' factor-based products have impressive back-tested results, many investors have reservations whether this will carry through into long-term real world results. There is also a concern that historically successful factors may see their performance eroded by a wall of money chasing that effect. As one adviser put it, "the identification of a factor could impede the very advantages that the factor investment is trying to exploit."

Others understand the theory of factor investing, and to some extent believe that some variant of the Fama-French analysis or a particular style factor can support long-term outperformance. Many simply doubt that the proliferation of Smart Beta products can all reflect sound implementation of the theory. One adviser explained that his issue is that the industry "has taken factors [a long-term investing concept from academia] and turned it into something that can be traded daily."

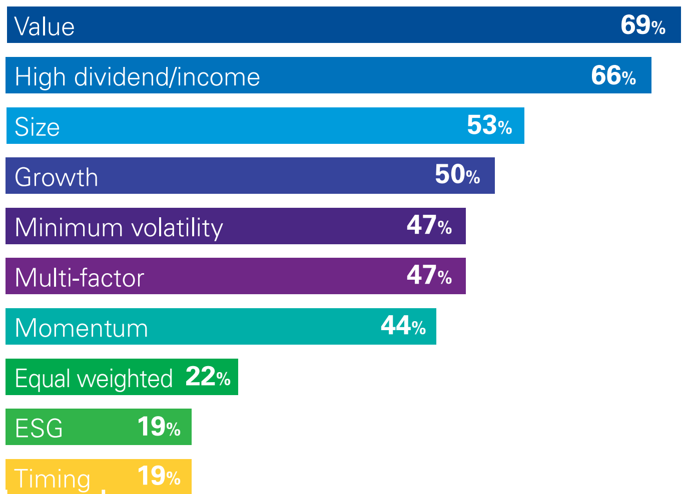
Some feel that existing products address all their needs or prefer capturing factor premia through active management. One private banker explained that "there are more than enough strategies out there at the moment to cover our needs." A financial adviser said that "I don't think [Smart Beta is] a good strategy, I would rather have active managers."

Many non-users are unsure whether Smart Beta is right for them and are adopting a wait and see approach. These people see Smart Beta products as being very expensive, and expect prices to rapidly fall over the next couple of years (similar to the price war seen in vanilla index products). One adviser noted that Smart Beta is "basically passive from a provider cost point of view, but priced halfway between passive and active which doesn't work."

We note elsewhere obstacles in switching products given that Capital Gains Tax (CGT) costs will likely outweigh cost savings. Amongst Smart Beta sceptics, many feel it makes more sense to wait for more evidence and falling prices, and pick a proven product a few years from now.

This suggests usage might well increase over time as products gain longer track records and come more onto central research teams' radar – and prices become more attractive. Providers could also do more education work to promote Smart Beta and explain its benefits directly to customers. Some interviewees felt that providers needed to focus on educating customers on the value of smart beta products – one said "he looked forward to seeing more education and debate" to help turn his interest into use.

Which of the following factors do you use in portfolio?

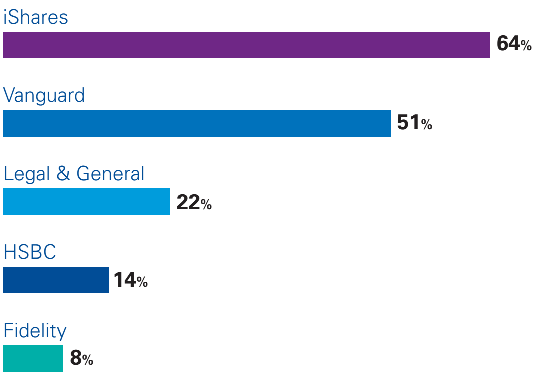


How likely are you to start using Smart Beta or factor investing in the next 12-18 months?

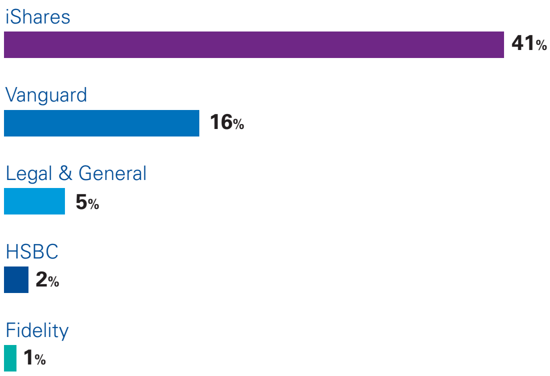
10.

Investors value providers who engage them in education and new product development

Which providers do you use for index products?[1]



With which provider of index products do you have the most AuM?[1]



Investors want to make use of a limited number of providers to service the majority of their index product needs. They look for their main providers to have both scale and product breadth. Investors are comfortable using smaller providers where they offer products which serve more niche index requirements.

Scale is most important to big investors. As one banker at a large international private bank said, "given we use passives as some of the building blocks of our portfolios, we need our providers to be able to supply us at scale." Technical capabilities are a key component of providers' ability to service big investors. One large financial adviser said it is important to understand "how big a trade can they easily handle – a typical rebalancing deal can be in the tens of millions of pounds. For the large private banks this will typically be hundreds of millions and require coordination with providers' capital markets desks in the primary market.

Product breadth is particularly important for investors who select product from a panel. Investors like having providers who can act as a 'one stop shop' for their index product needs. This minimises the number of providers they require, along with the number of diligence processes they must conduct.

We saw a great deal of variation in how much investors value a number of other factors.

Investors don't lose sight of product quality amidst other considerations. Breadth of product and large fund size don't matter so much if the product's performance is not good.. One financial adviser explained that his "key driver for choosing a supplier is performance – how well can they track the index. Cost is not a major influencing factor."

This highlights that investors are willing to pay a little extra for great product. Most investors however think that vanilla large cap beta is commoditised. They consequently focus a great deal on competitive pricing for core (e.g. S&P 500) products. Whilst many recognise that providers have been lowering prices, they still feel that there is scope for further reductions.

Sentiment about relationship management varies a great deal both in terms of utility and quality.

Most research teams do not find relationship management helpful, and just want to be able to pull data with minimal fuss. As one wealth manager said, "I don't want people to come out and service us, I just need a list of products they offer. We want to avoid too many sales pitches."

Other investors value interacting with providers. They appreciate having quarterly meetings and good access whenever they have questions. One private banker explained that "certainly service levels would impact our perception of providers... one provider does a lot more of the touchy feely stuff, which is good."

Financial advisers and wealth managers like support for field sales events. This is particularly true for regions-focused organisations who value providers engaging with their staff outside London. One wealth manager said he appreciated the provider who supported "our two investment conferences a year, where Investment Managers have the opportunity to hear from providers."

Our research found widespread desire for material engagement from providers in new product development and education opportunities.

Investors want responsiveness to their feedback when designing new products, for example asking if clients prefer reinvestment versus income distribution, or offering currency-hedged share classes. One investor captures widespread sentiment when he noted that "we like providers who listen to our needs during new product development… many providers do use us as a sounding board and ask us for feedback, which we like."

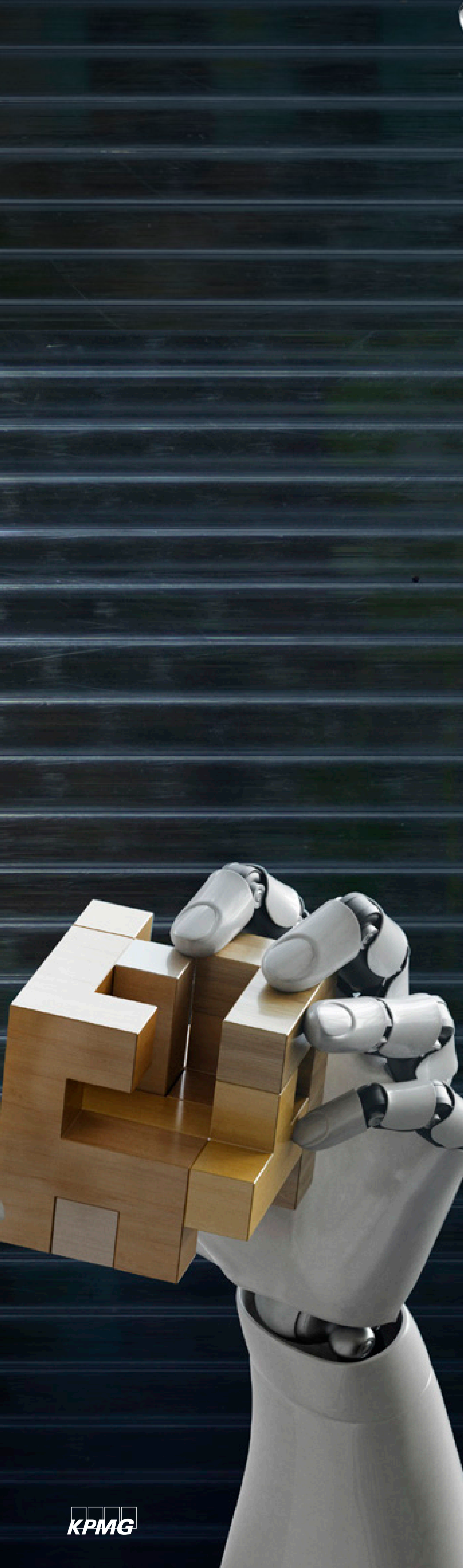
Big players value bespoke product. These investors are willing to pay a premium for this level of service, although some with internal asset management capabilities said seed funding requirements from external providers could be prohibitive. An Investment Director at one global private bank explained that "it's not just cost, but also the amount required to seed. In one example, the market was asking for £800-1,000 million to seed, whereas our guys said it would take £300-400 million."

Investors also greatly value education opportunities. We found great appetite for providers to share insights on industry trends, investors' peer group, and market innovation. To be effective, these educational opportunities needed to be genuinely educational and not disguised sales pitches.

"We like providers who listen to our needs during new product development… Many providers do use us as a sounding board and ask us for feedback, which we like."

Investment Director
UK Wealth Manager

[1] Whilst these results may have been influenced by our sampling method (61% of which were provided by BlackRock), we spoke to many investors who see the market for index products as one led by iShares and Vanguard. Participants were asked to select three options from a list of ten (one of which was 'other')



11.

Other industry trends

What do you believe will be the most critical drivers of change in the wealth industry in the next 12-24 months?

Regulatory change	**55%**
Fee pressure	**55%**
Client facing technology (e.g websites/ apps)	**46%**
Back office technology	**29%**

Note: Participants were asked to select three options from a list of ten (one of which was 'other')

MIFID II will have far reaching impact

Interviewees in discretionary fund management or private banking noted that they had missed the brunt of the impact of RDR, but felt that MiFID II would have far-reaching impacts on their business. Many felt the regulation would lead to increasing price transparency and consequently greater client scrutiny of the underlying portfolio. This scrutiny could result in more use of index investing products, and indeed potentially more direct investments amongst clients looking to remove a layer of cost from portfolios.

Robo advice is likely to complement rather than replace traditional methods

52% of participants think technology of some form will be a force of change in the wealth industry. Many advisers think their business will become increasingly digitalised. One private banker noted that "the level of value-add use of technology in UK wealth management has been shockingly low for decades" and that the industry needs to respond.

Interviewees perceive that evolving client demographics and preferences drive digitalisation. Advisers recognise that whilst much of their business is currently face to face, clients increasingly want to interact digitally.

Robo advice is one way the industry is responding to these changing customer preferences and the opportunities presented by technology. Index products could play a key role in shaping its impact given their importance in underpinning delivery of robo advice propositions.

Although in its infancy, firms are building two different robo propositions. Many propositions offer a new, tech-enabled way for organisations to interact with their clients and automate portfolio construction. Some firms are also looking to use robo propositions to package sophisticated trading strategies that don't necessarily work in a mutual fund structure. Financial advisers are leading the way in the former. Private banks appear particularly excited about the latter.

Some of the financial advisers we spoke to are already testing robo propositions. These are often for simpler customer journeys, for example ISAs. Advisers feel that robo is not yet ready for more complex questions given the intricacies of automating portfolio construction whilst ensuring the resulting portfolio is suitable.

Many private bankers think robo advice can be a value-adding complement to traditional strategic asset allocation decisions. None think robo advice will fully replace their portfolio construction process, but will instead be a helpful way to add a portfolio layer.

One private banker said that whilst "few of our clients will be investing in a 100% robo advice portfolio... we might look to do some interesting things with it as a satellite product, for example a fixed income trading strategy."

Many investors we spoke with foresee a race to the bottom on robo advice pricing similar to that in index investing. They note that scale will be a must, something unlikely to come from the new entrants proliferating in the market. Will the leading wealth managers and financial advisers of tomorrow be those of today? New entrants who have yet to be created? Or tech titans entering new verticals? Whatever the answer, wealth clients should benefit from increased competition for their wallet.

Glossary

Terms used

'Index products' to refer to all funds invested in index investments such as ETFs, index mutual funds etc.

'Interviewees' to refer to perspectives shared during the qualitative interview programme

'Study participants' or 'participants' refer to responses to the quantitative survey.

AuM/AuA – Assets under Management/ Administration

BPS – Basis Points – 0.01% of unit of measure

CGT – Capital Gains Tax

DFM – Discretionary Fund Management

ETF – Exchange Traded Fund

ETN – Exchange Traded Note

IFA – Independent Financial Adviser

IMF – Index Mutual Fund

MIFID II – Markets in Financial Instruments Directive II

RDR – Retail Distribution Review

REIT – Real Estate Investment Trust

RM – Relationship Manager

Smart Beta – Anything other than a market-cap weighted index

TCO – Total Cost of ownership

TIPS – Treasury Inflation Protected Securities

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