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Marketing Communication

ETFs: TO INFINITY AND BEYOND

ETFs and Sector Investing in Europe
Survey 2015

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SPDR

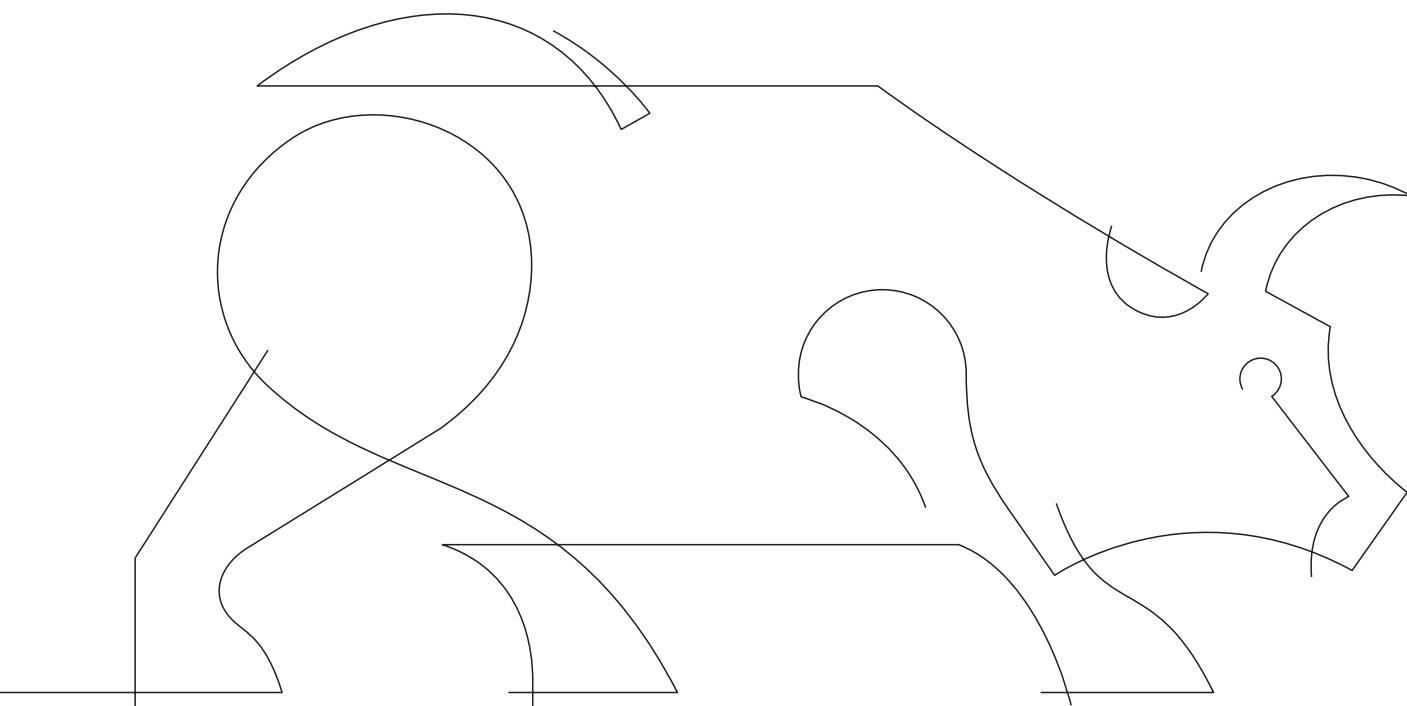
 **Kepler
Cheuvreux**

3	Foreword
5	Key Findings
6	The Growth of ETFs
7	The Strategy Choice: Styles or Sectors?
10	Sector Investing with ETFs
11	Sector Q&A with Antoine Lesné
12	ETF Trading and Execution
14	Conclusion

State Street Global Advisors and Kepler Cheuvreux are delighted to present the results of our 2015 survey into ETF use among professional investors.

This report aims to provide professional investors with a European benchmark of investment practice, and is based on a survey conducted in June 2015 with 135 investors in continental Europe and the UK. The majority of respondents were fund managers (43%) and private banks (43%).

The growth of ETF investing in Europe shows no signs of slowing down, with expected annual growth rates exceeding 15%¹ over the next five years. Thanks to an ever-expanding range of investment opportunities, sector investing using ETFs is also establishing a foothold as a key investor strategy.



135

Investors

43%
Fund managers

43%
Private banks

...took part in the survey.

Sector investing using ETFs has grown rapidly around the world, most notably in the United States. With the ever-expanding range of ETFs and investment opportunities, sector investing is also becoming increasingly popular in Europe.

Kepler Cheuvreux, in partnership with SPDR ETFs, conducted a research survey to uncover more about this trend and provide a snapshot of investor attitudes to sectors and ETFs.

Our findings show that despite growing interest, sector investing strategies are not yet as widely utilised as style strategies — 44% of our survey respondents have implemented a sector strategy, compared to 63% who have implemented a style strategy.

This should come as no surprise — equity investors tend to use style and size as part of their strategy to outperform broad index beta. However, a style can fall out of fashion, often for years. State Street Global Advisors' analysis suggests that compared to styles, sectors offer a wider dispersion of returns, and can therefore add an important layer of diversification and control to investors' portfolios.

Sector investing can provide more targeted exposure than growth and style investing, without the risk level of single stocks. The diverse performance of the various market sectors across economic cycles offers astute investors an opportunity to potentially harness these differences by capturing the returns from rising sectors and avoiding the laggards. From a risk perspective, given their relatively differentiated returns, sectors exhibit a wide range of volatility through time.

We believe that by tilting away from the sectors that would be expected to underperform in the short term during periods of economic stress, and towards sectors that are more resilient, investors can use sector rotation to reduce the impact of volatility on their portfolios. In addition, the more predictable risk and return outcomes of sector indices, compared to style indices, can enable investors to implement their cyclical views more precisely.

AT A GLANCE

Sector Investing

44% of respondents have implemented a sector strategy within one of their portfolios. Of this:

52% for tactical purposes

5% for a sector rotational strategy

By contrast **63%** have implemented a style strategy

Technology, Banks, Health Care and Financial Services:

Sectors expected to outperform the market within the next three months* in European and US markets.

Real Estate, Utilities, Basic Resources, Food and Beverages,

Banking: Sectors expected to underperform the market within the next three months* in European and US markets.

ETF Investing

Investors surveyed use ETFs because of:

71% low cost

64% ease of use

61% liquidity

72% ability to increase exposure to a market or sector

The majority invest in equity ETFs:

93% invest in equity ETFs

54% invest in fixed income ETFs

36% invest in commodity ETFs

Execution price is the most important factor for investors placing ETF orders (71%)

The Economy

Main investor concerns for the rest of 2015:

54% interest rate volatility

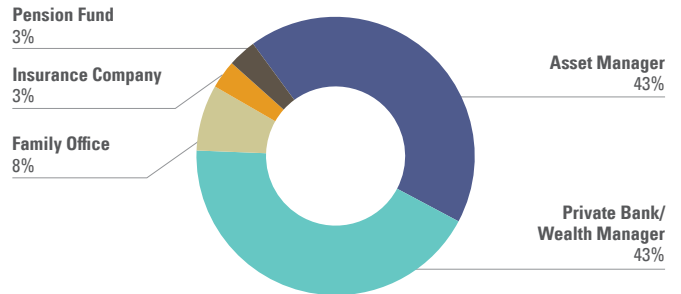
37% the global economy

33% the landing of the Chinese economy

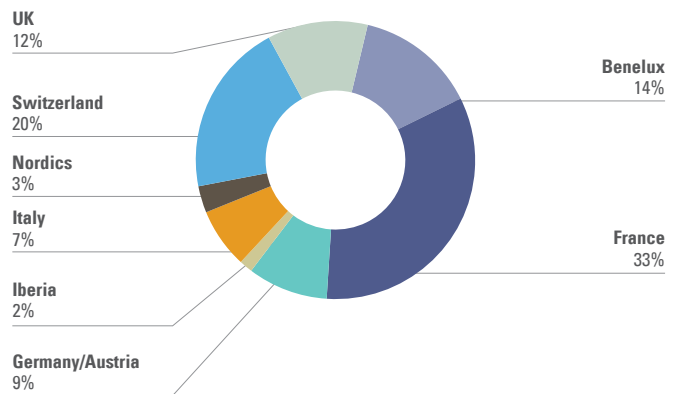
31% Grexit

6% inflation

INSTITUTION BREAKDOWN



REGIONAL BREAKDOWN



*From June 2015.
Respondents could select multiple answers.



Since the launch of the first ETF 22 years ago, the number of ETFs has grown rapidly to more than 5,500 ETFs listed globally.

Continual innovation has seen the introduction of currency-hedged, leveraged, short, volatility-tilted, smart beta and active funds, broadening the range of investment possibilities for investors.

Global ETF assets under management exceeded the \$1 trillion milestone in 2009 and reached \$2 trillion only four years later, touching \$3 trillion in 2015. Global AUM stood at \$2.9 trillion at the end of August following the recent equity sell-off. The size of the ETF industry now almost matches the size of the hedge fund industry in AUM terms, despite being developed four decades later.

Fabrice Barbereau, Equity Derivatives Strategist
Kepler Cheuvreux

ETFs HAVE BECOME MAINSTREAM

Figure 1: Worldwide Growth of ETFs and AUM (USD, billions)



Source: Bloomberg. Data in USD as at 31 August 2015.

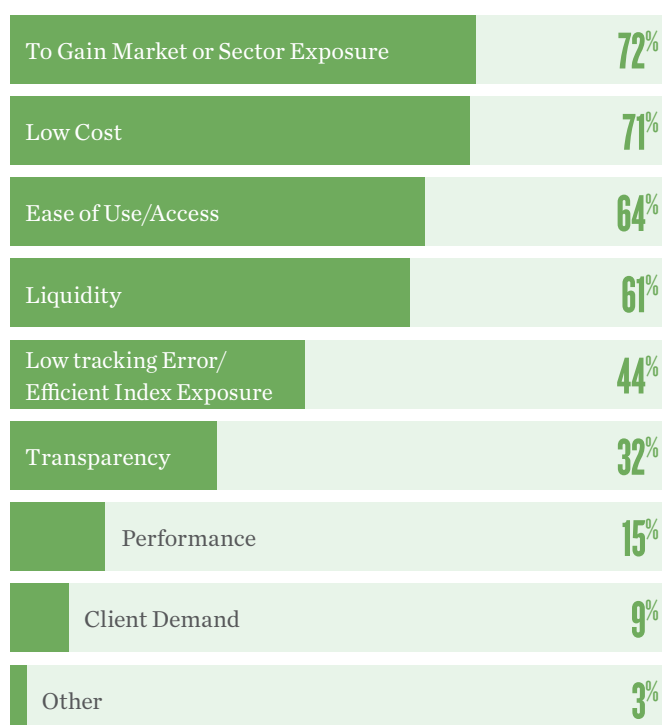
COST, LIQUIDITY AND EASE-OF-USE ARE THE TOP REASONS FOR INVESTORS WHO FAVOUR ETFs OVER OTHER VEHICLES

Almost all investors surveyed are active users of ETFs (82%). Investors cited three major reasons for using of ETFs: **low cost** (71%), **ease of use** (64%) and **liquidity** (61%). Roughly three investors out of four (72%) use ETFs **to increase their exposure to a given market/sector**. Transparency and low tracking error were mentioned less (44% and 32% of the sample, respectively). Fifteen percent cited performance criteria as a rationale for ETF investing.

Question 1: Do you currently invest in ETFs ?



Question 2: Why do you invest in ETFs?

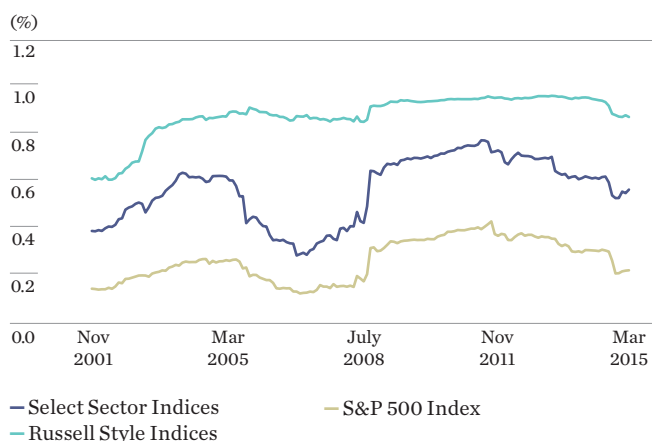


The Strategy Choice: Styles or Sectors?

When constructing an efficient portfolio, selecting stocks with disparate returns and low correlations from as broad and diverse a universe as possible enables investors to more easily differentiate between attractive and less attractive investments.

As Figure 2 illustrates, the 500 constituents of the S&P 500® are more disparate than the constituents of the sector indices or style indices (which group stocks by criteria like value or growth). This characteristic, as well as the lower average pairwise correlation (the average correlation of each pair of stocks within an index) for the S&P 500 constituents, suggests (incorrectly) that an effective strategy might be simply to select individual stocks from the S&P 500.

Figure 2: Sectors Exhibit Lower Mutual Correlations than Styles



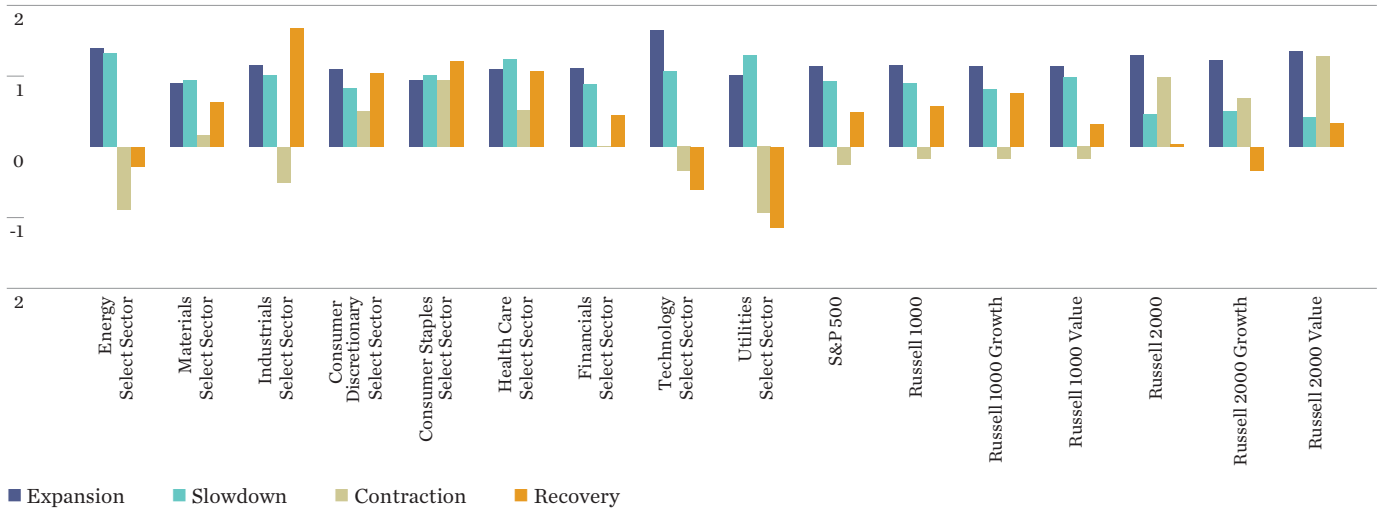
Source: FactSet, State Street Global Advisors, as of 31 March 2015. The correlation coefficient measures the strength and direction of a linear relationship between two variables. It measures the degree to which the deviations of one variable from its mean are related to those of a different variable from its respective mean. It is not possible to invest directly in an index.

However, the difficulty of consistently selecting attractive stocks from such a broad universe is a significant problem. Evaluating every stock in the S&P 500 Index essentially requires an investor to make 500 different decisions, compared to choosing from the nine Select Sectors or the four Russell Style index exposures. The opportunity set is simply too large.

A smaller opportunity set that ‘acts large’, or at least larger than the available alternatives, is ideal. For example, as shown in Figure 3, the nine Select Sectors have a risk/return profile that is much closer to the full S&P 500 than the four Russell Style indices. This makes intuitive sense since there are inherently more differences between stocks in different sectors – between, say, a tech stock and a utility stock – than between a growth and a value stock. In addition, because each of the Select Sectors is mutually exclusive, a stock cannot belong to more than one sector index. In contrast, the Russell style indices include multiple overlapping holdings, contributing to their lower return dispersion and higher pairwise correlations over time.

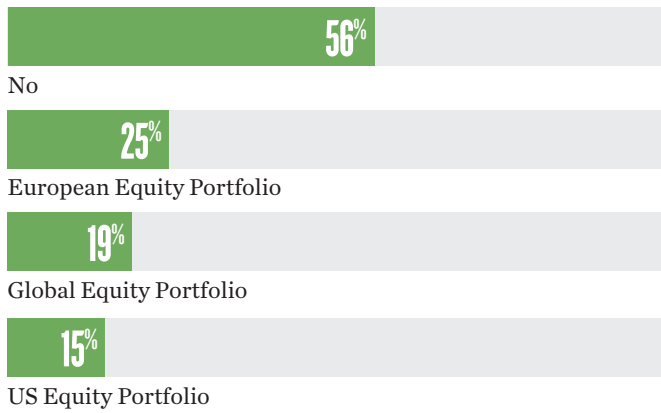
Figure 3: Individual Sector Performance During Economic Cycles

Average Cycle Absolute Returns (%)



Source: FactSet, Conference Board, State Street Global Advisors, 31 October 1989 through 31 December 2014. Past performance is not a guarantee of future results. The information contained above is for illustrative purpose only. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. It is not possible to invest directly in an index.

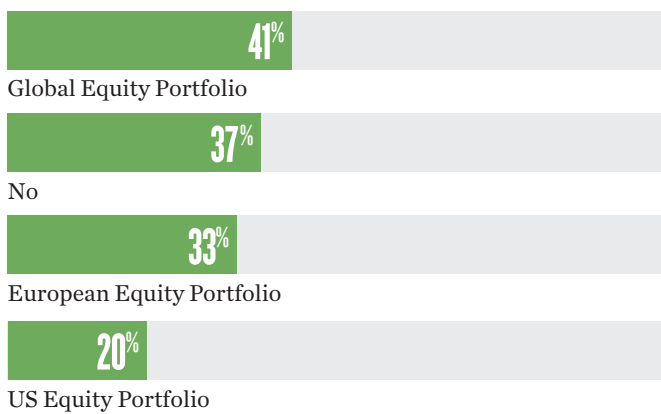
Question 3: Do you have a sector strategy?



LESS THAN HALF – 44%

have implemented a **sector strategy** within one of their portfolios. More than 50% do so for tactical purposes only and only 5% according to a sector rotational strategy. Thirty seven percent use a sector strategy for both rotational and tactical purposes.

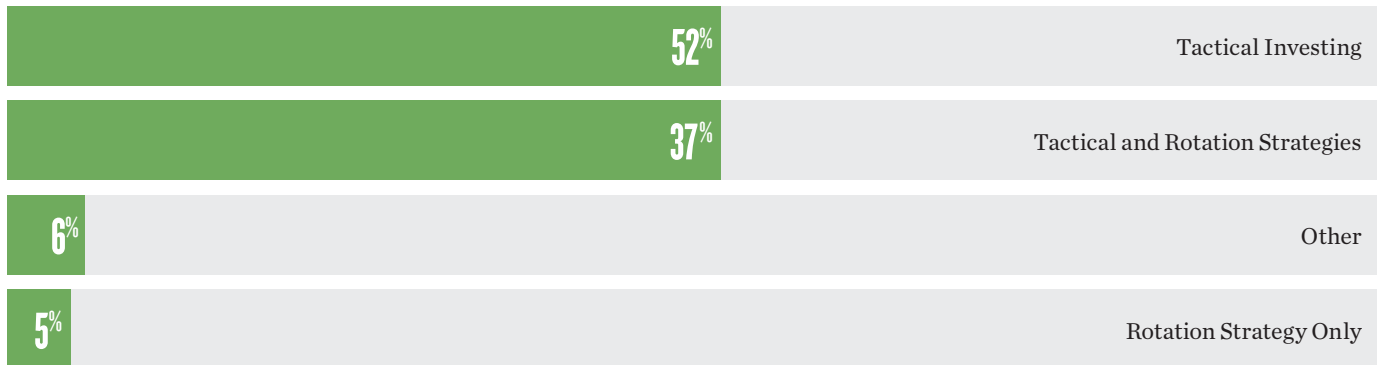
Question 4: Do you have a style strategy?



BY CONTRAST – 63%

have implemented a **style strategy** in their portfolios.

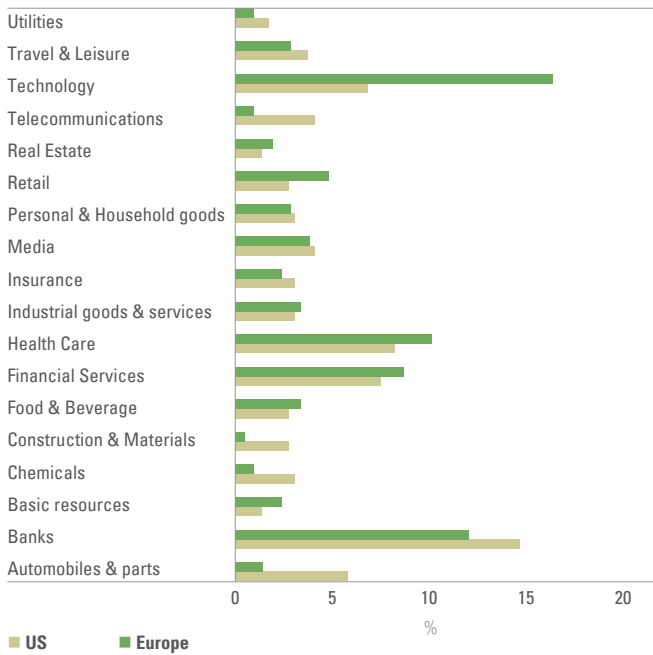
Question 5: Why do you invest in sectors?



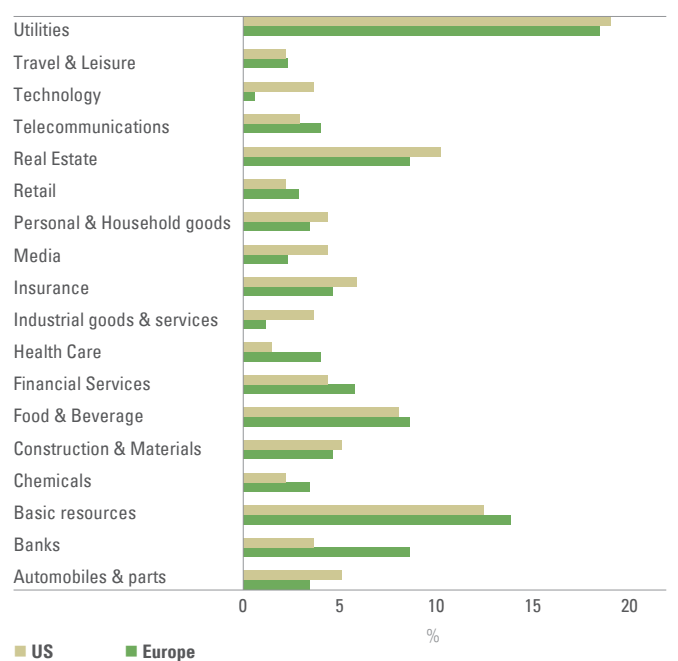
According to the investors surveyed, the main sectors which should outperform the market within the next three months (from June 2015) are expected to be the same across both European and US markets. In decreasing order of nomination they are: Technology, Banks, Health Care and Financial Services.

Conversely, the following markets are expected to underperform in the next three months: Real Estate, Utilities, Basic Resources, Food and Beverages. Some investors also named the Banking sector.

Question 6: Over the next 3 months, which do you believe will be the highest performing sectors in Europe and the US?



Question 7: Over the next 3 months, which do you believe will be the lowest performing sectors in Europe and the US?



Top 3 Sectors Expected to Outperform.



Top 3 Sectors Expected to Underperform.



SECTOR INVESTING THROUGH EXCHANGE TRADED FUNDS

ETFs are a cost-effective, efficient and precise way to implement sector investing and sector-rotation strategies. They enable investors to gain exposure to different sectors of the market without having to manage the risk of trading multiple positions. In recent years, the number of ETFs available to investors has burgeoned, with increasingly sophisticated products offering access to ever-more specific segments of the market.

A sector approach enables investors to take advantage of economic trends that have targeted implications for the performance of specific segments of the equity universe. Adding a sector strategy to portfolios allows for more nuanced investing without introducing the potential for additional idiosyncratic risk through single-stock investing.

Antoine Lesné

Head of ETF Strategy EMEA, State Street Global Advisors

Year-to-date flows into ETFs that track sector indices stood at \$9.4 billion at the end of August. Our ranking by sector flows shows that the Energy sector has been the most actively purchased sector so far this year despite the decline in the oil price (there were similar inflows into ETFs tracking oil commodity funds). Inflows mostly occurred in the first half, and then picked up again in July and August, certainly due to bargain hunting as the price of oil fell. The Health Care and Real Estate sectors were also actively purchased in the first eight months of the year, collecting \$4.9 billion and \$2.7 billion, respectively. By contrast, ETFs tracking the Industrial and Technology sectors saw the largest outflows, losing around \$2 billion.

Fabrice Barbereau

Equity Derivatives Strategist, Kepler Cheuvreux

Source: Morningstar as at 31 August 2015.



SECTOR Q&A

**Antoine Lesné, Head of ETF Sales Strategy,
EMEA, State Street Global Advisors**

Which sectors in Europe and the US might investors look to in the current market cycle and why?

In Europe, Financials and Health Care have benefited from the current positive ECB-supported environment. During the summer turmoil, defensive sectors like Utilities fared better than the rest of the pack on a relative basis.

In the US, while continuing to buy the market, investors may want to start evaluating sectors that have been able to grow their revenues in excess of the overall market and nominal GDP. US Financials, including Regional Banks, is one sector that may benefit from a Fed interest rate increase later this year. Meanwhile, in volatile markets of the kind we're experiencing now, Utilities tend to outperform, along with more domestic-focused exposures such as Telecoms. On a longer-term basis, Energy, the most unloved area of the market, could be worth considering for investors prepared to stomach volatility. While this sector is not favoured by our internal models at the moment, it is worth noting that, historically, the US Energy sector performed relatively well in previous rate-tightening periods.

From a macroeconomic standpoint, GDP growth in Europe is still on track to be around 1.4% this year according to economists. What's more, a number of tailwinds remain in place for the European market as the ECB's quantitative easing programme continues, with the potential to extend its list of quantitative easing (QE) assets beyond government and government-related bonds to corporate bonds. This should help corporations that stand to benefit from a lower interest rate environment, and could also trigger increased M&A activity in Europe.

In the US, despite being unusually late in increasing rates in the expansionary cycle, the Fed may finally engage in a rate normalisation cycle relatively soon. This could provide further fuel to weaken the euro.

What are the key risks in making these sector calls based on the current market cycle?

The increased volatility in Europe in 2015 – from the Grexit instability to the global effects of the turmoil in China – has made it difficult to predict the next direction markets will take.

With sector investing, the main risk comes from the active call that an investor makes on the macroeconomic environment, and which phase of the cycle we're in. If an investor makes the wrong call, then instead of outperforming the standard index they may underperform it – that is the main risk of an active sector rotation strategy.

What are the macroeconomic concerns in Europe and the US going into the second half of 2015?

Some of the biggest challenges facing investors include how to position portfolios for rising interest rates, higher volatility and a potential slowdown in corporate profits. Lastly, the impact of deceleration in the Chinese economy could bring some unknowns.

How can sector rotation help investors position their portfolios against this backdrop?

Sectors allow investors to precisely target what is driving risk and return. Against the current uncertain economic backdrop, efficient portfolio construction and the flexibility that sector investing can offer is particularly relevant. In contrast to implementing investment decisions through individual stocks or a limited number of style characteristics, sector investing can offer lower correlations between the constituents of the strategy, higher return dispersion, and discrete exposures – all of which gives investors a high degree of flexibility.

KEY INVESTOR CONCERNS

54%

Unsurprisingly, the volatility of interest rates before the end of 2015 is the main source of concern expressed by investors

37%

One third mentioned the growth of the global economy

33%

Hard landing for the Chinese economy

31%

Grexit

6%

Fewer see inflation as a source of concern

ETF TRADING AND EXECUTION

The main criteria considered by respondents when directing ETF trades is: **execution price** (71%), well ahead of **reactivity** (27%) and **payment/delivery quality** (19%). One out of four investors takes into account **research and/or execution advisory**.

Price is clearly the most important factor when it comes to ETF trades.

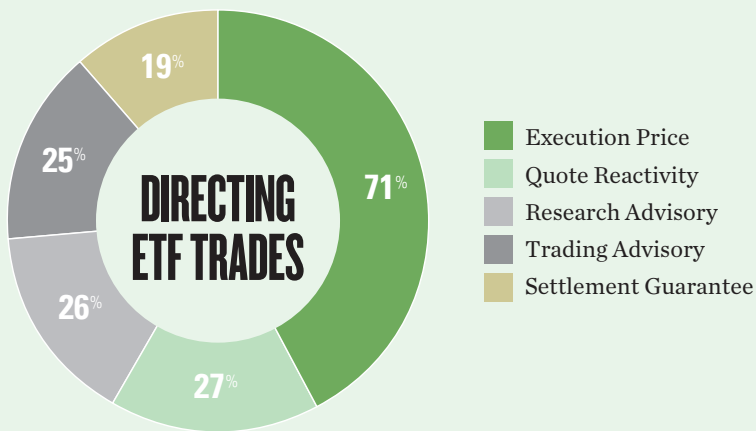
The majority (63%) of respondents experienced no problems in payment/delivery during the settlement process. Less than one out of five (17%) experienced problems with ETF settlements, versus 21% with shares and 10% with futures/options.

If trading on-exchange between a stock and an ETF looks similar, it is in fact very different. The origin of liquidity on-exchange varies between both products as most orders on equities are agency (client orders) while they are principal on ETFs (Market Makers). We observe some delays in settlement from counterparts providing liquidity. This can be when an ETF is traded over-the-counter or on-exchange after the cut-off, although there are many possible reasons. Settlement is an important feature to take into account in the best execution process when trading ETFs. It may bring additional costs if trading is not managed prudently. To avoid or minimize settlement issues, we believe it is very important to trade with counterparts providing a Trading Advisory service, and to not solely focus on price.

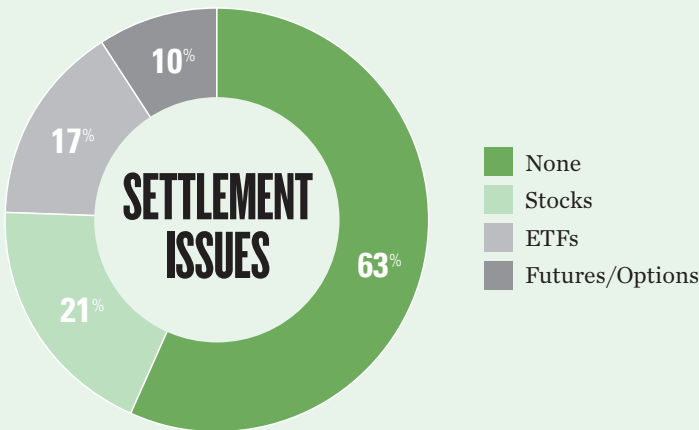
Charles Hoppmann

Head of ETF Business Development, Kepler Cheuvreux

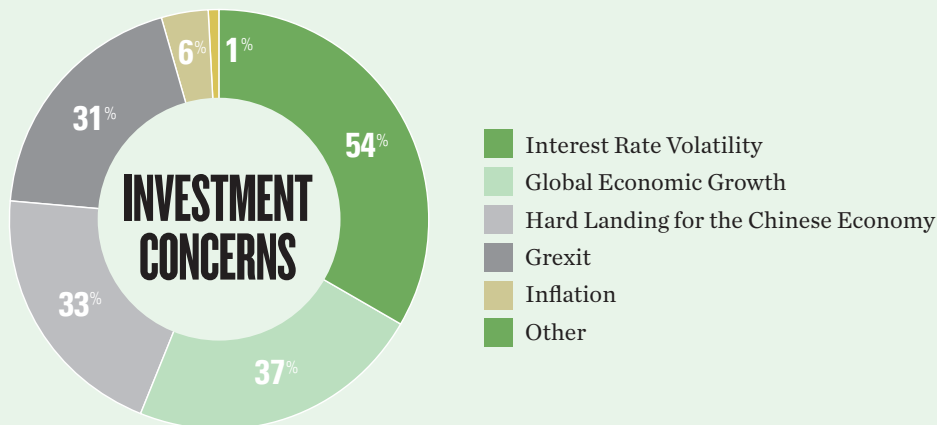
Question 8: What factors do you consider when directing your ETF trades?



Question 9: Have you ever experienced settlement issues?



Question 10: What are your biggest investment concerns for the remainder of 2015?



Please note that the survey was conducted in June 2015. Despite this being in the midst of the “Grexit” crisis, this still only came fourth in terms of what concerned investors most for the rest of the year.

ETF use continues to grow rapidly in Europe, particularly across equity exposures. Investors increasingly appreciate the inherent benefits of ETFs as a tool for active management thanks to their liquidity, low cost and precise market exposures.

Sector investing resonates with many investors, primarily as a tactical strategy or tactical in combination with a rotational strategy. Style investing is currently more widely adopted by investors, according to our survey.

As sector investing opportunities continue to grow, investors will have greater potential to diversify and control their investments.

In the coming months, anticipated interest rate volatility is the number one concern for investors. Efficiency and flexibility in investment strategies will be particularly relevant amid this uncertain economic backdrop. We believe that sector ETFs, with their precision, efficiency and ease-of-use, can play an increasingly strategic role in portfolios as investors seek to position and adjust market exposures to match changes in the economic cycle.

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For nearly four decades, State Street Global Advisors has been committed to helping financial professionals and those who rely on them achieve their investment objectives. We partner with institutions and financial professionals to help them reach their goals through a rigorous, research-driven process spanning both active and index disciplines. We take pride in working closely with our clients to develop precise investment strategies, including our pioneering family of SPDR ETFs. With trillions* in assets under management, our scale and global footprint provide unrivaled access to markets and asset classes, and allow us to deliver expert insights and investment solutions.

State Street Global Advisors is the investment management arm of State Street Corporation.

*Assets under management were \$2.37 trillion as of 30 June 2015. Please note that AUM totals are unaudited.

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Kepler Cheuvreux employs 90 equity analysts who research 675 Continental European companies, of which 438 are classified as Small & Mid cap (market capitalizations under €6 billion). Kepler Cheuvreux has the largest equity research footprint in Continental Europe.

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