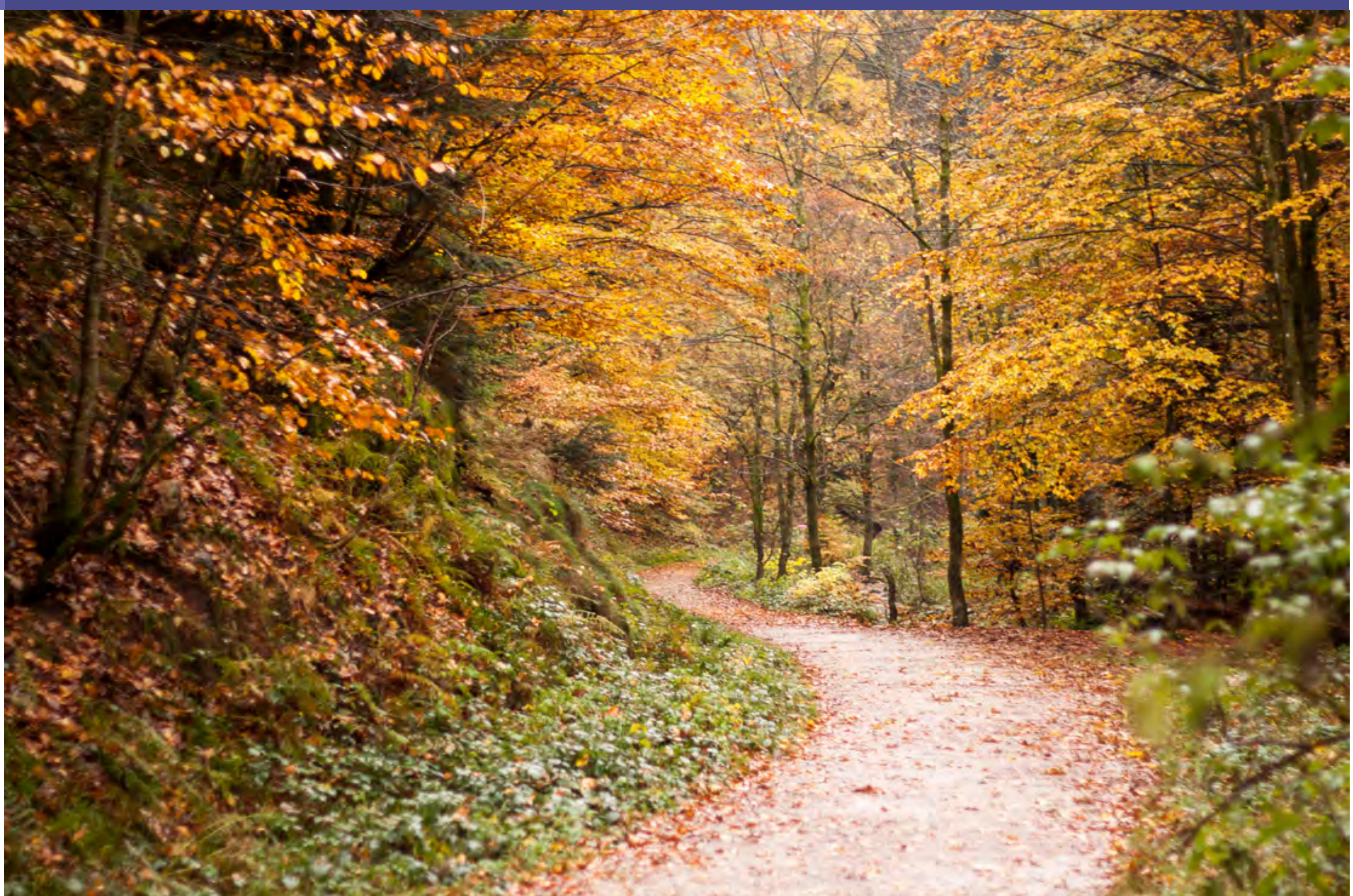
Q1 2016

ETFs in the European Institutional Channel: 5 Key Trends



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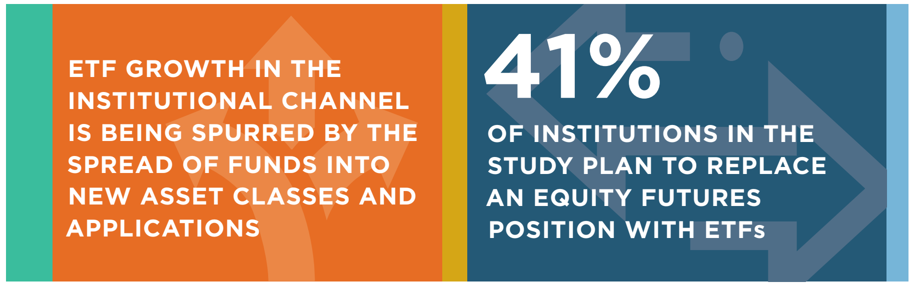
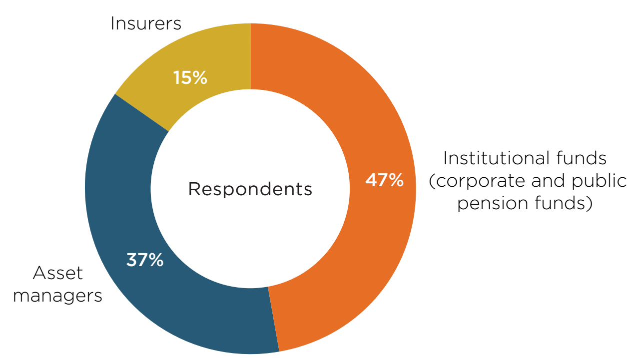
Consultant Andrew McCollum advises on the investment management market globally.



METHODOLOGY

Greenwich Associates interviewed a total of 123 European-based institutional investors, 68 of which were exchange-traded fund users and 55 were non-users, in an effort to track usage behaviors and examine perceptions associated with exchange-traded funds. The respondent base consisted of 58 pension funds (corporate funds, public funds, and other institutional investors), 46 asset managers (firms managing assets to specific investment strategies/guidelines) and 19 insurance companies.



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Executive Summary

ETFs are becoming a staple of European institutional equity portfolios. The results of the Greenwich Associates 2015 European Exchange-Traded Funds Study show that equity and fixed-income ETFs are on a solid growth trajectory in terms of both number of institutional users and overall investments. That momentum helped drive overall ETF allocations among institutional users in Europe to 9.3% of total portfolio assets in 2015, up from 7.2% in 2014.

Looking to the future, however, ETF growth in the institutional channel will be driven less by the continued advance of equity ETFs and more by the spread of the funds into new asset classes and applications.

The study results identify five emerging trends that will augment growth in equities and drive the expansion of ETFs throughout institutional investment portfolios in Europe:

1. ***Liquidity needs will fuel demand for ETFs in fixed income.***

2. ***ETFs are increasingly being used for core, strategic and tactical applications.***

3. ***Growing numbers of European institutions are using ETFs to replace derivatives positions.***

4. ***Innovative fund types, such as smart-beta ETFs, will provide new ways for investors to obtain exposures.***

5. ***The growing popularity of multi-asset funds is creating new demand for ETFs among the asset managers that offer these products.***

These findings suggest the flexibility and adaptability that allow institutions to find new ways to apply ETFs in their portfolios will play a central role in the continued proliferation of the funds in the institutional channel.

Introduction: A Strong Foundation in Equities

European institutions deploy ETFs in their portfolios in a wide variety of ways and for a broad range of purposes. According to the results of Greenwich Associates annual research with institutional investors in Europe, approximately a quarter of institutions on the Continent and 20% of U.K. pensions invest in ETFs. Between 30% and 35% of the largest institutional investors in both markets invest in ETFs.

The next 12 months are likely to bring increases in both adoption rates and the overall amount invested in ETFs. Approximately 17% of Continental European institutions not currently investing in ETFs plan to start using the funds in the next year. Over the same period, 35% of active users in Continental Europe plan to increase their investments in ETFs.

To gain a better understanding of how institutions are using ETFs and what role the funds are playing in institutional portfolios, Greenwich Associates launched its European Exchange-Traded Funds Study in 2014. Among the 123 European institutions we interviewed for this year's study, 55% use ETFs, including 63% of the insurers, 72% of the asset managers and 40% of the institutional funds.

Across all institutional ETF users in the study, allocations to the funds increased to 9.3% in 2015 from 7.2% in 2014. At 10.1%, 2015 allocations are largest among European asset managers, and smallest among insurance company ETF investors, which allocate 8.1% of total assets to the funds.

The institutions participating in the study described a wide range of ETF applications and benefits that are driving these allocations:

"We use ETFs when we have to act quickly—when a highly liquid investment is requested." ***– Corporate Pension Fund***

"Diversification and cost optimization." ***– Corporate Pension Fund***

"To depict the commodity sector. Due to fund regulation, we wouldn't be able to buy any other asset classes except for the ETF." ***– Asset Manager***

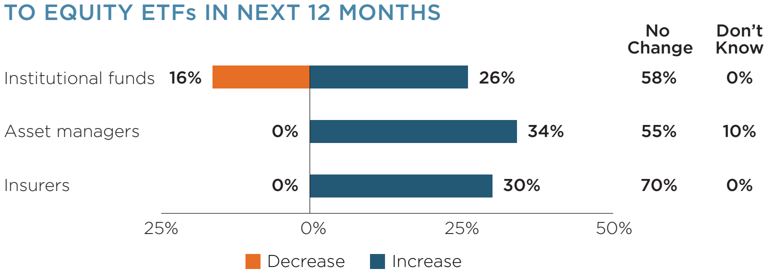
"We bought ETFs on Chinese equities and that gave us exposure in China." ***– Insurance Company***

European Institutional ETF Use on the Rise

The year-over-year growth in ETF allocations among institutional users in Europe is consistent with the trend seen in other markets around the world. Once institutions introduce ETFs to their portfolios, they generally start increasing allocations in relatively short order.

Data on overall ETF allocations actually understate the role the funds are playing in the portfolios of these institutions—especially in equities. Among the institutional ETF users in the 2015 study, 94% invest in equity ETFs. International equities are the most popular regional segment, followed by European, Asian and U.S. equities. Sixty-three percent of the institutions use ETFs in the domestic equities of their home countries.

EXPECTED CHANGE IN ALLOCATIONS TO EQUITY ETFs IN NEXT 12 MONTHS



Note: Based on 58 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

Among institutions currently investing in equity ETFs, the funds grew to approximately 25% of total equity assets in 2015, up from 22% in 2014. That 2015 allocation ranks second to only individual stocks, which make up one-third of equity assets. Institutional funds using equity ETFs invest 30% of their total asset in ETFs.

Nearly one-third of all users plan to increase allocations to equity ETFs in the coming year. (Only 5% of institutional equity ETF users plan to reduce allocations.) Among institutions planning increases, 25% expect to boost allocations by 10% or more.

Equity ETFs Provide a Range of Benefits

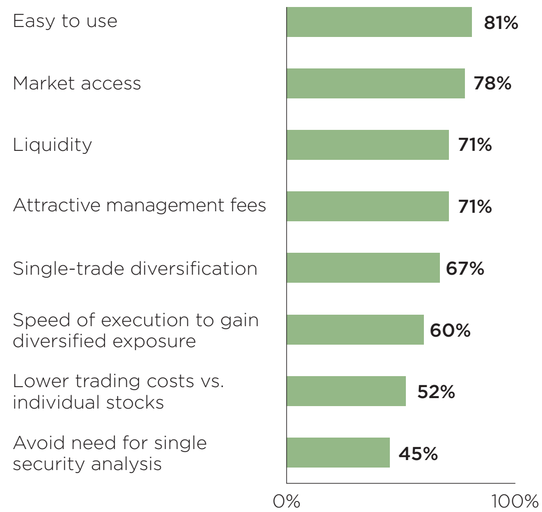
Institutions are drawn to equity ETFs for a range of benefits. Topping the list is ease of use, which is cited by 81% of ETF investors, followed by improved market access at 78%, and liquidity and attractive management fees, both at 71%. Institutions cite several other key reasons for using equity ETFs, including single-trade diversification, speed of execution to gain diversified exposure and lower trading costs vs. individual stocks.

These advantages are attracting the attention of non-users of equity ETFs as well. A full 44% of current non-users in the study say they are at least somewhat likely to start using equity ETFs in the coming year.

These results demonstrate the extent to which institutions have integrated ETFs into their equity portfolios and suggest that continued increases in use and allocation in equities will help fuel overall ETF growth in 2016.

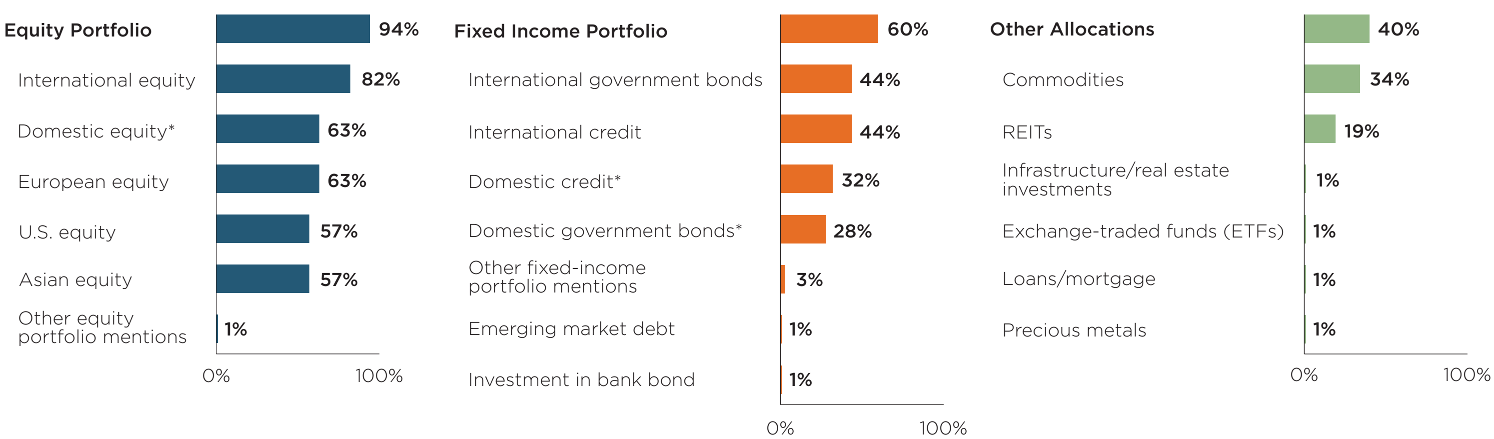
Over a longer horizon, however, other asset classes and applications will emerge as important drivers of ETF growth. This report identifies five emerging trends that will augment growth in equities and drive the expansion of ETFs throughout institutional investment portfolios in Europe.

TOP REASONS FOR USING EQUITY ETFs



Note: Based on 58 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

INSTITUTIONAL ADOPTION RATES BY ASSET CLASS



Note: *Respondent's country. Based on 68 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

Five Trends Driving ETF Use Among European Institutions

1. Lack of Liquidity Boosts Demand for Bond ETFs

Approximately 60% of ETF users in the study employ ETFs in fixed income. That share hits 79% among asset managers currently investing in ETFs. The fact that nearly one-quarter of bond ETF users started investing in these funds within the past two years shows that these funds continue to attract new institutional users.

Institutions participating in the study described why they are using bond ETFs in their portfolios:

"More liquidity" ***– Corporate Pension Fund***

"They are cheap, easy to implement and give diversification to the portfolios." ***– Asset Manager***

Bond ETFs are used most commonly in international credit and international government bonds, with usage rates at 44% of ETF investors in both sectors. Approximately one-third of ETF investors in the study use ETFs in domestic credit. These institutions invest an average 13% of fixed-income assets in the funds. Most institutions plan to hold these allocations steady over the next 12 months. Those planning a change are divided between 14% expecting an increase and 17% expecting a reduction.

Ease of Use and Liquidity Spur Bond ETF Demand

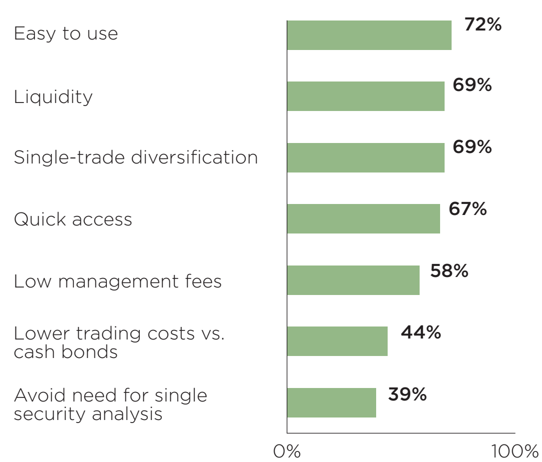
However, the study results reveal signs that institutional investment in bond ETFs could increase significantly in coming years. Current users of fixed-income ETFs cite three primary reasons for investing: **ease of use, liquidity and single-trade diversification**. Approximately 70% of bond ETF users cite these features, topping the share of institutions citing other benefits such as quick access (67%) low management fees (58%), lower trading costs vs. cash bonds (44%), and avoiding need for single security analysis (39%).

In both Europe and the U.S., institutional investors have experienced a reduction in secondary-market trading liquidity. Stricter capital requirements on banks have resulted in decreased liquidity, making

5 KEY TRENDS

1. **Lack of liquidity boosts demand for bond ETFs.**
2. **Institutions using ETFs for core exposures and other strategic applications.**
3. **ETFs are replacing derivatives in institutional portfolios.**
4. **Institutions adopting innovative new ETFs.**
5. **Boom in multi-asset funds fuels ETF demand among asset managers.**

TOP REASONS FOR USING FIXED-INCOME ETFs



Note: Based on 36 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

it more expensive for fixed-income dealers to maintain large bond inventories. As these capital rules and other new regulations erode profit margins for fixed-income dealers, banks are cutting back on their market-making activities, taking liquidity out of the market.

Meanwhile, ETF liquidity has been increasing. Assets in European fixed-income ETFs have grown by 2.4x since 2009.[1] Growth within the more liquidity-constrained credit sector has been more marked, at 4.9x, as users turn to ETFs to help them manage through an increasingly illiquid underlying bond market. While trading data in Europe is relatively scarce, anecdotal evidence points to a general increase in liquidity in recent years. For comparison purposes, in the U.S. where trading data is available, bond ETF liquidity has grown 5.1x, or at an annual growth rate of 31%, since 2008.[2]

SINCE 2008, BOND ETF LIQUIDITY HAS GROWN

5.1x

Nearly 20% of asset managers not currently investing in fixed-income ETFs and about 15% of institutional fund non-users say they are at least somewhat likely to begin using the funds in the next 12 months. Based on institutions' increasing need for liquidity, Greenwich Associates expects these shares to increase in coming years, along with overall institutional assets devoted to ETFs.

2. Institutions Using ETFs for Core Exposures and Strategic Applications

ETFs are taking on a bigger role in equity portfolios and gaining traction in fixed income and other asset classes. Presently, 34% of European institutions employ ETFs in commodities and 19% use them in REITs, for example.

European institutions as a group continue to discover new applications for the funds, and a smaller but growing group of institutions are adopting ETFs for their most important strategic functions.

Today, Tactical Uses Dominate...

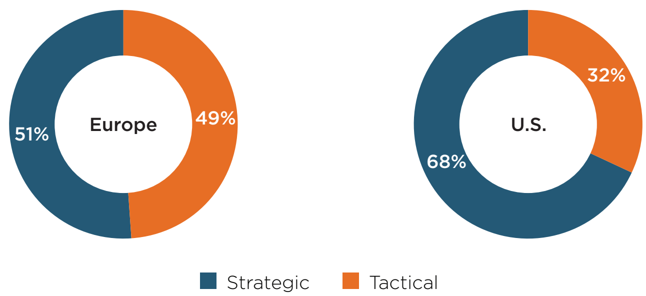
Compared to their counterparts in the U.S., European institutions use a relatively large share of their ETF investments for tactical functions within their portfolios. Eighty-four percent of the institutions in the study use ETFs for tactical purposes, making this by far the most common reason for using ETFs in Europe. In contrast, among U.S. institutions, the No. 1 application for ETFs is obtaining core investment exposures—a function that ranks among institutions' most important strategic imperatives.

Although currently weighted toward tactical functions in Europe, ETF use is trending toward increasingly strategic applications.

1 BlackRock, ETP Landscape as of 12/31/15.
2 BlackRock, Bloomberg, based on the cumulative annual trading volume of all U.S.-listed fixed-income ETFs, as of 12/31/15.

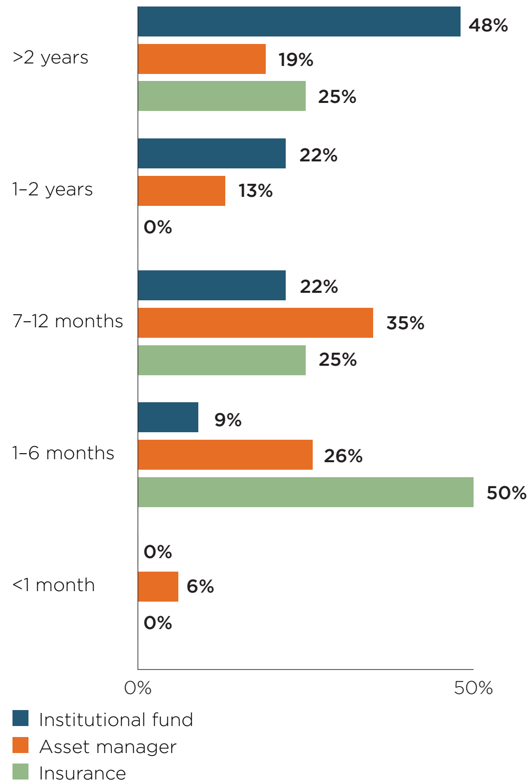
European institutions say their ETF holdings are about evenly split between tactical and strategic assets. In keeping with that split, 53% of European institutions report average ETF holding periods of one year or less, with 27% coming in at six months or shorter. In this respect European institutions again differ from their peers in the U.S., who describe three-quarters of their ETF assets as strategic in nature. About half of U.S. institutional ETF users report average holding periods of two years or longer.

ETF USE: STRATEGIC VS. TACTICAL



Note: Based on 66 responses for Europe and 121 responses for U.S.
Source: Greenwich Associates 2015 European and U.S. Exchange-Traded Funds Studies

TYPICAL ETF HOLDING PERIODS FOR EUROPEAN INSTITUTIONS



Note: Based on 66 responses: 23 institutional funds, 31 asset managers, and 12 insurance companies.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

...But Strategic Uses Are Also on the Rise

Although ETF use remains weighted toward tactical functions in Europe at the moment, there is no doubt that use is trending toward increasingly strategic applications. As documented in last year's European Institutional ETF Study, European institutions have been following a trajectory similar to that traveled by investors in North America: Institutions usually start using ETFs for relatively simple, short-term tactical tasks and expand their use to longer-term strategic functions as they learn about and become more familiar with the funds.

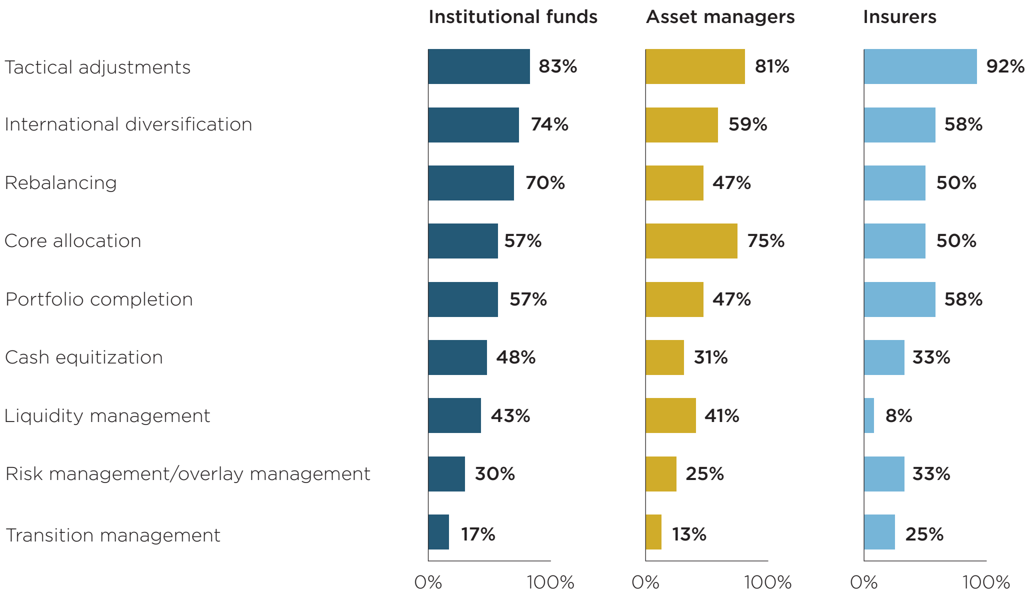
European institutions participating in the study described the following ways they are using ETFs in strategic functions within their portfolios:

> *"Flexibility. Depiction of liquid asset classes and very broad diversification."* ***– Asset Manager***

> *"They enable us to enter a selected market with limited costs."* ***– Institutional Fund***

Currently, 64% of European institutions and three-quarters of asset managers use ETFs to obtain core exposures. Overall, 64% of institutions and 74% of institutional funds use ETFs to achieve international diversification—another important strategic function. Thirty-six percent employ ETFs for liquidity management.

MOST COMMON ETF APPLICATIONS



Note: Based on 67 responses: 23 institutional funds, 32 asset managers, and 12 insurance companies,
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

Based on existing trends among investors in Europe and other markets around the world, Greenwich Associates expects European institutions to continue applying ETFs to increasingly strategic functions. Given the relatively high rate at which institutions in Europe are using ETFs for rebalancing and other important tactical functions, the continued adoption of the funds for strategic purposes points to steady growth in coming years.

3. ETFs are Replacing Derivatives in Institutional Portfolios

Greenwich Associates research with investors around the world shows that once institutions make their initial investments in ETFs, it typically takes a year or two for them to gain confidence in the funds and begin applying them more broadly throughout their portfolios. One finding in this year's research clearly shows that European institutions are reaching this level of comfort: Growing numbers of institutions are using ETFs to replace other products and investment vehicles.

ETFs are often cheaper than futures and easier than single shares.

– Asset Manager

One product most often in the crosshairs: derivatives. European institutions are active users of derivatives as a source of beta exposure. Among institutions in the study, 73% use futures to access beta. About 1 in 5 use credit default swaps and/or total return swaps. Institutions using futures to access beta do so mainly for hedging purposes and to obtain fully funded long positions.

European institutions are also active users of index mutual funds as a source of beta, with 51% of the institutions in the study citing this use.

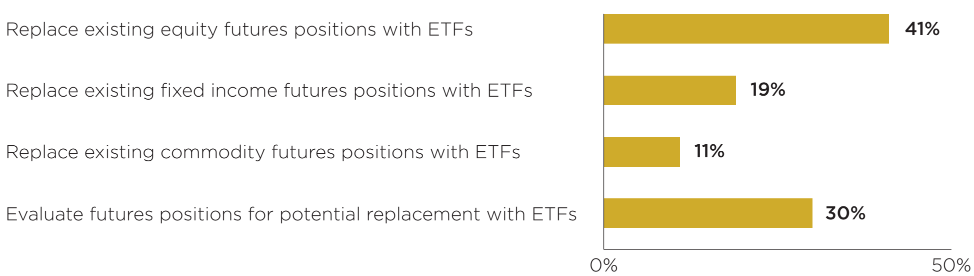
ETFs Provide More Effective Beta Exposure

Despite this pervasive use of derivatives, a majority of institutions believe ETFs can be a superior means of obtaining beta. Two-thirds of the institutions in the study say an S&P 500 ETF provides more effective beta exposure than an S&P 500 future for a fully funded S&P 500 position. Acting on these beliefs, almost half the institutions in the study shifted from derivatives products to ETFs in the past year. Overall, 17% of institutions made that shift for operational simplicity, and an equal share made the switch to lower costs.

Among institutions in the study, 41% plan to replace an existing equity futures position with ETFs in the coming year. Approximately 19% plan to replace existing fixed-income positions with ETFs, and 11% expect to replace commodities positions. Another 30% said they are evaluating futures positions across their portfolios for possible replacement with ETFs. Based on these findings, Greenwich Associates expects the continued substitution of derivatives positions for ETFs will contribute to growth in ETF use and investment in 2016 and beyond.

REPLACING DERIVATIVES WITH ETFs

Over the next 12 months do you expect to:



Note: Based on 27 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

4. Institutions Adopting Innovative New ETFs

The adoption of ETFs by European institutions has been driven in large part by their ability to find new applications for ETFs in their portfolios. In general, adoption starts with tactical functions within equity portfolios and then expands to more sophisticated and strategic applications in equities and other asset classes. This process could accelerate as innovations by ETF providers present institutions with new products for gaining investment exposures.

Minimum volatility stands out as the most used smart-beta ETFs.

Over 20% of institutional ETF users in the study are now investing in non-market-cap-weighted/smart-beta ETFs. Among asset managers currently investing in ETFs, that share approaches 30%. By far the most common of these funds are minimum-volatility ETFs, which are used by 86% of investors in non-market-cap-weighted/smart-beta ETFs. Half of these institutions use equal-weighted ETFs, 43% use multi-factor ETFs and 36% invest in single-factor funds.

Expected Boost in Allocations to New ETF Strategies

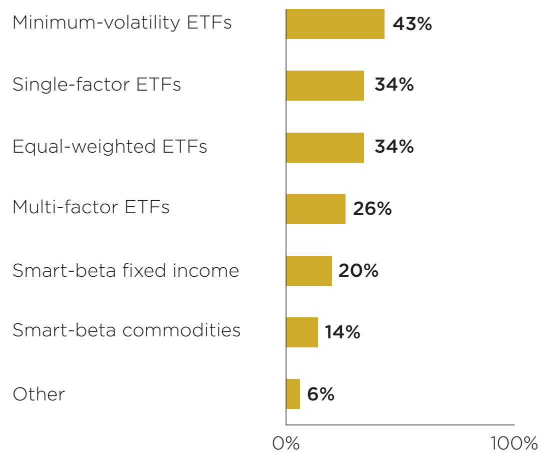
These and other relatively new strategies could be poised for growth given the sizable shares of institutions saying they are considering adding them to their portfolios or expanding existing allocations. Overall, almost 57% of current users of non-market-cap-weighted/smart-beta ETFs plan to increase allocations to these funds in the next 12 months, with 50% of those expecting to boost allocations by 10% or more.

Among ETF users in the study, 34% say they are thinking about making a first investment or increasing existing allocations to single-factor ETFs and/or equal-weighted ETFs, and 43% are considering such a move in minimum-volatility funds. About a quarter are thinking about exposure to multi-factor ETFs.

Other new ETF types are also gaining a toehold among European institutions. Approximately 16% of institutions in the study invest in currency-hedged ETFs, which they are using primarily in long-term risk management strategies, and also to hedge short-term exposures and to generate short-term tactical returns. In the U.S., usage of currency-hedged ETFs has climbed to 30% of institutions, and Greenwich Associates expects the funds to gain popularity among European institutions in coming years.

GROWTH IN SMART-BETA ETFs

Do you expect to invest in or add to allocations in the following strategies:



Note: Based on 35 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

5. Boom in Multi-Asset Funds Fuels ETF Demand Among Asset Managers

The increasing popularity of multi-asset funds among European investors represents an important source of potential growth for ETFs in the institutional channel. Multi-asset funds are attracting institutional investors across Europe and especially in the United Kingdom, where a quarter of corporate and local authority pension plans now invest in the funds. Reflecting this growing demand, 79% of the asset managers participating in the 2015 study offer multi-asset funds in which they employ ETFs to gain exposures.

Within these funds, the asset managers invest 22% of total assets in ETFs, making ETFs the second most important investment vehicle behind only individual securities, which represent 38% of assets.

The widespread use of ETFs in multi-asset strategies could presage future growth in approaches that utilize ETFs' unique characteristics to an even greater extent. Approximately one-quarter of the asset managers in the study say they are likely or very likely to offer a strategy made only or predominately with ETFs.

Selecting ETFs and ETF Providers

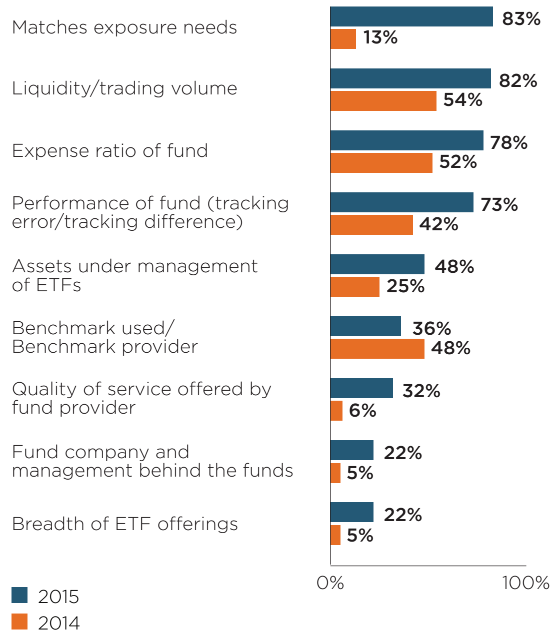
As ETFs take on an increasingly important role in institutional portfolios, institutions are becoming more careful and discerning in their selections of ETFs and ETF providers. Every year, Greenwich Associates asks institutions participating in our ETF study to identify the factors they view as important criteria when selecting an individual ETF or ETF provider. From 2014 to 2015, the number of citations increased significantly for many of the factors listed. In 2014, no single selection criterion was cited as important by as many as 70% of the institutions in the study. In 2015, no fewer than four factors received that level of mention: alignment with the institutions' exposure needs, liquidity/trading volume, expense ratio, and performance of the funds (including tracking error).

Shift to Strategic Drives Due Diligence

The importance of that first factor—match with exposure needs—gives evidence of ETFs' changing role in institutional portfolios. In 2014, alignment with exposure needs ranked only sixth in these terms, well behind considerations like fund structure and benchmark used. The growing number of institutions citing this factor as an important element in their selection process indicates that ETFs increasingly are being employed as a means of obtaining long-term or strategic investment exposures. In turn, as institutions employ ETFs in functions that are essential to their investment strategies, they are placing greater emphasis on due diligence surrounding the selection process and paying more attention to a wide range of fund characteristics.

PRIMARY CRITERIA USED WHEN SELECTING AN ETF

(Criteria cited as "Very Important")



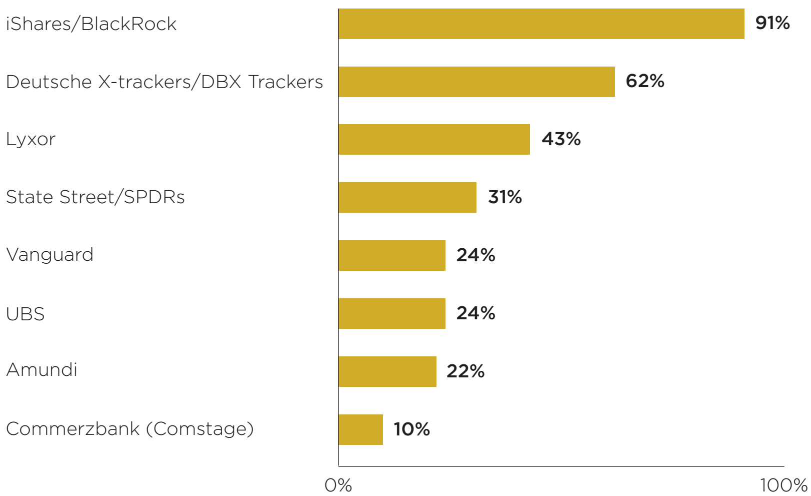
Note: Based on 68 responses in 2015 and 83 in 2014.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

ETFs increasingly are being employed as a means of obtaining long-term or strategic investment exposures.

BlackRock's iShares is Top Choice of Institutions

Based on these criteria, iShares, the exchange-traded fund division of BlackRock, ranks as the preferred provider of ETFs. Ninety-one percent of institutional ETF users in the study use iShares as a provider, followed by Deutsche X-trackers/DBX Trackers at 47% and Lyxor at 43%. The institutions name iShares as best in class in ETF liquidity, value for the management fees, range of product offerings, index tracking, innovation, product transparency, and service platform.

PROPORTION OF RESPONDENTS USING EACH ETF PROVIDER*



Note: *Other mentions included Credit Suisse, Global X Funds, PIMCO, PowerShares, and Source UK Services. Based on 58 responses.
Source: Greenwich Associates 2015 European Exchange-Traded Funds Study

Conclusion

Future growth of ETFs in the institutional channel will be driven by the new and increasingly sophisticated applications European institutions continue to discover for the funds within their investment portfolios. While ETF expansion has been mainly an equities phenomenon to date, adoption of fixed-income ETFs has also grown over the last several years. This trend should continue, and with almost all institutional ETF users employing the funds in equities, equity allocations remain on a solid trade for growth.

But the combination of a diverse slate of institutional needs and the inherent flexibility of ETFs will spur the spread of the funds into new areas. In fixed income, liquidity shortages will fuel demand for ETFs. Across portfolios, institutions are increasingly viewing ETFs as portfolio building blocks, using the funds to obtain core investment exposures and to replace less cost-effective futures positions. Consequently, as the number of funds grow and liquidity rises, the "toolbox" for institutions will become larger and more robust.

Already, the increasing popularity of multi-asset funds is boosting the use of ETFs among the soaring numbers of asset managers offering these products. Greenwich Associates expects innovation among product providers to fuel additional growth as institutions find applications within their portfolios for smart-beta ETFs and other new fund types.

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