Q2 2018

European Institutions Explore New Asset Classes with ETFs

GREENWICH ASSOCIATES

CONTENTS

3 Executive Summary

4 Introduction

5 Drivers of Growth

6 ETFs in the Portfolio Management Toolbox

7 Rapid Growth in Equities

8 New Users Boost Bond ETFs

10 Versatility Drives ETF Expansion

11 Smart Beta: The Growth Trend Continues

13 Multi-Asset Funds: Room for Growth

13 Growing Comfort, Fewer Obstacles

14 iSHARES/BlackRock Is Top European ETF Provider

Managing Director Andrew McCollum advises on the investment management market globally.

EUROPEAN INSTITUTIONS ARE FINDING ETFs TO BE SIMPLE, VERSATILE AND COST-EFFECTIVE TOOLS, AND ARE RAPIDLY RAMPING UP THEIR INVESTMENTS

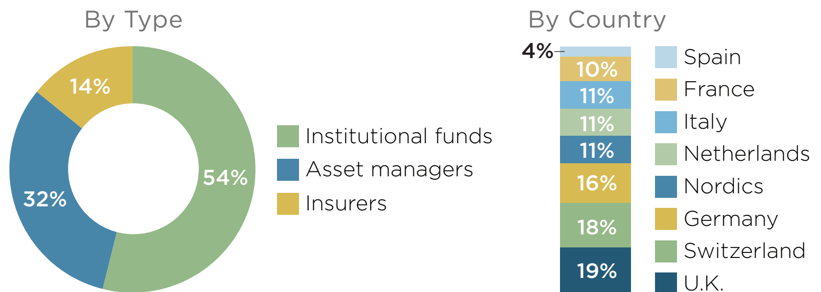
47% OF STUDY PARTICIPANTS HAVE SHIFTED FROM DERIVATIVES PRODUCTS TO ETFs IN THE LAST YEAR

METHODOLOGY

Between October and December 2017, Greenwich Associates interviewed 125 institutional investors for its fourth annual edition of the European Exchange-Traded Funds (ETF) Study. The research universe included 68 institutional funds, 40 asset managers and 17 insurance companies/insurance company asset managers. Corporate pension funds and asset management firms are the most widely represented, followed by insurance companies and public pension funds.

Most of the participants are large institutions. Sixty-four percent of the institutions in the study have assets under management (AUM) of more than $5 billion, up from 55% in 2016 and 50% in 2015. Among the participants in this year's study, 39% manage more than $20 billion, and 26% have AUM in excess of $50 billion. Institutions in the study manage approximately half of assets internally, on average. Respondents also represent a wide range of countries, including France, Germany, Italy, the Netherlands, Nordics, Spain, Switzerland, and the United Kingdom.

RESPONDENTS



Executive Summary

European institutional investors are adjusting their portfolios to a set of fast-changing conditions that include the return of volatility to global capital markets, the impending end of European Central Bank bond buying and the looming shift to a rising-rate environment. As they do so, institutions are integrating exchange-traded funds (ETFs) more deeply into their investment processes and strategies.

Average ETF allocations among the institutions participating in Greenwich Associates annual European Exchange-Traded Funds Study increased to 10.3 % of total assets in 2017 from just 7.7% in 2016. This growth reflects the continuing adoption of ETFs into institutional portfolios as a standard means of obtaining beta exposures and the introduction of ETFs to a long list of portfolio functions, both strategic and tactical. ETFs are spreading into asset classes outside equities and fixed income. For example, one-third of study participants in 2017 are investing in commodity ETFs, up from 20% the prior year.

Multi-asset investment funds have emerged as one of the most consistent and fast-growing sources of ETF demand in the institutional channel.

Two additional trends are boosting institutional demand for ETFs in Europe:

- ***Investments in non-market-cap weighted/smart beta ETFs are growing steadily in institutional portfolios.*** *The share of study participants investing in these funds has increased 10 percentage points in just two years, to 31%. Half the asset managers participating in the 2017 study are using these products. Given the increasing popularity of factor investing worldwide, demand for smart beta ETFs is expected to continue growing in both retail and institutional portfolios.*
- ***Multi-asset investment funds have emerged as one of the most consistent and fast-growing sources of ETF demand in the institutional channel.*** *As investor appetite for these strategies grows, the share of European asset managers buying ETFs for use in multi-asset funds increased to approximately 80% in 2017 from 63% in 2016. Even with this strong momentum there is room for growth, since European asset managers running multi-asset funds allocate far fewer portfolio assets to ETFs than do their counterparts in the United States.*

Given these powerful trends, ETFs will likely remain on a growth trajectory through the coming year. Approximately 40% of study participants currently investing in equity ETFs plan to increase ETF allocations in that asset class in the next 12 months, as do a quarter of current fixed-income ETF investors. More broadly, Greenwich Associates projects that total global institutional investment in ETFs will see U.S.$300 billion in flows annually by 2020.

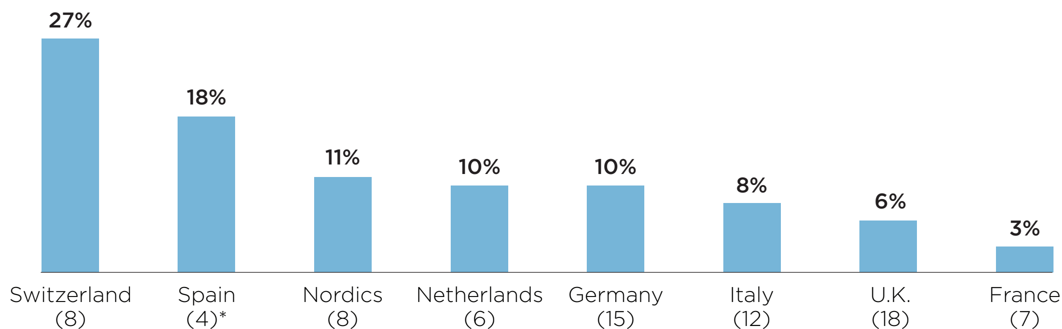
Amid this steady growth, iShares/BlackRock has maintained its position as European institutions' ETF provider of choice. iShares/BlackRock is used as an ETF provider by 9 out of 10 study participants and is considered by these institutions as the "best-in-class" provider in all nine of the product and service categories assessed in the study.

Introduction

The institutions participating in the Greenwich Associates 2017 European Exchange-Traded Funds Study express real concerns about their ability to find attractive investment opportunities at a time when yields remain near historic lows and asset valuations have increased rapidly. Combined with expectations of rising interest rates and "quantitative tightening," institutions are on watch for a spike in volatility and disruptive market events driven by unforeseen factors—concerns that became all too real in the sudden market sell-off of February 2018. Further complicating matters is the ongoing implementation of MiFID II and other new regulations, a process that prompted 40% of study participants to include regulatory compliance among their top challenges for the year ahead.

As institutions create and implement strategies to meet these challenges, they are making greater use of exchange-traded funds (ETFs), introducing them into a long list of functions that support their investment and portfolio management processes. After five or more years of regular use, European institutions have found ETFs to be simple, versatile and cost-effective tools, and they are ramping up their investments at a rapid clip. Average ETF allocations among study participants increased to 10.3% of total assets in 2017, up from just 7.7% in 2016. Among European asset managers and insurance companies, allocations in 2017 averaged 11.6% and 11.8% of assets, respectively, and approximately 1 in 10 European institutions overall now allocate more than 20% of total assets to ETFs.

AVERAGE ALLOCATION TO ETFs BY COUNTRY



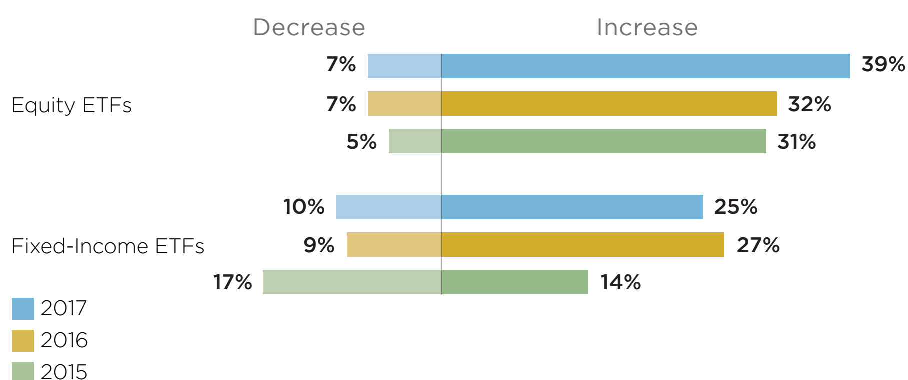
Note: Numbers in parentheses reflect number of respondents from each country. *Small base count.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Much of the growth over the past year can be attributed to the entry of new institutional users to the ETF market—especially in fixed income. The share of study participants investing in fixed-income ETFs increased to 45% in 2017 from 38% in 2016. Institutions are adopting ETFs in other asset classes as well. Approximately one-quarter of European institutions used ETFs in REITs in 2017, up from 1 in 5 in 2016. Over the same period, the increase in commodities was even more pronounced, with use climbing to one-third of European institutions, up from just 20%.

The continuing introduction of ETFs to new asset classes and portfolio functions is also creating new demand from existing investors. Roughly 40% of European institutions currently investing in equity ETFs plan to increase allocations in the coming year. Those plans are considerably more bullish than those of 2016, when one-third of study participants said they were planning to boost allocations to equity ETFs.

Meanwhile, European institutions will continue adding to ETF holdings in a growing list of fixed-income products, both domestic and international. A quarter of current fixed-income ETF investors in the study plan to increase allocations in the coming year.

EXPECTED CHANGE IN ALLOCATIONS TO ETFs IN NEXT 12 MONTHS



Note: Based on 36 respondents for fixed income and 58 for equity in 2015, 44 respondents for fixed income and 69 for equity in 2016, and 48 respondents for fixed income and 57 for equity in 2017.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

In this report, Greenwich Associates presents the full results of its 2017 European ETF Study—including a close analysis of the factors driving the growth of ETF holdings in institutional portfolios and a look at the top providers of ETFs to institutional investors in Europe.

Drivers of Growth

Over the past decade, ETF fund flows have received a consistent boost from the rising tide of passive strategies in the portfolios of institutions in Europe and around the world. Among European institutions that have used ETFs to replace other investment vehicles, by far the most commonly displaced have been underperforming active mutual funds. As the Head of Asset Management for an Italian institutional fund explains, "When the production of alpha by active managers is very low—for example in the American market—it is obviously more appropriate to use ETFs."

ETFs in the Portfolio Management Toolbox

In recent years, institutions have started using ETFs more broadly as a source of "beta" exposures in an expanding list of applications ranging from short-term, tactical portfolio functions and hedging strategies to long-term and core investment positions—in both passive and active strategies. "You can buy an ETF and you are immediately exposed to the systemic risk of that index, without cherry-picking," says a portfolio manager for a Dutch insurance company.

After a period of experimentation, institutions have adopted ETFs, alongside mutual funds, derivatives and other vehicles, as a standard tool for capturing these exposures. Prior to integrating ETFs into their investment processes, European institutions report using several main vehicles to capture beta exposures. Two-thirds of study respondents use futures, making these investors the world's heaviest futures users. (By comparison, only 35% of U.S. study respondents employ futures.) Approximately half of European study respondents use index mutual funds for beta exposures, and slightly more than a third use separate accounts/mandates for beta exposure.

Institutions are adding ETFs into that mix. Although ETFs generally supplement these other vehicles, they are replacing other sources of beta exposure in certain spots. "We evaluate case by case," says a representative of a Nordic institutional fund. "[We evaluate] costs compared to liquidity and the holding period. Typically, if our holding period is short, then it would be futures. If the holding period should be longer, then we tilt toward ETFs."

Over the past year, nearly half the study respondents have replaced derivatives positions with ETFs. That represents a significant increase over 2016, when only 35% of study respondents reported making this switch. Most institutions making that move in 2017 did so for the operational simplicity provided by ETFs. Smaller shares say they switched to comply with regulations or to lower rolling costs.

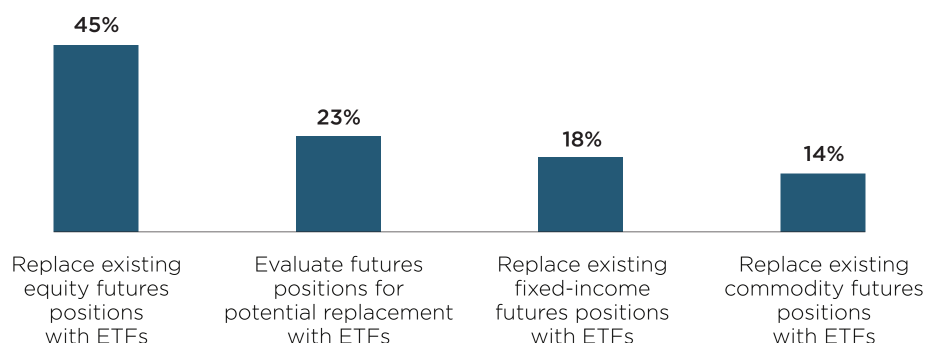
"For medium-term investments, I think that ETFs are more efficient than futures, both as far as the costs are concerned and also as far as the operative effort goes," says a portfolio manager for a German asset management firm.

Several asset managers in the study use ETFs for clients that prohibit the use of derivatives. Other participants say ETFs provide a valuable alternative in markets without liquid exchange-traded derivatives. "Exchange-traded derivatives are the first port of call because they do not have any management fees attached," says a multi-asset portfolio manager for a U.K. asset management firm. "ETFs are the next cheapest option. They have relatively low fees and trade on a relatively tight offer spread."

"ETFs are the next cheapest option. They have relatively low fees and trade on a relatively tight offer spread."

~Multi-asset portfolio manager for a U.K. asset management firm

INSTITUTIONS INTEGRATING ETFs INTO MIX OF BETA VEHICLES



Note: Based on 22 respondents.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Looking ahead, 45% of European institutions in the study plan to replace an equity futures position with ETFs in the next year. Approximately 1 in 5 expect to use ETFs to replace a fixed-income futures position, and a smaller but still meaningful 14% plan to make the same switch in commodities. Roughly a quarter of study respondents say they are evaluating the pros and cons of this option and could swap out derivatives for ETFs in the future. Together, these findings suggest that institutions will come to rely even more heavily on ETFs as a source of beta exposure.

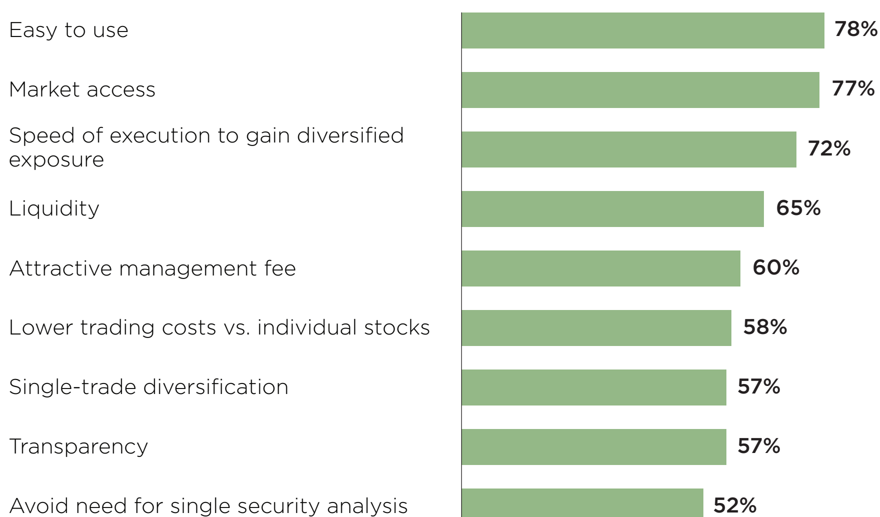
Rapid Growth in Equities

The Greenwich Associates ETF Study has tracked the steady growth of ETFs in European institutional portfolios for the past four years. That growth is likely to continue in the coming year. Of the 40% of study participants planning to increase existing allocations in the next 12 months, 43% expect to boost these allocations by 5% or more, and about 1 in 10 are planning increases in excess of 10%. Meanwhile, approximately a quarter of study participants not currently using equity ETFs say they are "somewhat" or "very" likely to make their initial investments in the next year.

Institutions are attracted to equity ETFs by a range of benefits. Topping the list are ETFs' ease of use, speed of execution, liquidity, and relatively low costs.

"We use ETFs when we wish to modify our asset allocation quickly and dynamically," says an equity portfolio manager for a French institutional fund. "The benefit we have found is the possibility of interceding at any time during the day on the market levels of our choice without having to wait for the next day's valuation on closed funds and to quickly get out from the market when we find the level unattractive."

TOP REASONS FOR USING EQUITY ETFs



Note: Based on 60 respondents.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Several other study participants say they use equity ETFs for markets and products in which liquidity can otherwise be scarce and research for individual security selection can be time-consuming and expensive. "We focus on ETFs to gain exposure in small- and mid-cap portfolios, in particular in North America," explains the CEO of a U.K. pension fund. "For one person to look at 3,000 stocks is a tall order."

Finally, many investors use equity ETFs to take on international market exposures and diversify their portfolios. "We use ETFs mainly to get quick equity exposure to the European market," says a portfolio manager for a Dutch insurance company. "They allow us to trade quickly and gain this exposure quickly."

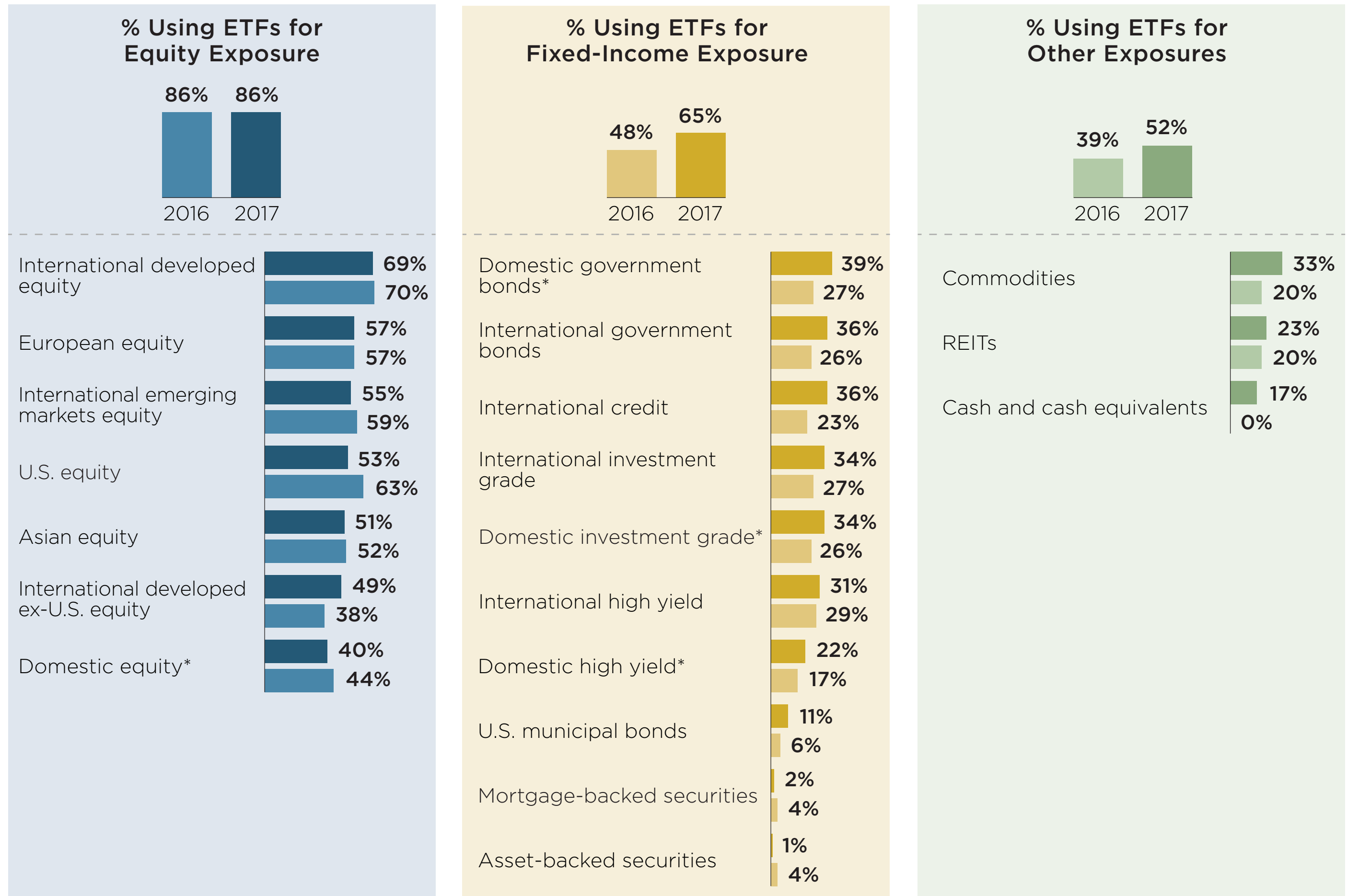
New Users Boost Bond ETFs

ETFs are expanding their presence in European institutional fixed-income portfolios. The share of current investors employing ETFs in fixed income jumped to approximately two-thirds in 2017 from just 48% in 2016. Globally, that adoption rate ranks second only to that in the United States, where 71% of ETF investors are using fixed-income ETFs. In Asia, a growing 44% of study participants use fixed-income ETFs; in Latin America, 30%.

ETF use increased last year in 8 of the 10 fixed-income products covered in the Greenwich Associates European study. (Mortgage-backed and asset-backed securities were the only products in which ETF usage did not increase during the period.) Usage rates are highest in domestic government bonds, where ETF use increased to 39% of ETF investors in 2017 from 27% in 2016. Reflecting European institutions' continued drive to diversify investment portfolios, the biggest jump in adoption rates last year came in international government bonds, where use

increased to 36% of ETF investors from just 26%. (By comparison, about a third of Asian institutions and a quarter of U.S. institutions use ETFs in international bonds.)

ETF USE



Note: *Your own country. Based on 93 respondents in 2016 and 83 in 2017.
Source: Greenwich Associates 2016 and 2017 European Exchange-Traded Funds Studies

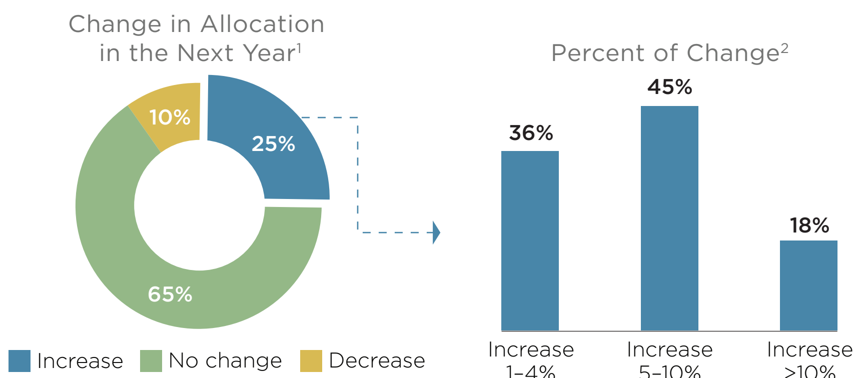
These nearly across-the-board increases helped drive the growth in ETF allocations among current investors to 9.6% of total fixed-income assets in 2017 from 8.1% in 2016. That steady expansion should continue in the year ahead. Of the 25% of existing fixed-income ETF users that are planning to increase allocations in the year ahead, most expect to boost allocations by 5% or more. About 1 in 5 of these respondents plan to boost allocations to fixed-income ETFs by 10% or more.

"Our principal use of ETFs is to displace cash bonds and access corporate bond market beta," says the Co-Head of Fixed-Income Portfolio Management for a U.K. asset manager.

The factors attracting institutional assets to bond ETFs are much the same as those driving interest in equities, with current investors citing benefits relating to ease of use, fast access, and relatively low fees and overall costs. In fixed income, however, institutions place considerably

more emphasis on ETF liquidity. Since the global credit crisis and subsequent regulations that increased bank capital reserve requirements, institutions in Europe and around the world have reported decreases and periodic disruptions in fixed-income market liquidity.

ALLOCATION OF FIXED-INCOME ETFs IN THE NEXT YEAR



Note: [1]Based on 48 respondents. [2]Based on 11 respondents.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Concerns about liquidity have fueled demand for ETFs throughout that period, and continue to do so today. "We have not really had a major challenge or problems in the market, but when things get stressed or create problems in the market, we need to get out of it fast and get the right market price," says the Head of Fixed Income for a Nordic institutional fund, explaining why his fund is stepping up its use of ETFs. The Director of Finance for an Italian insurance company recounted his own experiences with times of stress: "At a time of high volatility in financial markets, January–February 2013, some portfolios that had ETF holdings allowed for a quick selloff and were faster at exiting the market."

ETF FUND FLOWS: INDICATOR OF INVESTOR SENTIMENT?

Two-thirds of European institutions in the study, including 80% of the asset managers, monitor ETF flows as part of their basic investment processes. The reason: These institutions believe ETF flows can be used as an indicator of investor views and future market direction.

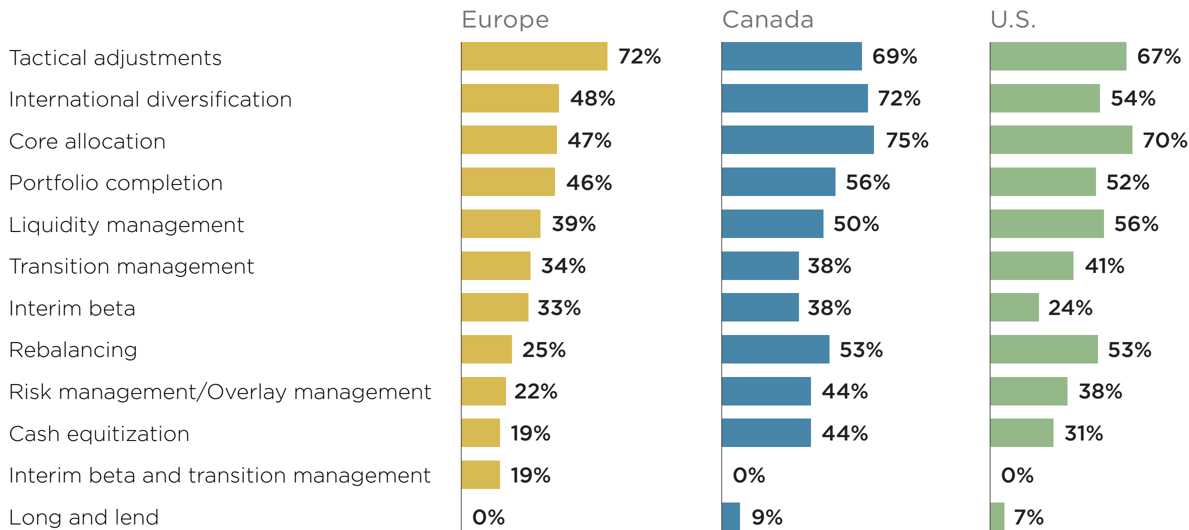
Versatility Drives ETF Expansion

In institutional equity and fixed-income portfolios around the world, the recent growth of ETFs is a function of versatility, which allows investors to apply ETFs to a long and diverse list of portfolio applications, both tactical and strategic. European institutions use ETFs most often to make tactical adjustments to their portfolios. Although also employed for a range of other short-term "tactical" tasks, such as transition management, interim beta and cash equitization, almost half of study participants use ETFs for essential strategic functions like obtaining "core" allocation investment exposures and achieving international portfolio diversification.

"We use ETFs for fast allocations," says a managing director for a European asset manager. "For tactical and rapid allocation decisions." At the other end of that spectrum, a portfolio manager for a German insurance company says "favorable costs and a good fit for our asset classes" make ETFs an effective tool in assembling the funds' strategic asset allocation.

Current ETF investments are about evenly divided between tactical and strategic holdings, and roughly half of institutions report average holding periods of a year or longer—a timeframe generally associated with strategic, as opposed to tactical, investments. By comparison, average holding periods top one year for 77% of institutional ETF investors in the United States and 57% of institutions in Asia.

ETFs USED FOR A BROAD VARIETY OF APPLICATIONS



	Europe	Canada	U.S.
Tactical adjustments	72%	69%	67%
International diversification	48%	72%	54%
Core allocation	47%	75%	70%
Portfolio completion	46%	56%	52%
Liquidity management	39%	50%	56%
Transition management	34%	38%	41%
Interim beta	33%	38%	24%
Rebalancing	25%	53%	53%
Risk management/Overlay management	22%	44%	38%
Cash equitization	19%	44%	31%
Interim beta and transition management	19%	0%	0%
Long and lend	0%	9%	7%

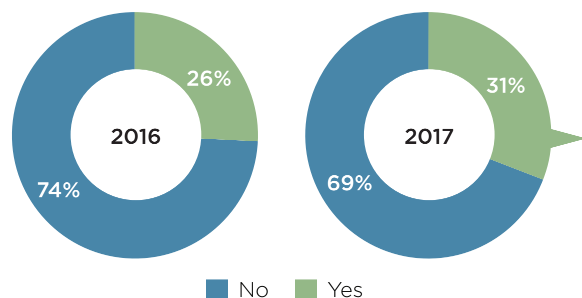
Note: Based on 83 respondents in Europe, 32 in Canada and 138 in the U.S.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Smart Beta: The Growth Trend Continues

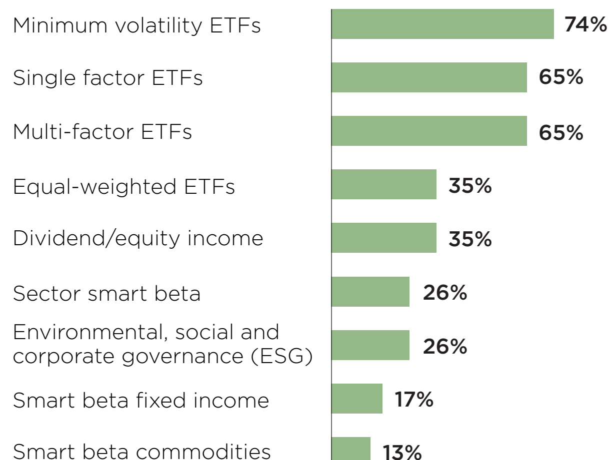
Investments in non-market-cap weighted/smart beta ETFs are growing steadily in institutional portfolios. Thirty-one percent of European institutions in this year's study invest in smart beta ETFs, up from 26% in 2016. Half the asset managers participating in the 2017 study are using these products.

DEMAND FOR MIN-VOL STRATEGIES BOOST INVESTMENT IN SMART BETA

Use of Non-Market Cap Weighted/Smart Beta[1]



Type of Smart Beta/Factor ETFs[2]



Type	%
Minimum volatility ETFs	74%
Single factor ETFs	65%
Multi-factor ETFs	65%
Equal-weighted ETFs	35%
Dividend/equity income	35%
Sector smart beta	26%
Environmental, social and corporate governance (ESG)	26%
Smart beta fixed income	17%
Smart beta commodities	13%

Note: [1]Based on 93 respondents in 2016 and 84 in 2017. [2]Based on 23 respondents in 2017.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Much of this growth can be attributed to the increasing popularity of factor investing among investors around the world. Indeed, 60% of smart beta ETF investors in the study say they use these funds primarily to implement their investment views on specific factors such as momentum, value and growth.

Both single factor and multi-factor ETFs rank among the most popular categories in non-market-cap weighted/smart beta ETFs. However, in every year since the debut of the Greenwich Associates study in 2014, the most popular product with European institutions has been minimum-volatility ETFs. This reflects both the growing interest in factor investing and institutions' continuing concerns about a potential spike in market volatility.

Smart beta momentum appears to be carrying over into 2018 and beyond. Nearly 40% of existing investors in non-market-cap weighted/ smart beta ETFs plan to increase allocations to these funds in the next 12 months, while none plan a decrease. Most institutions plan to increase allocations by at least 5%, and about 1 in 5 current investors expect to boost allocations by 10% or more. Similar results from research among institutions in North America and Asia suggest that global demand for smart beta ETFs will continue to grow for the remainder of 2018.

COMMITMENT TO ESG BOOSTS ETF DEMAND

One factor contributing to the growing institutional demand for smart beta ETFs in Europe is the increasing importance of environmental, social and governance (ESG) considerations in institutional investment decisions and strategies. A third of study participants investing in non-market-cap weighted/smart beta ETFs are using ESG ETFs.

Fully 43% of European institutions overall and 55% of asset managers believe ESG overlays/investments enhance the likelihood of strong investment returns over the long term. Those beliefs set European institutions apart from their peers in other markets.

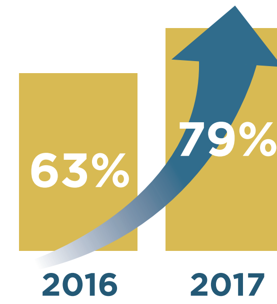
European institutions are already putting their ESG beliefs into action: Roughly half of study participants have sold out of certain strategies or invested in new strategies as a result of ESG considerations (versus 31% of global institutions.) Twenty-seven percent of European institutions overall and 36% of asset managers invested in index products when implementing those changes. These actions have put European institutions at the forefront of ESG investing globally. By way of comparison, only 15% of U.S. study participants have sold out of strategies or invested in new strategies as a result of ESG considerations.

Multi-Asset Funds: Room for Growth

Multi-asset investment funds have emerged as one of the most consistent and fast-growing sources of ETF demand in the institutional channel. As investor appetite for these strategies grows, the share of European asset managers buying ETFs for use in multi-asset funds has increased to approximately 80% in 2017 from 63% in 2016.

Even with this strong momentum, there is room for growth. Within their multi-asset funds, European asset managers participating in the 2017 study are investing about a quarter of total assets in ETFs. By comparison, U.S. multi-asset fund managers invested 58% of total assets in ETFs in 2017, up from 55% in 2016 and 50% in 2015. Given that steady upward trajectory in the U.S. and the gap in ETF usage between multi-asset fund managers in the two regions, Greenwich Associates projects continued growth in ETF demand among asset managers marketing multi-asset funds to clients in Europe.

Strong growth in asset managers' use of ETFs in multi-asset funds



Growing Comfort, Fewer Obstacles

Although institutions still face obstacles in investing in ETFs, many of the impediments that limited ETF use in past years are starting to give way, opening the door for higher levels of future activity and investment. These impediments include internal investment guidelines, regulations, previously legitimate concerns about ETF structure and liquidity, and some pervasive myths.

Case in point: Almost two-thirds of European investors now say the once commonly held belief that the low prices of ETFs reflect a low-quality product is a misconception. A majority of institutions in the study say ETF providers are doing a good job in providing information and educational materials that help to dispel this and other similar myths.

Meanwhile, fewer institutions are citing concerns about liquidity as a reason for abstaining from investment. Over the past 12 months, only 20% of non-users named liquidity as the main driver of their decision not to invest, down from 42%. After five-plus years of growing institutional use, most portfolio managers have seen their peers not only trade ETFs seamlessly, but actually enhance portfolio liquidity through the use of the funds. In fact, in both equity and fixed income, current institutional users cite liquidity benefits as one of their top reasons for using ETFs. This has been the case particularly in fixed income, where investors have experienced a general reduction in liquidity marketwide.

A similar process is playing out with regard to fees and costs. Thirty percent of institutions that don't use fixed-income ETFs cite expenses as a reason for not investing. That share approaches 40% among institutional funds. However, when current ETF investors are asked to name the primary reasons they continue using fixed-income ETFs, 68% cite low management fees and 46% cite lower trading costs versus cash bonds. As more institutions realize cost savings by using ETFs, more holdouts with concerns about ETF costs will enter the market.

Nevertheless, substantive obstacles still exist. Almost 30% of non-users say they are prohibited from investing in the funds. Most are restricted by internal organizational rules or portfolio investment guidelines/methodology. Greenwich Associates expects that share to decline steadily in coming years. Almost half of institutions not currently investing in fixed-income ETFs cite internal guidelines and restrictions as their primary reason for abstaining, as do 35% of institutions planning to reduce existing equity ETF portfolios in the next 12 months.

However, with so many European institutions actively and successfully integrating ETFs into their portfolios, growing numbers will likely conclude that these internal prohibitions are outdated or unnecessary. The same trajectory should hold true for regulations. A small but not insignificant share of European institutions say they would need regulatory or accounting changes to start investing in ETFs. It seems unlikely that regulatory bodies will maintain prohibitions or limitations on ETFs, however, as use of the funds becomes standard practice globally. To that end, only a small number of institutions think their use of ETFs will be affected by this year's implementation of MiFID II. Specifically, 3% plan to begin using ETFs as a result of regulatory reforms, while another 11% plan to conduct more research on the topic.

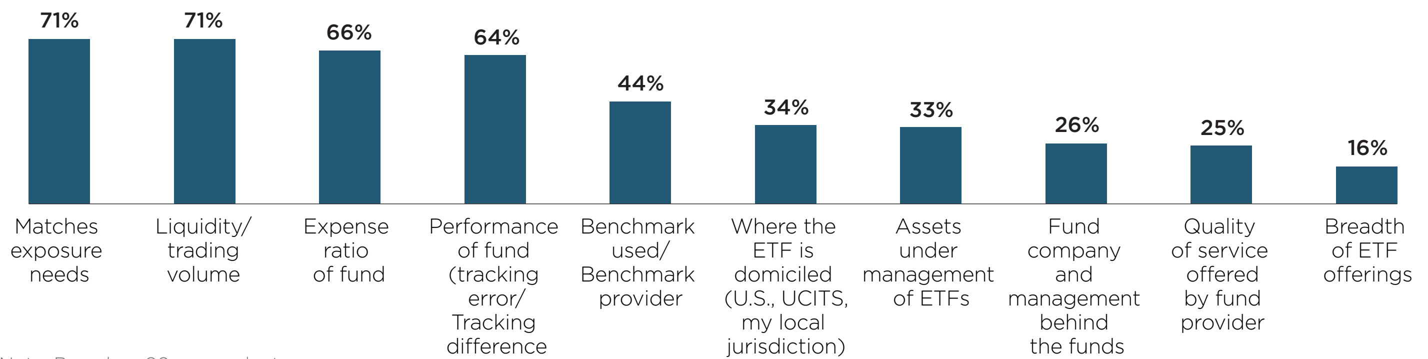
IMPROVEMENTS IN ETF PLATFORMS, TOOLS AND INFORMATION

Improvements in technology platforms and a proliferation of ETF information sources have helped bring institutions into the market and fueled ETF investment. Almost 80% of institutions in the study say they have the tools they need to analyze and compare ETFs to other investment vehicles, such as futures and swaps.

iSHARES/BlackRock Is Top European ETF Provider

When it comes to selecting a specific ETF for investment, European institutions first and foremost seek out ETFs that most closely match their exposure needs. In comparing funds within this group, institutions assess three primary factors: liquidity/trading volume, expense ratio and fund performance, including tracking error. Next, institutions analyze a range of additional criteria including benchmark employed and the AUM, reputation and service quality of the fund company behind the ETF.

IMPORTANT FACTORS WHEN SELECTING ETFs

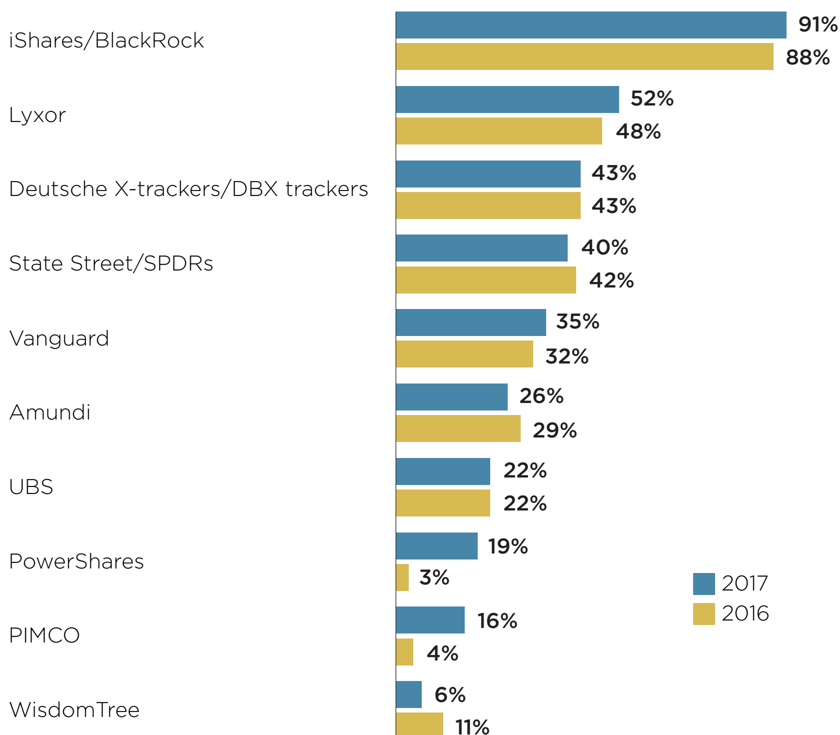


Note: Based on 86 respondents.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

Based largely on those criteria, European institutions have selected iShares/BlackRock as their ETF provider of choice. Nine out of 10 institutions participating in the 2017 European ETF Study use iShares/ BlackRock as an ETF provider.

For the fourth consecutive year, study participants name iShares/ BlackRock as the market's best-in-class provider in all nine of the product and service categories assessed by Greenwich Associates in this year's study, including liquidity, range of products, exposures and domiciles, value for management fee, index tracking, use of institutional quality benchmarks, servicing platform, innovation, product transparency, and commitment to local markets (presence in the European market).

TOP ETF PROVIDERS



Note: Based on 91 respondents in 2016 and 77 in 2017.
Source: Greenwich Associates 2017 European Exchange-Traded Funds Study

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greenwich.com ContactUs@greenwich.com Ph +1 203.625.5038

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