



European Investor Research 2015 The Emergence of a New Era in Index Investing

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Contents

- 1
The search for alternative investment tools
 - Motivations for investing
 - Recognition of cost efficacy in the UK
 - Route to investing in smart beta
 - Non-users

- 2
From concept to action: a new era in factor-based index investing
 - Common challenges facing investors
 - Strategies and implementation of smart beta
 - Funding smart beta

- 3
The state of smart beta and its potential future
 - Potential demand from non-users
 - Future of smart beta
 - Allocation history
 - In summary

- Appendix
 - Sample and methodology

Welcome

As head of Invesco PowerShares EMEA, I am delighted to share our second research report with you: The Emergence of a New Era in Index Investing. This year we have expanded our study to include a total of 320 interviews across Germany, Italy, Switzerland and the UK.

Having increased in usage over the last few years, smart beta has become an increasingly important part in many investors' portfolios. Originating in academia, specifically the Fama-French model, many smart beta strategies emerged and were commercialised by providers. More recently, they have extended into European markets.

Despite variations, a common story exists and details of the transition and adoption of factor-based indices within Europe are covered in this year's report.

We have a wealth of data from this year's research but a few key themes have emerged:

- Outcome is pivotal. According to respondents, smart beta is used to achieve a specific outcome: lowering volatility, isolating a factor like dividends, or outperforming the traditional benchmarks, to name a few.
- Users of smart beta consider it to be more of an active strategy than a passive strategy. Although it incorporates passive traits (fully invested, scalable, efficient, transparent, lower cost), in users' minds it's an active strategy as they track performance closely, evaluate portfolio attribution and conduct due diligence in the same way they would for active strategies.
- Usage is already pronounced but respondents indicate significant increases expected over the coming years.

This year we have worked with independent research company, CoreData Research, to gauge the mindset of professional investors and those with influence over the investment decisions of their respective organisations. The respondent pool represents a spectrum of industry practitioners and is primarily comprised of portfolio managers, CIOs, gatekeepers, and fund analysts; users and non-users¹ of smart beta. We have segmented our findings into financial advisers and wealth respondents². 300 interviews were captured through an online questionnaire and 20 via telephone-based interviews.

This year's report looks specifically at the drivers, barriers to and implementation of smart beta and the potential for future adoption. We first investigate the momentum behind factor-based indexing and the reasons for using it. This is followed by a detailed analysis depicting the journey and challenges that existing users of smart beta faced as a guide to future potential users.

The research concludes with a summary of the market and the potential future demand for smart beta.

As a leading provider of smart beta strategies, Invesco PowerShares is committed to delivering high-level insight and education to the industry. I hope this report provides you with a clearer picture of smart beta investors and the future of smart beta in Europe. We look forward to discussing the findings with you in due course.

¹Smart beta 'users' are defined as respondents who have invested in smart beta strategies while 'non-users' are those that have zero allocations.

²Wealth respondents include general asset managers, discretionary fund managers, family offices, private banks, fund of funds, life insurance companies.



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Path to factor-based indexing

While we recognise that every investor is unique, our 2015 survey has enabled us to draw a typical journey of smart beta investing. The following diagram attempts to capture the access points and important steps, including the due diligence focus points that professional investors typically go through in their quest to invest in the most adequate smart beta strategy and product.

Route to smart beta (%)

Began with market cap-weighted indices



Invested directly from an active only investment position

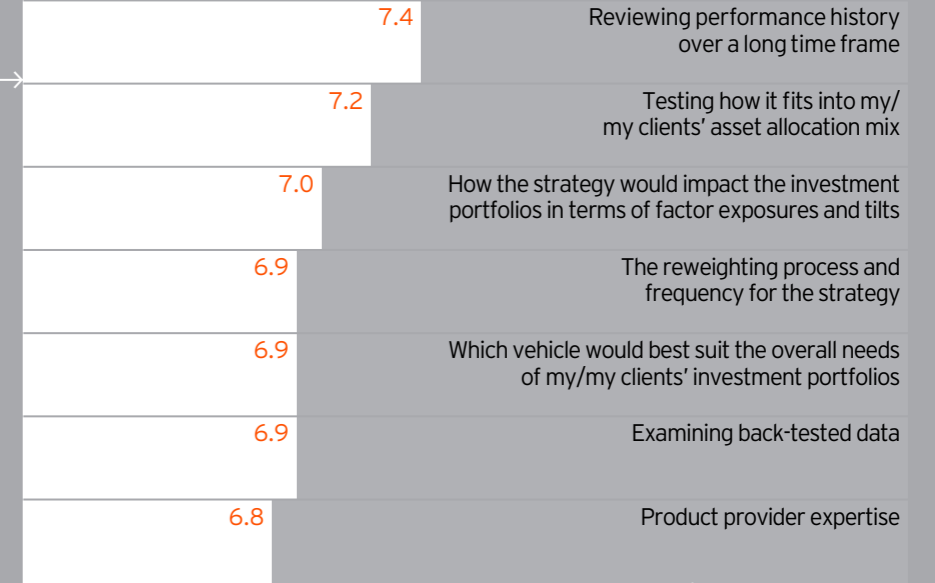


Top reasons for initial investment in smart beta¹



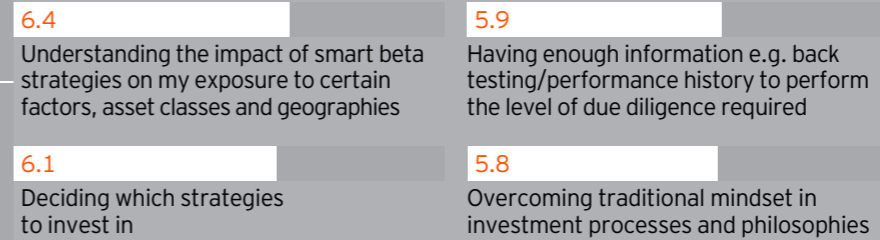
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Due diligence process¹



2

Main challenges¹



3

4

Popular initial strategies (%)



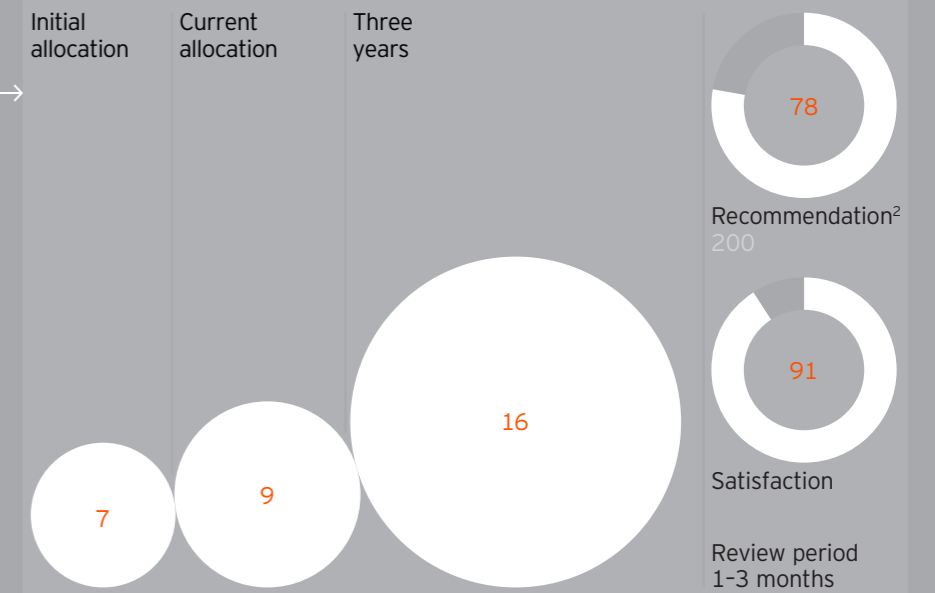
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Implementation of strategies (%)

Tactical and strategic approach 192		Germany	Italy	Switzerland	UK
As part of a strategic asset allocation only		51	42	33	46
As part of a tactical asset allocation only		20	40	55	49
As a part of strategic and tactical asset allocation		29	18	12	5
Core and satellite approach 114		Germany	Italy	Switzerland	UK
As a core holding only		30	29	22	46
As a satellite holding only		70	71	75	50
As a core and satellite holding		0	0	3	4

6

Evolution of smart beta allocation (%)



Sample size is 256, unless otherwise indicated in grey.
¹Importance rated 1-10 where 10 is most important.
²Recommendation to clients, colleagues and investment professionals. Smart beta users only.

1
The search for alternative
investment tools



The search for alternative investment tools

The emergence of factor-based indexing in Europe signals a new era for investors who now have access to an increasing range of investment tools. Our study found wealth respondents and financial advisers are increasingly turning to smart beta - something we believe, given its perceived flexible and efficient nature, can add value and help control a portfolio's risk/return profile in the context of challenging and often volatile markets. As an integral part of investor portfolios, smart beta currently makes up 9% of a user's total portfolio according to our research.

The momentum behind factor-based indexing is a relatively recent occurrence in the investment industry, with an increasing number of strategies being developed by providers aiming to meet varying investment needs and objectives. Having originated in academia and still maintaining strong links with scholarly research, smart beta is perceived by users as an additional and valuable tool that can help them with their investment goals. A central story can be told that details the transition and adoption of factor-based indices within Europe, and it is laid out in the coming chapters.

The investment challenge headwinds facing European investors are common across the region. According to our 2015 research, three main challenges abound: the low yield environment, difficulty in finding value, and assets becoming increasingly correlated. These challenges have helped shape the smart beta user mindset; traditional investment philosophies and strategies may not be meeting expectations and a portfolio could benefit from the implementation of factor-based indexing.

Keeping these challenges in mind, the majority of users agree smart beta strategies have the ability to perform in most market conditions. In the same vein, 65% think smart beta complements both purely active and purely passive strategies. This in turn should facilitate potential users' adoption as significant shifts in existing portfolio investment processes would not be required.

The incorporation of factor-based indexing or smart beta is at a preliminary stage. Figure 1 shows that 65% of users have only invested in strategies within the past two years. This in part is a reflection of the availability and awareness of smart beta strategies - something that is improving. "They've gained lots of traction in the past three to five years," said one respondent. "My knowledge of them comes from recent conferences, the media and our own internal meetings." Many users, it seems, waited to assess how strategies perform before investing, explaining further why a large number have only invested more recently.

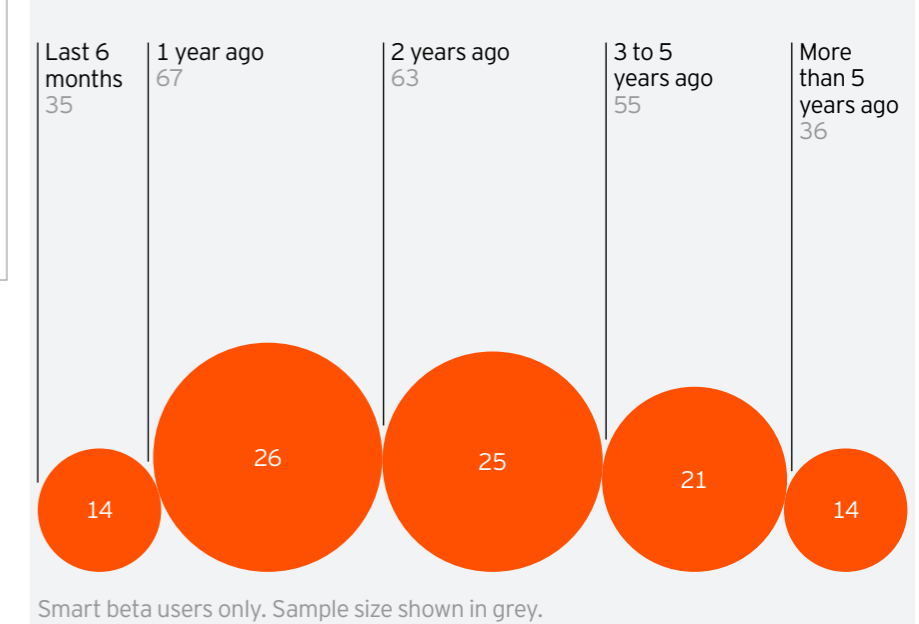
65% agree smart beta strategies complement both purely active and purely passive strategies

70% agree smart beta strategies can perform in most market conditions

"We know that gilt yields are at a three hundred year low, so we're very wary of any investments and we're looking for securities and instruments with a high degree of protection."

UK discretionary fund manager

Fig 1. Timings of initial allocation to smart beta – respondents (%)





Motivations for investing

Figure 2 highlights that the main reason for first investing in smart beta was a conviction in the selected strategy/philosophy, followed by a need for diversification. In both cases users in Germany are the strongest proponents. "I find it intellectually a bit more appealing in that it potentially provides a better weighting for investments rather than just overweighting larger companies." said a UK discretionary fund manager.

These strategies target a specific factor, fundamental or alternative weighting system, to gain the desired exposure to markets.

Smart beta attempts to go beyond geographical or market-cap considerations in traditional passive strategies, and serves portfolio construction in a multitude of ways. The choice of strategy is a vital part of the process when first considering smart beta. For example, some commonly used strategies and the investment aims they serve are cited by users in figure 3.

There is general agreement in the investment objectives these strategies aim to meet. For example, low volatility strategies have been used to potentially reduce risk according to 76% of users, while 68% have selected dividend strategies seeking to provide return. There are some strategies with multiple purposes, like fundamentally weighted strategies, and this is likely a result of the range of strategies within this category. Fundamental strategies can target different fundamentals such as a company's sales, cash flow, or book value.

Please note that the list of analysed strategies in this report represents a portion of the factor-based indexing universe.

Apart from conviction in a selected strategy, the quest for diversification is also a primary reason for investing in smart beta and ties in with one of the major challenges in achieving investment objectives: greater correlation among asset classes.

The evolution of smart beta demand is underpinned by the needs assessments and recommendations of professionals within the industry rather than external demand from clients. The movement has been expanded from within the investment industry itself, which continually seeks to add additional solutions aiming to overcome investment challenges. Adopters are either using their discretion to invest on behalf of clients or mandates, promoting the benefits to internal investment decision makers or recommending clients to invest in smart beta.

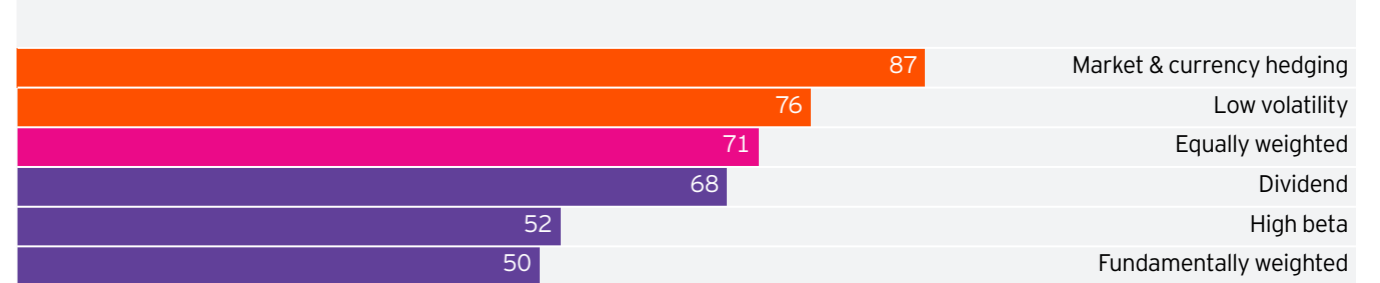
With this confidence, wealth respondents and advisers are positioning smart beta to clients in multiple ways (see figure 4), in particular as either a potential way to meet an investment outcome or as part of a cost assessment. The former is more common, with 67% of users having positioned it as a diversification strategy, consistent with a leading motivation for investing. A smaller but still significant group (40%) also position smart beta as an alternative source of return. As with any allocation, investment return is an important objective and some adopters believe smart beta is able to deliver. As mentioned previously, there is also the recognition of smart beta as a cost-efficient solution: 29% of investors position smart beta as a low-cost investment. This is something which is more of a theme in the UK.

Fig 2. Reasons for initial smart beta investment in order of importance



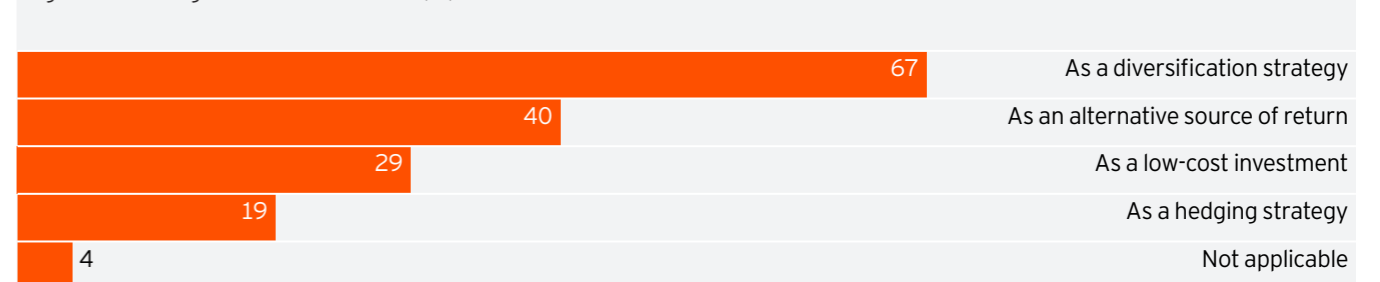
Importance rated on a score of 1 to 10 where 10 = most important. Smart beta users only. Sample size shown in grey.

Fig 3. Smart beta strategies – use and objective (%) 256



Multiple responses. Smart beta users only. Sample size shown in grey.

Fig 4. Positioning smart beta to clients (%) 256



Multiple responses. Smart beta users only. Sample size shown in grey.

"I don't see why there would need to be a transition from a market-cap weight index before investing in smart beta. Smart beta is a different philosophy to passive but the most important thing is investors have confidence that it can produce returns over the long term."

UK discretionary fund manager

Recognition of cost efficacy in the UK

Although wealth respondents in the UK value the investment benefits of smart beta strategies, they believe there is a more compelling reason for them to invest: the cost efficacy compared to other investments. According to our respondents, UK users are more influenced by cost factors than their Continental European peers (figure 2), ranking cost ahead of other considerations when investing in smart beta. This can perhaps be explained by the UK Financial Conduct Authorities Retail Distribution Review requiring transparency of fees and charges. With this need for transparency, there is a greater pressure for professional advisers to justify their cost to clients, while added regulatory requirements have increased the financial burden. This has inevitably raised the focus on cost and the efficient use of resources. "Well I think it [smart beta] can add value at lower cost than a lot of the active funds," explains one UK financial adviser.

Overall, smart beta is viewed by UK users in our study as a cost-efficient way to achieve market exposure while still aiming to deliver the performance expected by internal stakeholders or clients.



Route to investing in smart beta

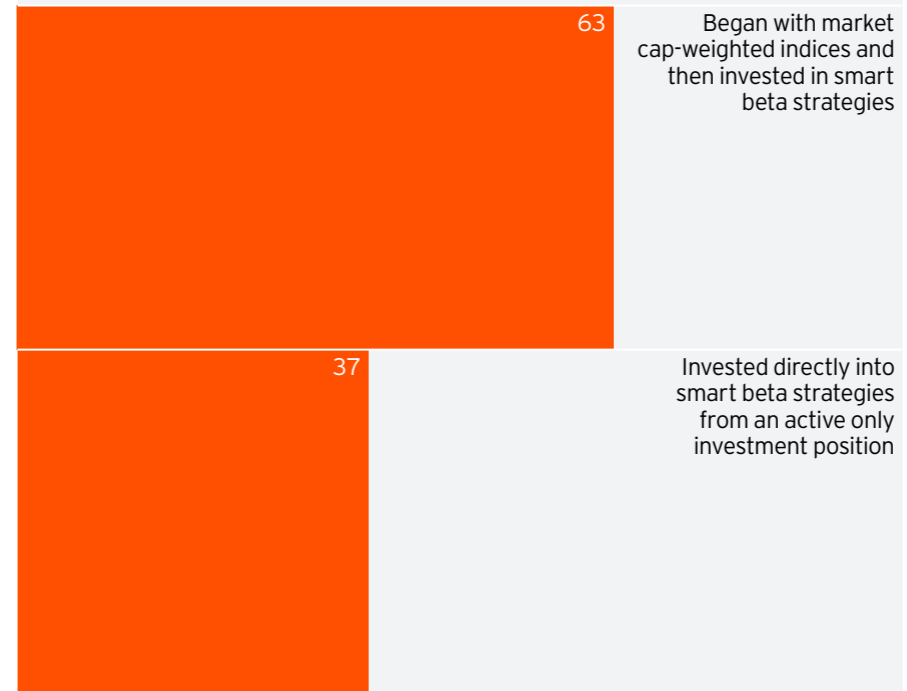
Figure 5 shows that many adopters of smart beta used traditional indexing investments as a stepping stone to smart beta. This is not because they perceive smart beta as necessarily passive, but rather recognise the roots of smart beta, which builds upon the index construction techniques established with market cap-weighted indices.

Our study reports that, while 32% of users would place smart beta strategies closer to passive on a passive/active scale, the other 68% recognise the active elements of smart beta, placing them either in the middle of the scale or closer to a pure active investment. Conversely, our research also shows that 59% of non-users classify smart beta closer to passive investment. This signals a knowledge and experience gap between the two groups.

Smart beta users have a better understanding of the active decision aspects of a smart beta strategy, akin to the decisions made by active managers. As one respondent comments: "Active managers typically have some kind of smart beta bias in their investment style, but with smart beta value strategies, you can really tilt your portfolio in the way you want it to be tilted". At a deeper level, adopters also recognise the differences between the varying strategies and how far they focus on a particular conviction.

This sheds light into the 37% of investors who have allocated straight into smart beta from a fully active position - another viable path for investing in smart beta. It is clear that adopters understand how smart beta incorporates elements from both passive and active strategies by blending them together.

Fig 5. Route to smart beta investments (%) 253



Smart beta users only. Sample size shown in grey.

Fig 6. Reasons for not investing in smart beta (%) 44



Multiple responses. Non-users only. Sample size shown in grey.

Non-users

Non-users of smart beta generally sit in three groups: those who do not invest because of a lack of knowledge, those restricted by their organisation's investment process, and lastly, those who are simply advocates of active management. The latter group are the largest according to our study, ranking it as the top reason for not investing (see figure 6). This is unsurprising as certain individuals within the investment industry will only define themselves as providing pure active services and do not perceive smart beta as part of their possible toolkit. With greater education, there should be a shift in mentality with non-users recognising the active nature of smart beta and potentially seeking future investment in factor-based index strategies.

A need for improved education was something highlighted in our study last year. Improved education should help those non-users whose reason is their lack of understanding of smart beta strategies and their benefits. This is cited by more than half of non-users (52%) and could be overcome with the help of providers.

Another barrier unearthed among non-users is the insufficient performance history for certain strategies and providers. This is not inherently negative as with time newer strategies will accumulate the necessary track record. Potentially this will be sufficient to corroborate the belief in a strategy and also meet certain requirements set out by an organisation's investment guidelines. Moreover, this issue is one current users of smart beta also had to overcome. With greater education and time - this should become a less prohibiting element.

Noticeably, there are two particular factors which non-users do not believe are barriers to their investment: the potential overweighting of riskier assets and bias towards particular sector/stock. Smart beta is meant to create a desired bias which moves strategies away from market-cap weighted indices. Positively, non-users have not cited this as a reason for their lack of investment. Along with what has already been mentioned, this factor makes us optimistic about future usage by this group.

2
From concept to action: a new era
in factor-based index investing



NEU! DER HRS BUSINESS TARIF
SO EINFACH BUCHT
MAN GÜNSTIG.

BIS ZU 30% RABATT, GRATIS
WLAN UND KOSTENLOSE
STORNIERUNG BIS 18 UHR.

JETZT
ANMELDEN
AUF HRS.DE

TESTSIEGER
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ofenfrische
Brezeln
0,70 €/Stück.



The new era in factor-based index investing

Once a decision is made to explore smart beta as a viable investment option, there are important considerations at the outset. First is to identify what strategy to invest in from the range available. Once a strategy is selected, a due diligence process is conducted, which includes selecting an investment vehicle as well as evaluating how a strategy will impact the existing portfolio.

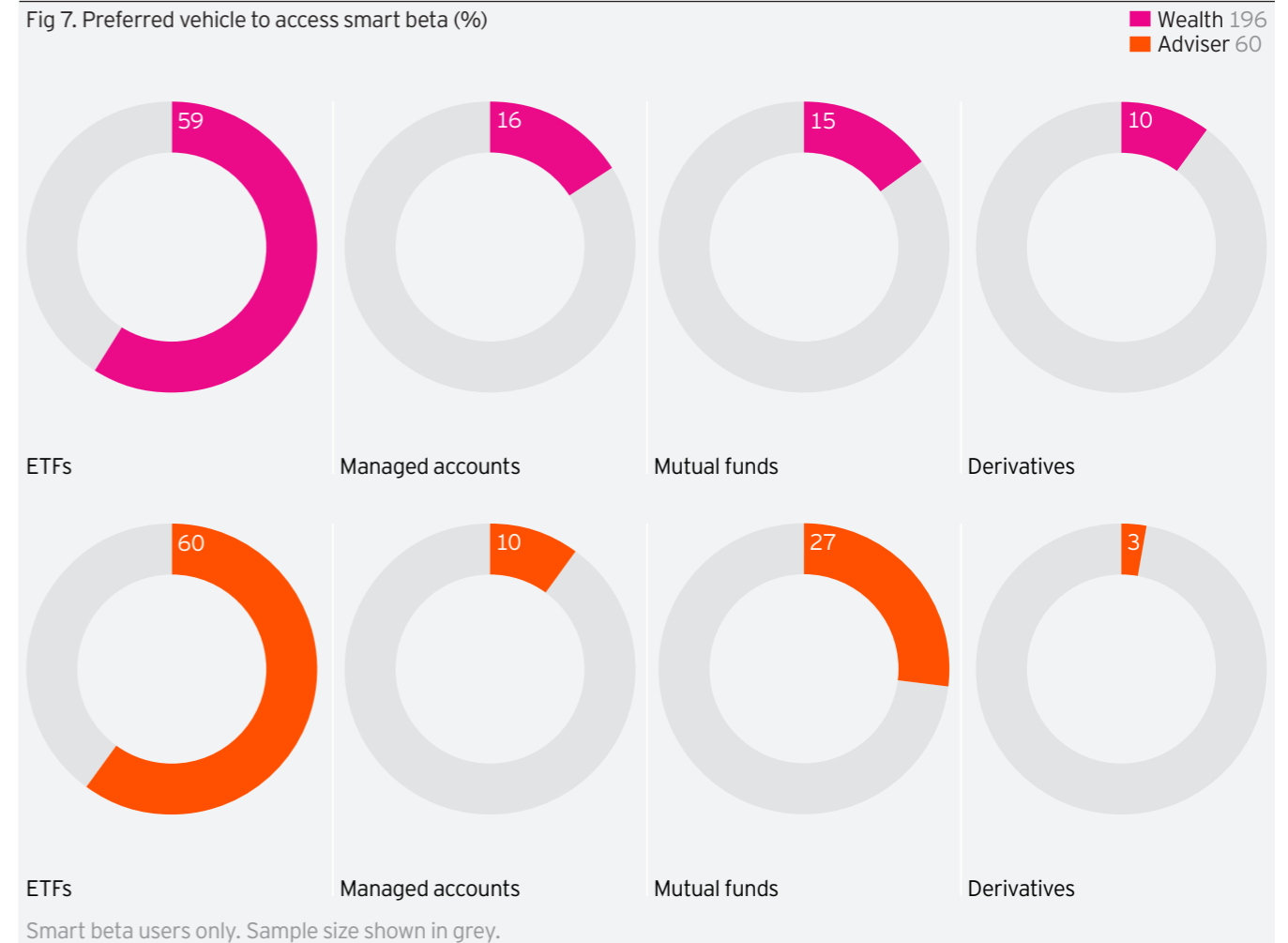
The strategy chosen is highly dependent on the required exposure and can vary significantly. What is more limited in choice is the actual investment structure housing the strategy, as seen in figure 7. The most popular way to access smart beta is through an ETF vehicle, with on average 60% of users ranking it as the most preferred method.

Based on feedback from our qualitative interviews, the popularity of an ETF as a vehicle is due to the transparency and ease of use of the instrument. An ETF allows a smart beta investor access to the full list of holdings within the strategy in real time. Moreover, ETFs provide greater liquidity and flexibility as a result of the potential for intraday trading. These elements combined, as well as the fact that many users would have past experience with an ETF when investing in market-cap weighted strategies, explains the strong preference for this instrument.

The second most popular way for advisers to access smart beta is through mutual funds which, like ETFs, are also commonly used outside of smart beta in both the active and passive arena. 27% of advisers would invest using a mutual fund compared to significantly less (15%) of the wealth segment. 16% of the wealth segment would prefer to access smart beta via a managed account. Derivatives are the least popular vehicle for both category of respondents. This is probably because they are very specific in nature and likely to suit more specific requirements and client types.

Once the particular strategy and vehicle is chosen, the next stage is to evaluate the providers and narrow them down. The process is similar to any carried out for an active or passive investment and does not require any significant changes.

Fig 7. Preferred vehicle to access smart beta (%)





Users report that it is important to have confidence in providers and their expertise in the investment products offered. This has been stressed more strongly by financial advisers within our study, who rate this as the most important aspect of their due diligence (8.2 out of 10 - see figure 8).

Respondents also said that if a strategy didn't have a long-term performance history then a trusted name would help build confidence in the new strategy and encourage potential users to adopt the new approach. Nevertheless, expertise of providers can only go so far in the due diligence process; the most important point is the review of a strategy's performance history, according to our full sample of users.

This part of the due diligence process helps explain why the adoption of smart beta in Europe has started to gain momentum within the past few years as many strategies have recently started to accumulate a track record. As a commercially new and expanding universe in Europe, factor-based indexing is still growing and will soon reach a point at which many strategies meet the requirements for this stage of the due diligence process. Until then, back-tested or simulated data is also provided to prospective investors to help overcome this limitation by simulating the performance of a strategy in past market cycles - another important aspect of due diligence stressed by investors.

Moreover, adopters have indicated the importance of testing how strategies fit into their or their clients' asset allocation mix (rated 7.2 out of 10). One UK discretionary fund manager explained, "It's all about understanding and how it [the smart beta strategy] will work within a portfolio. We have worked to test past performance and see how it will correlate with other asset classes." This links back to one of the main reasons for investing in smart beta - diversification.

Building upon this, users have also recognised the necessity of testing anticipated changes to portfolio exposures against certain factor exposures and tilts. As with any new investment in a portfolio, exposures will be altered and it is crucial that exposures change as intended. Finally, it is important to understand how the reweighting process works, as well as its frequency, to fully appreciate and effectively use a strategy. The reweighting mechanisms will be akin to the experiences of investors who have encountered passive instruments.

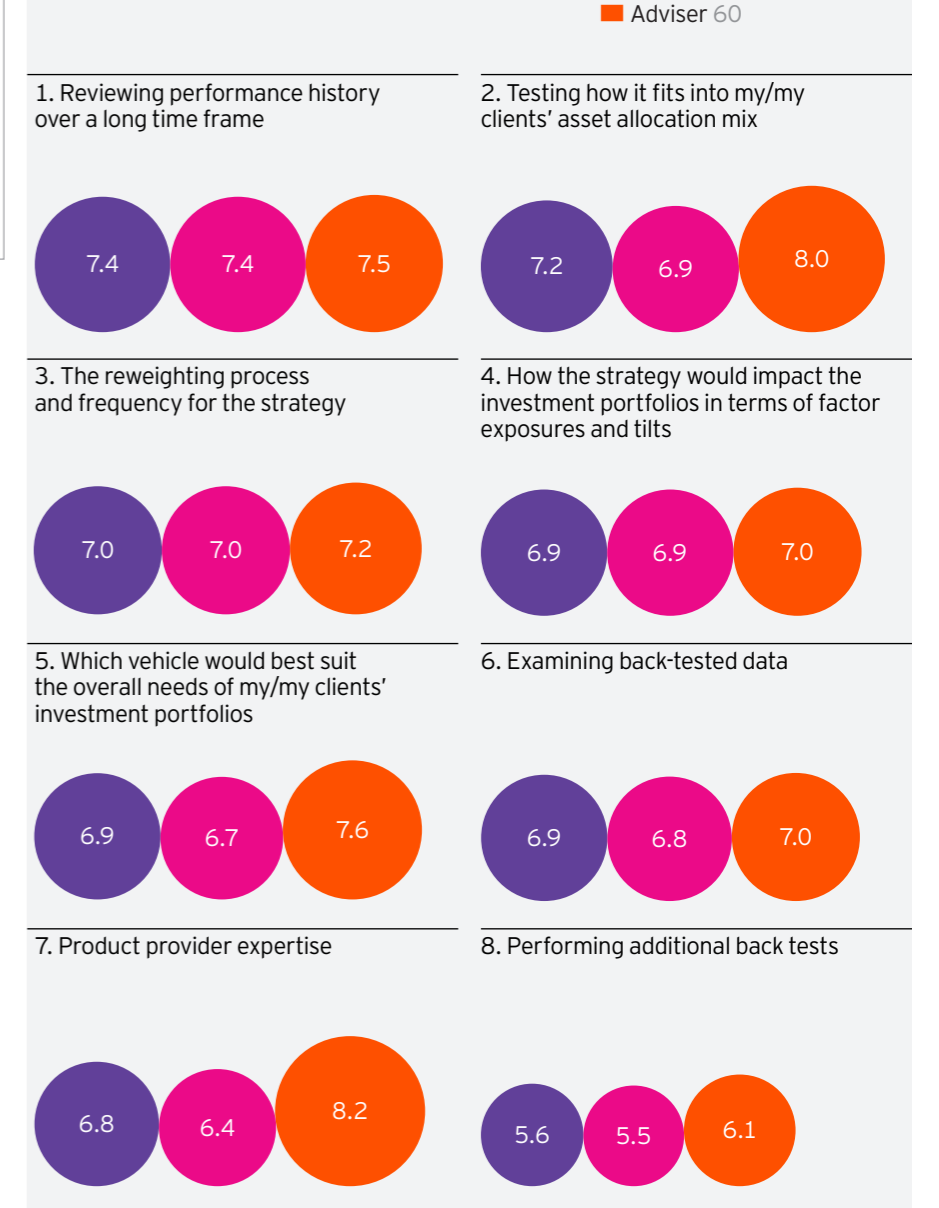
The due diligence process is not complete once the investment is made. It is essential for investors to review smart beta allocations as they would any other investment to ensure they are performing in the way anticipated and if any reweighting changes are needed. Users tend to review investments on a monthly or quarterly basis.

Overall, this provides a general guide to the important steps in the due diligence process but it is by no means exhaustive.

"It's all about understanding and how it [the smart beta strategy] will work within a portfolio. We have worked to test past performance and see how it will correlate with other asset classes."

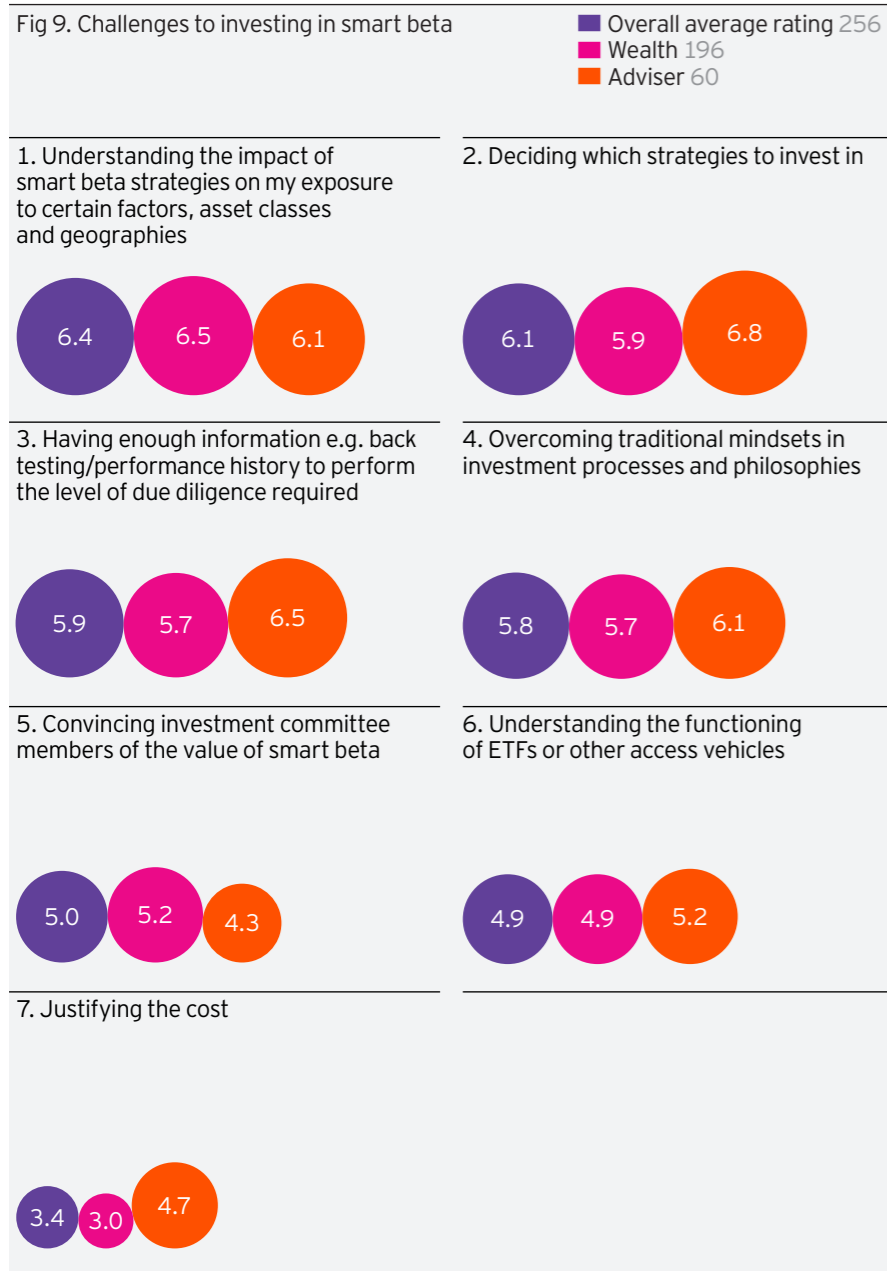
UK discretionary fund manager

Fig 8. Due diligence process in order of importance



Importance rated on a score of 1 to 10 where 10 = most important. Smart beta users only. Sample size shown in grey.

Fig 9. Challenges to investing in smart beta



Importance rated on a score of 1 to 10 where 10 = most important. Smart beta users only. Sample size shown in grey.

Common challenges facing investors

Despite the process of investing in smart beta being similar to other modes of investing, there are unique challenges users experience when first investing. However, according to the average scores shown in figure 9, most investors do not see these issues as very difficult to deal with. There are also some differences between wealth respondents and financial advisers - the latter group finding smart beta investing slightly more challenging.

However, when asked directly, 52% of users have found the implementation of smart beta strategies in their portfolio straightforward.

As with any new investment in a portfolio, the most challenging consideration is understanding how a strategy impacts exposures to certain factors, asset classes as well as the geographical exposures. Feedback highlighted it would be prudent to allocate sufficient time to this as it is an essential part of the due diligence, as indicated earlier.

Even at a very early stage, some focus is required in selecting a particular strategy or strategies to invest in from the spectrum of choices. This is an area for improvement, educating potential investors about different strategies and how they can be used, something which respondents said should be led by providers. As one non-user reveals, "I'd like to understand it [smart beta] specifically as it pertains to an instrument a bit more and nobody's really knocked on our door and asked to discuss it with us."

Users have also found the performance history a challenge but, as stated earlier, this is something that will be partially overcome by back-tested data which providers are able to pass on to interested parties to provide greater confidence in a strategy.

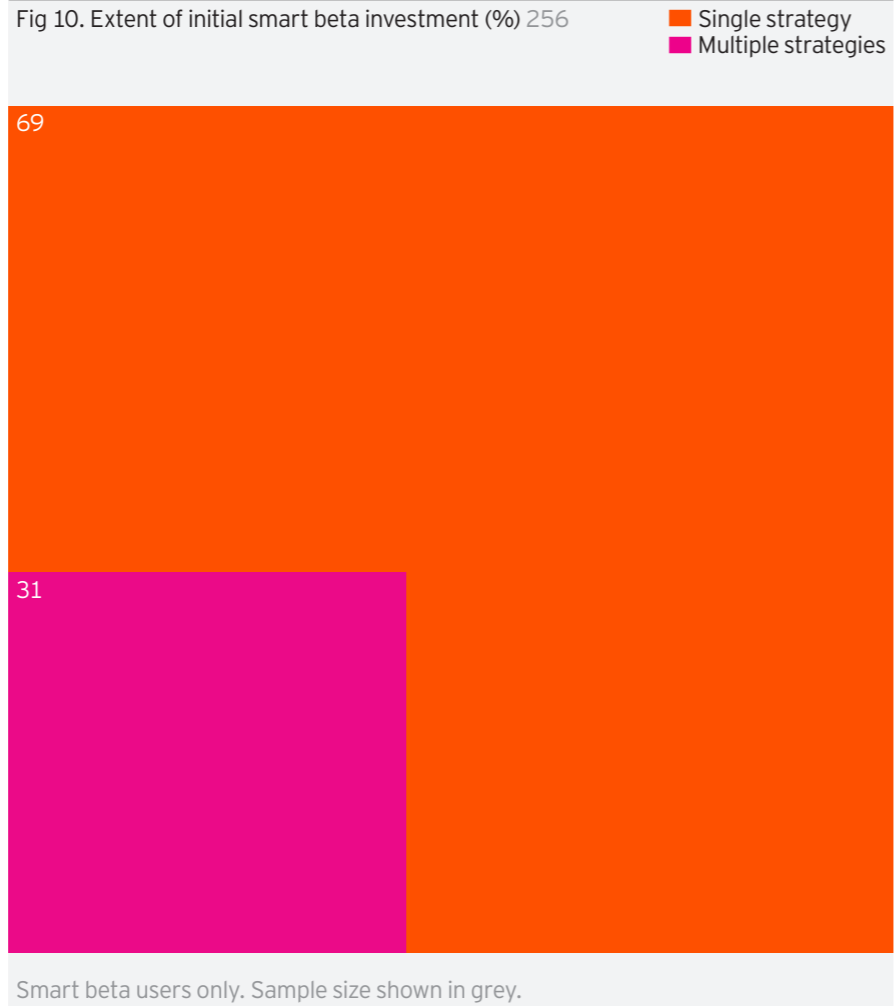
Lastly, some users of smart beta found it challenging to convince critical decision makers from an investment perspective. This may be due to traditional mindsets or processes within organisations, things which can be difficult to overturn. "I guess our and many other processes will remain biased against them [smart beta] until they're a little more established," a UK discretionary fund manager explains.



52% agree implementing smart beta strategies within a portfolio is straight forward

“We thought it would make sense to invest in different smart beta strategies as the different factors typically perform at different times in the cycle.”

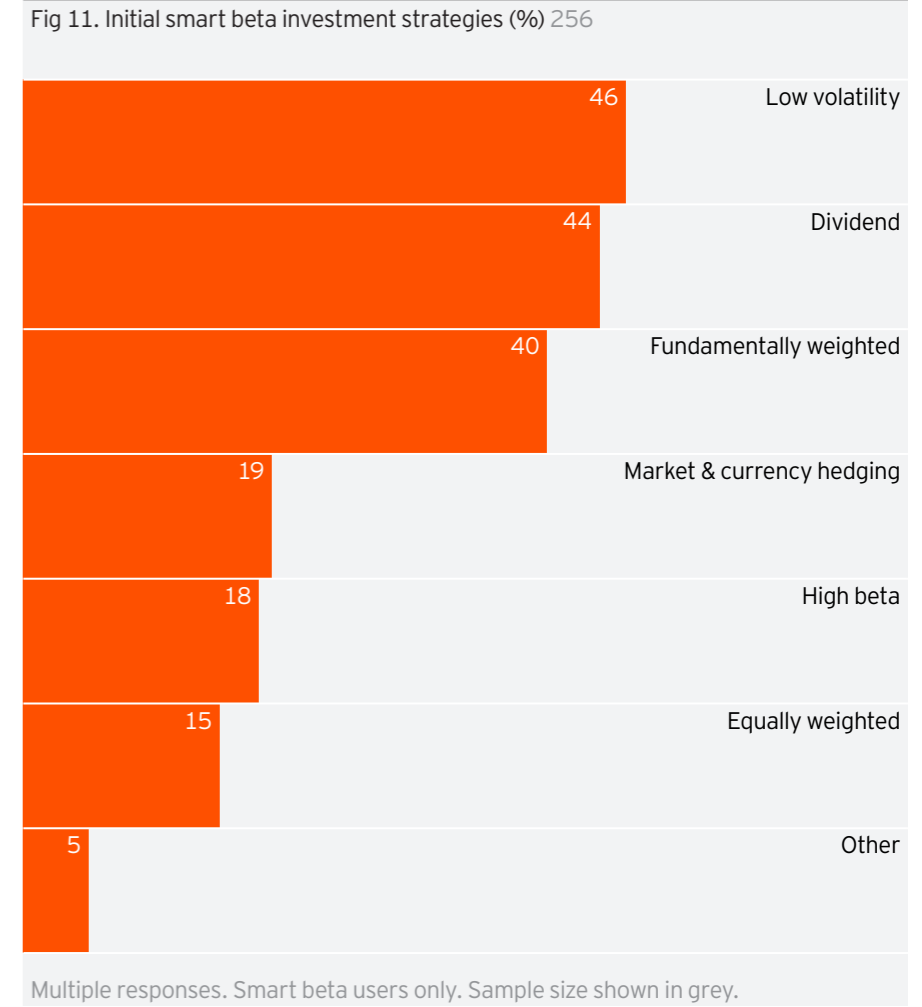
German asset manager

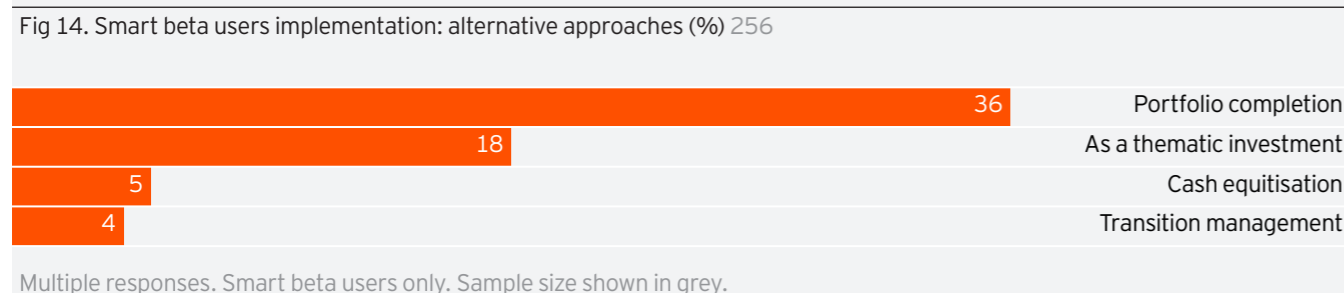
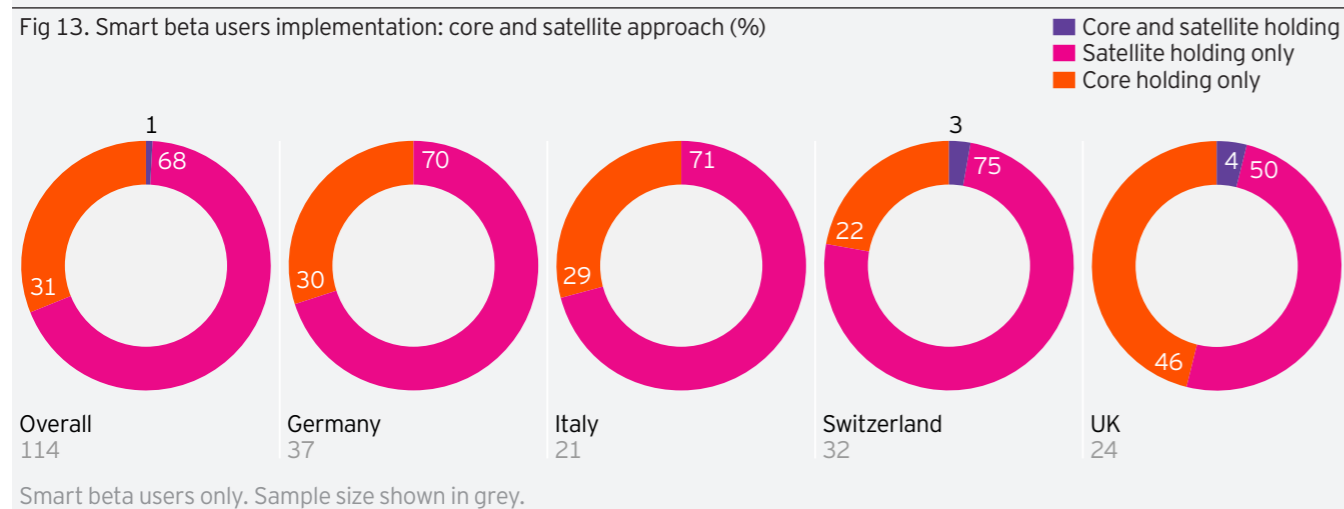
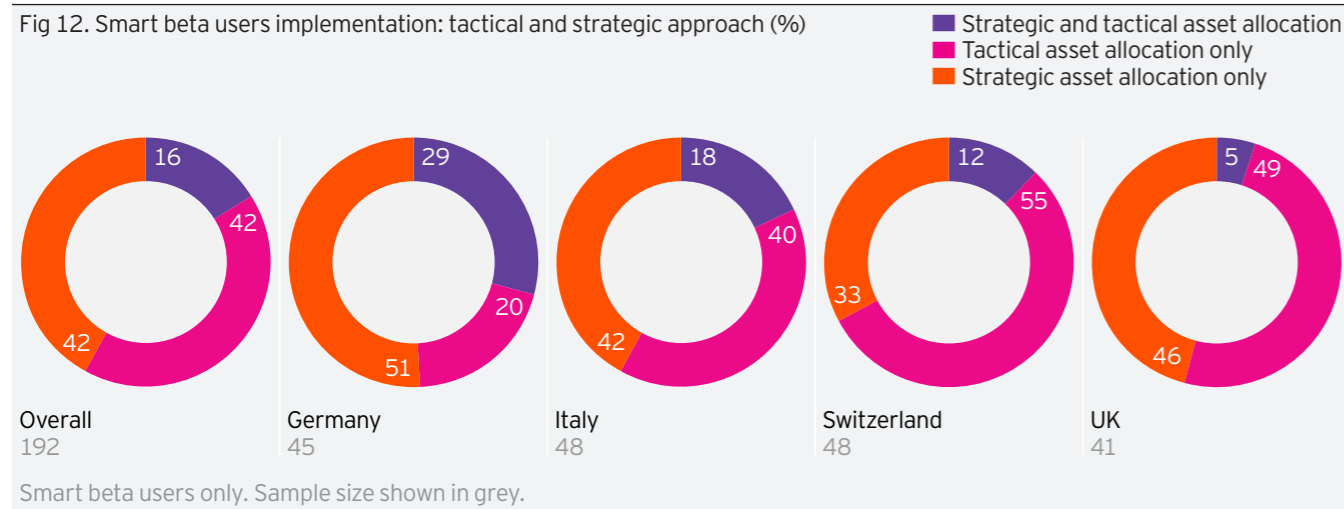


Strategies and implementation of smart beta

Once confidence in a strategy or strategies has been established, users then decide how to implement them in a portfolio. Looking at our sample in figure 10, 69% of users begin with a single strategy while 31% decide to invest in multiple strategies at the outset. The choice is very much a decision based on the particular needs and aims of the investor.

The popular initial strategies invested in can be seen in figure 11. Low volatility, dividend and fundamentally weighted strategies are the most popular by far according to our sample of users. Less popular initial strategies are market & currency hedging, high beta and equally weighted.





When it comes to implementation of smart beta, different strategies are used in a multitude of ways, depending on their chosen investment framework or perspective. A popular approach used by 75% of users is to place investments as part of either their tactical or strategic allocation (or both). Alternatively, another investment methodology is to invest using a core and satellite approach. Although this is done by 45% of users, it should be noted that they can use different frameworks and smart beta strategies in multiple ways simultaneously.

Figure 12 shows there is an even split (42% respectively) of users who place investments as part of either their tactical-only or strategic-only allocation. Strategic allocations tend to be a long-term commitment while tactical investments are made with a shorter term perspective. However, smart beta is not limited to either, with 16% of users having placed smart beta strategies in both parts of their allocation. This spread of responses demonstrates the flexibility of smart beta as an investment tool. This decision is often based on whether single or multiple strategies are chosen and which strategies are implemented. As a German asset manager explains, "I use it [smart beta] for both tactical and strategic asset allocation. For example, the minimum volatility is more a strategic solution and momentum is more tactical. Some are suited for one or the other."

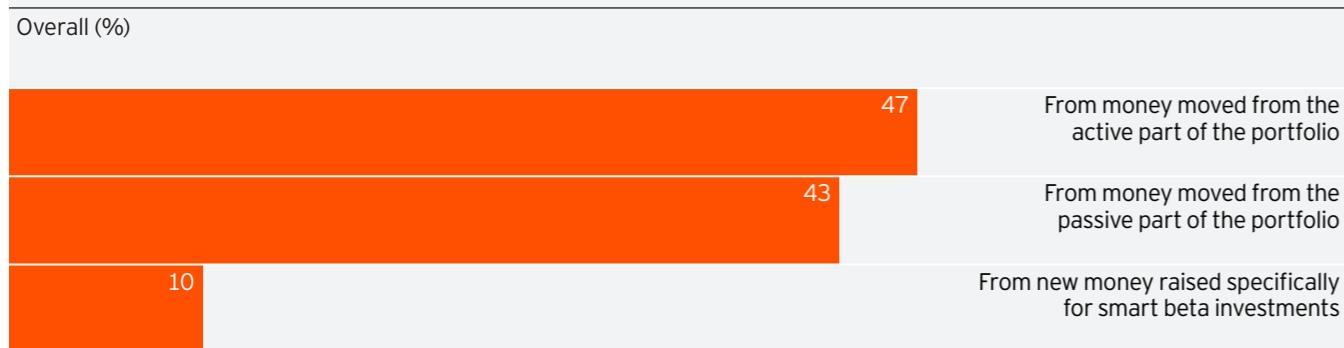
Interesting observations are made at a country level with differences in how smart beta has been implemented. This is evident in Switzerland where 55% of users have invested in smart beta as part of a tactical-only movement. In contrast, in Germany the greatest focus is on the longer term, with 51% of users implementing smart beta as part of their strategic allocation. Germany also has the greatest portion of users (29%) when compared to other countries that are using smart beta in both tactical and strategic allocations. UK and Italian findings show a more even spread between strategic and tactical asset allocation.

Moving on to users who invest using a core and satellite approach, figure 13 highlights 68% that place smart beta in the satellite part of the portfolio only. The satellite part of a portfolio is often assigned to value add investments with potential to generate alpha. This is separate to the core part of the portfolio where market-cap weighted indices are often held as part of the lower cost allocations. This evidence is in line with views expressed earlier by users in the report, identifying smart beta as having elements of active investments. This helps explain why it is more often placed in the satellite part of the portfolio than core.

Another consistency is also seen with the country level breakdown. Overall, UK users are more likely to use smart beta as part of their core allocation. This is consistent with earlier findings about the focus in the UK around the cost efficacy of smart beta.

Lastly, figure 14 presents other popular methods of implementation of smart beta including portfolio completion (36%) and as a thematic investment (18%). The former is simply attaining the desired exposures without the need for wholesale rebalancing of a portfolio that could be costly (e.g. tax consequences) while the latter is seeking to capture exposures that match investment convictions.

Fig 15. Funding smart beta 256



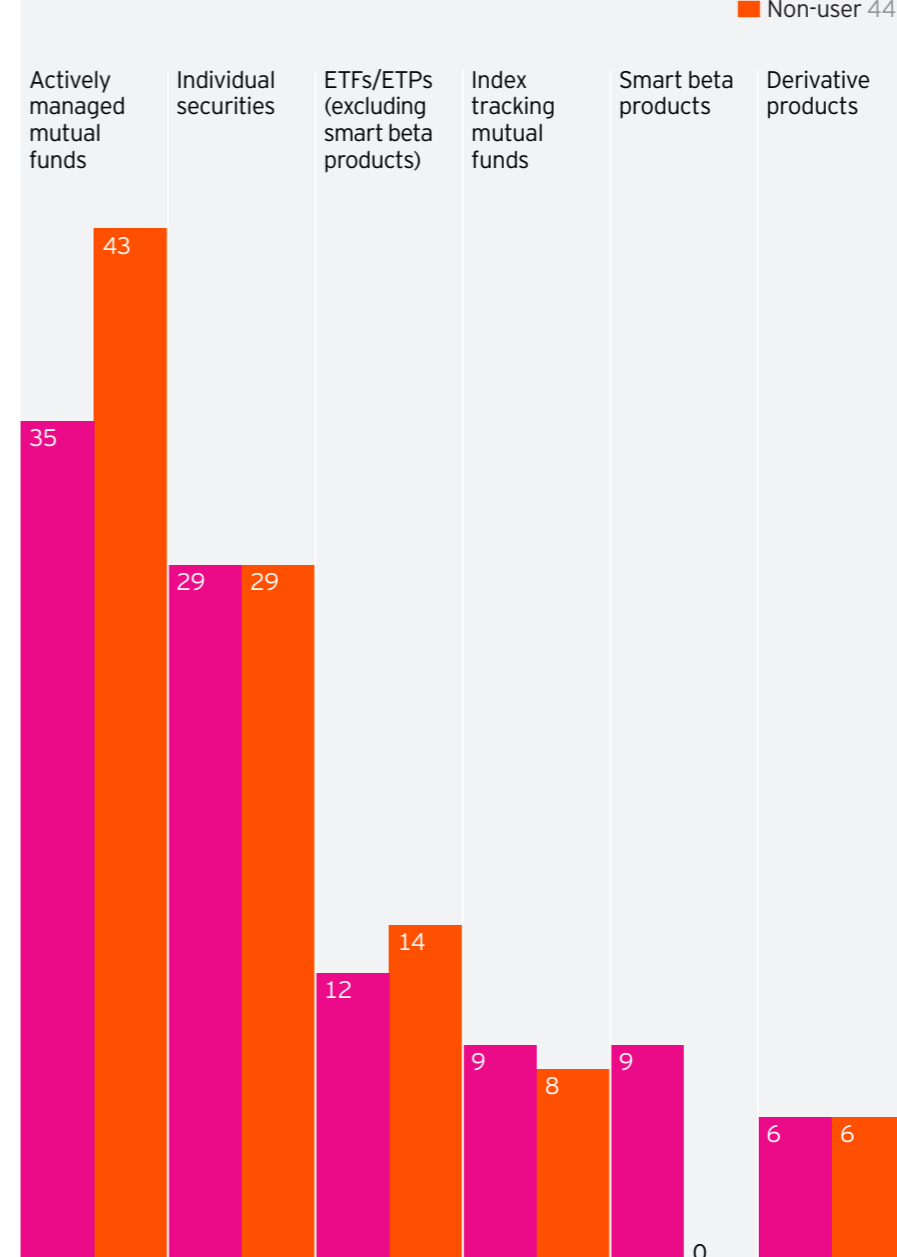
Smart beta users only. Sample size shown in grey.

Wealth vs. adviser respondent (%)



Sample size shown in grey.

Fig 16. Current allocations – smart beta users vs non-users (%)



Sample size shown in grey.

Funding smart beta

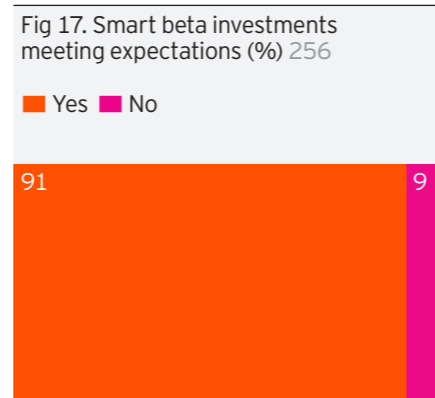
In terms of financing, allocations are sourced from a variety of perspectives. Despite many users having used passive investments as a stepping stone into smart beta, almost half (47%) of respondents are typically moving money from the active part of portfolios. This helps support the narrative that many users perceive smart beta as behaving closer to an active investment.

When segmented, it is more evident for wealth respondents that money is moved from the active part of the portfolio while advisers are more likely to move money from the passive part of their or their clients' portfolios. This helps explain why there is still 43% of users stating allocations moved, and will move from passive, while 10% suggest allocations made from new money raised specifically for smart beta.

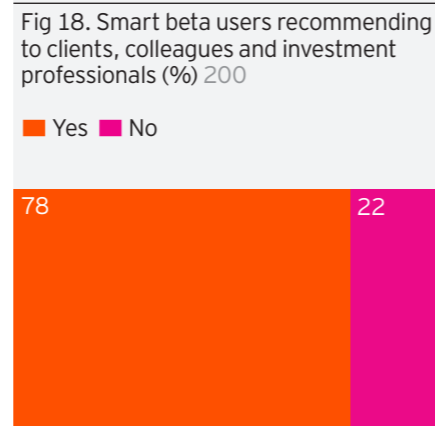
A further explanation can also be found in figure 16 allocation data. In aggregate, smart beta users have slightly smaller allocations to traditional passive products than non-users. This includes ETFs and index tracking mutual funds. More importantly, there is distinctively lower allocation to active mutual funds – almost 10% less. This result along with anecdotal feedback suggests a larger part of the allocation to smart beta has come from funds originally invested in active investments.



3
The state of smart beta and
its potential future



Smart beta users only. Sample size shown in grey.



Smart beta users only. Sample size shown in grey.

The state of smart beta and its potential future

As a result of their investment so far, figure 17 shows an overwhelming majority of users that feel smart beta has met their expectations. This general satisfaction appears to have lent itself to the momentum behind the recent uptake of smart beta strategies.

As pointed out earlier, growth in the usage of smart beta has been largely driven internally by the investment industry. This is supported in figure 18 with 78% of users actively recommending smart beta to clients, colleagues and other investment professionals. In the same vein, when asked about the perception of smart beta, 60% of users feel smart beta strategies will become a widely accepted investment over the next few years. This industry-led promotion as well as confidence is a positive sign for smart beta and we believe signals the arrival of a new era in index investing.

Examining users' allocation breakdown in detail in figure 19, one can see smart beta is now a distinct asset group when compared to traditional investments. The highest average allocation is in the UK at 12% of the total portfolio, overtaking traditional index tracking mutual funds and traditional ETFs/ETPs as the 3rd largest group.

In Germany the allocation is at 10% and in Italy it is 8% of total portfolio allocation. The lowest is reported by users in Switzerland at 7%.

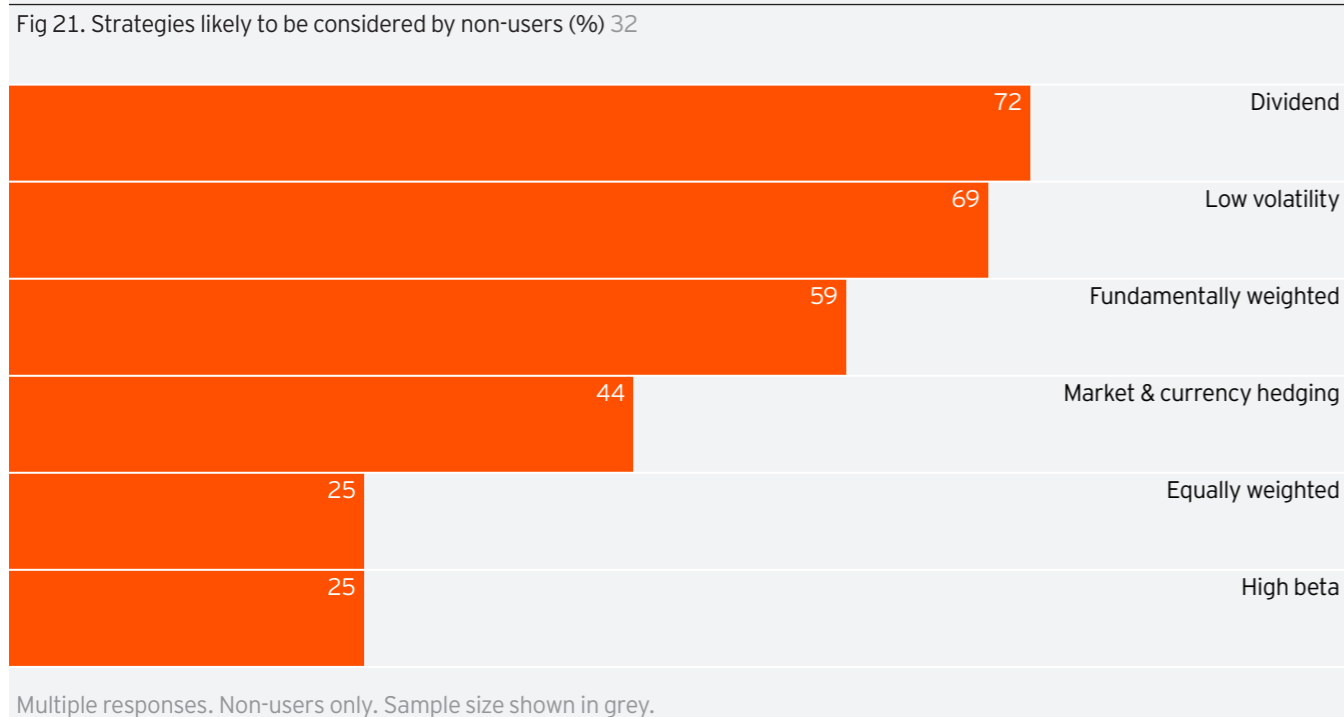
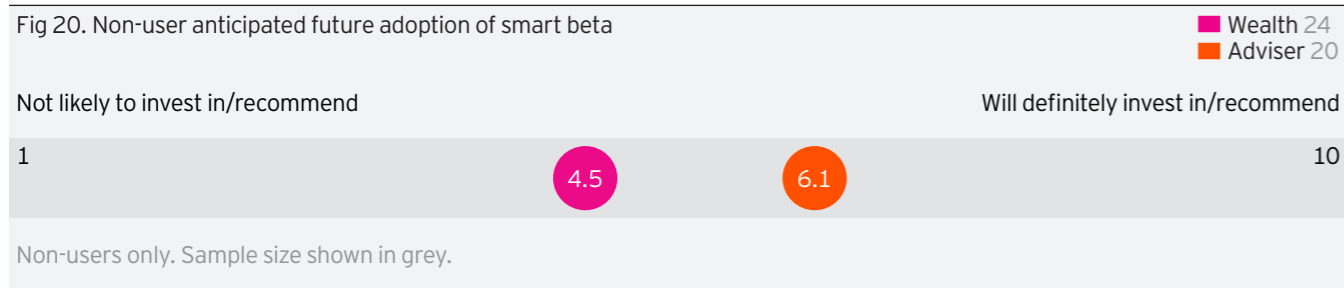
"I feel the performance of smart beta has improved my conviction towards them and subsequent investment. I have even won new clients off the benefits of explaining how these products work as a cost-effective diversifier to traditional products."

German asset manager



Smart beta users only. Sample size shown in grey.

60% agree smart beta strategies will become a widely accepted investment over the next few years.

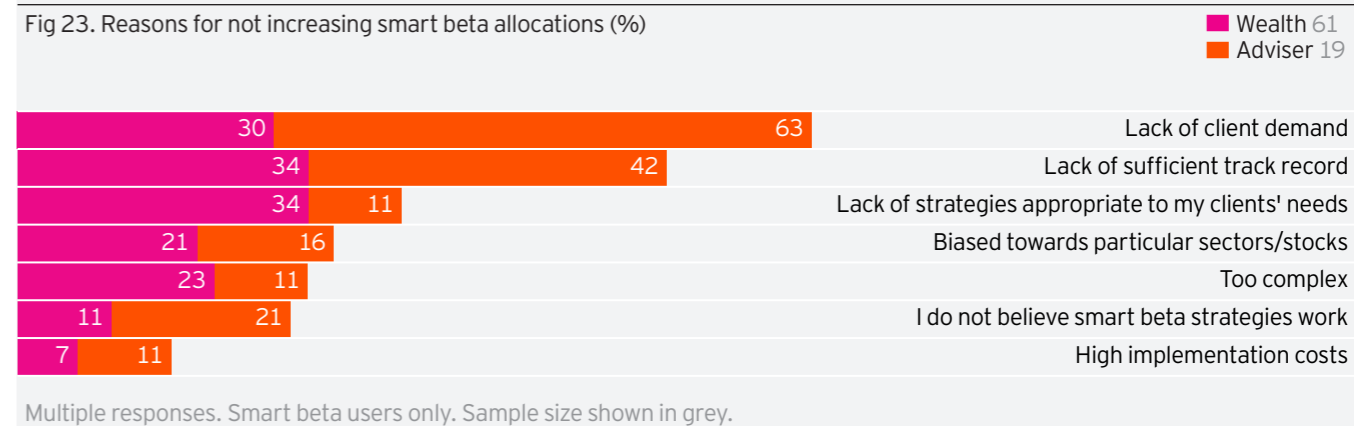
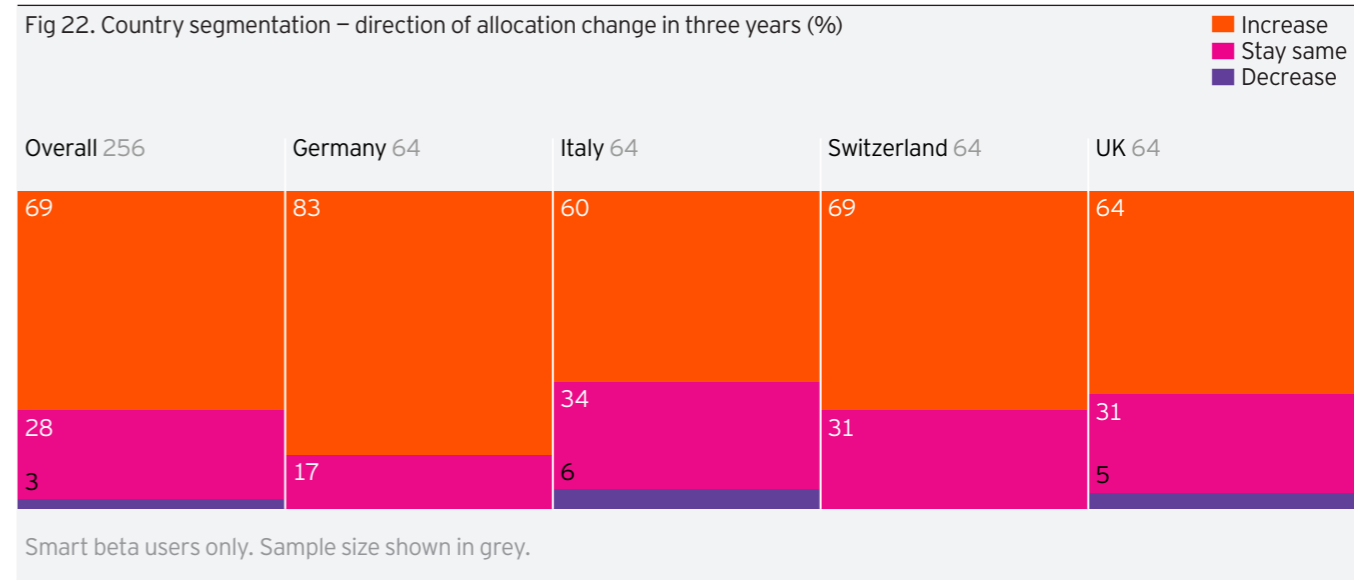


Potential demand from non-users

Demand in the future is likely to be driven partly by current non-users. Figure 20 shows this is truer of financial advisers who are more open to considering investing in smart beta than their wealth respondent counterparts. There is still some scepticism and this is a result of the reasons mentioned earlier around track record as well as an understanding of strategies.

When asked what would encourage investment a UK discretionary fund manager responded: "Performance and trust. I would like to see a few more established products in the space and I would like to see their success from a performance and cost perspective. I am not certain I understand them fully given the different strategies and how they take a stance on the market."

Focusing on non-users who are likely to invest in the future, there are certain strategies which they are more likely to consider. Figure 21 highlights dividend (72%) and low volatility (69%) as the most commonly cited strategies. Fundamentally weighted rounds off the top three strategies with 59% of non-users saying they are likely to consider them.



Future of smart beta

Figure 22 shows that 69% of users overall see their allocation increasing over the next three years. This represents a majority of users who have a positive experience of the benefits of smart beta strategies and believe they will become an increasingly important part of their future portfolios. Conversely, only 3% said they will decrease their allocations while 28% believe their allocation will remain the same.

At a country level, a greater portion of German users (83%) believe they will increase their allocation to smart beta compared to the other countries in our study. This is noticeably higher than users in Italy (60%) and reflects some differences in speed of further transition into smart beta adoption.

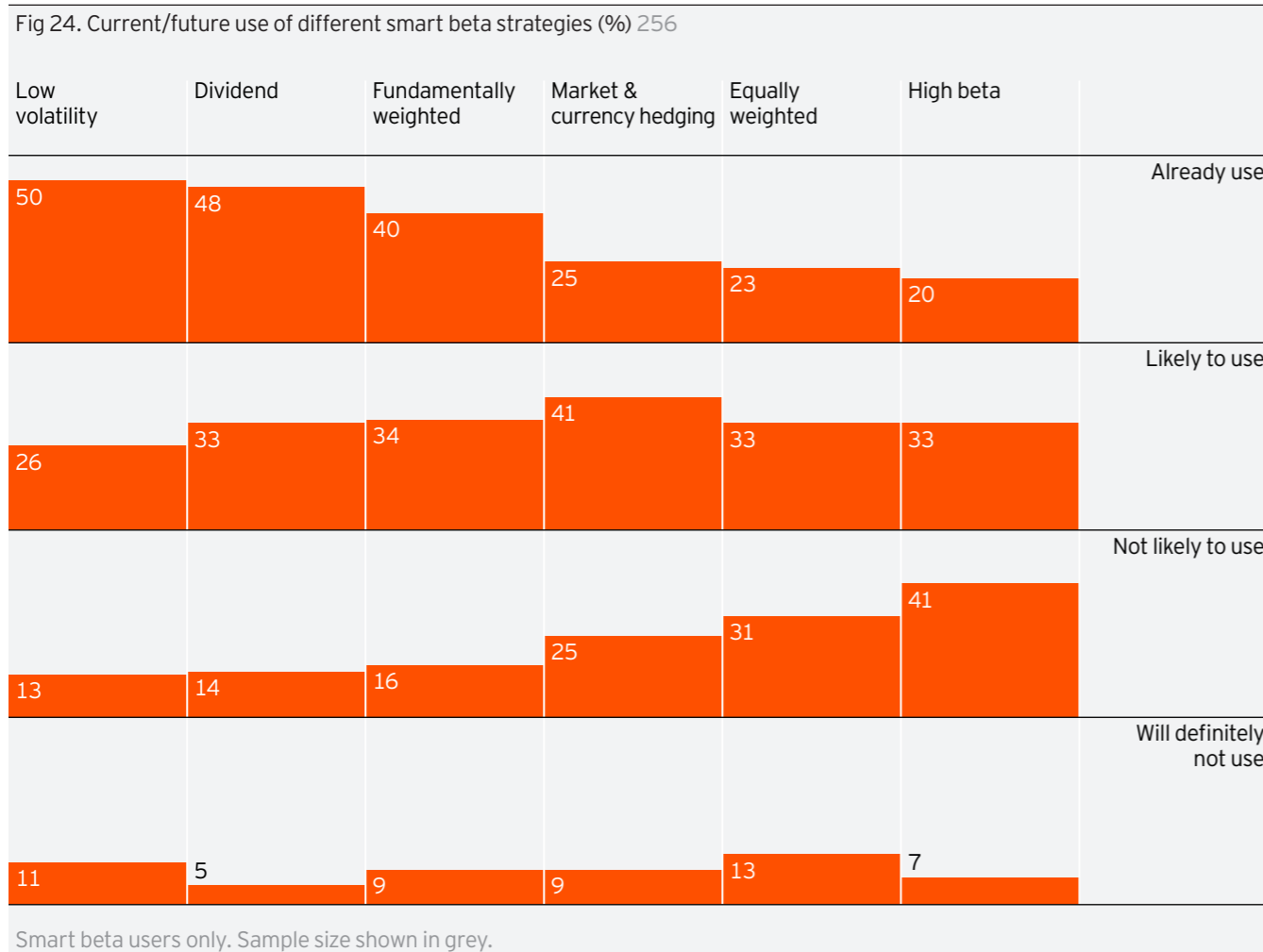
It is also important to examine why 31% of users would not be increasing their allocation to smart beta. According to these respondents, lack of client demand is the most cited issue. This can be seen in figure 23 with over a third of those not increasing their allocation to smart beta giving this as the reason. This portion has been pushed up significantly by financial advisers and is unsurprising given that most retail investors are less likely to be aware of all the dynamics of smart beta and consequently not likely to drive demand for strategies.

A recurring theme is the lack of track record for some strategies; some users are still waiting to see how strategies perform before increasing allocations further. There is also an opportunity for further innovation within the smart beta universe as there is demand which providers have not yet met. 29% of those who said they would decrease or keep their allocation the same are not increasing their allocation due to the lack of strategies appropriate to client needs. For example, a UK private bank has said, "I've not seen anything come out on the fixed income side of things. So if there was someone able to demonstrate a product there which did what I needed it to do, that would be interesting."

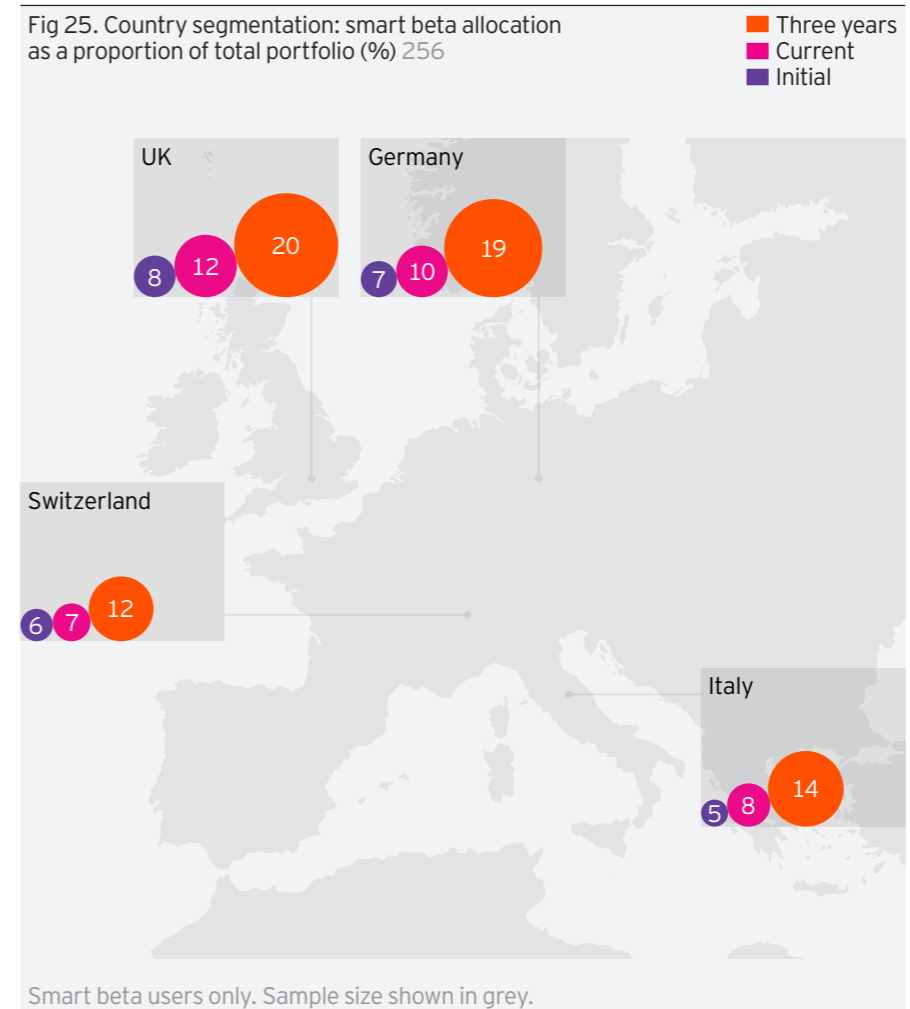
Some further education is likely needed, as strategies which are actually already available might meet client needs. There may also be some improvements possible in terms of offering guidance to a fifth (overall) finding smart beta too complex to manage within a portfolio.

"Well, over the last three years, it [allocation] has grown from zero to 5% and over the next three years I can't imagine that it would become less... maybe if I'm more convinced or hear it gains more popularity maybe it will grow."

Swiss asset manager



At the moment, the most popular strategies used are low volatility (50%), dividend (48%) and fundamentally weighted (40%) as shown in figure 24. When looking at the potential future demand for certain strategies, these three remain a likely option for those users not already invested. Moreover, what has interested users apart from the aforementioned strategies is market and currency hedging, with 41% of users stating they are likely to use this type of strategy in the future.



Allocation history

Based on our research findings, expected growth in smart beta allocations is displayed in figure 25. Initially, allocations have been in single digits when users first allocated to smart beta. The increase from initial allocations to the current position has not been significant because many users have only recently invested in smart beta.

However, it is within the next three years that users of smart beta expect allocation to significantly increase. Those in the UK forecast the highest future allocation in the next three years at 20%. German users follow behind and expect to allocate 19% of their portfolio to smart beta in three years. In Italy, it is expected that smart beta will make up 14% of their portfolios while the smallest future allocation in the next three years is expected to be made by those in Switzerland, rounding off at 12%.

In summary

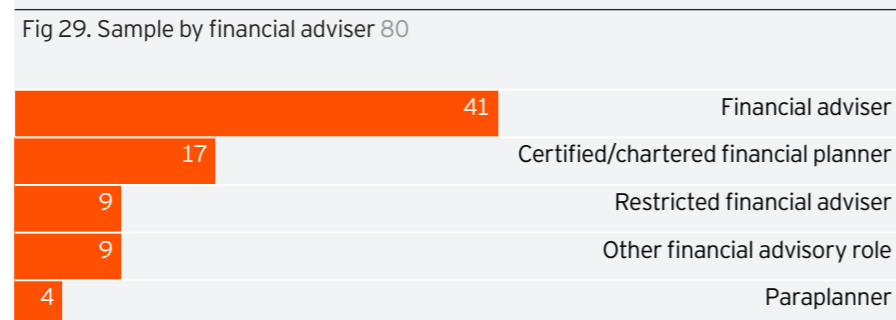
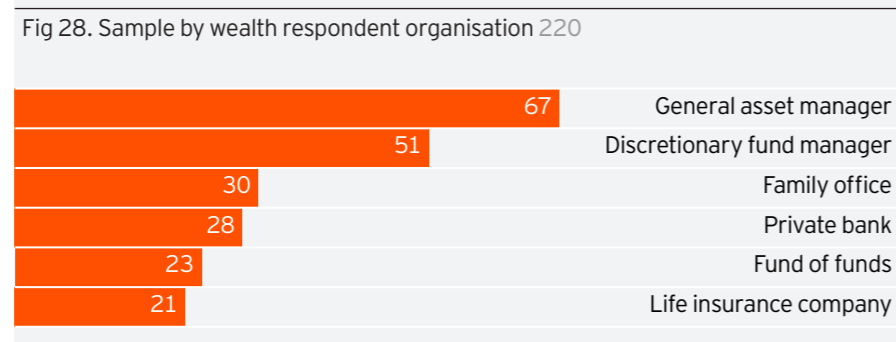
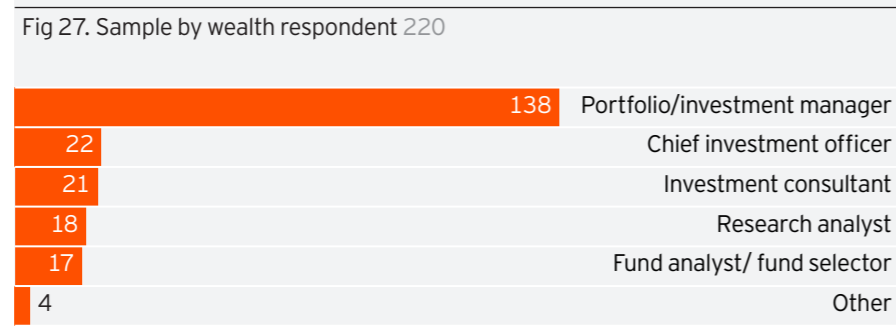
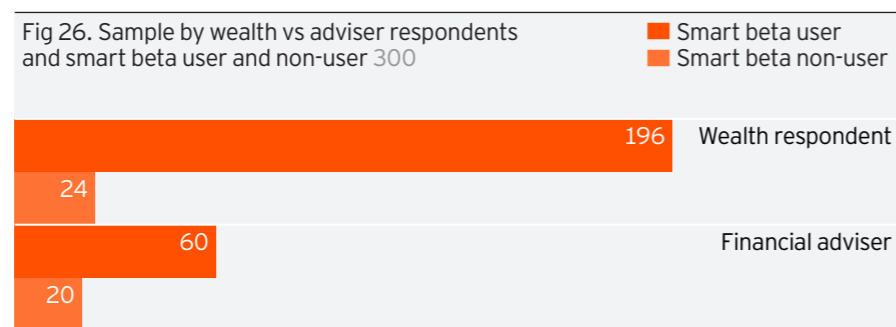
The results of this year's research support our view on the continuing momentum behind factor-based indexing in Europe. The forward momentum is seen in three particular dimensions. The first is that factor-based indexing is viewed as a solution to the needs-based requirements of the investment industry. According to our research, outcomes matter and both the wealth respondents and financial advisers are becoming increasingly receptive towards smart beta strategies because of their ability to provide outcomes to help meet investment objectives.

Secondly, smart beta strategies can be implemented into portfolios in multiple ways and can either complement existing passive and active strategies or begin to replace them as an alternative investment tool - signaling a new era for index investing.

Lastly, not only are investment professionals using factor-based strategies, they are also becoming promoters of these strategies, recommending them to both clients and peers within the industry.



Appendix



The above charts provide demographic information about the 300 online respondents. Total sample size shown in grey.

Sample and methodology

In this study we conducted interviews with both financial advisers and wealth respondents, including both users and non-users of smart beta. The fieldwork consisted of an online quantitative survey of 300 investors covering 220 wealth respondents and 80 financial advisers with a split of 256 smart beta users and 44 non-users.

To complement the online methodology, we conducted 20 depth interviews with 12 wealth respondents (7 users, 5 non-users) and 8 financial advisers (4 users, 4 non-users).

The fieldwork was conducted by CoreData Research, between May and June 2015. Key components of the methodology include:

- A focus on professionals who have influence over investment decisions
- Non-users were required to have some knowledge of smart beta to participate.

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