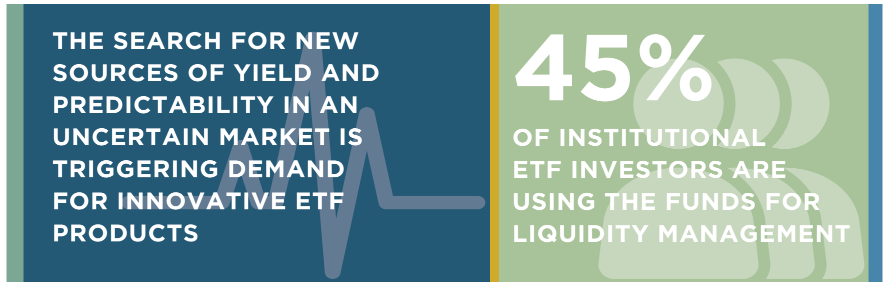
Q1 2017

ETFs: Dynamic Tools for Institutional Portfolios

GREENWICH ASSOCIATES

CONTENTS

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

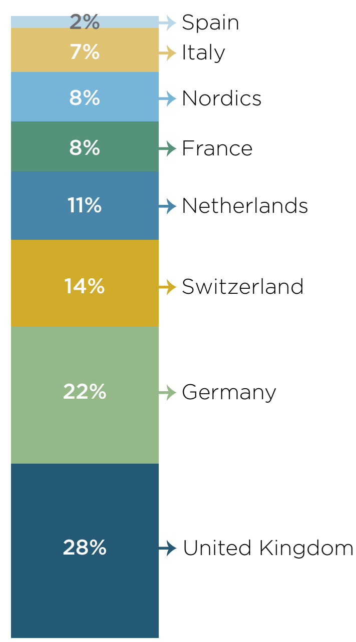


METHODOLOGY

Between October and December 2016, Greenwich Associates interviewed 132 institutional investors for its 2016 European Exchange-Traded Funds (ETF) Study, including 65 institutional funds, 48 asset managers and 19 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. Fifty-five percent of the institutions in the study have assets under management (AUM) of more than $5 billion, one-third manage more than $20 billion, and 1 in 5 have AUM in excess of $50 billion. Respondents also represent a wide range of countries, including France, Germany, Italy, the Netherlands, Nordics, Spain, Switzerland, and the United Kingdom.

RESPONDENTS BY COUNTRY



Note: Based on 132 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Executive Summary

Powerful market dynamics including quantitative easing by the ECB, increased market volatility and diminished liquidity in fixed income are causing European institutions to increase their use of exchange-traded funds (ETFs).

The results of the Greenwich Associates 2016 European Exchange-Traded Funds Study show that institutional investors are turning to ETFs for liquidity, ease of use and fast access to exposures.

Institutions are taking full advantage of that versatility in equities, where ETFs now account for about a quarter of total assets among the 86% of study participants currently investing in the funds. Institutions' integration of bond ETFs is more of a work in progress. Nearly half the ETF users in the Greenwich Associates study use bond ETFs, but invest only 8% of total assets to the funds. Approximately 1 in 4 of these investors have been using the funds for less than two years, and 17% of users started investing in bond ETFs in the past 12 months.

Across asset classes, institutions are using ETFs for a diverse set of applications, ranging from high-level strategic functions like obtaining core exposures and achieving portfolio diversification, to making tactical portfolio adjustments and executing short-term tasks.

ETFs are poised for further growth, with approximately a third of current equity ETF users planning to increase allocations to these funds in the year ahead, and 27% of bond ETFs users planning to do so. Among institutions in the study not currently investing in equity ETFs, nearly a quarter say they are at least somewhat likely to consider investing in the funds in 2017. Meanwhile, slightly more than 1 in 10 non-users of bond ETFs express similar plans.

Four major trends are contributing to this growth trajectory:

- ***One-third of the institutions in the study say they are using ETFs to complement or replace other investment vehicles—a share that climbed from 29% in 2015.***
  Institutions currently use a variety of derivatives to access beta, such as futures, swaps, and options. Half of ETF users plan to replace an existing equity futures position with ETFs in the coming year, and 40% say they will evaluate futures positions for potential replacement.
- ***Growing proportions of institutions are using ETFs to manage risk.***
  These increases likely reflect institutions' need for tools to help manage increased volatility associated with Brexit, as well as other structural changes and market events. ETFs are viewed as effective for managing liquidity, inflation, or concentration risk.
- ***European institutions experiencing liquidity shortages in fixed income are turning to ETFs for relief.***
  The liquidity, speed and ease of use of bond ETFs could attract additional investors in 2017, as the European banks that institutions rely on for liquidity struggle to meet new capital requirements.
- ***European institutions seeking new sources of returns and predictability in uncertain markets are triggering demand for innovative ETF products.***
  Approximately a quarter of institutional ETF investors are now using non-market-cap weighted/smart beta ETFs, up from 21% expecting to do so in 2015. Three-quarters of these users plan to increase allocations to these funds in the next year.

Introduction: Versatility Fuels ETF Expansion in Institutional Portfolios

European institutions are increasing their reliance on ETFs to help them manage an array of challenges in today's markets.

A combination of low interest rates brought on by quantitative easing programs by the ECB, uncertainty surrounding Brexit and a corresponding surge in currency volatility is prompting institutional investors to implement more diversified and tactical asset allocations. At the same time, new bank regulations have altered the functionality of fixed income and derivatives trading, draining liquidity from both markets and leaving investors to search for alternatives. As institutions respond to each of these trends, ETFs are proving themselves as highly effective and efficient tools.

Innovations in ETF structure are also providing new opportunities for institutions to implement specific outlooks and trends, and to capture well-known performance factors like value, size, momentum, quality, and minimum volatility in a systematic way.

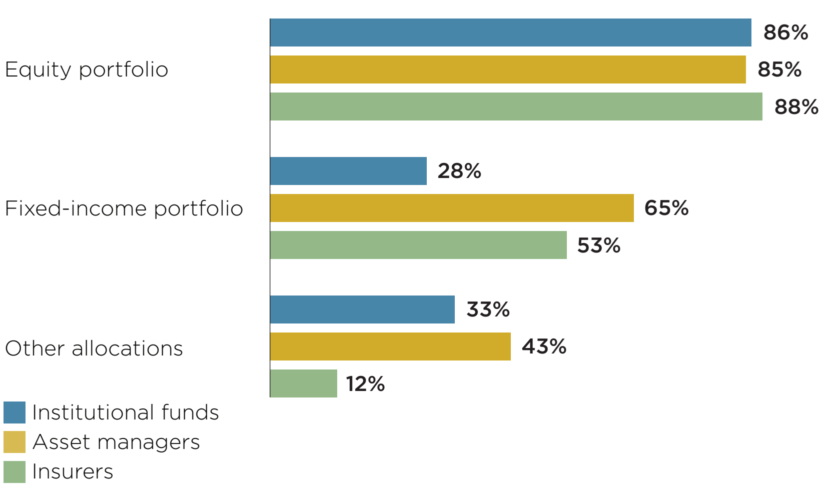
Thanks in large part to this versatility, institutional use of ETFs has become widespread in European equity portfolios, and ETFs are evolving into a standard component of institutional fixed-income investing.

European institutions that use ETFs invest an average 7.7% of total assets in the funds. At 10.7%, allocations are highest among asset managers, some of which invest large shares of total assets in ETFs as part of multi-asset funds.

[Our use of ETFs] has become more sophisticated. We are not just using them as building blocks anymore.

~ Portfolio manager, U.K. asset manager

ETF USAGE BY ASSET CATEGORY



Note: Based on 93 responses: 36 institutional funds, 40 asset managers, and 17 insurers.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Equity ETFs Most Widely Used

The vast majority of institutional users in the 2016 study invest in equity ETFs. Usage levels are highest in international developed equities (70%), U.S. equities (63%), international emerging-market equities (59%), and European equities (57%).

Institutions that use equity ETFs invest about a quarter of total equity assets in the funds on average. In addition, 76% of study participants expect developed market equities (47%) and emerging market equities (29%) to be the best performing asset classes by the end of 2017, while approximately 20% of investors think bonds will outperform.

On average, 41% of these investors plan to use passive vehicles, ETFs (28%) and index mutual funds (13%) to implement this view. Among insurance companies, 62% plan to use ETFs for this purpose. The 38% of institutions that plan to use active funds to implement their view confirms the shift to passive not only as a replacement but also when first selecting a vehicle.

Bond ETFs Gaining Popularity

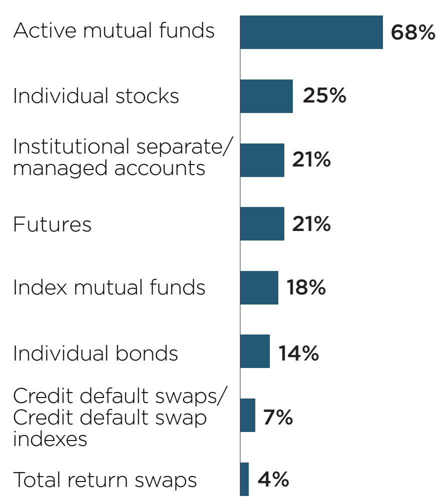
Approximately half the institutions in the study invest in bond ETFs. Usage increased sharply last year among asset managers, two-thirds of which now invest in the funds. Across all types of institutions, ETF usage is heaviest in international high yield (29%) and international investment grade (27%), domestic and international government bonds (26%–27%), domestic investment grade (26%) and international credit (23%). Institutions that use bond ETFs invest about 8% of total fixed-income assets in the funds, with asset managers reporting the highest allocations at slightly more than 10%.

ETFs Complimenting and Replacing Investment Vehicles

Across all asset classes, one-third of the institutions in the study say they are using ETFs alongside other investment vehicles—a share that climbed from 29% in 2015. Asset managers and insurance companies are leading this trend, with approximately 40% of 2016 study participants in each category saying they have replaced other investment vehicles with ETFs.

Active mutual funds are the most commonly replaced. Of institutions that have used an ETF in place of other investment vehicles, 68% moved out of active mutual funds. A quarter of these investors used ETFs to replace individual stocks, and about 1 in 5 to replace each of institutional accounts (separate or managed) and futures.

PRODUCTS OR INVESTMENT VEHICLES REPLACED BY ETFs



Note: Based on 28 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

ETF investments will continue to benefit from shifts in portfolio management philosophies among European institutions. Many current investors say they adopted ETFs as part of a move to passive management strategies in asset classes in which they no longer believed active management could deliver sufficient value. That trend will continue in 2017 and beyond.

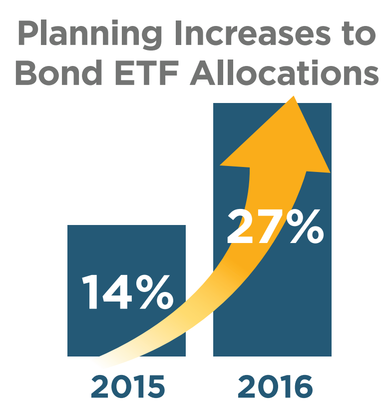
ETFs Alongside Derivatives

European institutions currently use a range of derivatives to access beta. Futures are most common, but credit default swaps, total return swaps and options are also employed. Increasingly, institutions are also using ETFs alongside these derivatives. Thirty-five percent have replaced an existing futures position with an ETF in the past year. Among asset managers, that share tops 50%.

More than half of European institutional ETF users expect to replace an existing futures position with ETFs in the year ahead. Most report making these switches to control costs and for operational simplicity, while some cite reasons of regulation or securities lending. Overall, 40% say they will evaluate futures positions for potential replacement with ETFs.

Key Growth Trends in ETF Use and Allocations

Institutions using ETFs alongside and in place of other investment vehicles has set the funds on a trajectory for future growth. Approximately a third of current equity ETF users plan to increase allocations to these funds in the year ahead. Among all institutions planning increases, half expect to boost allocations by at least 5% and 1 in 10 are planning increases of 10% or more.

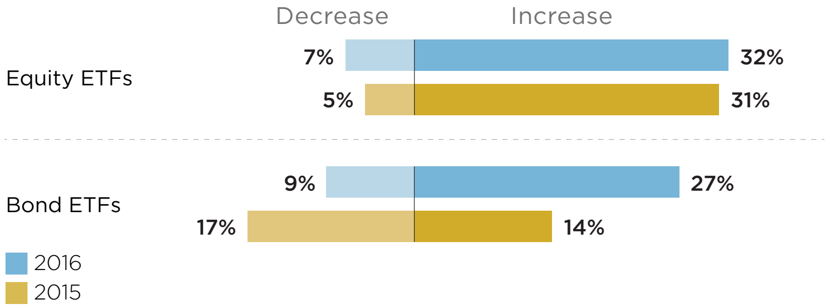


Strong Increases for Bond ETFs

Twenty-seven percent of bond ETF users say they will increase allocations to bond ETFs in the coming year—including 44% of insurance company investors. That 27% represents a dramatic increase from 2015, when only 14% of bond ETF users planned to increase allocations and an equal share planned a reduction. Of those currently planning increases, 63% expect to grow allocations to bond ETFs by 5% or more, and 17% are planning increases of more than 10%.

Slightly more than 10% of institutions not currently investing in bond ETFs plan to start using the funds in the coming year.

EXPECTED CHANGE IN ALLOCATIONS TO ETFs IN NEXT 12 MONTHS

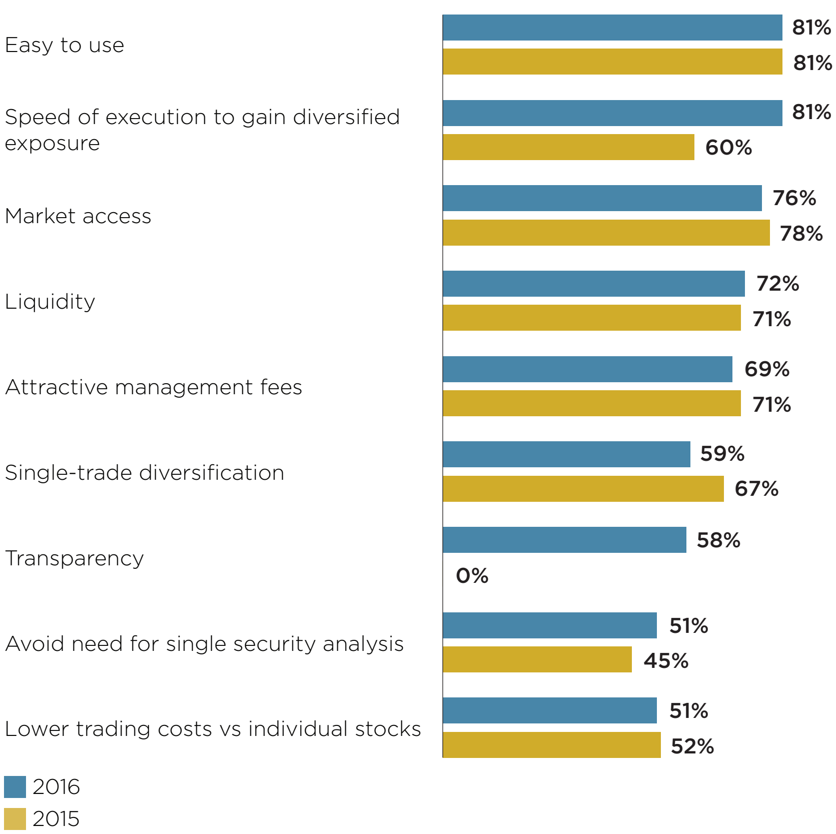


Note: Based on 36 responses for bond ETFs and 58 for equity in 2015, and 44 responses for bond ETFs and 69 for equity in 2016.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Ease of Use and Fast Access

Institutions invest in equity ETFs to access a long list of benefits, led by "ease of use" and "fast execution to gain diversified exposures"—both of which are cited by 81% of the institutions as important reasons for using the funds. More than 70% of equity ETF users name liquidity, and more than two-thirds cite attractive management fees. Over half mention

TOP REASONS FOR USING EQUITY ETFs



Note: Based on 74 responses in 2016 and 58 in 2015.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

single-trade diversification, transparency, eliminating the need for single-trade analysis, and lower trading costs relative to individual stocks as benefits of equity ETFs.

As an investment professional for a Nordic corporate pension fund concludes, "We are using ETFs more today than we did in the past, not because we are looking at a broader universe, but because the costs and fees of using ETFs have come down. This will continue to be the case in the future, and it will be important to consider further decreases in cost."

Liquidity Drives Demand

Institutions expecting to use bond ETFs for the first time in the next year say liquidity is by far the most important factor. Institutional investors have reported meaningful reductions in fixed-income market liquidity as a result of the Basel III bank capital requirements. To comply, banks in Europe and North America have had to slash bond inventories and retreat from their traditional roles as providers of broad market liquidity.

At the same time, increases in market volatility could place an even bigger premium on attributes like liquidity, ease of use and quick access. "ETFs allow us to buy back quickly in the violent movement of markets—during the big drops," says the Director of Investments for a French public pension fund.

HOW ARE EUROPEAN INSTITUTIONS USING ETFs?

Study respondents gave many examples of the diverse ways they are using ETFs in their portfolios:

- "ETFs have become more of a core allocation for our portfolios."
  ~ Portfolio manager for a U.K. investment manager
- "We certainly use them for transitional purposes, launching new products, achieving the required asset allocation, finding niche vectors, and finally as building blocks for portfolios."
  ~ Head of Portfolio Construction for a U.K. asset manager
- "We use ETFs for ease of access to small markets, for liquidity during a transition event and for foreign market exposure."
  ~ Manager of External Management for a U.K. corporate pension fund
- "ETFs make sector rotations agile."
  ~ Head of Equity for a Spanish public pension fund
- "We use them for market access where we're otherwise restricted from trading the underlying equities. We also use them for assisting with the management of cash flows in and out of our pooled funds."
  ~ Investment professional at a U.K. asset manager
- "We use ETFs for tactical asset allocation to gain our desired exposure and to avoid frequent trading in the portfolio and mutual funds."
  ~ Vice president of a Nordic asset manager

Institutions Applying ETFs in Risk and Liquidity Management

Over the past three years, European institutions have adopted ETFs for a broad and growing list of portfolio functions, integrating the funds ever more deeply into their portfolio management strategies. As a result of this process, ETFs are now used for a diverse set of applications.

Strategic vs. Tactical Applications

European institutions divide their ETF assets about equally between strategic and tactical applications. However, more than half the institutions in the study—52%—report average ETF holding periods of a year or longer. That share is up nearly 10 percentage points from 2015, reflecting that growing numbers of institutions are employing ETFs in longer-term strategic functions, such as obtaining investment exposures in the core components of their portfolios and other desired exposures.

"It all comes down to expressing allocation views," says a portfolio manager for a U.K. asset management firm. As just one example, approximately three-quarters of the institutions in the study predict that equities will be the best-performing asset class in 2017, with 47% naming developed-market equities and 29% favoring emerging-market equities. Twenty-eight percent of the institutions say they will use ETFs to implement that market view.

Over the past 12 months, institutions have made some important changes in how they use ETFs. Specifically, institutions are increasingly using ETFs to manage risk and liquidity. "Before liquid ETFs were available, it was more difficult for us to manage flows in and out of funds," notes an investment professional from a U.K. asset manager.

Liquidity Needs Boost ETF Use

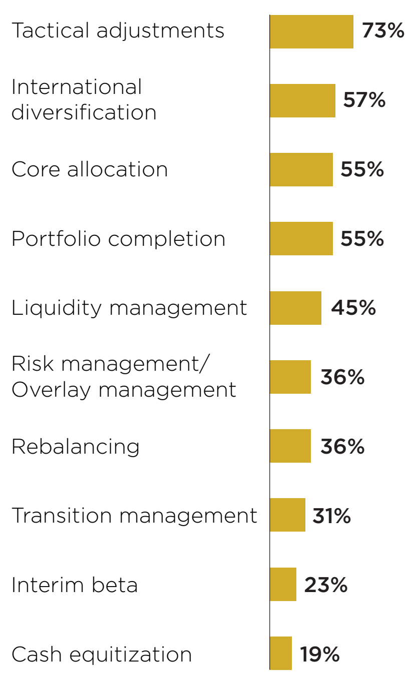
The share of institutional ETF investors using the funds for liquidity management increased to 45% in 2016 from 36% in 2015. That share jumps to 58% among asset managers. An equity portfolio manager for a U.K. asset manager explains how a recent need for liquidity prompted his fund to begin investing in ETFs: "We're quite new to ETFs, adopting them properly over the last six months," he says. "We found liquidity difficult over the summer, sitting on too much cash. The market was strong, so secondary opportunities were also limited. That prompted us to start using ETFs."

More Investors Holding ETFs for 1 Year or Longer

44% 2015

52% 2016

KEY USES OF ETFs IN EUROPEAN PORTFOLIOS



Note: Based on 94 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

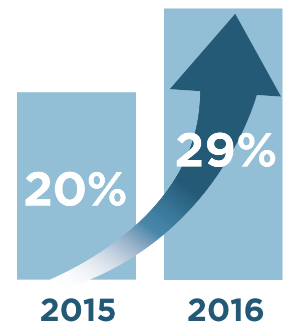
Managing Specific Risks

Meanwhile, the share of institutions using ETFs in risk management or management overlay strategies climbed to 36% in 2016 from 28% in 2015. These investors say they are regularly using ETFs to hedge credit and interest-rate risk, as well as to manage more specific risks.

An investment professional from a Nordic public pension fund explains: "Within our Swedish portfolios, if we have a really long-term view of a stock on the positive side, our cash-neutral requirement means we have to go short, so we use ETFs to mitigate stock-specific risk." A U.K. corporate pension fund provides another example: "We have a manager that has quasi-equity 'risk-on' exposure. A way to hedge this is through a gold ETF. It's a partial hedge to reduce volatility of the growth mandate."

More broadly, the increased use of ETFs in risk management likely reflects institutions searching for tools to help manage increased volatility associated with Brexit and structural changes to European and global fixed-income markets. As such, Greenwich Associates expects this trend to continue in 2017.

Allocation of Fixed-Income Assets to Passive Strategies



Bond ETF Newcomers Spur Growth

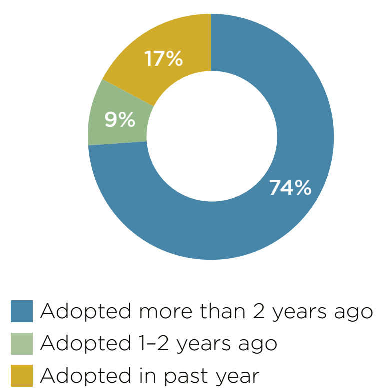
Mounting demand for passive investment strategies and expanding allocations among new ETF users point to continued growth for bond ETFs in European institutional portfolios.

Although the bulk of European institutions' fixed-income assets are invested in active strategies, allocations to passive are growing. Among the institutions in the study, passive assets grew to 29% of fixed-income assets in 2016 from 20% in 2015. "We use ETFs to obtain beta if we don't believe in active management for a particular investment category," says the Director of a Dutch corporate pension fund.

Approximately 25% of European institutions that invest in ETFs have been using the funds for less than two years, and a full 17% of users started in the past 12 months. The sizeable proportion of relative newcomers to bond ETF investing suggests allocations have ample room for further growth, as these investors get more comfortable and integrate ETFs more deeply into their fixed-income portfolios.

Greenwich Associates believes ongoing concerns about fixed-income market liquidity will fuel increased institutional investment in bond ETFs. As an investment professional from a Spanish asset manager observes, "We rely on ETFs in moments of no liquidity."

LENGTH OF TIME INVESTORS HAVE USED BOND ETFs



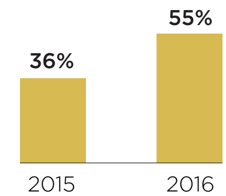
Note: Based on 46 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Growing Demand for Innovative/Smart Beta ETFs

European institutions' search for new sources of returns in a low-rate environment is triggering demand for innovative ETF products.

Growing numbers of European institutions are introducing smart beta ETF products into their portfolios. Non-market-cap weighted/smart beta ETFs were used by 26% of European institutional ETF investors in 2016, up from just 21% the prior year. Among European asset managers using ETFs in their portfolios, 37% invest in non-market-cap weighted/smart beta ETFs.

GROWTH OF SINGLE-FACTOR ETFs

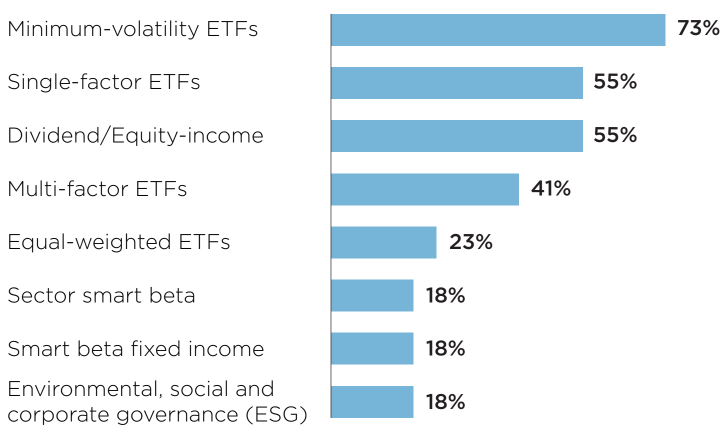


Note: Based on 14 responses in 2015 and 22 in 2016.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Min-Vol and Beyond

Although minimum-volatility ETFs have been the biggest draw for European institutions moving into the category to date, demand is building for a growing list of other types of non-market-cap weighted/smart beta ETFs. Among institutions investing in these non-traditional funds, 73% are using min-vol ETFs, and use of single-factor ETFs increased to 55% in 2016 from 36% in 2015. However, the biggest shift in demand occurred in dividend/equity-income ETFs, for which usage jumped to 55% of investors in the 2016 study from zero in 2015—a sure sign that European institutions were on the hunt for new sources of yield and income.

MOST WIDELY USED SMART BETA ETFs



Note: Based on 22 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

The study results show consistent demand for a range of other types of non-market-cap weighted/smart beta ETFs, including equal-weighted ETFs, sector smart beta, smart beta commodities and smart beta fixed income.

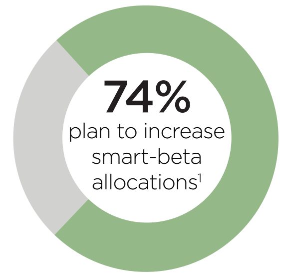
Facing a continued environment of low rates and the prospects of increased volatility from Brexit and other factors, institutions are planning to increase their use of non-market-cap weighted/smart beta ETFs. Three-quarters of current investors expect to increase allocations to these funds in the next year, up sharply from the 57% projected in the 2015 study. Among asset managers investing in these funds, approximately 80% expect to increase allocations in the year ahead.

Thirty-six percent of these institutions plan to increase allocations to min-vol ETFs, and approximately 30% each expect to boost allocations to dividend/equity-income ETFs and multi-factor ETFs.

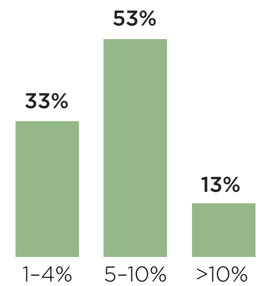
European institutions are showing a growing interest in ETFs designed to deliver positive environmental, social and governance (ESG) impact. Currently 18% of those using non-market-cap weighted/smart beta ETFs invest in ESG ETFs. However, nearly one-quarter of institutions planning to increase allocations to non-market-cap weighted/smart beta ETFs expect to boost their holdings of ESG ETFs next year.

INCREASE IN SMART BETA ETFs

Plan to Increase[1]



Expected Percent Increase[2]



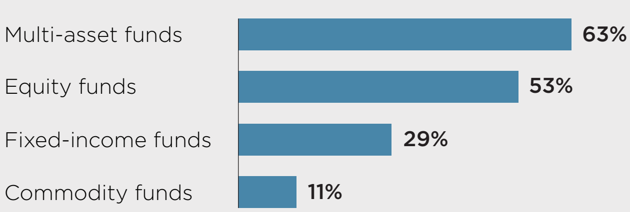
Note: [1]Based on 23 responses.
[2]Based on 15 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

MULTI-ASSET FUNDS PROVIDE QUICK DIVERSIFICATION

Multi-asset funds have been growing in popularity among investors globally for the past several years. As asset management firms create multi-asset products to fill this demand, they are incorporating ETFs into their investment portfolios. “ETFs allow us to quickly build a diversified exposure,” says a multi-asset portfolio manager for a Swiss asset management company.

Sixty-three percent of the asset management ETF investors in the study use ETFs in multi-asset funds. Within these funds, these managers invest approximately a quarter of total assets in ETFs on average. That share represents an increase from 2015, when asset managers reported average allocations of 22%. It’s also greater than the 22% of total assets invested in index mutual funds in 2016. Only individual securities get a bigger allocation, at 38%.

ASSET MANAGER ETF USE BY PRODUCT



Note: Based on 38 responses.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

Barriers to Entry Falling

Approximately 30% of institutions in the study that do not invest in ETFs cite expenses as a reason for not using the funds, and 28% say low trading activity or assets discourage use. Given the number of European institutions that have adopted ETFs or expanded allocations for the express purposes of lowering expenses and gaining liquidity, Greenwich Associates expects these perceived impediments to fade over time and for many of these holdouts to eventually start experimenting with ETFs in some capacity.

Internal Restrictions Should Ease

A similar process likely will play out among the roughly 25% of institutional non-users who say they are prevented from investing in ETFs by either internal investment guideline restrictions or regulations. Greenwich Associates believes institutional use of ETFs will grow as institutions revise internal guidelines and national regulators reform rules to allow investment.

This process will unfold naturally as institutions and regulators alike see the myriad ways the funds are being used to achieve investment exposures and to accomplish a wide range of strategic and tactical tasks within institutional portfolios. However, ETF providers can help remove these structural barriers by taking a proactive role and providing investment committees and regulatory bodies with information demonstrating how and to what extent ETFs are being employed by institutions in Europe and around the world.

Sustained work by providers to educate portfolio managers and other professionals about ETFs could continue to draw in new institutional users.

Educating Non-Users

Providers can also help stimulate demand by continuing to educate portfolio managers and other professionals about ETFs. Approximately 1 in 10 institutional non-users say a lack of understanding or familiarity prevents them from investing in ETFs. Between roughly 10% and 30% of institutions that have never invested in an ETF say they need more education about ETF mechanics, specific ETF products or product suites, or how ETFs can help them meet their investment objectives. These relatively small shares show that providers' past educational efforts have been effective, but suggest that sustained work in this area could continue to draw in new institutional investors.

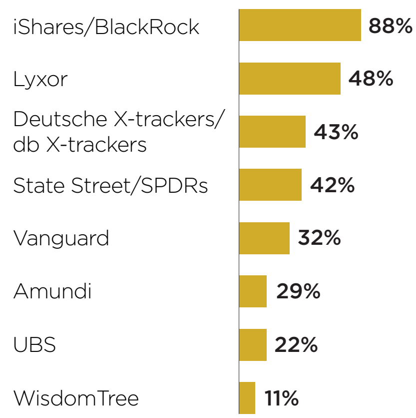
iShares/BlackRock is Europe's Top ETF Provider

Cost and liquidity are by far the most important criteria considered by institutions when conducting due diligence on a potential ETF investment. In addition to these factors, institutions also assess how well the ETF would match their exposure needs, the performance of the fund/tracking error, the benchmark used, the fund company and management behind the fund, and quality of service offered by the ETF provider.

Based largely on its performance in these key areas, iShares/BlackRock retained its position as the ETF provider of choice for European institutions in 2016. Among the European institutional ETF investors in the study, 88% use iShares/BlackRock as a provider, while 48% use Lyxor, 43% use Deutsche X-trackers/db X-trackers and 42% use State Street/SPDRs.

Institutions participating in the Greenwich Associates 2016 European ETF Study ranked ETF providers across a range of critical categories including product liquidity, range of products, exposures and domiciles, value for management fees, index tracking, servicing platform, innovation, and transparency. This year, iShares/BlackRock was named No. 1 in all categories.

MOST FREQUENTLY USED ETF PROVIDERS



Note: Based on 91 responses. Other providers mentioned included PIMCO, PowerShares, Comstage, Source UK Services, Handelsbanken, XACT Sweden, and DNB ASA.
Source: Greenwich Associates 2016 European Exchange-Traded Funds Study

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