Q1 2019

In Turbulent Times, European Institutions Turn to ETFs

GREENWICH ASSOCIATES

CONTENTS

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

THE SHARE OF EUROPEAN INSTITUTIONS INVESTING IN ENVIRONMENTAL, SOCIAL AND GOVERNANCE ETFs CONTINUED TO GROW IN 2018, CREATING A SUSTAINED SOURCE OF DEMAND FOR ETFs

44%

OF STUDY PARTICIPANTS ARE USING ETFs TO ADDRESS ESG

Executive Summary

Allocations to exchange-traded funds by institutions currently investing in ETFs increased by 50% in 2018, totaling 15% of total assets among the 127 institutional investors participating in Greenwich Associates most recent European Exchange-Traded Funds Study. That growth was driven in large part by three key trends:

- ***ETFs thrive in volatility:*** *European institutions in 2018 were repositioning their portfolios for a turbulent investment environment featuring the prospect of European Central Bank (ECB) rate hikes and a host of geopolitical risks. The implementation of these changes increased demand for ETFs. Institutions say ETFs' speed of execution, single-trade diversification, liquidity, and other characteristics make them versatile tools for portfolio construction.*

- ***Index revolution:*** *European institutions in search of low-cost beta continued shifting assets from active management to index strategies last year. As they did so, many used ETFs as their preferred vehicle for index exposures. This trend will likely continue in 2019, since institutions' allocations to index strategies still fall well short of what they consider optimal levels.*

- ***ESG is key:*** *European institutions are integrating Environmental, Social and Governance (ESG) standards into their investment process, and many of these investors are using ETFs as their vehicle of choice for ESG exposures. Forty-four percent of study participants overall and half the investment managers are using ETFs as a main vehicle to address ESG.*

These trends helped fuel robust growth in ETF allocations among the institutional funds, asset managers, insurance companies, and discretionary wealth managers participating in the 2018 study. That growth seems poised to continue in 2019, since nearly 40% of existing ETF investors in the research sample are planning to increase their ETF allocations in the coming 12 months.

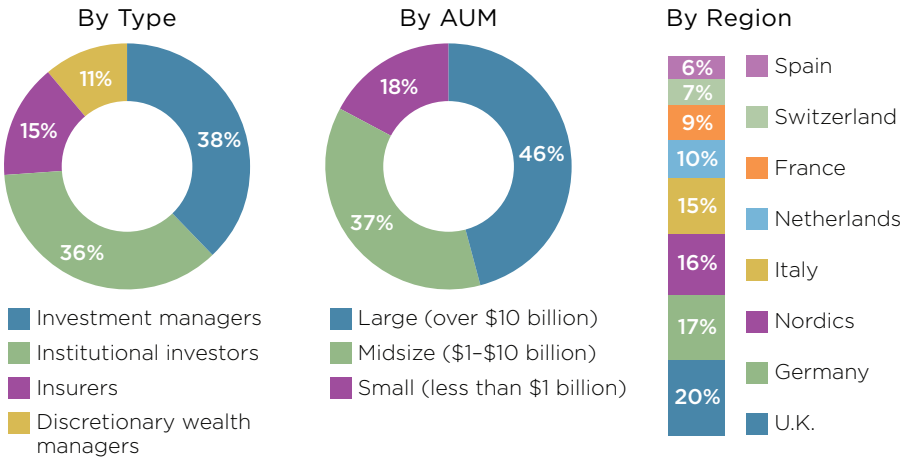
METHODOLOGY

Between October and December 2018, Greenwich Associates interviewed 127 institutional investors for its fifth annual edition of the European Exchange-Traded Funds Study. The research universe includes 46 institutional funds, 48 asset managers, 14 insurance companies/ insurance company asset managers, and 19 discretionary wealth managers. Most of the institutional funds are corporate pension funds (21) and public pension funds (10), although the group also includes representation from endowments, foundations, sovereign wealth funds, and family offices.

Most of the participants are large institutions. Forty-four percent of the institutions in the study have assets under management (AUM) of more than $10 billion, and more than half manage in excess of $5 billion. Respondents represent a wide range of countries, including France, Germany, Italy, the Netherlands, Nordics, Spain, Switzerland, and the United Kingdom.

A large majority of study respondents (92) are portfolio managers and/ or Chief Investment Officers. Twenty-three are research analysts, six are traders and six are in product development, sales or marketing.

RESPONDENTS



Introduction

Institutional allocations to exchange-traded funds (ETFs) rapidly grew last year, driven in large part by investors repositioning their portfolios in the face of an increasingly volatile and fast-changing market environment and the continued shift of institutional assets from active management to index strategies.

This report presents the findings of the latest Greenwich Associates European Exchange-Traded Funds Study, which we have been conducting annually since 2014. The results of this year's study reveal strong growth in ETF investments by European institutional funds, asset managers, discretionary wealth managers, and insurance companies.

This growth occurred in the midst of turbulent and, at times, even chaotic market conditions that featured, among other things, a U.S.-China trade war, Brexit negotiations, interest rate hikes in the United States, and an unexpected economic slowdown in Europe. All of these factors contributed to a surge of market volatility and a stock sell-off that resulted in one of the worst years for global equity markets since the financial crisis.

The study results suggest that last year's robust growth in ETF investments by European institutions occurred not in spite of these factors, but because of them. As institutions repositioned their portfolios to address heightened volatility and risk, they made wide use of ETFs to implement specific modifications. Institutions are utilizing ETFs as both tactical tools and as a strategic, longer-term staple in the portfolio.

Meanwhile, the ongoing shift of institutional assets from active management to index strategies has been one of the key drivers of ETF growth for the past decade. This growth has been fueled by a search for low-cost beta during a period when many active managers have underperformed benchmarks. Continuing through the hectic environment of 2018, this shift shows no signs of abating.

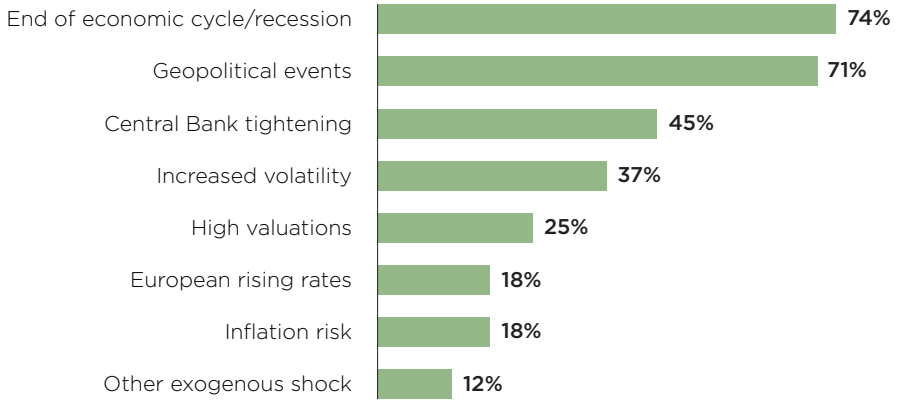
Together, these two developments—along with other factors like the rising influence of Environmental, Social and Governmental (ESG) investing and growing demand for smart beta strategies—helped fuel a 50% increase in institutional ETF allocations in 2018. With nearly 40% of existing institutional ETF investors planning to further expand allocations in the year ahead, expect to see continued ETF growth in European institutional portfolios in 2019.

As European institutions repositioned their portfolios to address heightened volatility and risk, they made wide use of ETFs to implement specific modifications.

Institutions' Top Priority: Managing Mounting Risks

The institutional investors participating in the Greenwich Associates 2018 European ETF Study are more concerned with macroeconomic developments and geopolitical events than at any time since the global financial crisis and, for the 12 months covered in the research, they were actively looking for ways to position their portfolios against what they see as a host of building risks.

TOP RISKS FACING INSTITUTIONAL PORTFOLIOS



Note: Based on 92 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

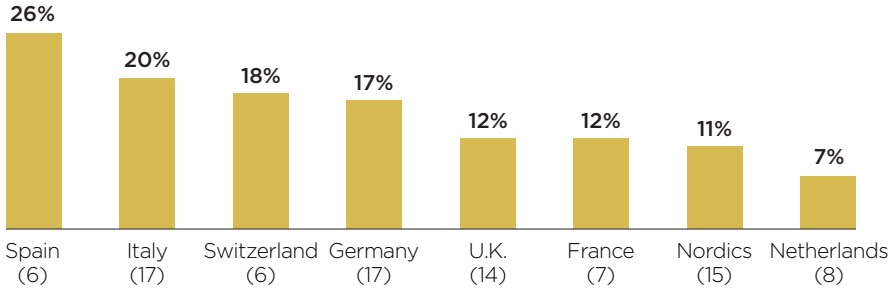
At the top of the list of concerns is the widespread belief that we are approaching the end of the current economic cycle. After witnessing slowing growth in major economies like Germany and China in 2018, three-quarters of the institutional investors in the study see an economic recession as a real risk for 2019.

Underlying these worries about recession are two key variables: the unpredictability of geopolitical events and the prospect of central bank tightening—which may or may not have been disrupted by economic weakness at the end of last year. Forty-five percent of study participants rank central bank tightening as one of the three biggest risks facing their portfolios in 2019. More than 70% of respondents—including almost all of the buy-side research analysts—see geopolitical events as a top risk. Drilling down into those fears, investors are most concerned about the impact of trade wars, European fragmentation/Brexit and the more general specter of the spread of populism in Europe and around the world.

Faced with these conditions, institutions in the study are prioritizing risk management over all other factors when it comes to portfolio construction in 2019. Nearly two-thirds of the investors rank "managing risk/return that is in line with objectives/outcome" ahead of other requirements, such as finding attractive investment opportunities with good returns and at appropriate costs. Of the four major types of study respondents—institutional funds, investment managers, insurance companies, and discretionary wealth managers—only wealth managers rank sourcing attractive investment opportunities on par with risk management as a priority for 2019.

As investors reposition portfolios to address these risks, they are increasing their use of exchange-traded funds. As a respondent from a large U.K. investment manager contends, ETFs offer the "ease of affecting lower operational risk at a reasonable price." Institutions in the study currently investing in ETFs increased ETF allocations to 15% of total assets in 2018, from 10% in 2017 and just 7.6% in 2016. At 17.5%, allocations are largest among investment managers, followed by insurance companies at 16%.

AVERAGE ALLOCATION TO ETFs BY COUNTRY



Note: Numbers in parentheses are number of ETF investors.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

These allocation increases have helped drive growth in overall ETF fund flows. The $315.8 billion of global inflows into ETFs in 2018 represented the second-biggest year ever, behind only the $467.1 billion recorded in 2017. Last year's robust inflows occurred despite volatile market conditions and the deep sell-off in global equity markets.

European institutions continued adding ETFs to their portfolios throughout that period to take advantage of several traits that make the funds versatile tools in such an environment. According to study participants, one of ETFs' primary benefits is an ease of use that allows investors to quickly and seamlessly integrate the funds into strategies across portfolios and asset classes. "ETFs are cost-efficient and operationally easy to increase or decrease exposure," says a study respondent from a large Dutch insurance company, explaining why his

"ETFs are cost-efficient and operationally easy to increase or decrease exposure."

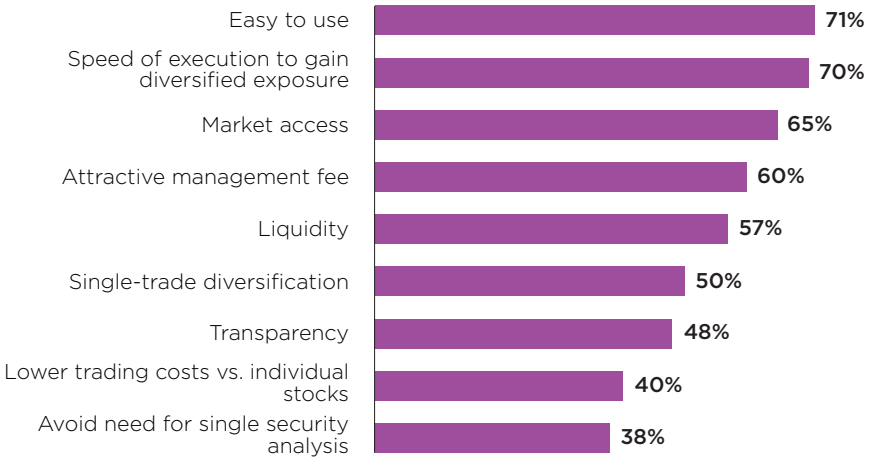
~Large Dutch insurance company

"They are more flexible than other vehicles."

~Midsize French corporate pension fund

organization has been using ETFs during this period. A study participant from a French corporate pension fund agrees, adding, "They are more flexible than other vehicles."

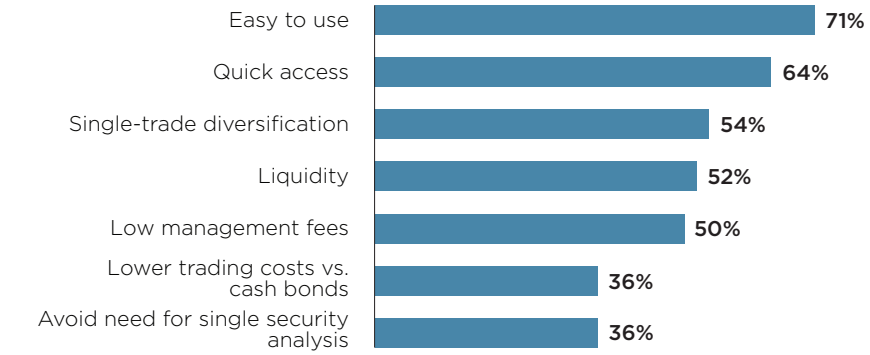
WHY DO YOU INVEST/PRIMARY BENEFITS FOR EQUITY



Note: Based on 82 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

"ETFs give us the broadest investments, low cost, good liquidity, and fit our strategic plan," says a study respondent from a Nordic regional bank. A portfolio manager of a multi-asset strategy for a U.K. asset management firm adds that ETFs provide "ease of implementation, liquidity, efficient valuation, and also effective management of risk when gaining exposure."

WHY DO YOU INVEST/PRIMARY BENEFITS FOR FIXED INCOME



Note: Based on 56 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

The Indexing Revolution Fuels Institutional Investment in ETFs

Regulation, technology and evolving client needs are forcing investors to reassess portfolio construction, and the resulting changes in approach are revolutionizing the role of index strategies in institutional portfolios. Active managers are finding it increasingly difficult to make a compelling argument in an environment of increased scrutiny on fees and democratization of information.

The shift of assets from active management to index strategies has been one of the main drivers of growth for ETFs in the institutional channel—and that trend seems poised to continue in coming years.

The investors participating in this year's study have about one-quarter of total assets allocated to index strategies. However, current index allocations still fall well below optimal levels, which investors set at 37% of assets in equity portfolios and 34% in fixed income. The gap, a result of legacy portfolio positions, seems to shrink each year.

INDEX ALLOCATION

Note: Based on 93 overall respondents, 80 for fixed income and 81 for equity.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

As investors continue bringing index allocations closer in line to these desired levels, they will further raise their investments in ETFs, which 84% of study participants name as their preferred index wrapper. "ETFs tend to be cheap, liquid, and track the indices of the markets we're

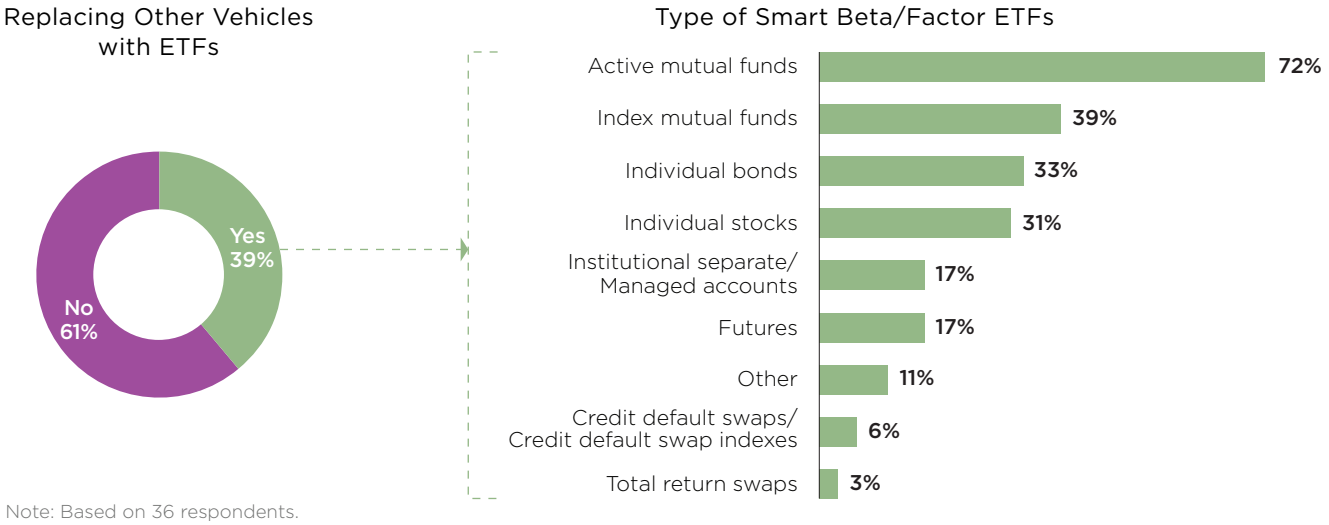
A NEW FRONTIER FOR ETF INVESTMENTS: CASH HOLDINGS

As investors take on a more defensive stance in portfolio construction, ETF flows could get a boost from a seemingly unlikely source: cash. Throughout 2019, European institutions will be keeping a close eye on several geopolitical fault lines—any of which could trigger a crisis and move markets into a "risk-off" environment. In that situation, most institutions will boost cash allocations by shifting assets into physical cash/cash deposits and money market funds. However, 31% of study participants overall and nearly half the discretionary wealth managers also employ ultra-short duration ETFs for cash exposures.

interested in with low tracking error," says the Head of Investment Risk and Portfolio Analytics for a U.K. asset management company, explaining why his firm prefers ETFs for index exposures.

Increases in index ETF allocations will come at the expense of active index mutual funds and other investment vehicles. "ETFs are more liquid than other options," says a study respondent from a midsize Nordic discretionary wealth management firm. "They offer more niche products, while mutual funds only have a basic level of core allocations. ETFs are cheap and efficient."

REPLACING OTHER VEHICLES WITH ETFs/TYPES OF SMART BETA/FACTOR ETFs



Note: Based on 36 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

Forty percent of ETF investors in the study say they have already replaced other investment vehicles in their portfolios with ETFs—up from 34% in 2017. Seventy-two percent of these investors have used ETFs to replace active mutual funds. That share climbed 10 percentage points from 2017 to 2018. That large jump could reflect investors' disappointment in the performance of active strategies during a time of heightened market volatility—a period in which active management was expected to demonstrate its value. Growing numbers of European institutions are also using ETFs to replace individual stocks (31% in 2018 vs. 24% in 2017) and individual bonds (33% vs. 14%).

But not all of the replacement trend can be explained by the move to indexing. In particular, 39% of study participants have used ETFs to replace index mutual funds, a move driven by institutions' more general appreciation of ETF benefits such as ease of use, liquidity and single-trade diversification. "ETFs are a cleaner solution," concludes the Senior Investment Manager of a midsize U.K. insurance company.

"ETFs are more liquid than other options. They offer more niche products, while mutual funds only have a basic level of core allocations."

~Midsize Nordic discretionary wealth manager

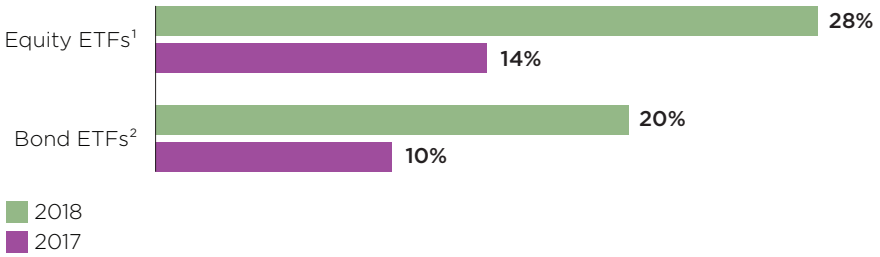
"ETFs are a cleaner solution."

~Midsize U.K. insurance company

Charting ETF Growth

Due in large part to these trends of portfolio repositioning and growing demand for index strategies, ETF allocations surged in both equity and fixed income last year. ETF investors in the study more than doubled their equity ETF allocations to approximately 28% of assets in 2018 from 14.4% in 2017. Institutional funds and wealth managers in the study now invest roughly a third of equity assets in ETFs. In fixed income, ETF allocations doubled to 20% of total assets from just 6.5% in 2017. Bond ETF allocations were largest among institutional funds, at nearly a quarter of total fixed-income assets.

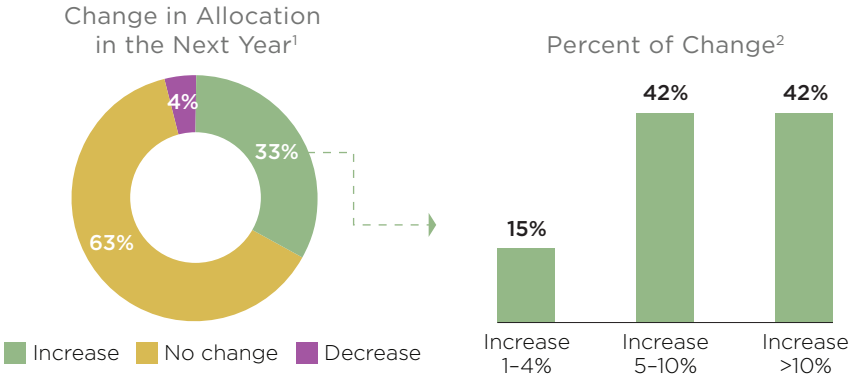
ETF ALLOCATIONS AS A PERCENTAGE OF AUM



Note: [1]Based on 82 equity ETF respondents in 2018 and 58 in 2017. [2]Based on 56 bond ETF respondents in 2018 and 68 in 2017.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

In contrast to past years, the biggest growth ahead could occur in equity portfolios. One-third of current equity ETF investors in the study plan to increase allocations in 2019—a share that includes nearly 40% of institutional funds and wealth managers. Those investors are planning significant increases. Forty-two percent of respondents planning to expand allocations are looking for increases north of 10%, with another 42% planning growth in the 5–10% range.

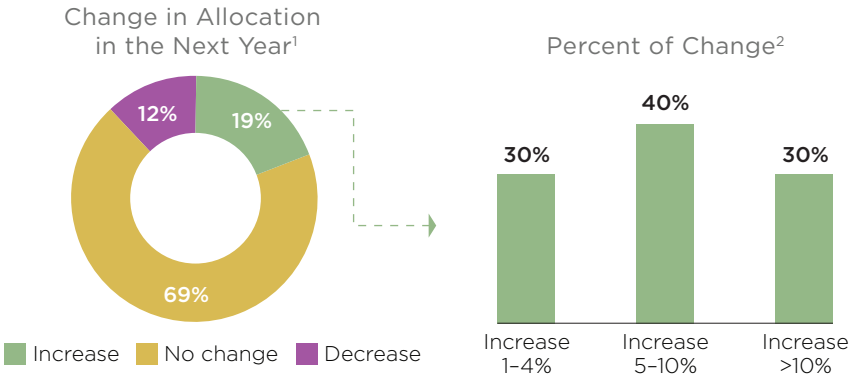
CHANGE IN ALLOCATION OF EQUITY ETFs



Note: [1]Based on 78 respondents. [2]Based on 26 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

In fixed income, approximately 20% of current ETF investors expect to increase allocations in 2019. Seventy percent of these investors plan to boost allocations by at least 5%, including 30% planning increases of 10% or more.

CHANGE IN ALLOCATION OF BOND ETFs



Note: [1]Based on 52 respondents. [2]Based on 10 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

ETFs Are a Source of Long-Term and "Core" Exposures

Qualities like ease of use, speed of execution and relatively low cost make ETFs extremely useful for short-term exposures and in tactical portfolio functions. In fact, many institutional investors first experiment with ETFs in exactly this type of short-term application in equity portfolios, and "making tactical adjustments" remains the most common way institutions employ ETFs in their portfolios today. "Because they are exchange-traded, ETFs are advantageous from an ease of portfolio implementation perspective," says the portfolio manager of an EMEA multi-asset strategy for a U.K.-based asset manager.

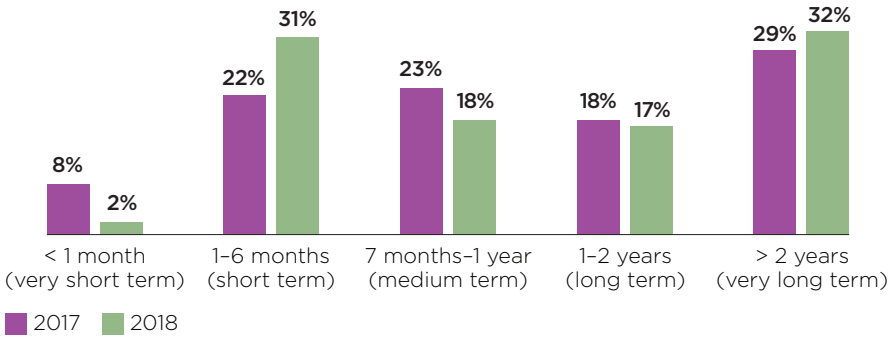
However, European institutions are increasingly using ETFs to obtain long-term investment exposures that play critical, strategic roles in their portfolios. For the first time since the debut of this study, European investors say the majority of their ETF investments are strategic, as opposed to tactical in nature.

STRATEGIC VS. TACTICAL ASSETS

Note: Based on 86 respondents in 2017 and 93 in 2018.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

Study participants now categorize 55% of their ETFs holdings as strategic, up from 49% in 2017. Those descriptions are backed up by data on average holding periods. The share of investors reporting average holding periods of one year or longer—the general threshold for an asset to be considered a "strategic" investment—increased to 49% in 2018 from 47% in 2017.

AVERAGE HOLDING PERIOD FOR ETFs



Note: Based on 77 respondents in 2017 and 88 in 2018.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

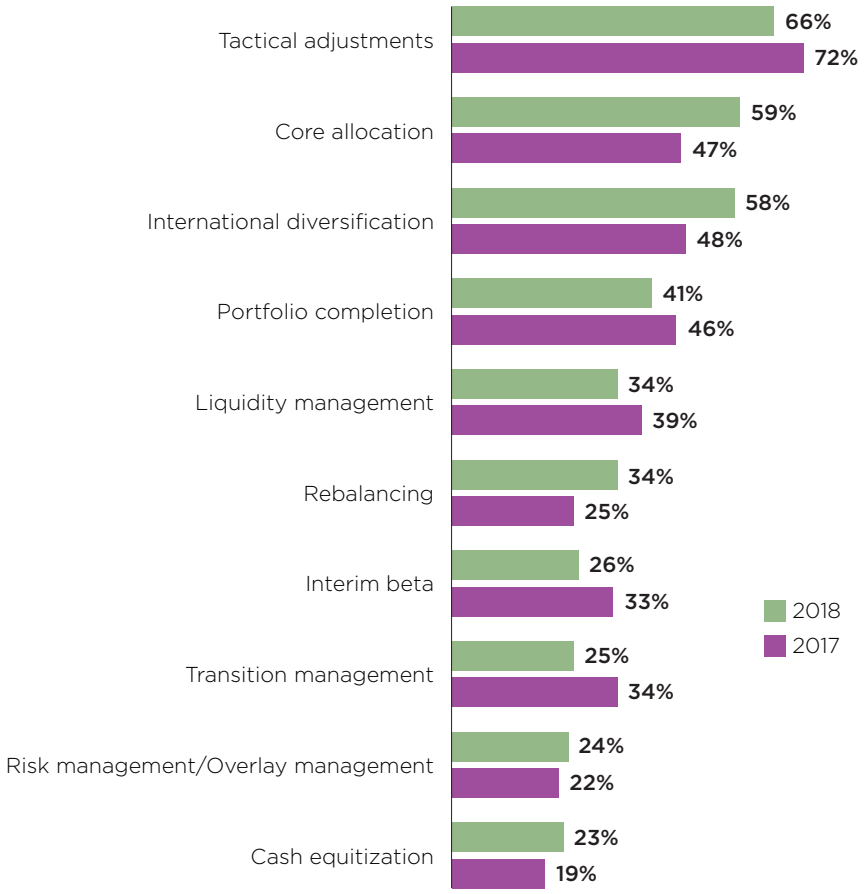
As shown in the following chart, here are several clear examples of this shift to strategic uses. The share of study participants using ETFs to obtain investment exposures in "core allocations" increased to approximately 60% in 2018 from 47% in 2017, and the share using ETFs for international diversification—another critical strategic function—increased to 58% from 48%. At 66%, wealth managers are the most likely to use ETFs to obtain core allocations.

USING ETFs FOR DIVERSIFICATION

Note: Based on 92 respondents in 2018 and 83 in 2017.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

Responses from traders, meanwhile, demonstrate that even as ETFs take on a more strategic role, investors are still making full use of the funds in more tactical applications. Every buy-side trader participating in the study says his or her organization uses ETFs to make tactical portfolio adjustments. Two-thirds say they use ETFs for cash equitization, and half use the funds for transition management and/or interim beta.

ETF USE WITHIN PORTFOLIOS



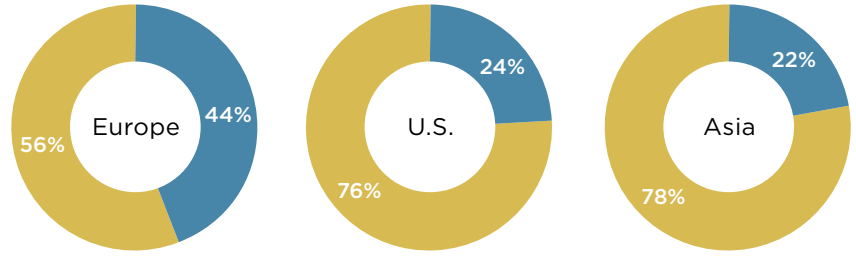
Note: Based on 92 respondents in 2018 and 83 in 2017.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

ETFs: A Primary Vehicle for ESG Investing

The share of European institutions investing in environmental, social and governance (ESG) ETFs continued to grow in 2018, and the ESG movement appears to be forming into a sustained source of demand for ETFs.

European investors are at the global frontline when it comes to incorporating ESG into investment decisions. Forty-four percent of participants in this year's European study—and more than half the discretionary wealth managers—have sold out of or invested in certain strategies due to ESG implications. By way of comparison, only 24% of U.S. investors have bought into or sold an investment strategy on this basis.

DOES APPROACH TO ESG LEAD TO CHANGES IN INVESTMENT PROCESS?



Yes, I have sold out of certain strategies/invested in new strategies

No, I will continue to monitor, but have not yet applied an ESG overlay for my current investments

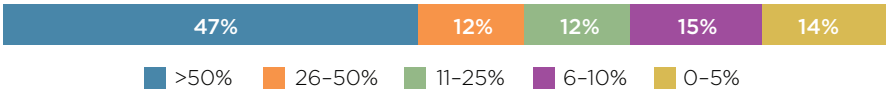
Note: Based on 119 respondents in Europe, 173 in the U.S. and 49 in Asia.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

What's driving European institutions to take ESG so seriously? Fifty-five percent of all study participants and three-quarters of the wealth managers agree that "investors are more important than ever to address issues such as climate change and diversity because governments are not doing enough." But these actions are not motivated only by a sense of social responsibility. Thirty-six percent of all respondents and 44% of the institutional funds agree that "ESG overlays/investments will enhance the likelihood of strong investment returns over the long term."

Reflecting this real sense of commitment to these issues, half the European investors in the study implement ESG into their organizations through a comprehensive integration, meaning they systematically incorporate ESG factors throughout the investment process. Another 31% of investors implement ESG with screens that filter out securities that don't meet ESG criteria or identify ones that do.

Many European investors are implementing ESG into their portfolios with ETFs. Forty-four percent of study participants overall and half the investment managers are using ETFs as a primary vehicle to address ESG—that's up from just one-third in 2017.

PERCENTAGE OF ASSETS EXPECTED TO BE MANAGED ACCORDING TO ESG CRITERIA IN NEXT 5 YEARS



Note: Based on 113 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

Those results suggest that ETF flows should increase as ESG grows in importance. Almost half the investors in the study—and almost 60% of the institutional funds and insurance companies—expect to have more than 50% of their total assets managed with ESG criteria within the next five years.

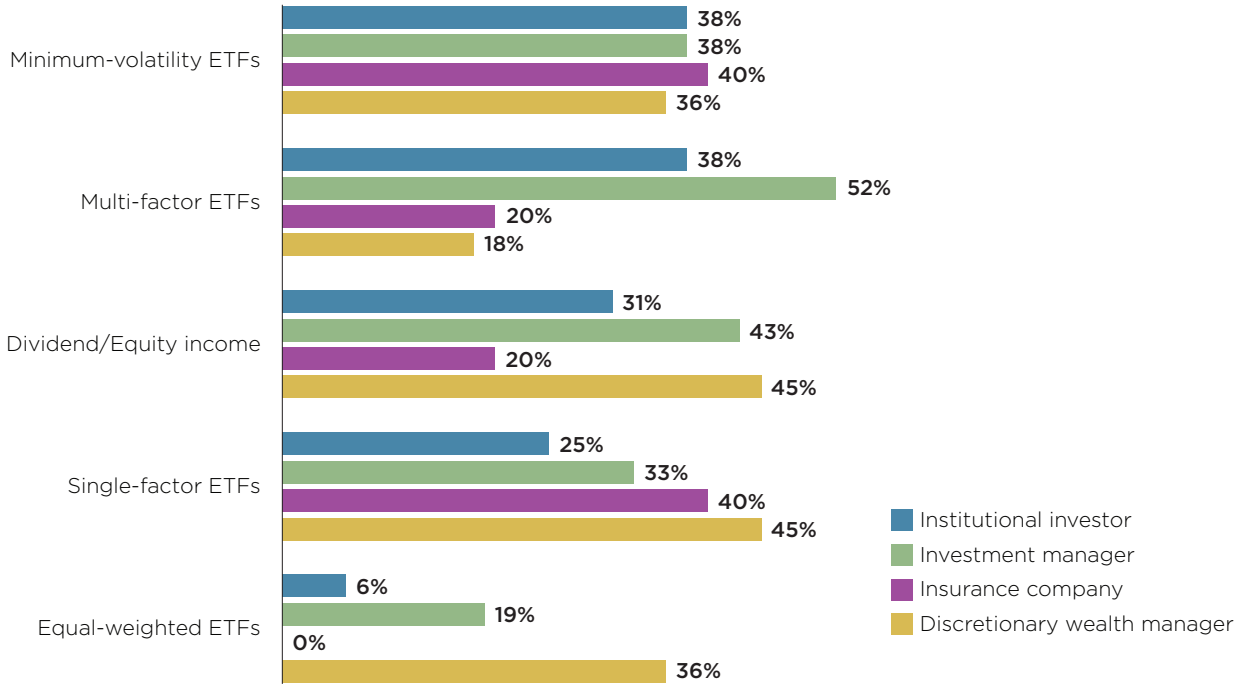
At the same time, 45% percent of participants in the study say they could use more information and support when it comes to understanding how to implement ESG in their portfolios. This finding suggests the number of investors utilizing ESG will continue to rise as organizations and investment teams become more familiar with both the issues and factors underlying the movement, and the mechanisms by which their peers are integrating ESG into their investment processes.

Smart Beta Thrives in Institutional Portfolios

The proliferation of smart beta strategies in institutional portfolios remains a steady driver of ETF demand and growth.

Two-thirds of study participants overall and nearly three-quarters of discretionary wealth managers invest in factor-based or smart beta ETFs. Almost two-thirds of these investors expect to hold allocations stable in the coming year, and only 2% expect reductions. Meanwhile, 35% expect to increase allocations in the next 12 months. These investors could have an outsized impact on overall demand levels because they are planning significant increases. Forty-six percent of respondents planning to increase smart beta ETF allocations expect to boost these levels by 10% or more. That group includes 55% of the investment managers and two-thirds of the institutional funds.

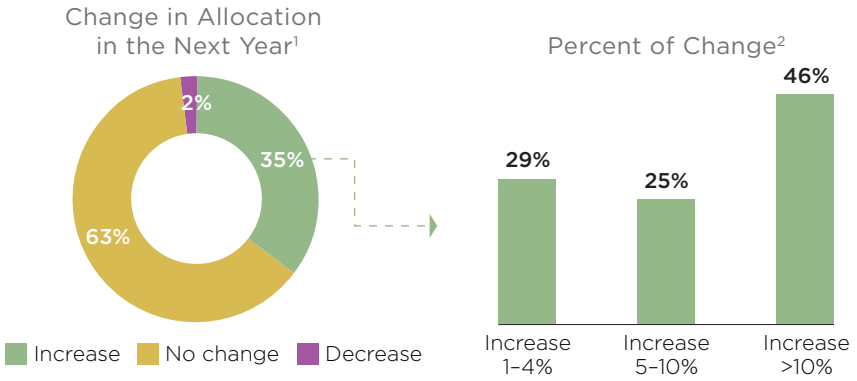
TYPE OF SMART BETA/FACTOR ETFs USED



Note: Based on 16 institutional investors, 21 investment managers, 5 insurance companies, and 11 discretionary wealth managers.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

Investors say they are increasing allocations to smart beta ETFs for two interrelated reasons. First, after several years of exposure, they now have an enhanced understanding of how factor-based strategies work, and as a result, they are more comfortable having smart beta ETFs in their portfolios. In fact, almost four in five respondents now report that they have a solid understanding about how to implement factor strategies in their portfolio. Second, as they've become more comfortable with these strategies, they've developed views on specific factors that they want to implement into their portfolios.

CHANGE IN SMART BETA/FACTOR ALLOCATION



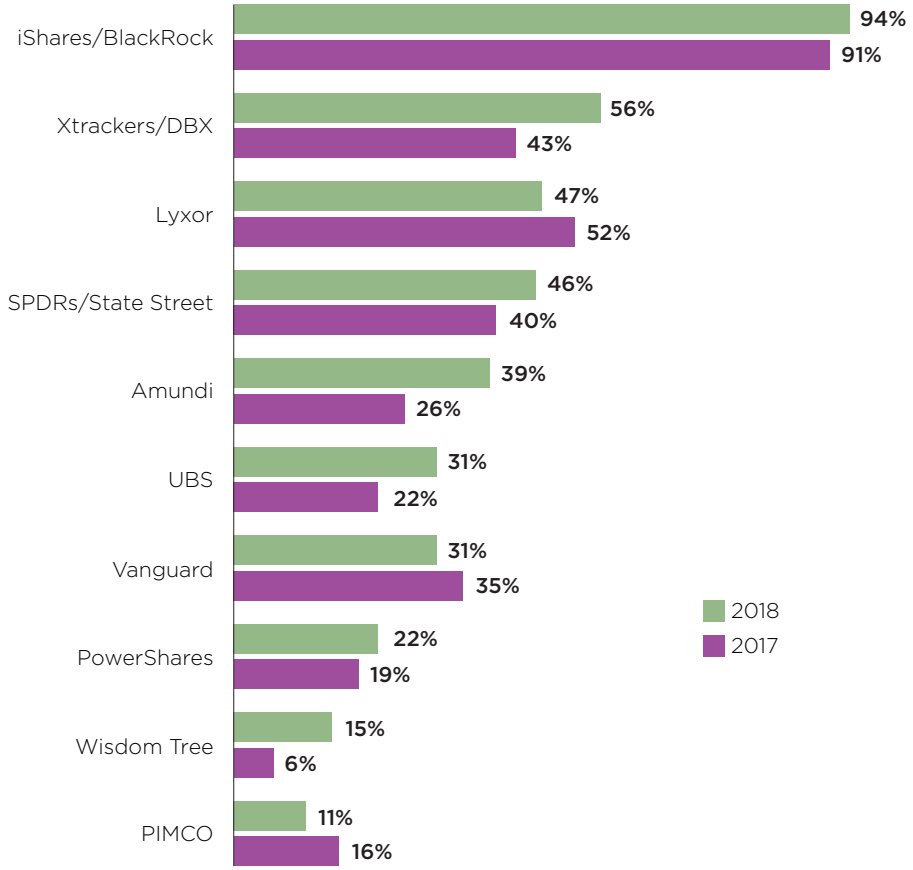
Note: [1]Based on 84 respondents. [2]Based on 28 respondents.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

iShares/BlackRock is European Institutions' Top ETF Provider

iShares/BlackRock is the ETF provider of choice for European institutions—by a wide margin. Ninety-four percent of the institutions participating in the 2018 European ETF Study use iShares/BlackRock for ETFs.

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, 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 89 respondents in 2018 and 77 in 2017.
Source: Greenwich Associates 2018 European Exchange-Traded Funds Study

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