

SMART BETA

A DEEPER LOOK AT ASSET OWNER PERCEPTIONS

FINDINGS FROM RUSSELL INDEXES
GLOBAL SMART BETA SURVEY

**RUSSELL
INDEXES**

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Introduction

In recent years, an evolution in indexing – generally known as “smart beta” – has blurred the lines between active and passive investing. While still transparent and rules-based, smart beta indexes differ from traditional indexes in that, often, they are not weighted by market capitalization. These strategies typically focus on specific systematic risk factors, behavioral anomalies or structural inefficiencies that may exist in the market, instead of on the broad market exposure offered by traditional market capitalization-weighted indexes. They are generally designed to enhance returns or reduce portfolio risk and to offer investors new ways to tailor their exposures to specific market segments.

In January 2014, Russell Indexes conducted a survey of institutional asset owners in North America and Europe to better understand the perceptions and adoption of smart beta within these important investor populations. The survey intentionally recruited equity investment decision makers across a broad spectrum of AUM size and at different stages in their evaluation of smart beta. We have prepared this report to offer insights into the growing acceptance of smart beta and the key considerations for investors as they evaluate these strategies and incorporate them in their portfolios.

Effectively integrating smart beta strategies within a broader portfolio requires that an asset owner maintain standards of assessment and ongoing review similar to those associated with any active strategy. For example, smart beta indexes that apparently target the same factor – such as low volatility – can differ greatly in their construction, with the result being potentially significant differences in market exposures and investment performance. Thus, understanding the objectives and the construction methodology of a smart beta index, and how the index can be expected to perform in a range of market cycles, is critical.

An investor might hold a combination of actively managed strategies, cap-weighted index strategies and smart beta strategies within a diversified global multi-asset portfolio. Determining which strategies are preferable will depend on the investor’s individual beliefs, objectives, tolerance for risk and time horizon.

The results of our survey demonstrate asset owners’ growing interest in and adoption of smart beta strategies and highlight the need for additional education, information and advice. Smart beta indexes have given investors more choice and greater control in constructing portfolios focused on achieving specific outcomes. But increased choice requires additional information for investors seeking to make appropriate decisions. We hope that the results of this survey can provide additional insights for investors who are considering the use of smart beta strategies in their portfolios.

Rolf Agather, CFA

Managing Director, Global Index Research & Innovation, Russell Investments



SUMMARY OF KEY THEMES:

Smart beta is taking off with a strong outlook, even if there is little consensus on what to call it

- › Preferred smart beta definition focuses on alternative ways to construct market exposure, but there is no agreement on “name”
- › Smart beta adoption is happening, and happening broadly
- › Europe leads in smart beta adoption
- › The outlook for increased adoption and usage of smart beta is strong

Role definitions overlap: Who is driving smart beta adoption and evaluation – the asset manager, or the consultant?

- › Asset managers play a key role in asset owners’ evaluation of smart beta strategies
- › Consultants are not driving the demand for smart beta in North America to the extent that they are in Europe

Early smart beta adopters favor fundamental and low-volatility index strategies; going forward, greatest unmet need is for exposure control

- › Low-volatility and fundamental index strategies dominate, but there are large regional differences in adoption
- › Greatest unmet need is for smart beta indexes that control exposures

Sample

We conducted this survey in January 2014. The 181 asset owners included in the study were drawn from Europe¹ (52%) and North America (48%). Almost 90% of the survey respondents either have direct responsibility for selecting equity investments or play a role in a team that performs this function. Roughly half of the respondents work for corporations or private businesses; one-quarter work for non-profits or universities, and one-quarter work for government organizations. Seventy-five percent of the respondents manage defined benefit plan assets, 43% manage defined contribution plan assets and 19% manage endowment or foundation assets. By AUM, 75% of respondents manage assets in excess of \$1 billion, and 35% manage assets in excess of \$10 billion. The sample size of the survey is sufficiently large to allow for segmenting results on AUM size and region. Full detail on the sample demographics can be found in the appendix.

¹Europe sample includes some respondents from the Middle East; see appendix for detailed break by country.



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Preferred smart beta definition focuses on alternative ways to construct market exposure, but there is no agreement on “name”

Preferred smart beta definition focuses on alternative ways to construct market exposure

Respondents were asked how they would define “smart beta.” Close to 50% selected the definition “Alternative ways to construct market exposures such as minimum variance, fundamental weighting, maximum diversification, equal risk or equal weighted.”

EXHIBIT 1
Which of the following do you think is the best definition for smart beta?

Alternative ways to construct market exposures such as minimum variance, fundamental weighting, maximum diversification, equal risk or equal weighted	45%
Any index that is not based on traditional market capitalization-weighting	22%
A transparent, rules-based investment strategy that is designed to provide a specific exposure to market segments or factors	22%
An index that weights the portfolio by risk characteristics, such as volatility	7%
Other	5%

Data may not equal 100% on all exhibits due to rounding.



Between North America and Europe, and across AUM levels, no clear winner on best name

There has been significant industry coverage regarding the best name to use for smart beta, and this survey revealed no strong winner. In North America, the most popular response is “Alternatively weighted indexes” (33% of respondents preferred this name); in Europe, it is “Smart beta” (35% of respondents). When segmented by size, “Alternatively weighted indexes” is most popular among owners of assets under \$1B, “Smart beta” and “Alternatively weighted indexes” are essentially tied among owners of assets between \$1B and \$10B, and “Smart beta” wins among owners of assets exceeding \$10B.

EXHIBIT 2

What is your preferred name to call what the industry has been calling “smart beta”?

	Europe	North America
Alternatively weighted indexes	29%	33%
Smart beta	35%	15%
Factor indexes	6%	16%
Risk premia indexes	5%	6%
Strategy indexes	7%	9%
Custom beta	6%	7%
Strategic beta	5%	6%
Other	5%	7%

	Under \$1B	\$1B - \$10B	\$10B +
Alternatively weighted indexes	38%	30%	24%
Smart beta	23%	29%	29%
Factor indexes	8%	9%	16%
Risk premia indexes	5%	3%	7%
Strategy indexes	8%	8%	9%
Custom beta	3%	11%	2%
Strategic beta	5%	6%	7%
Other	10%	5%	7%



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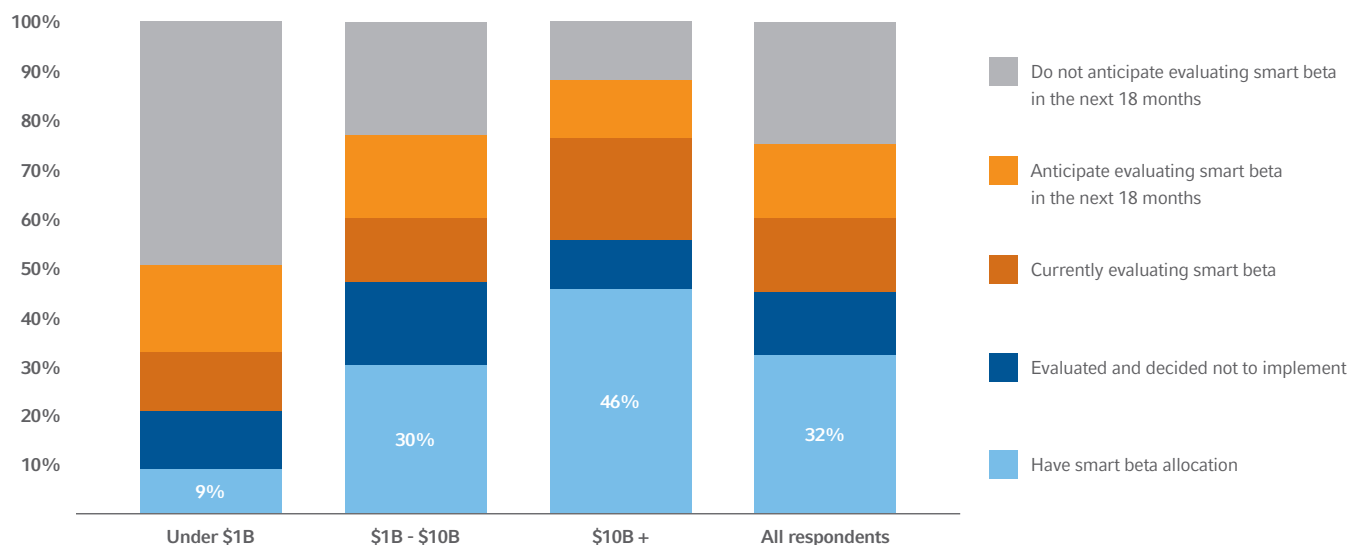
Smart beta adoption is happening, and happening broadly

At all AUM levels, the majority of asset owners have already evaluated smart beta, or expect to evaluate it in the next 18 months

Thirty-two percent of asset owners currently have smart beta allocations. Adoption of smart beta is greatest among the largest asset owners, but smaller asset owners are quickly following. Eighty-eight percent of respondents with over \$10B in AUM have evaluated smart beta or plan to do so in the next 18 months; 77% of respondents with AUM between \$1B and \$10B, and even 50% of those with AUM under \$1B, responded similarly.

EXHIBIT 3

What best describes your organization's usage of smart beta?





For asset owners who do not plan to evaluate smart beta, the primary reasons are concerns regarding investment merit and lack of consultant recommendation

The minority of asset owners who have not already evaluated smart beta and do not anticipate doing so within the next 18 months said the primary reasons are that they do not believe smart beta has investment merit and that their consultants have not recommended this option. In Europe, concerns are almost exclusively about investment merit; in North America, both concerns are factors.

EXHIBIT 4

What are the primary reasons you have not yet evaluated smart beta strategies?

Do not believe they have investment merit	41%
Consultant has not recommended this option	32%
Lack of investment resources to make the evaluation	24%
Do not believe in passive allocations	21%
AUM is too small for this type of strategy	3%
Other	24%

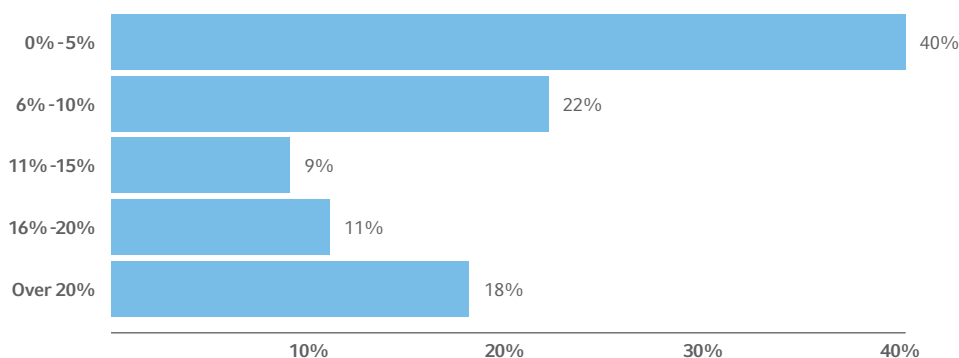
Multi-pick.
Segment = Do not anticipate evaluating smart beta in the next 18 months

Majority of asset owners have allocated 10% or less of equity portfolio to smart beta

Among survey respondents currently using smart beta, most allocations are under 10% of an equity portfolio, but there is a group making more sizable allocations (more than 20%) to these strategies.

EXHIBIT 5

What percent of your organization's equity portfolio is invested in a smart beta strategy?



Segment = Have smart beta allocation



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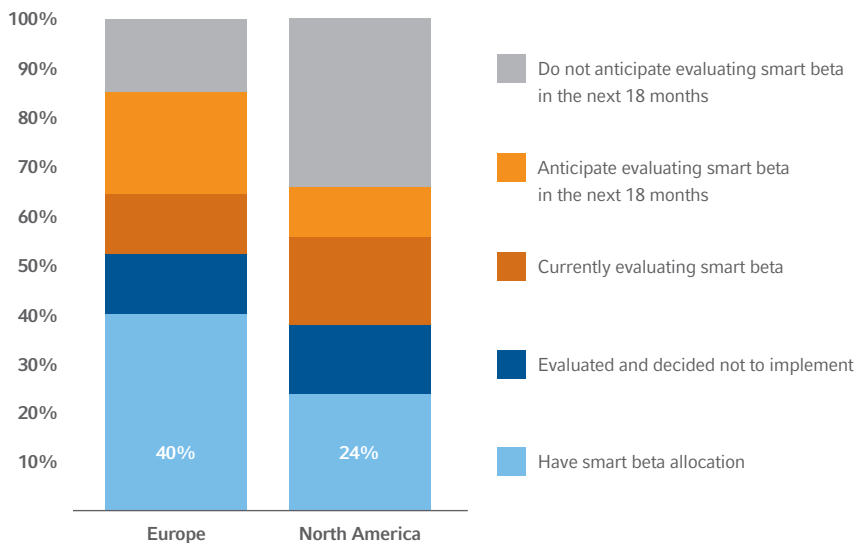
Europe leads in smart beta adoption

In Europe, 40% of asset owners have adopted smart beta; in North America, 24%

Europe is leading North America in smart beta adoption, with 40% of European respondents reporting smart beta allocations, compared to 24% of North American respondents. In addition, in Europe, only 15% do not expect to evaluate smart beta in the next 18 months, compared to 34% in North America.

EXHIBIT 6

What best describes your organization's usage of smart beta strategies?

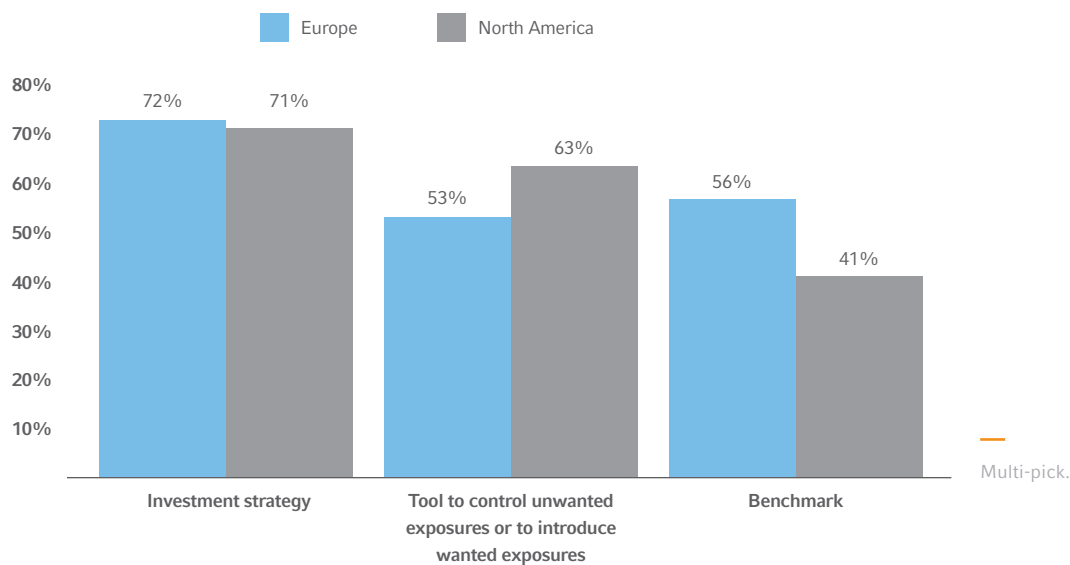




Regional views on appropriate uses for smart beta indexes differ as well

Another regional difference in smart beta adoption is that European asset owners more often view smart beta indexes as possible benchmarks, while North American asset owners tend to see smart beta as a tool to control unwanted exposures or to introduce wanted exposures in a portfolio.

EXHIBIT 7
In your view, what are appropriate applications for smart beta indexes?





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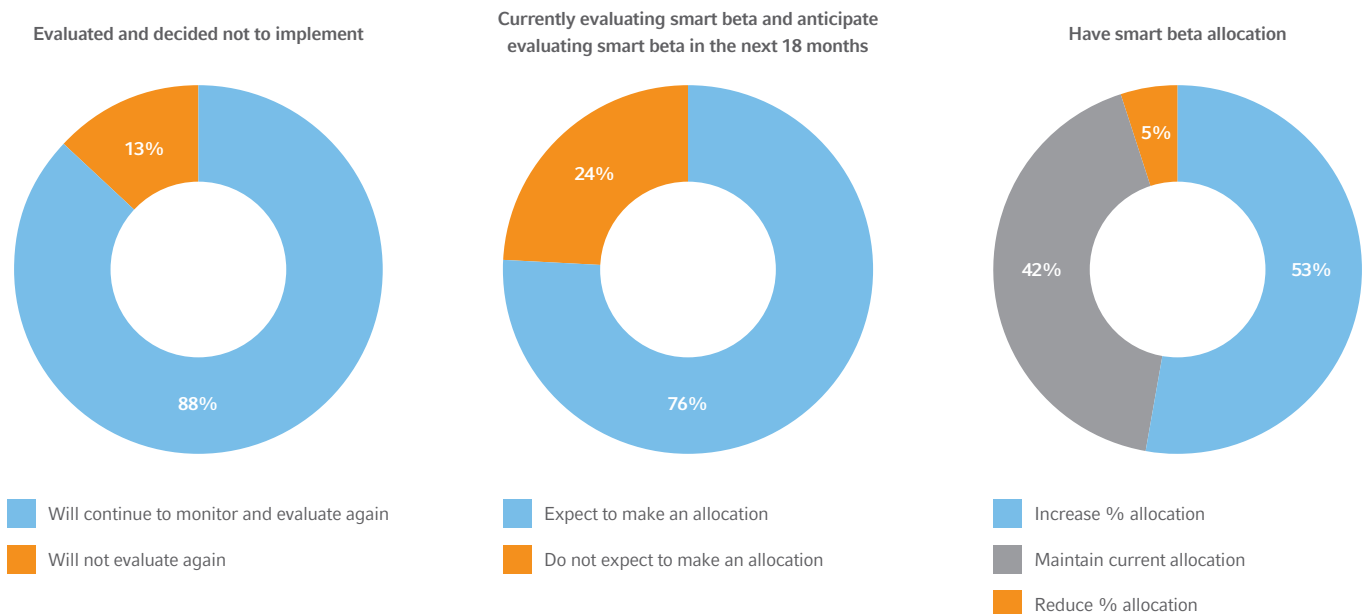
The outlook for increased adoption and usage of smart beta is strong

Of asset owners currently evaluating smart beta or planning to evaluate its use in the next 18 months, a large majority expect to make an allocation, and the majority of respondents with a smart beta allocation plan to increase it

For asset owners who already have an allocation to smart beta, 53% expect to increase the allocation and only 5% plan to reduce it. For asset owners currently evaluating smart beta or planning to evaluate its use in the next 18 months, 76% expect to make an allocation and only 24% plan to reduce it. For asset owners currently evaluating smart beta or planning to evaluate its use in the next 18 months, 76% expect to make an allocation.

EXHIBIT 8

What is your outlook for future usage of smart beta in your portfolio?



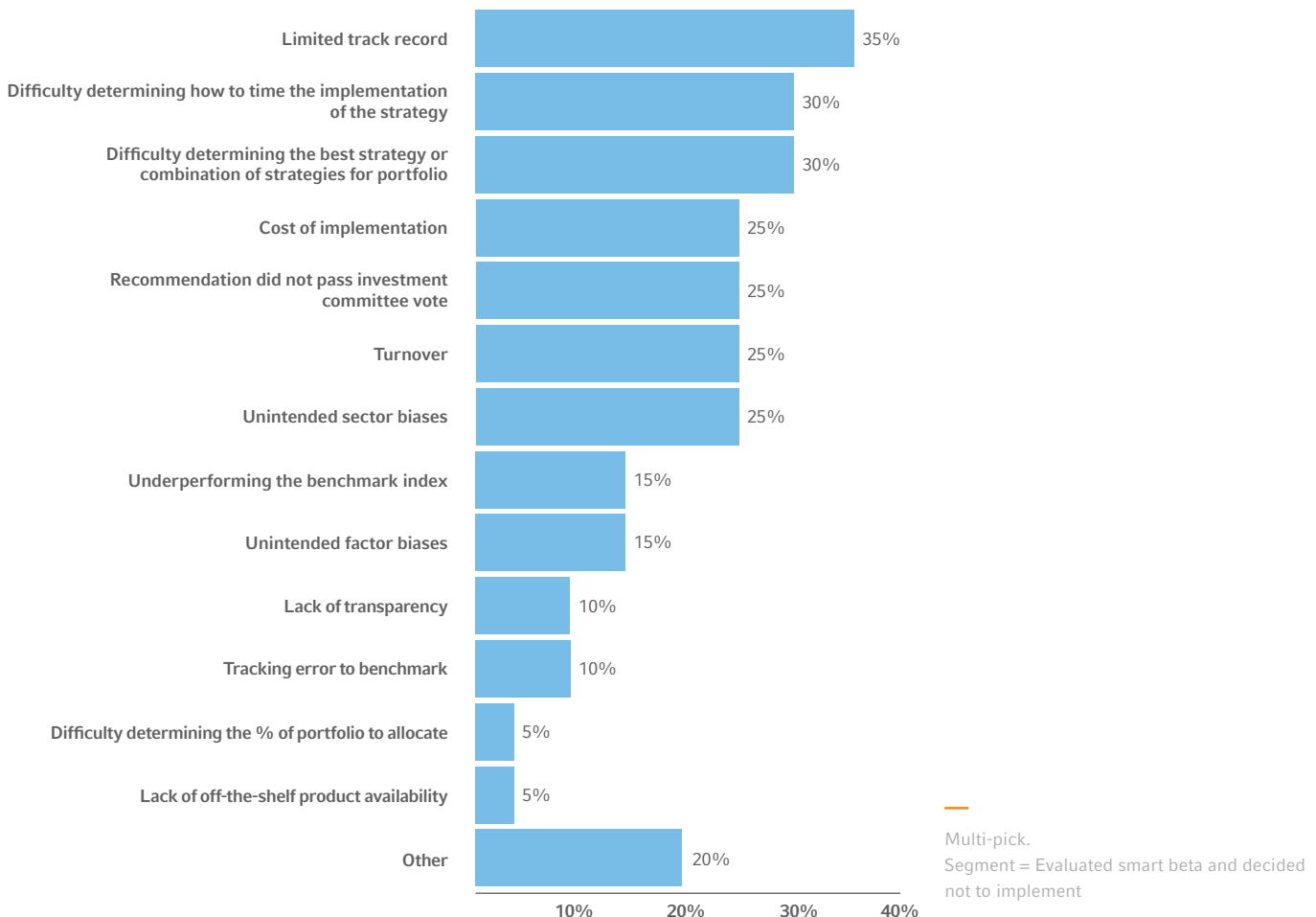


Among asset owners who decided not to implement smart beta, nearly 90% plan to evaluate smart beta again

Even among the asset owners who evaluated smart beta but have decided not to implement it, 88% plan to monitor and evaluate again. The top reasons these asset owners did not implement smart beta are “Limited track record,” “Difficulty determining how to time implementation of the strategy” and “Difficulty determining the best strategy or combination of strategies.”

EXHIBIT 9

What are the primary reasons you did not implement a smart beta strategy?





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Asset managers play a key role in asset owners' evaluation of smart beta strategies

In both Europe and North America, asset managers are the top source for credible information about smart beta strategies

"Asset manager" was the top response in both North America and Europe as to sources of credible information about smart beta strategies. It appears that the asset manager is viewed as an unbiased partner in the evaluation process.

"Journal publications" is essentially tied with "Asset manager" in North America as the leading source of information, but this is less important in Europe. Asset owners in North America also rely more on peers and index providers than do asset owners in Europe.

EXHIBIT 10

What sources of information do you rely on most for credible information about smart beta strategies?

	Europe	North America
Asset manager	58%	59%
Journal publications	43%	58%
Consultant	43%	46%
Index provider	32%	50%
Industry events / symposiums	38%	36%
Peers	22%	41%
General financial / investment news media	26%	34%
Trade financial news media	28%	30%
Online industry forums & groups	7%	14%
Other	13%	5%

Multi-pick.



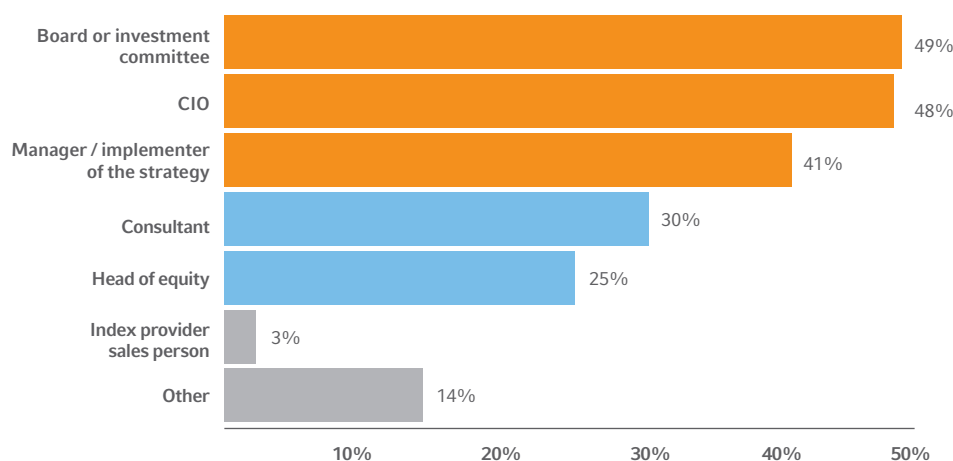
Manager / implementer is also a key player in evaluating smart beta

In addition to the asset manager being deemed a reliable source of information, the manager / implementer of the strategy is also involved in the evaluation of smart beta strategies. The Tier 1 participants in the evaluation are “Board or investment committee,” “CIO” and “Manager / implementer.” Tier 2 are “Consultant” and “Head of equity.” The index provider sales person is not seen as part of the evaluation team.

“Board or investment committee” was named primary decision maker by over 50% of asset owners.

EXHIBIT 11

Who is involved in evaluation of smart beta strategies within or on behalf of your firm?

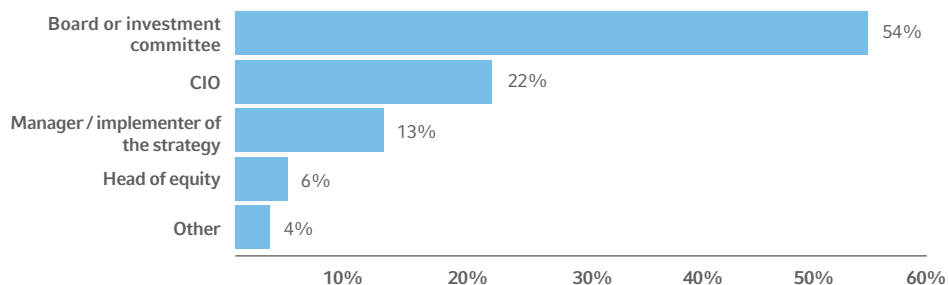


Multi-pick.

Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation

EXHIBIT 12

Who is the primary decision maker involved in evaluation of smart beta strategies within or on behalf of your firm?



Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation

Overlap in role definition between consultants and asset managers regarding smart beta adoption and evaluation

Asset owners surveyed rely on asset managers as the top source of credible information about smart beta and regard them as key players in the evaluation of smart beta indexes. This indicates that there may be overlap in the roles of the asset manager and consultant in regard to smart beta adoption and evaluation.



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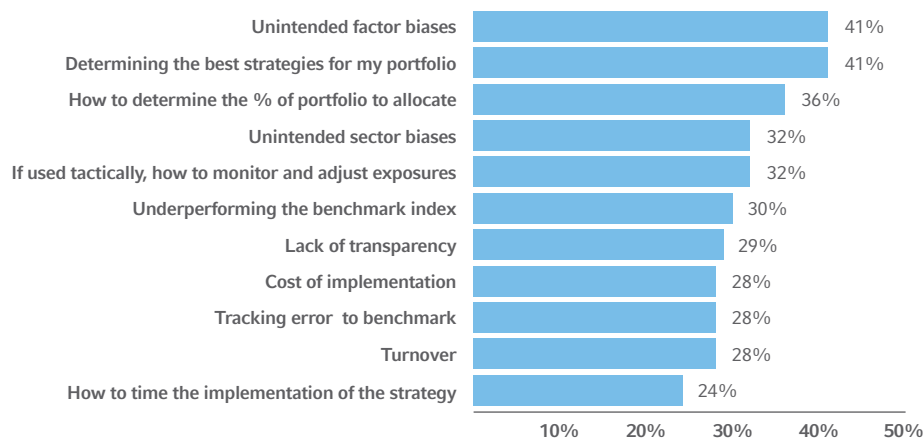
Consultants are not driving the demand for smart beta in North America to the extent that they are in Europe

“How to avoid unintended factor biases” and “How to determine the best implementation strategy or combination of strategies” are top concerns for respondents considering or using smart beta

Asset owners’ top concerns with implementing smart beta are “Unintended factor biases” and “How to determine the best strategy or combination of strategies for my portfolio,” followed by “How to determine the percentage of the portfolio to allocate.” These concerns all speak to an increasing need for consultant assistance or a larger investment team, in order to best conduct the necessary analysis and evaluation of smart beta strategies.

EXHIBIT 13

Please rate your level of concern with the following, if implementing a smart beta strategy. Scale = 1-7 where 1 is not a concern and 7 is significant concern. Top 2 Box = % rating 6 or 7



Index provider initiating the evaluation of smart beta in North America

Asset owners’ strong need for advice in smart beta implementation is being met by index providers in North America. There, “Information from index providers” is cited as the top reason for initiating the evaluation of smart beta, with 54% of asset owners in North America starting their evaluation of smart beta in response to this information and just 19% citing “Consultant recommendation.”



In Europe, the consultant and the index provider are both driving the evaluation of smart beta

In Europe, “Consultant recommendation” ties with “Information from index providers” as the most-cited reason for initiating the evaluation of smart beta (27% each).

EXHIBIT 14

What event(s) initiated the evaluation of smart beta strategies?

	Europe	North America
Information from index providers	27%	54%
Consultant recommendation	27%	19%
Board member or member of investment committee interest	17%	16%
Recent press	12%	19%
A peer implemented a smart beta strategy	7%	5%
Other	37%	35%

Multi-pick.

Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation. Most common responses included in “Other” are “Asset manager,” “Academic research” and “Internal staff”

Among asset owners who plan to evaluate smart beta in the next 18 months, the primary reason for not yet having evaluated the strategy is that their consultant has not recommended it

For asset owners who have not evaluated smart beta, but who anticipate doing so within the next 18 months, the top reason why they have not yet evaluated is “Consultant has not recommended.” These asset owners appear to be looking to their consultants to initiate the discussion.

EXHIBIT 15

What are the primary reasons you have not yet evaluated smart beta strategies?

Consultant has not recommended this option	50%
Lack of investment resources to make the evaluation	33%
Do not believe they have investment merit	6%
Other	33%

Multi-pick.

Segment = Anticipate evaluating smart beta in the next 18 months. No consistent trend with respect to “Other” responses



The consultant is a more important source of information for asset owners with less than \$10B in AUM

As AUM decreases, the consultant becomes an increasingly important source of credible information for asset owners considering smart beta strategies. “Consultant” ranks #5 among respondents with over \$10B in AUM, #2 among respondents with AUM between \$1B and \$10B and #1 among those with AUM under \$1B (albeit “Consultant” tied with “General financial / investment news media” and “Industry events / symposiums”).

EXHIBIT 16

What sources of information do you rely on most for credible information about smart beta strategies? Ranked by percentage of respondents selecting each option.

	Under \$1B	\$1B - \$10B	\$10B +
Asset manager	4	1	1
Consultant	1	2	5
General financial / investment news media	1	6	8
Index provider	7	4	3
Industry events / symposiums	1	5	6
Journal publications	5	3	2
Online industry forums & groups	9	9	10
Peers	7	8	4
Trade financial news media	6	6	7
Other	10	10	9

Multi-pick.
1 = Highest 10 = Lowest



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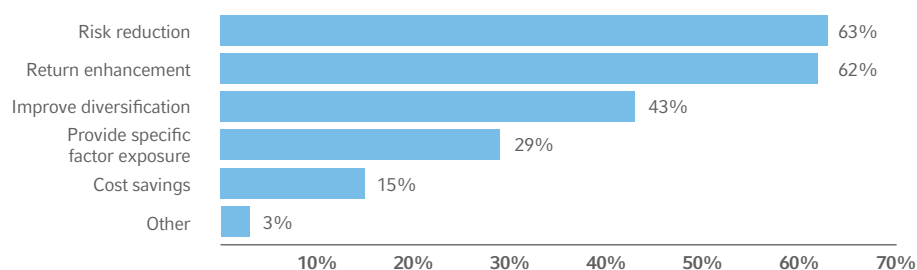
Low-volatility and fundamental index strategies dominate, but there are large regional differences in adoption

Interest in smart beta is driven by the desire for risk reduction and returns enhancement, rather than for cost savings

“Risk reduction” and “Return enhancement” ranked at the top of the list of investment objectives that motivated respondents’ evaluation of smart beta strategies, with over 60% of asset owners attributing their evaluation to each of these two investment objectives. “Cost savings,” cited just 15% of the time, ranked at the bottom of the list.

EXHIBIT 17

What investment objective initiated evaluation of smart beta strategies?



Multi-pick.

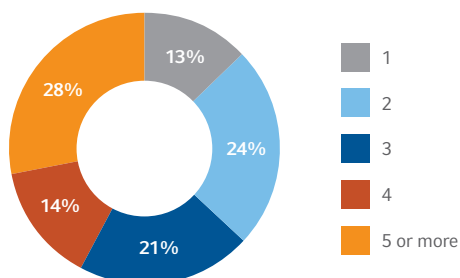
Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation

Most asset owners are evaluating three or more different types of smart beta strategies

In their evaluation of smart beta, 63% of asset owners are considering at least three types of strategies, and 28% are looking at five or more.

EXHIBIT 18

Number of smart beta strategies evaluated



Multi-pick.

Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation



The U.S. and the UK are using fundamental index strategies; Europe ex-UK and Canada are using low-volatility

Low-volatility and fundamental indexes dominate the smart beta strategies being evaluated and used by asset owners, but there are large differences by region. Fundamental index usage is much greater in the United States and the United Kingdom, while low-volatility is the dominant strategy in Europe ex-UK and Canada.

EXHIBIT 19

What smart beta strategies have you evaluated or are you currently evaluating?

	U.S.	Canada	UK	Europe (ex UK)
Low volatility	54%	86%	55%	81%
Fundamental	61%	29%	90%	59%
High quality	32%	43%	30%	44%
Maximum diversification	11%	36%	20%	41%
Risk parity	25%	50%	40%	37%
Momentum	25%	29%	15%	26%
Equal weight	25%	29%	40%	44%
Stability (defensive / dynamic)	36%	21%	25%	22%
High dividend	21%	29%	40%	41%
Other	4%	7%	5%	11%

— Multi-pick.

Segment = Currently evaluating smart beta, evaluated and decided not to implement, or have smart beta allocation

EXHIBIT 20

What type of smart beta strategies are you using?

	U.S.	Canada	UK	Europe (ex UK)
Low volatility	33%	100%	33%	77%
Fundamental	67%	17%	60%	23%
High quality	17%	33%	7%	23%
Maximum diversification	8%	33%	0%	31%
Risk parity	17%	17%	13%	8%
Momentum	25%	0%	7%	8%
Equal weight	0%	17%	20%	8%
Stability (defensive / dynamic)	17%	0%	13%	0%
High dividend	0%	17%	13%	8%
Other	17%	17%	13%	23%

— Multi-pick.

Segment = Have smart beta allocation



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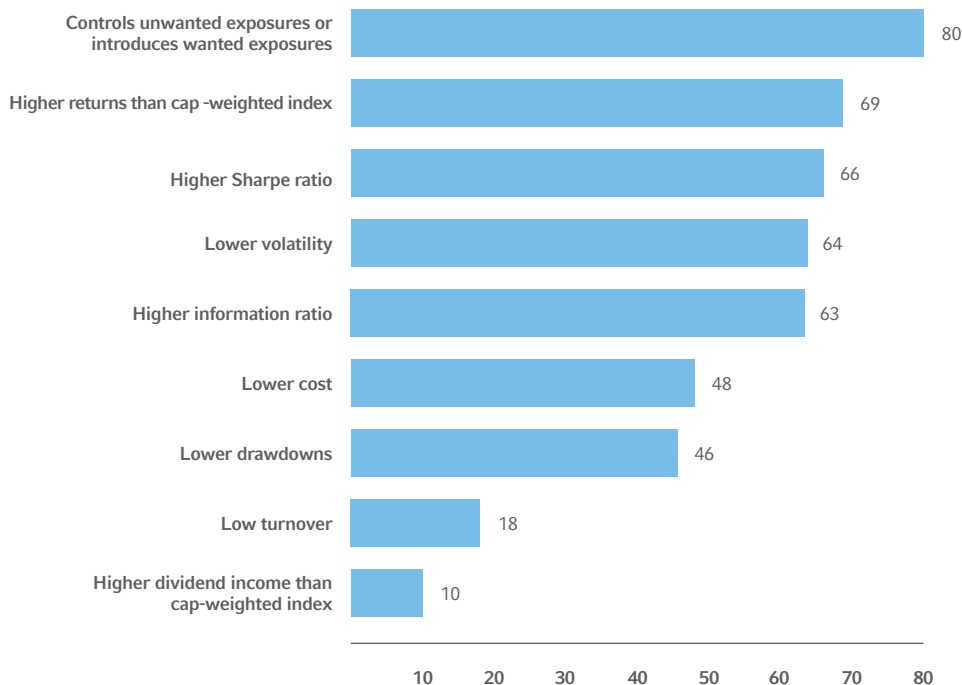
Greatest unmet need is for smart beta indexes that control exposures

In the survey, participants were asked to rate the importance of a number of investment objectives and to express their levels of satisfaction in regard to having achieved these objectives via their current active and market cap-weighted passive equity investment solutions. Russell calculated an “unmet needs” score for each of these objectives. An objective with a high unmet needs score corresponds to high importance among respondents but low satisfaction with current solutions.

The greatest unmet need is for products that can control exposures.

EXHIBIT 21

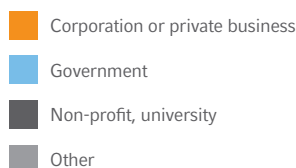
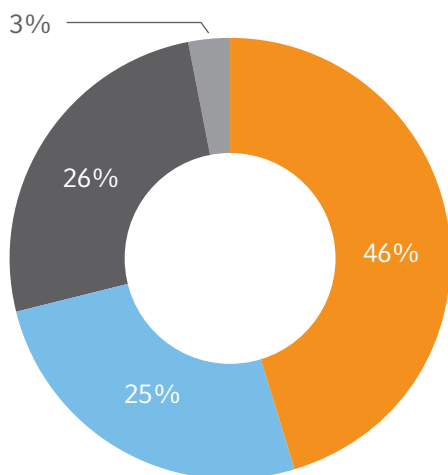
Equity investment product feature unmet need score





The survey covered more questions than have been included in the discussion of the results. This appendix includes additional information on survey participants and results for questions not already included, for reference.

Organization type



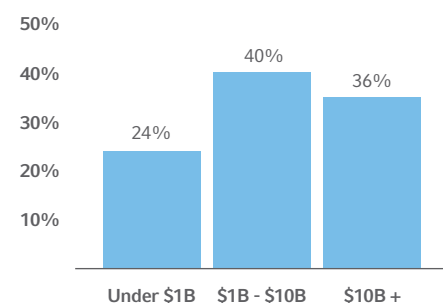
Title

Executive (CEO, CFO, CIO, EVP)	24%
Portfolio manager	18%
Trustee, board or investment committee	15%
Investment officer or director	13%
Analyst	11%
Risk manager	5%
Human resources / employee benefits manager	4%
Associate / assistant portfolio manager	2%
Compliance officer / legal	1%
Other	8%

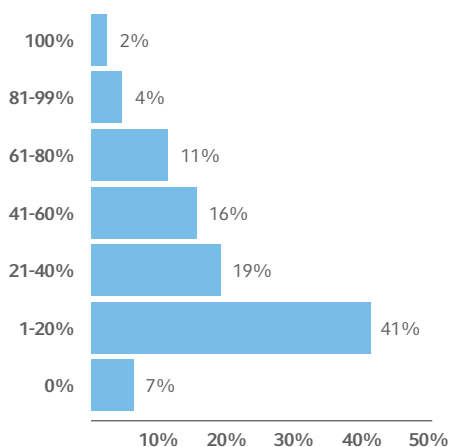
Country

U.S.	35%
UK	26%
Canada	13%
Netherlands	7%
Germany	4%
Denmark	3%
France	3%
Middle East	3%
Other	7%

Total AUM



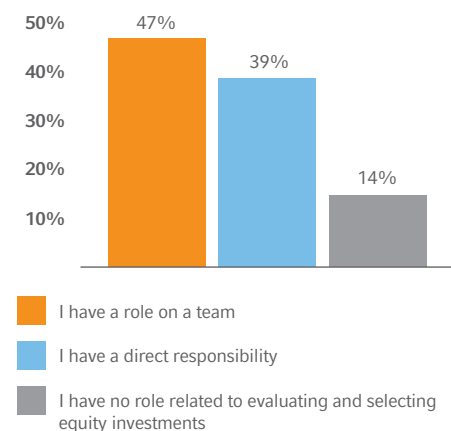
What % of your organization's equity portfolio is invested in a cap-weighted passive strategy?



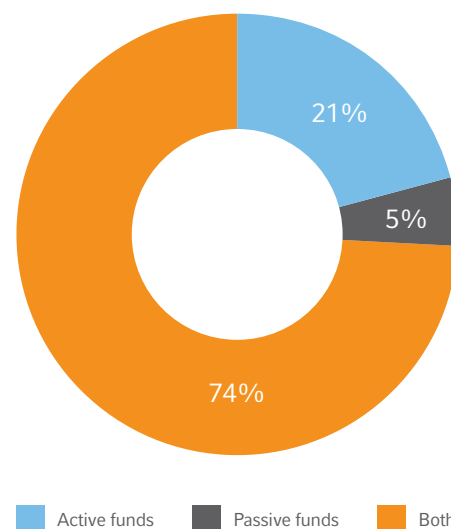
Plan Type

DB	75%
DC	43%
E/F	19%

Which of the following statements best describes your role in evaluating and selecting equity investments for your organization?



Which of the following strategies do you use in your equity allocation?

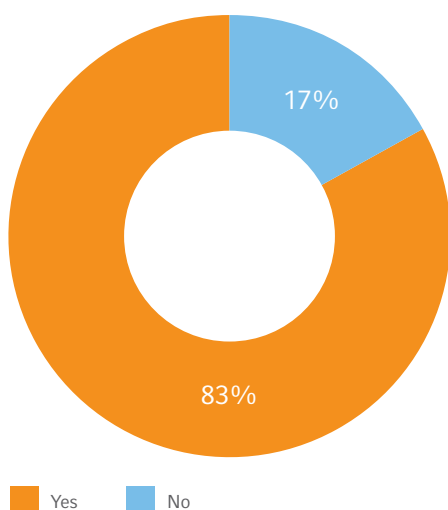




Does your organization use an investment consultant?

Yes	68%
No	32%

Have you heard the term *smart beta* before?



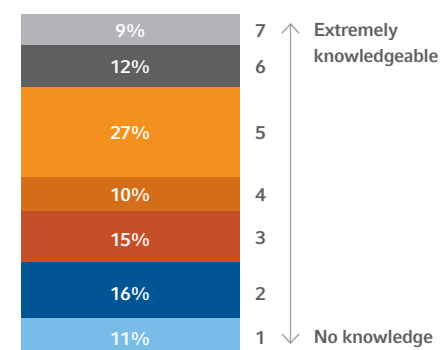
What types of indexes would you consider smart beta?

Low volatility	80%
Risk parity	68%
Fundamental	67%
Stability: defensive / dynamic	65%
High quality	60%
Momentum	58%
Equal weight	55%
High dividend	54%
Maximum diversification	53%
Style: value / growth	52%
Cap size: large, small, micro	38%

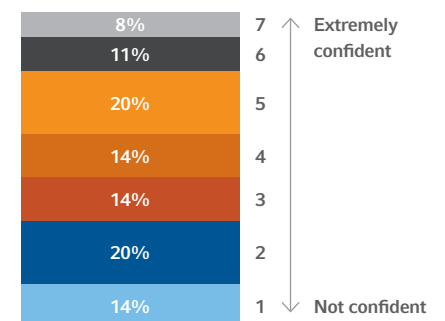
Should smart beta be part of your active equity allocation, passive equity allocation, or neither?

Active equity allocation	42%
Passive equity allocation	41%
Neither, it should be considered a new asset class	10%
Other	7%

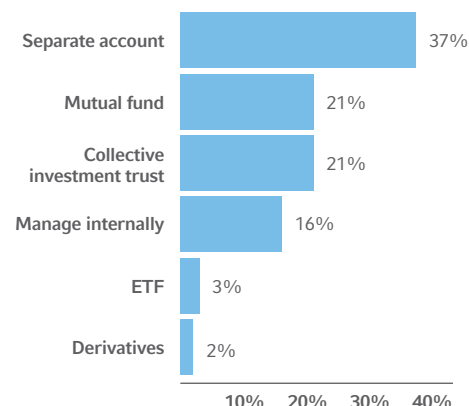
How would you assess your level of knowledge in regard to smart beta?



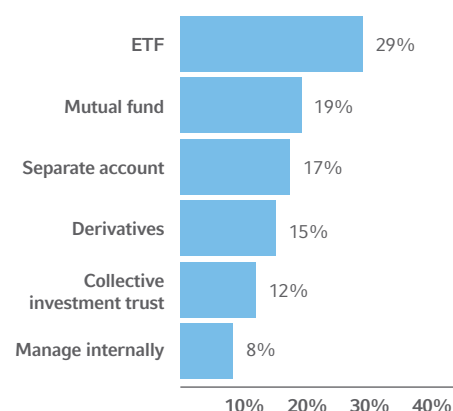
How confident do you feel in your understanding of how to best implement smart beta in a portfolio?



For strategic uses of smart beta strategies, what vehicle type would you prefer?*



For tactical uses of smart beta strategies, what vehicle type would you prefer?*



For which strategy do you view smart beta as a replacement?*

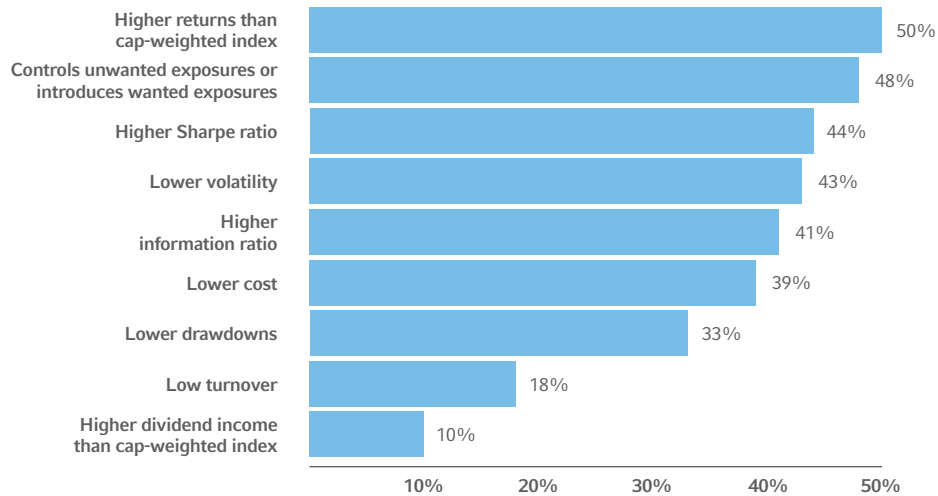
Both active and passive	44%
Passive management	32%
Active management	21%
Neither	3%

* Segment = Have smart beta allocation or currently evaluating smart beta



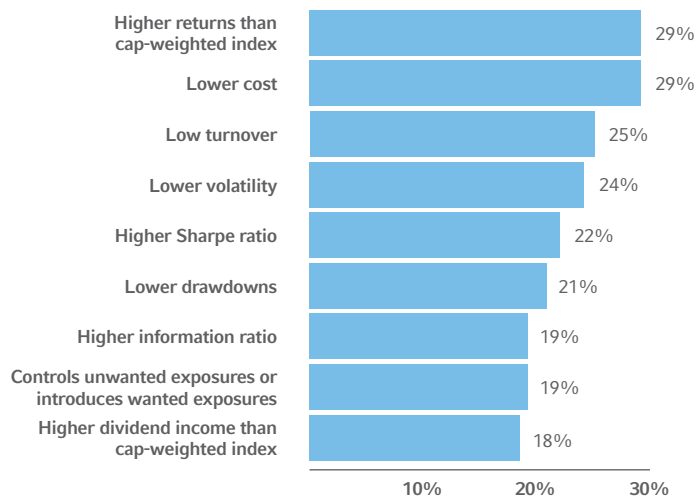
Please rate the importance of the following investment objectives.

Scale = 1-7 where 1 is not important and 7 is extremely important. Top 2 box = % rating 6 or 7.



Please rate your satisfaction with achieving these objectives with current active and market cap-weighted passive equity investment solutions.

Scale = 1-7 where 1 is not satisfied and 7 is extremely satisfied. Top 2 box = % rating 6 or 7.





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