

ETFs: Broad Usage Increases Amongst European Institutional Investors



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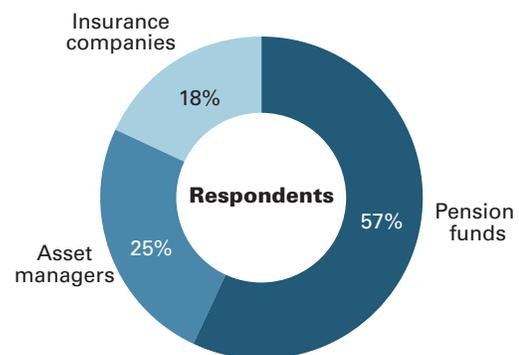
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METHODOLOGY

Greenwich Associates interviewed a total of 120 European-based institutional investors, 83 of which were exchange-traded fund users and 37 were non-users, in an effort to track usage behaviors and examine perceptions associated with exchange-traded funds. The respondent base consisted of 68 pension funds (corporate and public funds, and other institutional investors), 30 asset managers (firms managing assets to specific investment strategies/guidelines) and 22 insurance companies.



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Executive Summary

European institutional investors have adopted ETFs into their portfolios for a surprisingly diverse range of uses. Institutions are using ETFs to obtain the long-term strategic exposures they need in their “core” portfolio allocations and as tools for achieving international portfolio diversification. They are also employing ETFs for a variety of shorter-term tasks, including making tactical adjustments to portfolios and rebalancing. Thanks largely to this flexibility, ETFs have become a mainstay in European institutional equity portfolios, and they are fast gaining traction in fixed income.

To better understand how and why institutions in Europe are integrating ETFs into their investment portfolios, Greenwich Associates conducted a study of 120 European insurance companies, asset managers and pension funds.

The results of this study suggest that ETFs will continue to grow in Europe in terms of both number of institutional users and size of institutional allocations. Institutions in the study say they are drawn to ETFs for three primary benefits: ease of use, efficient market access and liquidity. All three of these features will be important for European institutions as they move to diversify portfolios away from the traditional domestic and government bonds that have made up the bulk of their investments, and as the increasing complexity of their portfolios prompts institutions to outsource assets in search of external expertise and skill sets that are not in abundance in their internal management teams.

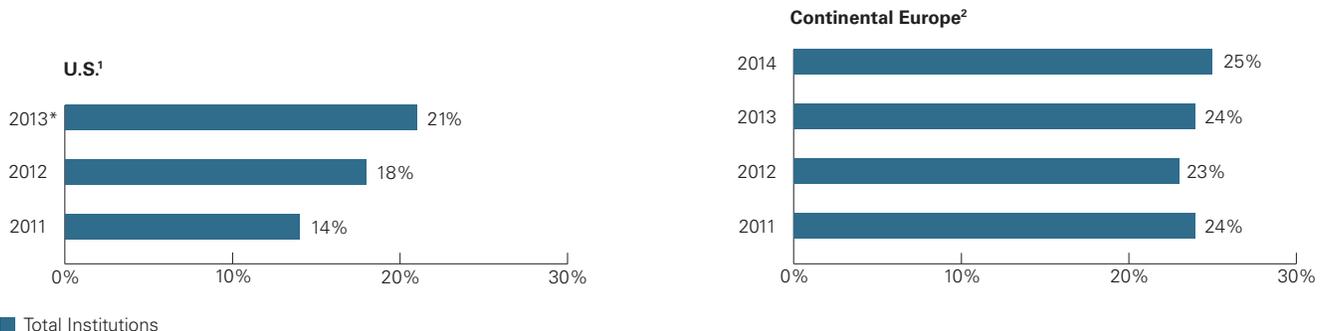
When making specific ETF investments, European institutions seek out high levels of liquidity, attractive expense ratios and benchmarks that fit their strategies. Because institutions rate BlackRock as best-in-class in these and other important areas, the firm has emerged as the ETF provider of choice for European institutions.

European Institutions: Leading the World in ETF Investing

Although ETFs first gained widespread popularity in the U.S. market, new research from Greenwich Associates reveals that institutions in Europe actually adopted ETFs earlier than their counterparts in North America and continue to use ETFs at a slightly higher rate.

One-quarter of the European institutions participating in the Greenwich Associates 2014 Continental European Investment Management Study employ ETFs in their portfolios. That share has been relatively steady since 2011, when 24% of the institutions reported using ETFs. By contrast, only 14% of U.S. institutions were using ETFs in 2011, and today about 1 in 5 institutions in the U.S. employ ETFs.

Institutional Use of ETFs: U.S. vs. Continental Europe



Note: *Most recent data for U.S. ¹Based on responses from 623 total institutional funds in 2013, 731 in 2012 and 817 in 2011. ²Based on responses from 673 in 2014, 591 in 2013, 526 in 2012 and 541 in 2011. Source: Greenwich Associates 2013 U.S. and 2014 Continental European Institutional Investors Studies

According to the results of a special ETF study conducted by Greenwich Associates in Continental Europe and the United Kingdom in Q3 2014, institutions that use ETFs allocate an average 7% of total assets to them. A meaningful share of institutions participating in the study allocates significantly more.

Asset Managers

Asset managers have led the movement into ETFs, and allocations among users in this group average 11% of total assets. Nearly 1 in 10 of the European asset managers in the Greenwich Associates study allocate more than a quarter of total assets to ETFs. These sizable allocations support a wide range of uses. Three-quarters of the asset manager users employ ETFs in institutional client mandates, 71% use ETFs in multi-asset or flexible funds, approximately 40% use them in straight equity funds, and roughly a third use ETFs in retail managed accounts. More than half the asset managers in the study—54%—say they are “likely” or “very likely” to manage an ETF-only product (mutual fund, managed account, unit-linked, etc.) at some time in the future. This finding suggests that many asset managers are adopting ETFs as a tool in product development.

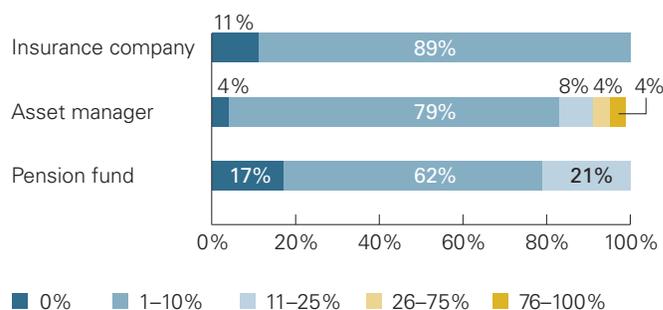
Pension Funds

While sharp differences in pension fund regulation and market structure from country-to-country make it difficult to draw detailed conclusions about investment patterns among European pension funds, the results of Greenwich Associates annual European Investment Management research program show that public and industry pension funds in Continental Europe are heavier users of ETFs than their corporate peers. About 28% of public and industry pension funds on the Continent use ETFs versus only 19% of corporate pensions. Although most of the pension fund users in the ETF study have allocations of 1–10%, about 1 in 5 have built ETF allocations of 11%–25% of total assets.

Insurance Companies

Most of the insurance companies in the study maintain ETF allocations of between 1% and 10% of total assets. European insurers have built these allocations by applying ETFs widely throughout their investments and operations: Almost two-thirds use the funds directly on their balance sheets, while the

Most Institutional Users Allocate 1–10% of Total Assets to ETFs



Note: Based on 71 responses: 29 pension funds, 24 asset managers and 18 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

remainder invest in ETFs through an asset manager. Most insurance companies that use ETFs—about 58%—use them to invest surplus assets, and nearly a third use them to invest reserve assets. This difference in application corresponds to the greater adoption of ETFs used in growth portfolios.

More than 40% use ETFs in unit-linked products and about a quarter use them in annuity products. Slightly more than 40% use ETFs to invest their own assets.

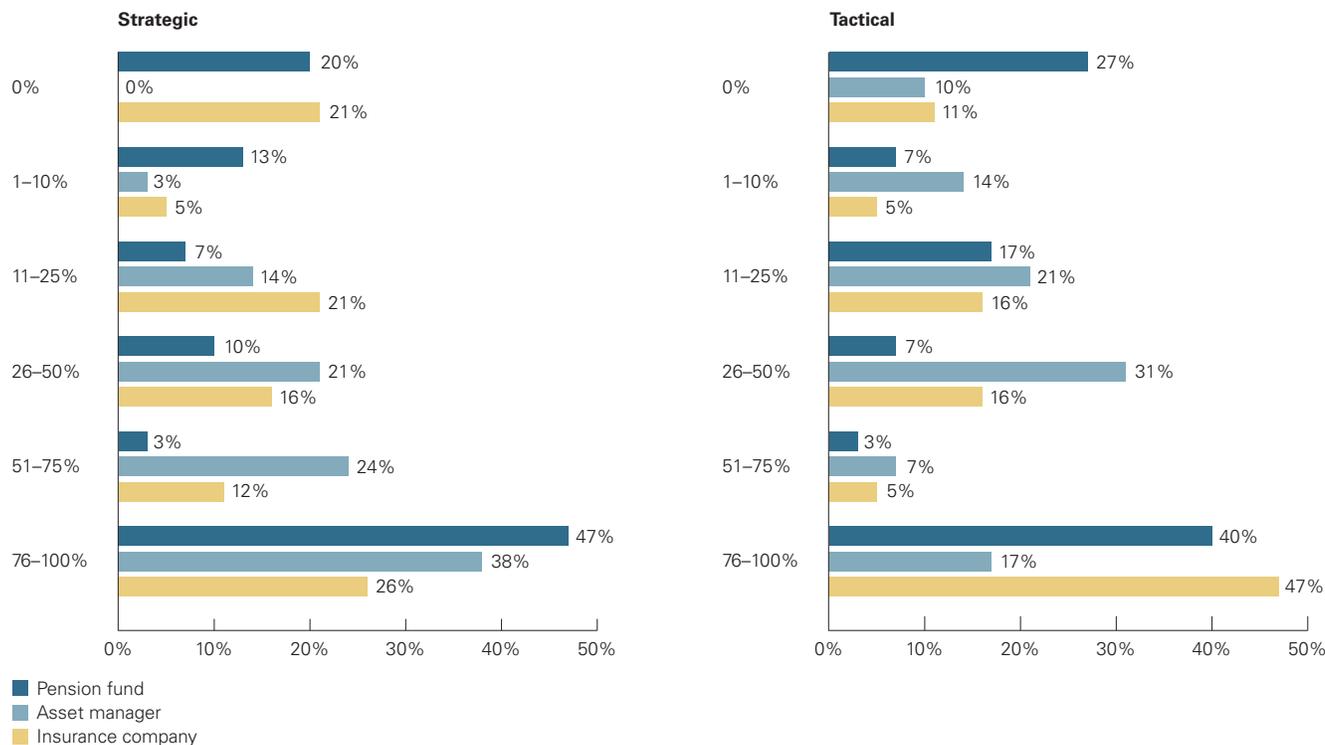
Institutions Adopt ETFs for a Wide Variety of Uses, Strategic and Tactical

The flexibility of ETFs as an investment tool becomes evident with a look at how European institutions view the role of the funds within their portfolios. Sixty-two percent of asset managers in the study and 53% of pension funds describe their use of ETFs as “mainly strategic” in nature. By contrast, a solid majority of 57% of insurance companies describe their use of ETFs as primarily tactical. Many institutions are using ETFs for both, as demonstrated by a pension fund executive who said there were two reasons his fund started using ETFs: “One was to get country exposure in areas where it was difficult to invest directly. The second reason was to cover short-term liquidity problems, so for instance if we had cash just sitting there, we would use an equity exposure quite quickly.”

Other institutions gave the following reasons for introducing ETFs into their portfolio:

“We have used ETFs for a while to gain market exposure to certain small markets in which it was less easy to invest. We still use them for Canada and some other

Percentage of ETFs Used as Strategic vs. Tactical Approach



Note: Based on 83 responses: 33 pension funds, 29 asset managers and 21 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

fringe markets, but also to gain exposure to markets as a strategic allocation—and then the intention is to unwind those positions as we gradually invest the money. Also, to gain exposure to small caps where we might not invest directly. The former is what I describe as ‘park and ride,’ to gain an exposure to markets, and part of the money is there ready to invest in.” – Pension fund

“Ease of use, liquidity, low cost. There is a wide range of choices.” – Insurance company

“We were an active manager. We thought that selecting stocks on foreign markets was not possible. Therefore, when selecting international equities, we would just buy the index [using ETFs]. We first started using equities.” – Asset manager

“We did not have anything internal in the particular asset class at an appropriate price or liquidity. We first started using [ETFs in] commodities as we were managing a multi-asset portfolio at a broader opportunity set and it was part of its strategic asset allocation.” – Asset manager

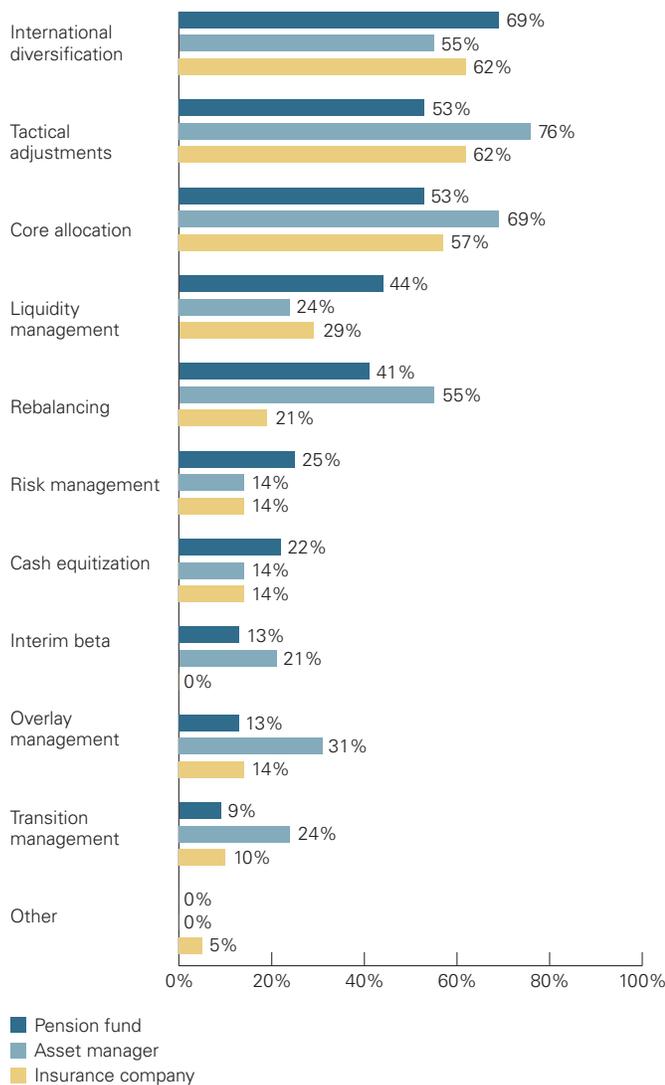
“To get an efficient exposure towards the markets, or when we have surplus liquidity. We use ETFs for the liquidity, while investing into an active fund.” – Pension fund

“We use ETFs to invest in markets where we don’t have internal analyst coverage.” – Insurance company

Across all types of European institutions, ETFs are used most often for three specific purposes. The first is to make tactical changes within their portfolios. The other two are strategic in nature— achieving international diversification and obtaining desired exposures in the core (as opposed to satellite) component of their portfolios. European institutions also use ETFs in a wide variety of other applications, ranging from the broadly strategic to the tactical.

For example, 44% of European pension fund users employ ETFs for liquidity management and 41% use ETFs in rebalancing their portfolios. While 55% of asset manager ETF users utilize the funds for rebalancing, nearly a third also use ETFs in overlay strategies, a quarter use the funds in transition management and 1 in 5 use ETFs to obtain interim beta. Insurance companies’ wide use of ETFs in surplus assets, reserve assets, annuities, and in companies’ own assets was discussed in the previous section of this report. Although insurance companies’ ETF activity in these areas is focused mainly on international diversification, tactical adjustments and core allocations, about 30% of insurance companies

Primary ETF Applications in Institutional Portfolios



Note: Based on 83 responses: 33 pension funds, 29 asset managers and 21 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

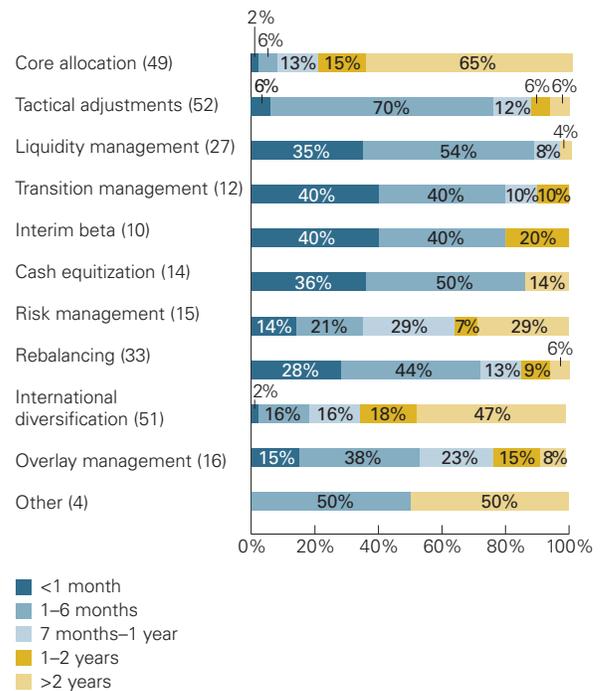
also use ETFs for liquidity management. Even within these functions, insurance companies are employing ETFs for many different strategic and tactical purposes.

When institutions start using ETFs for these various applications, about 60% say the funds are displacing other products or investment vehicles such as futures, index funds or actively managed funds. The remaining 40% say that ETFs are being used in addition to existing products and vehicles. At 67%, insurance companies are the most likely to report that ETFs are replacing other products and vehicles. A representative of one pension fund said his institution had used ETFs to replace unit and

ETF Holding Periods

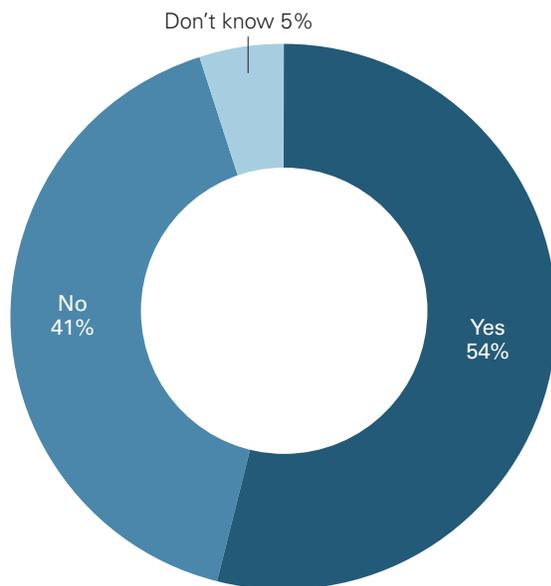
A look at average holding periods for ETFs illustrates the many different ways institutions are using the funds. In general, institutional investments are considered “strategic” in nature if they are held for at least two years. Indeed, for primary strategic applications like obtaining investment exposures in core portfolio allocations and achieving international diversification, the vast majority of institutions (about three-quarters) report average ETF holding periods of two years or more. By comparison, institutions using ETFs to make tactical adjustments to their portfolios report average holding periods of just 6.5 months. Despite the widespread use of ETFs for tactical applications, few institutions are employing ETFs as true short-term investments. Less than 2% of study participants report average holding periods of a month or shorter. In practice, European pension funds seem to be employing ETFs in the most strategic manner, having the longest average holding periods at 29 months.

Average Holding Periods for Primary ETF Applications



Note: Numbers in parentheses represent respondent count. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

Has Your Firm Consciously Considered Whether to Invest in ETFs?



Note: Based on 37 responses: 35 pension funds, 1 asset manager and 1 insurance company. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

investment trusts “on the grounds of liquidity and cost.” Even more common was the explanation that institutions were utilizing ETFs to replace active managers, often as a shift to passive investment strategies from active strategies judged to be too expensive given lack of benchmark outperformance.

Demand for ETFs Expected to Increase

The study results suggest that institutional ETF investment and allocations will increase in coming years. Twenty-two percent of the institutions participating in the study expect to increase their allocations to ETFs within the next three years. About 1 in 10 institutions expect to increase allocations by more than 10% within that time period.

Greenwich Associates believes the actual rate of growth could even surpass the levels suggested by these reported expectations as European institutions alter their portfolios and investment practices. Many institutions—particularly those on the Continent—are diversifying their portfolios away from the European government bonds that traditionally made up the bulk of their assets. As they do so, they are moving beyond the area of expertise and the

capabilities of the internal investment departments that have managed sizable portions of those assets. These changes will likely create demand for new means of achieving desired investment exposures and for new tools for risk management, transition management and other functions associated with more diverse and complex portfolios.

ETFs will play a role in all these areas—especially as institutions change their own internal policies and practices to accommodate the demands of an evolving marketplace. Nearly 70% of institutional ETF users in the study say internal limits and investment guidelines place constraints on their ability to increase ETF allocations. Many institutions will need to revisit existing internal guidelines and limits as they diversify portfolios and take other steps needed to achieve required investment returns.

Of course, rates of ETF adoption will vary from country to country in Europe, in part due to differences in regulation and market structure. Across Europe, 17% of institutions say regulatory limits place a ceiling on their ETF investments. But the actual impact of regulation and market structure is much bigger than that figure suggests. For example, the prevalence of *spezialfonds* in Germany limits demand for mutual funds among institutions in that country and could have a similar impact on ETFs.

Nevertheless, Europeanwide ETF growth rates could receive a boost from more aggressive outreach and education on the part of providers. Of the non-ETF users in the study, only about half said they had made a conscious choice not to employ ETFs. The other half was divided mainly between those that were currently considering implementing ETFs and institutions that had never really thought about the funds. Among the main reasons given for not investing in ETFs were concerns about liquidity, price, and a lack of knowledge about how the funds work or what benefits they can deliver.

These findings suggest that there are significant numbers of institutions that could be open to experimenting with ETFs if provided with education about the funds, their applications and their potential benefits. Given the fact that so many institutions in Europe and in other markets are using ETFs to achieve both strategic and tactical goals, it is likely that outreach and information from providers about

how other institutional investors are benefiting from ETFs could overcome some of the concerns that are now limiting use.

Drivers of ETF Growth

Future growth in institutional ETF investment will come from two main sources:

1. Most institutions got their start in ETFs in equities, and it is in equities where ETF allocations are largest. The study results show that a sizable share of institutions are planning to further increase the share of equity assets invested in ETFs in coming years.
2. Many European institutions have begun using ETFs in fixed income, and the study results suggest that both usage and allocations of

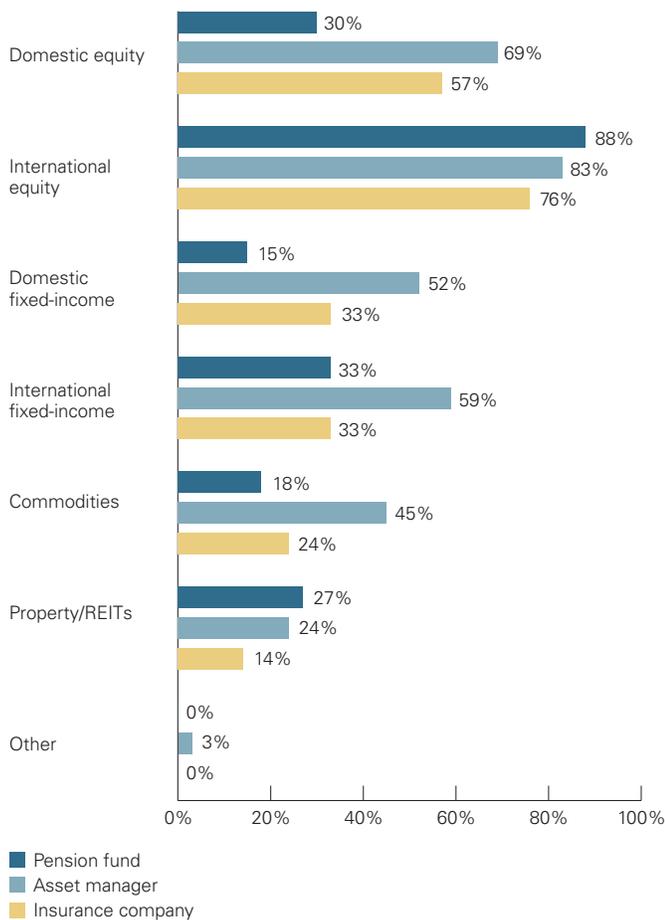
bond ETFs are poised for significant growth. Institutions are also starting to apply ETFs in other asset classes. Forty-five percent of asset manager ETF users employ the funds in commodities, and about one-quarter of asset manager and pension fund ETF users do so in Property/REITs.

Equities: Big Allocations Poised to Get Bigger

Eighty-three percent of the institutional ETF users in the study use ETFs in international equities and about half use ETFs in domestic equities.

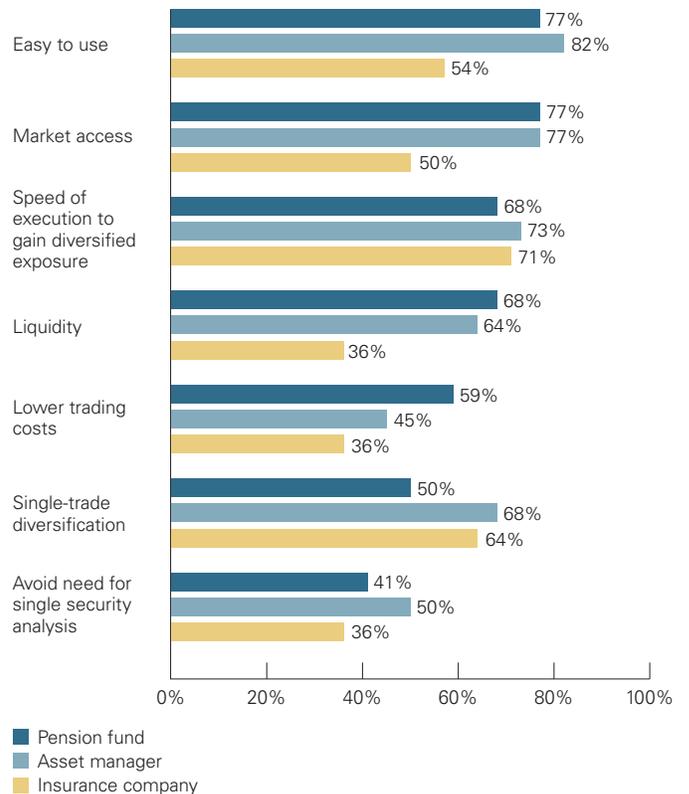
Traditional mutual funds are the most popular method for investing in equities among the institutions in the study. About 29% of total equity assets held by the institutions are invested in these mutual funds. ETFs are a close second and make up 22% of total equity assets. The institutions hold 17% of equity assets in separately managed accounts. Only insurance companies have more assets in separately managed accounts than ETFs.

ETFs Are Moving Beyond Their Institutional Base in Equities



Note: Based on 83 responses: 33 pension funds, 29 asset managers and 21 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

Reasons for Using Equity ETFs



Note: Based on 59 responses: 22 pension funds, 23 asset managers and 14 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

These reported ETF allocations are poised for significant growth. Forty-three percent of the institutions plan to increase their equity ETF allocations in the next three years. Although most of those institutions expect to increase allocations on the order of 1–10%, about 1 in 10 of the investors plan increases of 10% or more. Asset managers are the most bullish about future equity allocations, with nearly half projecting an increase.

Institutions cite several main reasons for investing in equity ETFs, including ease of use, market access, speed of execution in obtaining diversified exposures, and liquidity. Among the factors holding back institutions from implementing equity ETFs or increasing current ETF allocations are internal policies or rules prohibiting use and concerns about ETF costs. Greenwich Associates does not view either of these factors as serious impediments to ETF growth in light of the long-term trend toward portfolio diversification among European institutional investors.

Fixed Income Could Drive ETF Expansion

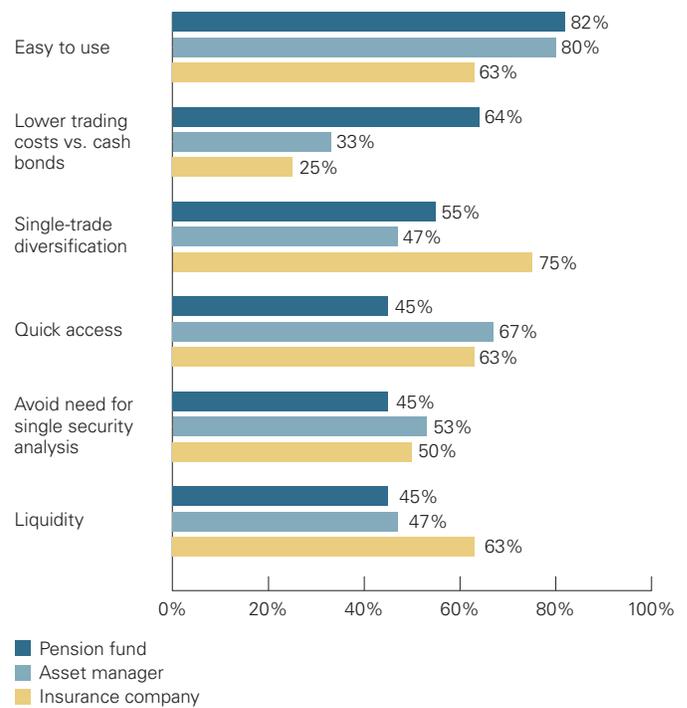
Forty-two percent of the ETF users in the study employ ETFs in international fixed income and a third use ETFs in domestic fixed income. Asset managers have been the fastest to adopt bond ETFs: Approximately 60% use ETFs in international fixed income and 52% use ETFs for domestic fixed income.

Although this report marks the debut of the European Exchange-Traded Funds Study, Greenwich Associates has long tracked the use of ETFs by European institutions in the Firm’s annual Institutional Investors study in Continental Europe. That research shows the rapid rate at which institutions on the Continent have been adopting ETFs in fixed income. Usage of bond ETFs has increased to current levels from just 23% in 2011.

For the institutions in this study, investments in individual issues are the primary means of obtaining fixed-income exposures, and individual issues make up nearly a third of fixed-income assets. Traditional mutual funds (not including ETFs) are next at slightly more than a quarter of fixed-income assets. However, after several years of steady growth in usage, ETFs now make up about 20% of the fixed-income assets of the institutional ETF users in the study.

That share is expected to increase. One-third of institutional bond ETF users expect to increase their

Reasons for Using Fixed-Income ETFs



Note: Based on 35 responses: 11 pension funds, 16 asset managers and 8 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

allocations in the next three years. This demand is driven by a number of factors. Three-quarters of institutional bond ETF users say they are attracted to fixed-income ETFs for their ease of use. Approximately 60% cite quick access as a primary reason for using ETFs, and half cite ETF liquidity. Pension funds are particularly attracted to ETFs’ lower trading costs relative to cash bonds. Three-quarters of insurance company bond ETF users say they use the funds to gain single-trade diversification.

Among the factors that cause institutions to omit bond ETFs from their portfolios or limit allocations are a preference for actively managed investments in fixed income and concerns about ETF costs. Greenwich Associates believes institutions will get past both of these impediments as they diversify fixed-income portfolios beyond domestic and European bonds with bigger investments in credit products and international fixed income.

A significant investor appetite for passive management strategies should also contribute to future growth in bond ETF usage. Among all institutions participating in the study, 37% of fixed-

ETFs are a Tool for Innovation

European institutions face the daunting task of hitting return targets required to fund obligations in challenging markets, while at the same time minimizing risk and volatility within their portfolios. Pressure to achieve these often contradictory goals is creating demand for innovative investment products—including ETFs. Among institutional equity ETFs users, for example, about 1 in 5 are employing non-market-cap-weighted/strategic-beta ETFs. That share approaches one-third among asset managers. By far the most popular of these products are minimum volatility (minvol) ETFs, which are used by 57% of institutions that employ non-market-cap-weighted/strategic-beta ETFs. About 36% use factor ETFs. Greenwich Associates believes continued innovation in ETF structure will attract new institutional users in Europe and contribute to the growth of allocations among existing investors. Study participants gave the following responses when asked to name the innovations that would encourage them to step-up their use of ETFs:

“It might be interesting to have something that is done in terms of global industry or global sector that cuts across geography, a global equity sector ETF like global healthcare.” – Asset manager

“More currency-hedged ETFs.” – Asset manager

“More single-country ETFs, preferably with physical replication.” – Asset manager

“More specific tactical thematic ETFs.” – Pension fund

“More options on alternatively weighted index funds.” – Insurance company

“I want to see them turn U.S. ETFs into a UCIT-eligible format.” – Asset manager

“Smart indexes built for long-term investors.” – Asset manager

income assets are invested in passive strategies. But pension funds have already begun allocating much larger amounts to passive products. Among pension funds in the study, passive strategies make up 44% of total fixed-income assets.

How Institutions Select ETFs and ETF Providers

The study results show clearly that when European institutions are in the market for an ETF investment, they focus on three primary factors: 1) liquidity/trading volumes, 2) expense ratios, and 3) the benchmark used in the fund. Asset managers also emphasize past performance of the fund.

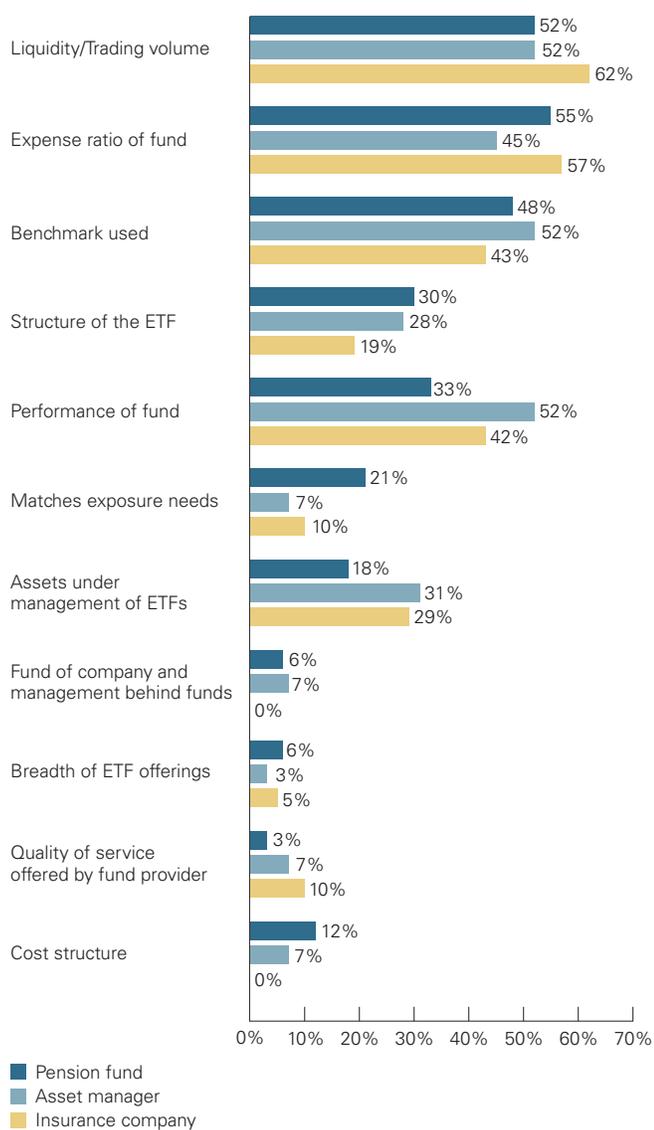
The prominence of these three criteria in institutions’ selection process helps explain why BlackRock has emerged as the ETF provider of choice for

European institutions. In the Greenwich Associates study, institutions were asked to name the best ETF providers in a number of product and service categories. Institutions named BlackRock as “Best-in-Class” in the three categories that track most closely with their most important selection criteria:

1. Provides the Most Liquid Products
2. Offers Good Value for Management Fees
3. Strong Index Tracking

BlackRock was also named Best-in-Class in other categories such as “Range of Products,” “Delivers Exceptional Service” and “Innovation” and also ranked No. 1 in “Overall Recognition as an ETF Provider” among institutions that do not use ETFs.

Primary Criteria Used When Selecting an ETF



Note: Based on 83 responses: 33 pension funds, 29 asset managers and 21 insurance companies. Source: Greenwich Associates 2014 European Exchange-Traded Funds Study

Conclusion

Most European institutions that employ ETFs in their portfolios have been using the funds for at least two years. Over that time, institutions have adopted ETFs for a wide variety of applications. Pension funds, asset managers and insurance companies have found that ETFs are easy to use and provide ample liquidity and efficient market access. These features make ETFs flexible enough to be applied to both strategic and tactical tasks within institutional portfolios. That flexibility will make ETFs valuable tools for European institutions in coming months and years as they continue to diversify their portfolios.

Based on the results of our inaugural European ETF study, Greenwich Associates expects ETFs to grow from current levels in both use and allocation. Much of that expansion will occur in equities, where institutional use is by far the highest. But robust adoption rates in fixed income and experimentation with ETFs in new asset classes such as commodities will also drive ETF growth. As European investors implement new approaches needed to generate sufficient returns in an increasingly complex and challenging market, ETFs will likely receive a further boost as institutions gradually relax conservative internal investment guidelines limiting or prohibiting their use.

Consultant Lydia Vitalis is responsible for managing relationships with a number of leading asset managers and investment consultants globally, and oversees the Firm's work with investors across Europe.

The data reported in this document reflect solely the views reported to Greenwich Associates by the research participants. Interviewees may be asked about their use of and demand for financial products and services and about investment practices in relevant financial markets. Greenwich Associates compiles the data received, conducts statistical analysis and reviews for presentation purposes in order to produce the final results. Unless otherwise indicated, any opinions or market observations made are strictly our own.

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Transactions in shares of ETFs will result in **brokerage commissions** and will generate **tax consequences**. All regulated investment companies are obliged to distribute portfolio gains to shareholders. In addition to the normal risks associated with investing, **international investments** may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in

other nations. **Narrowly focused investments** typically exhibit higher volatility. **Bonds and bond funds** will decrease in value as interest rates rise and are subject to credit risk, which refers to the possibility that the debt issuers may not be able to make principal and interest payments or may have their debt downgraded by ratings agencies.

Diversification and asset allocation may not protect against market risk or loss of principal. Shares of ETFs may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from a Fund by Authorized Participants, in very large creation/redemption units. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

This study was sponsored by BlackRock.

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