PASSIVE & SMART BETA INVESTING REPORT

FinalytiQ

BETA'S THE NEW ALPHA

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1. INTRODUCTION

The growth in the use of index funds over the last few years has been extraordinary, as financial planners, professional and retail investors have come to acknowledge how difficult it is to generate alpha consistently through stock selection over the longer term.

Research by Allianz shows:
57% of institutional investors think alpha generation is a priority, but 64% of those surveyed agree that there is little alpha to be found.

It's official, alpha has become a shyer animal. This has fueled an increase in strategic beta funds, which are funds that track indexes that seek to either improve performance or alter the level of risk relative to a standard benchmark. Over the last few years, a deluge of academic and industry evidence has drawn increasing attention to the elusive nature of alpha. Investors are waking up to the reality that much of what is called alpha can be achieved through exposure to market factors such as value, small cap, profitability and other market factors. Beta is the new alpha.

The demand of index funds has grown exponentially prompting a proliferation of products and the so called 'price war' among providers. The retail investment industry is undergoing a sea change, driven in part by regulations, technology - in particular the so-called robo-advice - and other market forces such as vertical integration. Much of these changes are driving price compression, and make the environment a little more challenging for asset managers.

Pension Freedoms is one clear example of how regulation is driving change in the investment industry. It is forcing asset managers to think differently about what the consumer really wants.

The days when investment success is measured by the ability to beat an index are coming to an end. For investors (and their advisers), the benchmark for investment success is the ability to meet their goals, not beat a fund benchmark. The upshot of this is the increasing demand for risk-rated multi-asset funds and retirement income funds. These are funds measured not against a market benchmark but against specific client objectives.

For years, the investment industry has been fending off attacks as consumer groups and regulators call for more transparency and cost disclosure. RDR and the PS13/1 Sunset Clause has brought greater clarify for investors and advisers on the cost of each part of the value chain. Each part of the value chain - advisers, platforms, product providers and asset managers, are having to fight harder to preserve their margin. This has brought advisers closer to their clients, while asset managers have become even more distant from the end investor. One upshot of this is the rise in vertical integration, where providers are seeking to control as much of the value chain as possible and those with enormous distribution clout are pitching asset managers against each other.

This increased focus on cost by investors and regulators is driving increased competition among asset managers, resulting in what the industry press have now dubbed 'passive price war.'

OBJECTIVES OF THIS STUDY

The primary purpose of this paper is to conduct a forensic examination of the direction of travel of the passive fund universe in the UK and to:

> Provide in-depth competitive market analysis with specific focus on AUM, market share, fund flow, fees, and distribution channels;
> Understand key drivers of competition between providers and how each provider is responding to market developments; and
> Benchmark providers and understand the key strengths and weakness of their propositions.

If industry press are to be believed, there is a "price war" raging between index fund providers, and if so, who are the winners and losers?

This report is designed to provide a definitive competitive market analysis for asset managers, with particular focus on AUM, market share, fund flow and pricing on passive and smart beta products in the UK.

It is an impartial assessment of developments and direction of travel in the market place. †Ultimately, it provides in-depth insight into what's going on in the marketplace to help providers understand what competitors are up to and to help inform product development and distribution strategy.

Our aim is to update the report on a quarterly basis to help providers keep their fingers on the pulse of ever-changing market dynamics in passive and strategic beta investment in the UK.

RESEARCH APPROACH

The study is based on analysis of index-based products across 10 major sectors or asset classes available to UK investors.†

As at the end of June 2015 these covered a total of

> £135 billion of assets in OEICs/Unit Trusts and
> £115 billion in EFTs.

The asset class/sectors covered include UK, US, European, Japan, Emerging Markets and Global Equities, as well as UK Corporate Bond, Gilts, Index Linked and Global Bonds. We also examined multi-asset fund ranges offered by providers, which are constructed using predominantly index funds.

Our study is based on publicly available funds denominated in Sterling and available to UK investors. We obtained data from sources such as Morningstar, FE and directly from providers. Data on fees and fund flow is based on publicly available share-classes and does not include segregated institutional mandates.

As part of the study, we interviewed the leading asset managers in the industry; we looked fund managers and distribution teams straight in the eye as we asked them questions on everything from product development plans to pricing strategy. We gained insight into where they thought their industry is heading.

WHO WILL BENEFIT

This report is aimed primarily at asset managers and product providers. It offers market insight based on robust facts and figures to support business planning and validate strategy.

For distribution teams, the report provides a key insight to support distribution and marketing strategies by identifying trends in terms of flows, competitive positioning, as well as potential strengths and weaknesses of existing offerings.

For product development teams, it provides a helicopter view of existing product ranges in the market place, potential gaps and the key drivers of demand.

Advisers and discretionary investment managers will benefit immensely from understanding the direction of travel in the industry and the potential strengths and weakness of their key partners.

2. EXECUTIVE SUMMERY

The rise of passive funds and ETFs in the UK over the last few years has been nothing short of phenomenal, prompting intense competition between providers of passive funds. The conclusion we drew from our price analysis is that while a “price war” is starting among the big providers in main asset classes such as the UK equity index trackers, there are areas that are seeing very little competition. We identified specific sectors where there is practically no competition between providers. This presents product development opportunities for providers. These are equity income funds, smart beta fixed income and equity products, SRI funds and retirement products.

As at the end of June 2015, there are over £135billion of assets invested in passive funds (OEICs/Unit Trusts) and £115billion invested in ETFs, across the 10 asset classes examined in this report. Around 5.5% of the EFT AUM is invested in smart beta products. Across the combined ETF and tracker funds, BlackRock has 36% of the combined market share, followed at some distance by Vanguard with 15% market share.

Over the last 12 months, Vanguard has taken the lion’s share of fund flow, with around 39% of the net fund flow into OEICS. This is more than twice the inflow to BlackRock, which came second accounting for around 18% of net fund flow. This means that £38 of every £100 invested in passive funds (OEICs) goes to Vanguard. At this pace, we expect Vanguard to overtake BlackRock as the largest retail provider of tracker funds in the UK in the next 3 years.

In the ETF space, Vanguard takes 37% of the net inflow, compared to BlackRock’s 24% and db-x at 13%, across the 10 major asset classes we examined. Nevertheless, BlackRock (iShares) is expected to maintain the top position in the EFT space for years to come, thanks to its extensive product range under the iShares brand.

Increasing adoption of ETFs over OEICs/UTs presents a particularly unique challenge to providers such as L&G, Fidelity and even Dimensional who currently have no ETF offerings. The growth in EFTs in the UK is driven by institutional investors and providers with no ETF capability are missing out on a growing opportunity. L&G is currently considering ETFs, and may use the proceeds of the divestments of its French business to build or acquire ETF capability.

Overall, the conclusion we draw is the competition between passive fund providers fell far short of a full blown war but winners and looser are beginning to emerge. BlackRock, Vanguard and Fidelity are emerging as winners and L&G and HBSC are losing out. Fidelity and L&G are the biggest players of the “super clean”card. Both providers offered super clean share classes to a select number of platforms. Fidelity has exclusive share classes which are only available on its own platform. But there is little indication that this in itself is having a meaningful impact on flows; over the last 12 months, inflows to L&G trackers has been particularly poor. For L&G, the super clean play is a bit futile. Fidelity is fairing a bit better, but we don’t believe this is necessarily down to having an influence on distribution via its own platform.

One observation is the correlation between product range and the providers’ ranking in term of AUM. Managers with capability and commitment to index investing clearly have a better chance than those with just a product or two. We note a particular phenomenon of far too many active fund houses, who have no business peddling index funds - Allianz, Henderson, M&G, Old Mutual, F&C to name but a few.

Their managers have no passive fund capability and are trying to cash in on the growth in index investing. Without an adequate fund range and the capacity to compete in this increasingly cut-throat world, we struggle to see the commercial viability of active funds houses maintaining a foothold in the passive funds space. We are not ignorant as to why active fund house have their own passive funds - even if it's simply just sub-advice mandates to core index fund managers. Many of them use index funds within their own portfolios and see this as a chance to cash-in on the rise on the use of index products. But in a world where institutional investors can access UK equities for 1 or 2 bps, "branding" the same funds and selling to any investor for 20 times that goes against fiduciary principles, and they risk destroying their brand integrity. And the cut-throat world means that even providers like Virgin with their own distribution channels will struggle to continue pulling this off.

Going forward, the outlook for index funds is very positive indeed thanks to ongoing regulatory pressures such as: increased cost disclosure requirements, pension freedoms, the rise of automated investment management services (robo-advisers) and other market forces such as vertical integration.

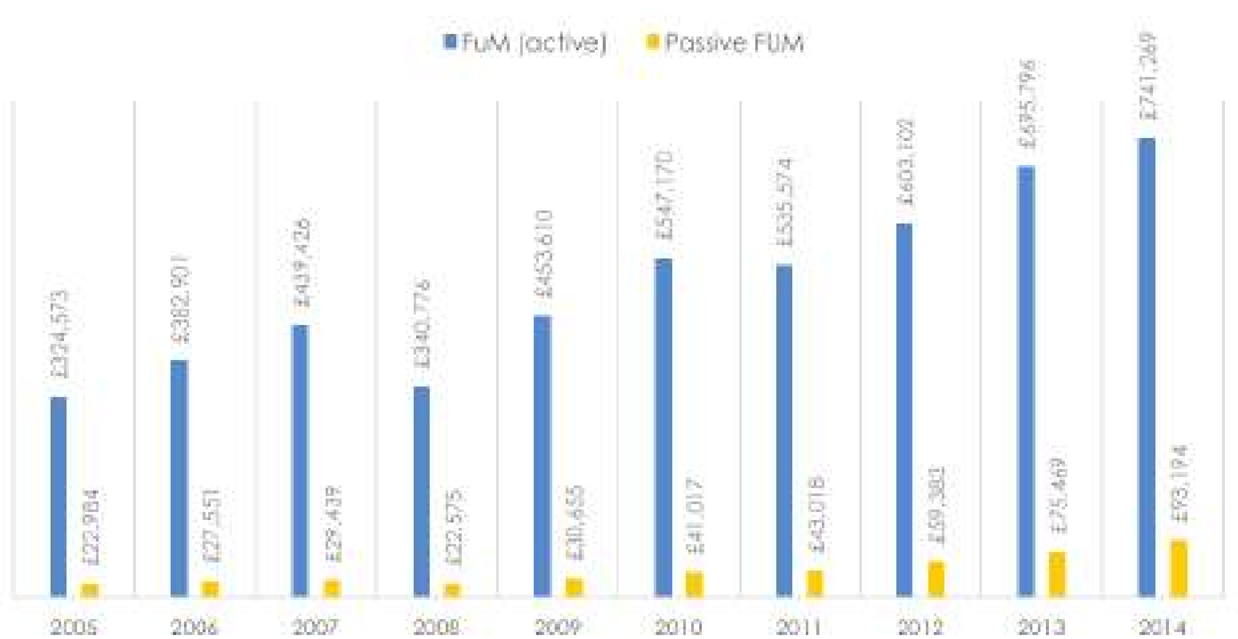
3. MARKET OVERVIEW: PASSIVE AGGRESSIVE

When I took my first financial services job in 2005, there was £22.9billion invested in index tracker funds (OEIC& UT only, not including ETFs), representing around 6.6% of the UK domiciled funds under management. Ten years later, FUM has more than quadrupled to £93.2billion, representing 11.2% of the total assets invested in UK domiciled funds as at the end of 2014.

ETFs have also seen phenomenal growth. Since the iShares listed the first ever UK ETF on the LSE about 15 years ago, it is estimated that over £131billion has been invested across 710 products as at March 2015. (ETGI, FinalytiQ's own calculation). The London Stock Exchange has roughly 1,500 listings of exchange-traded products. The majority of ETP users in the U.K. are institutional investors; however, analysts believe that as average investors become more familiar with ETPs, the U.K. will likely follow the same trajectory as the U.S., where more and more retail investors have embraced ETFs.

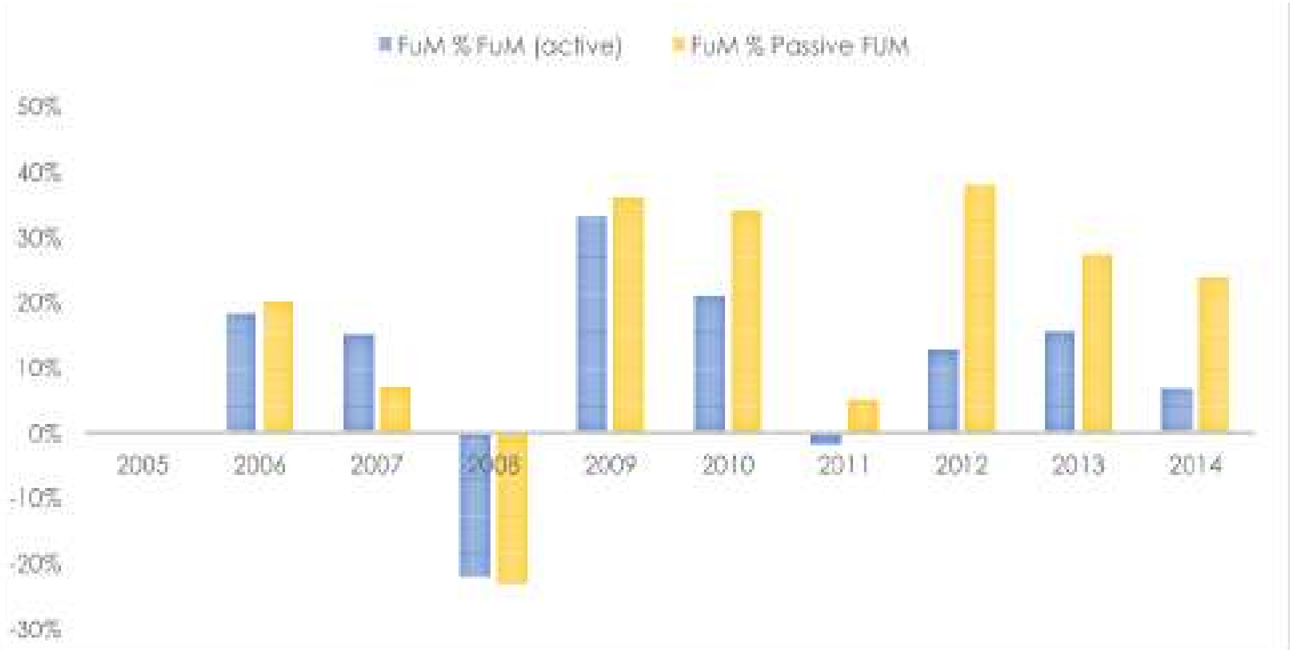
> While inflows to active funds outstrip inflows to passive funds more than fivefold, the rate of growth in the passive funds is consistently higher, albeit from a very low base.

FIG 1.1: ASSET UNDER MANAGEMENT (ACTIVE VS INDEX FUNDS) - £ MILLION



1. Source: FinalyitQ's own calculations using data from Investment Associations.
UK Domiciled funds only. Investment Trusts and ETFs not included.

FIG 1.2: ANNUAL GROWTH IN AUM (ACTIVE VS INDEX FUNDS)



KEY TAKEAWAYS

Going forward, we expect the tectonic plates underneath UK passive investing will continue to spin even faster for a number of reasons:

> The rise in online automated investment management services, robo-advisers will accelerate the adoption of index trackers. There's one thing that virtually all these robo-advisers have in common: the underlying portfolio is constructed using passive funds and ETFs (including smart beta products). In the US, data from research firm Corporate Insight shows that, online automated investment services increased their total assets under management by 11% in the first six months of 2015 to a total of $21billion and a 34% increase since July 2014. Indeed, established asset managers are beginning to enter the space, with Vanguard's Personal Advisor Service (VPAS) and Scwab's Intelligent Portfolios being the recent entrants into the robo-advice market. BlackRock is the latest entrant to this market place after recently acquiring FutureAdvisor. Here in the UK, similar services include Nutmeg, Wealth Horizon (powered by Parmenion), and WealthWizard, which was recently purchased by insurer LV. The emergence of Robo-advisers is expected to put some pressure on advisers, who will in turn look for ways to drive down the total cost of their clients' portfolios.

> Financial Advice Market Review; the so called RDR 2, recently launched by the Treasury and the FCA to examine how to make financial advice accessible to the less wealthy. Invariably, conversations about product cost will be a key part of this review and the upshot will be finding ways to keep fund charges as low as possible to ensure it is viable for advisers (human or robots) to serve this segment.

> A recent poll of 400 senior executives within the asset management industry by State Street reveals that 79% of them expect a left-field disruption to the asset management industry; the same way that Apple's iTunes disrupted the music industry. The threat of Amazon or Google steeping up to eat asset managers' lunch is very real. This is already happening in China where internet firms such as Alibaba have entered the asset management business.

The outlook is positive for index funds and EFTs in general but there are also indicators of more intense competition between providers. We expect to see sub-scale funds and providers without a comprehensive product range struggle in this market place. Strangely, there is space for new entrants with unique product offerings. For instance, the UK market for smart beta products is up for grabs.†We're beginning to see new entrants like WisdomTree and FirstTrust in the market place. Other product categories will include retirement income products, target-date funds and other lifecycle investment products.

4. CLASH OF THE TITANS

SINGLE ASSET FUNDS

As at the end of June 2015, there are over £135billion of assets invested in index funds by UK investors. BlackRock is the clear leader in terms of AUM, accounting for around one quarter of the overall market share. Closely followed Vanguard and L&G[2] Dimensional, which is less familiar to many because its funds are only available exclusively through financial advisers and institutional investors come 4th, with nearly 10% of the entire market. Dimensional funds are not index trackers in the traditional sense, but their low cost, transparent and quantitative rule-based strategies put them firmly in the smart beta category.

Scottish Widow is the 5th largest provider of passive funds in the UK, which is strange because nearly all of that it held in its humongous FTSE All Share tracker funds. Virgin's one FTSE All Share Index Fund accounts for 3% of the entire passive fund market. Interestingly, brands better known for their passive funds account for a relatively small share of the market, including State Street (1%), Fidelity (2%) and HSBC (4%).

State Street's market share is somewhat understated because a key part of its strategy is to manage funds predominantly on behalf of other providers. It's the sub-advised manager behind passive offerings from brand names like Virgin, Henderson and Liontrust. These products tend to have one thing in common; they are reassuringly expensive and needless to say, their performance is amongst the worse in the industry.

> There are far too may active fund houses who have no business peddling index funds. They are better off leaving passive fun to providers who have got the capacity to make it worth their while.

2. L&G's has substantive segregated institutional mandates, which are managed separately and not reported within its retail and advisory funds. Its own data shows an estimated £276.51billion in index tracking mandates including workplace pension and institutional mandates.

MULTI ASSET FUNDS

There are providers who don't offer index funds in the traditional sense; Standard Life, Architas and 7IM offer multi-asset portfolios built using index funds. We have added them to the list because this unique proposition is gaining ground among investors looking to buy index-based portfolios rather than single asset funds. However, this introduces an element of double counting for providers such as Vanguard, BlackRock and L&G who use their own single asset funds to create multi-asset portfolios. Having said that, the multi-asset funds bring in additional revenue (over and above the individual single asset fund constituents of the portfolios). They are used by investors who may not ordinarily use their single asset funds, meaning the providers sell more single asset class funds by selling their multi-asset funds. Even after excluding the multi-asset funds, the overall market share remains broadly consistent - albeit 7IM and Standard Life would not appear in the list of providers.

ACTIVE FUND HOUSES

There are far too many active fund houses - Allianz, Henderson, M&G, Old Mutual, F&C to name but a few, who have no business peddling index funds. There are managers with no passive fund capability trying to cash in on the growth in index investing. We've shoved many of them in the 'Other' category in our graph below if they have less than £500million in AUM each. One observation is the correlation between product range and the providers rankings in terms of AUM. Managers with capability and commitment to index investing clearly have a better chance than those with just a product or two.

FIG 2.1: MARKET SHARE OF PASSIVE FUND PROVIDERS[3] (%)

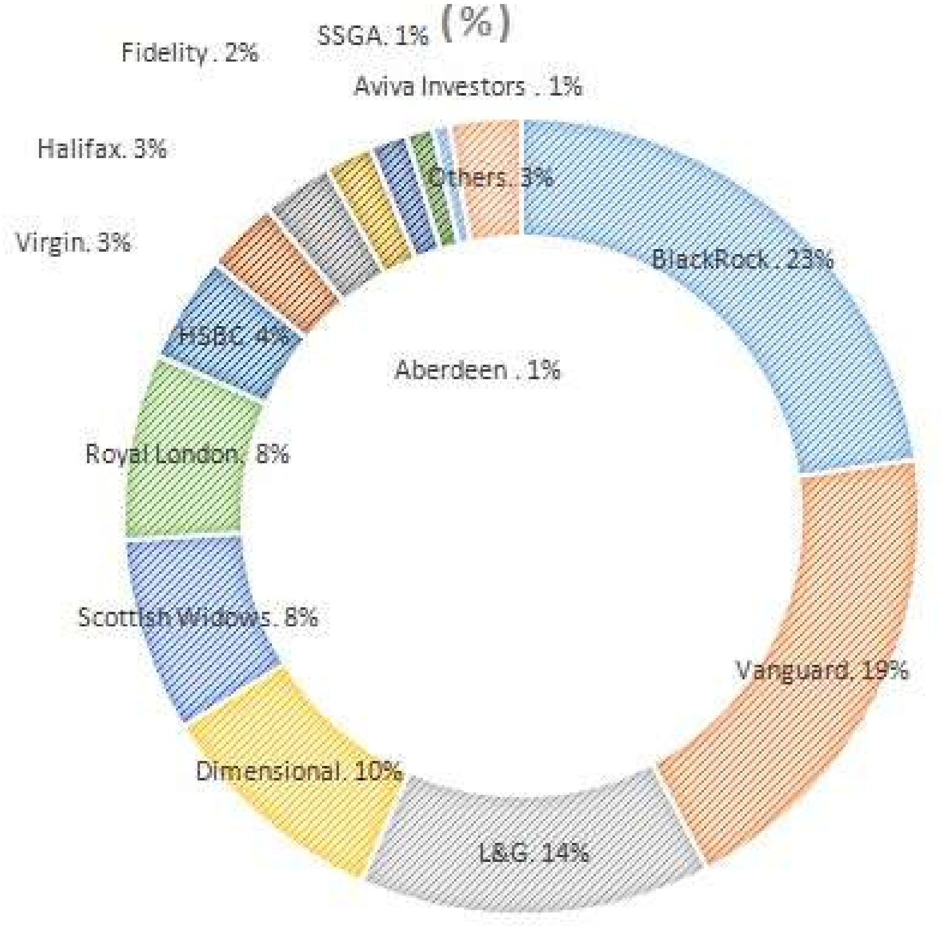
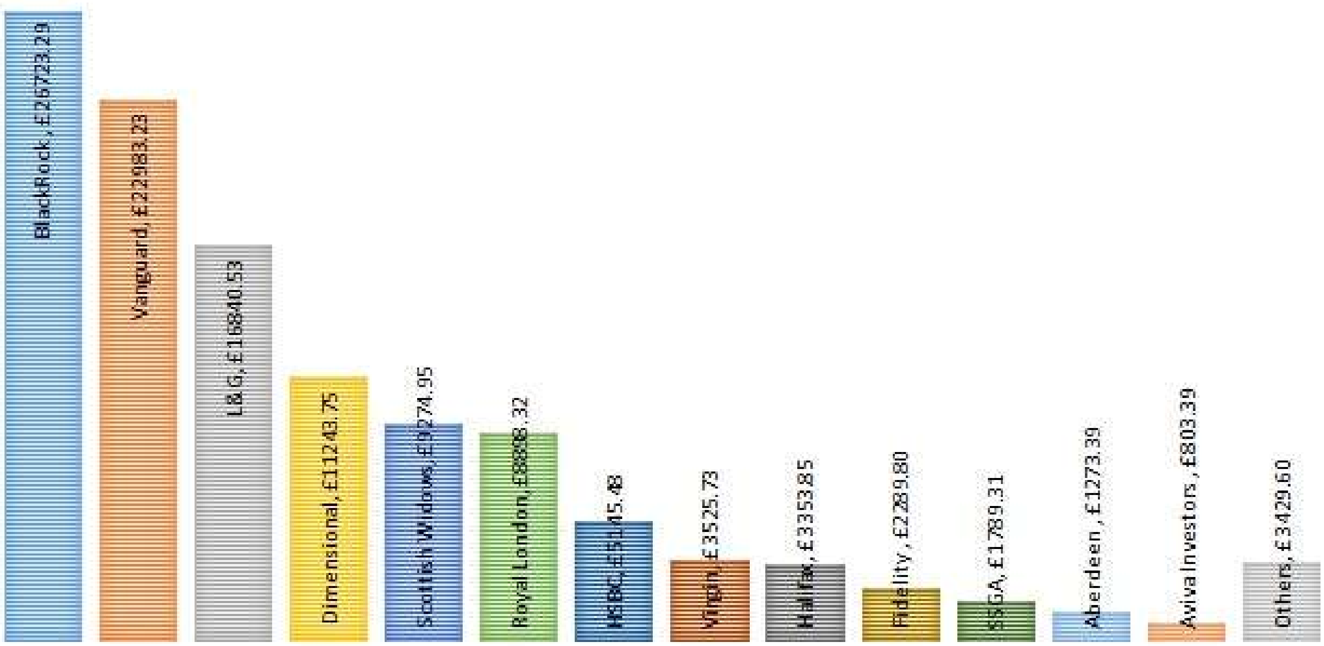
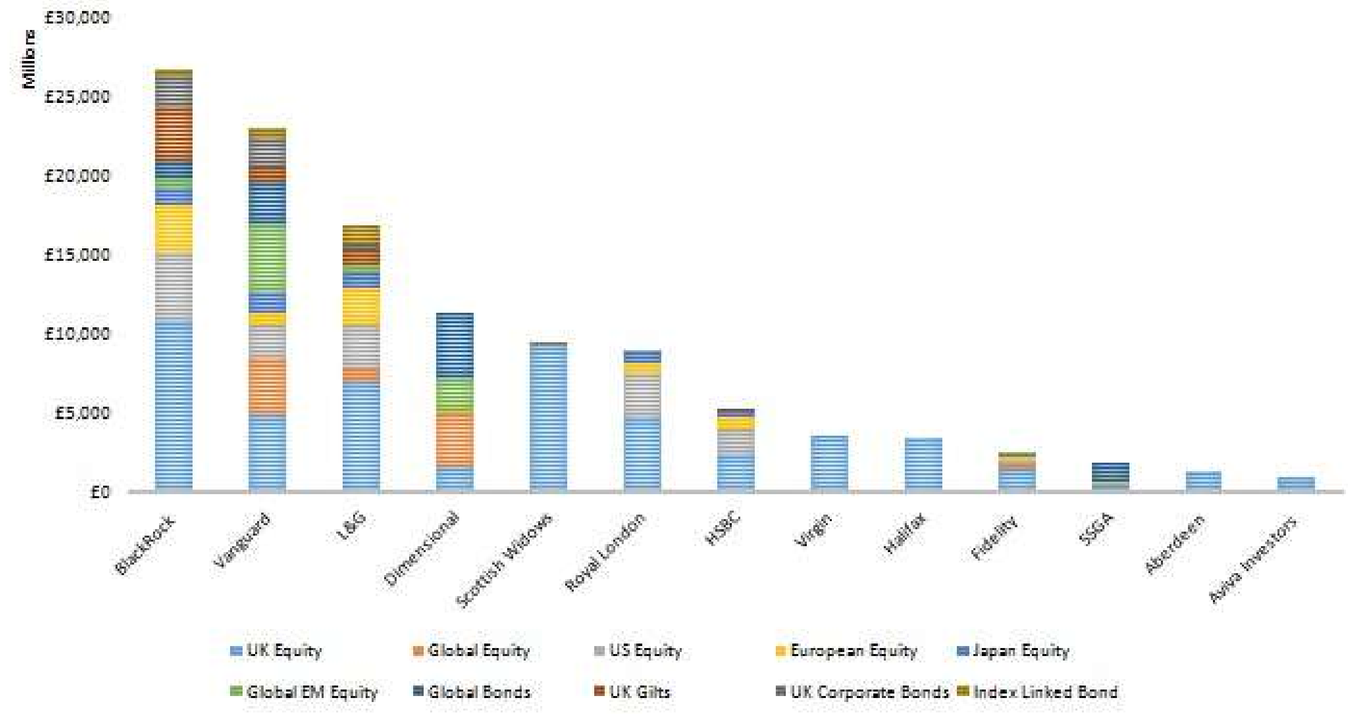


FIG 2.2: AUM OF PASSIVE FUND PROVIDERS (£MILLION)[4]



3. OEICS/Unit Trust only, includes ten single asset funds
4. OEICS/Unit Trust only, covers ten single asset class fund sectors

FIG 2.3: AUM PASSIVE FUNDS PROVIDERS (£MILLION)[5] - ASSEST CLASS BREAKDOWN



5. OEICS/Unit Trust only, covers ten single asset classes and multi-asset funds

TABLE 2.1: FUM OF PASSIVE FUNDS PROVIDERS (£MILLION)[6] - ASSEST CLASS BREAKDOWN

Providers	UK Equity	Global Equity	US Equity	European Equity	Japan Equity	Emerging Markets Equity	Global Bonds	UK Gilts	UK Corporate Bonds	Index Linked Bond	Mixed Investment	Total AuM
BlackRock	£10720.14		£4390.82	£2978.88	£1116.32	£688.85	£991.20	£3398.10	£2064.51	£374.48	£7648.94	£34372.23
Vanguard	£4802.32	£3533.24	£2094.80	£824.27	£1382.35	£4324.56	£2641.05	£865.54	£1938.42	£576.67	£2338.47	£25321.71
L&G	£6953.50	£744.88	£2816.10	£2342.14	£853.51	£552.38		£927.67	£380.15	£1270.20	£451.41	£17291.94
Dimensional	£1505.32	£3319.89	£104.06	£148.58		£2099.68	£4066.22				£677.97	£11921.71
Scottish Widows	£9264.09							£7.08		£3.78		£9274.95
Royal London	£4695.78		£2774.66	£605.17	£822.70							£8898.32
HSBC	£2319.05		£1545.58	£760.19	£436.49			£84.18				£5145.48
Virgin	£3525.73											£3525.73
7IM											£3468.26	£3468.26
Halifax	£3353.85											£3353.85
Fidelity	£1360.26	£239.61	£331.51	£267.07	£52.36	£39.00						£2289.80
Standard Life											£1939.46	£1939.46
SSGA	£282.98		£143.15	£111.11	£42.92		£1209.15					£1789.31
Aberdeen	£1273.39											£1273.39
Aviva Investors	£803.39											£803.39
Architas											£788.03	£788.03
CAF	£574.00											£574.00
M&G	£453.01			£65.48								£518.49
UBS			£403.20						£60.81			£464.01
F&C	£359.46											£359.46
Santander	£344.20											£344.20
Henderson UK	£324.34											£324.34
Marks & Spencers	£301.02											£301.02
Old Mutual UK	£210.15	£85.39										£295.54
Chariguard	£102.96											£102.96
RBS	£51.52											£51.52
Total Clarity											£51.34	£51.34
Liontrust	£50.20											£50.20
Scottish Mutual	£18.55											£18.55
Allianz	£16.87											£16.87
Clerical Medical	£8.44											£8.44
TOTAL	£53674.50	£7923.01	£14603.89	£8102.88	£4706.65	£7704.46	£8907.62	£5282.58	£4443.88	£2225.14	£17363.89	£134938.50

6. Source, Morningstar, FinalytiQ's own calculations. OEICS/UT only

KEY TAKEAWAY

> BlackRock has the leading position in terms of AuM, followed by Vanguard, L&G and Dimensional in second, third and fourth place respectively. Scottish Widow is the 5th largest provider of passive funds in the UK, which is strange because nearly all of that it held in its humongous FTSE All Share tracker funds. Interestingly, brands better known for their passive funds account for a relatively small share of the market, including State Street (1%), Fidelity (2%) and HSBC (4%)

> Across the 11 category including multi-asset fund, BlackRock has the leading position in terms of AUM in 6. Vanguard leads in 3 categories and L&G in 1.

> For core index fund providers, we cannot over-emphasize the importance of having a broad product range. The correlation between product range and the providers' ranking in term of AUM is simple too glaring. Managers with capability and commitment to index investing clearly have a better chance than those with just a product or two.

> BlackRock, Vanguard and L&G have the most comprehensive product range. Royal London, HSBC, SSGA and Fidelity are lagging in terms of their fixed income product range and accordingly, this should be an area of priority for these providers.

AUM VS FUND FLOW

Looking at AUM alone doesn't paint the full picture. We have to look at inflow to understand what is really going on. The net inflow into passive OEICs in the first 6 months of 2015 is £6.7billion and £14.2billion in the 12 months to June 2015. This compares strongly with ETFs, with around £4.4billion net inflow over 6 months and £15.5billion over the 12 months for the 10 asset classes that we looked at.

FIG 2.4: AUM VS 12 MONTH NET FLOW

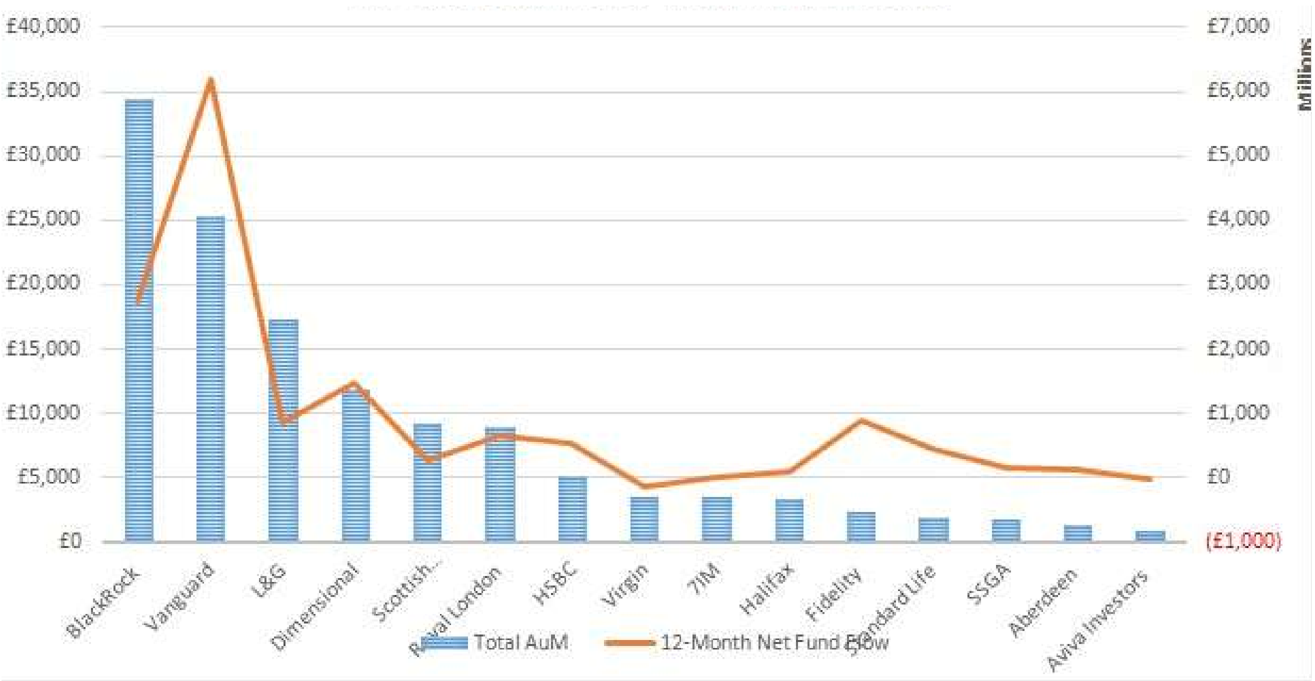


TABLE 2.2; NET FLOW BY ASSET CLASS

	YTD	1 Year	3 Year
Global Bonds	£1504.03	£2697.27	£4305.74
US Equity	£198.18	£266.58	£2605.69
Global Equity	£794.42	£1526.60	£2965.19
European Equity	£854.98	£1528.10	£2242.97
UK Gilts	£244.61	£788.33	£1838.04
UK Equity	£501.81	£3043.71	£2032.11
Global Emerging Markets Equity	-£295.74	£10.03	£1523.69
Japan Equity	£256.63	£548.40	£1597.42
UK Corporate Bonds	£847.83	£1307.89	£1821.24
Multi-Asset	£1768.00	£3243.31	£4614.19
Index Linked Bonds	£55.38	£136.12	£74.94

TABLE 2.3: NET FUND FLOW INTO PASSIVE FUNDS BY PROVIDER

	YTD	1 Year	3 Year
Vanguard	£3257.99	£6113.13	£11641.44
BlackRock	£1173.59	£2745.00	£8771.76
Dimensional	£793.89	£1487.91	£4407.14
HSBC	£118.93	£529.93	£1431.58
Standard Life	£234.96	£449.18	£1374.48
7IM	£428.45	£875.50	N/A
Aberdeen	£76.19	£121.59	£476.73
Fidelity	£250.46	£725.91	£439.45
Architas	£38.67	£50.62	£406.17
Halifax	£92.16	£86.63	£364.92
Royal London	£32.51	£644.66	£349.95
L&G	£229.35	£967.46	£320.20
Santander	£2.22	£225.20	£240.93
Aviva Investors	-£18.15	-£22.03	£20.95
SSGA	£86.13	£145.61	£0.00
Total Clarity	£18.30	£30.23	£0.00
UBS	-£169.25	-£0.68	£0.00
Chariguard	-£4.10	-£23.45	£0.00
Scottish Mutual	-£0.43	-£0.61	-£1.69
Clerical Medical	-£0.37	-£0.68	-£2.40
RBS	-£2.31	-£3.54	-£3.74
Allianz	-£1.40	-£2.21	-£10.27
Liontrust	-£6.82	-£6.10	-£12.62
CAF	-£4.94	-£65.87	-£20.50
Marks & Spencers	-£10.38	-£16.81	-£49.00
F&C	-£13.81	-£69.19	-£59.77
M&G	-£14.35	-£24.59	-£81.97
Henderson UK	-£17.50	-£28.40	-£110.98
Old Mutual UK	-£6.68	£6.12	-£184.85
Virgin	-£114.77	-£127.21	-£232.95
Scottish Widows	£281.61	£283.04	-£3853.75

TABLE 2.4: 12-MONTHS NET FUND FLOW (£ MILLION)[7] - ASSET CLASS BREAKDOWN

	UK Equity	US Equity	European Equity	Japan Equity	Global Equity	Global Emerging Markets Equity	Global Bonds	UK Gilts	UK Corporate Bonds	Index Linked Bond	Multi-Asset	Total
Vanguard	£941.35	£336.93	£258.12	£76.49	£763.19	-£117.14	£1505.54	£384.16	£725.04	£178.19	£1061.26	£6113.13
BlackRock	£1338.83	-£256.46	£321.86	£201.55		-£17.04	£147.10	£253.56	£405.54	-£15.67	£365.72	£2745.00
Dimensional	£7.24	-£41.98	-£118.22		£471.28	£4.50	£899.01			£55.70	£210.37	£1487.91
L&G	£27.97	-£350.54	£200.57	£129.69	£125.60	£115.32		£251.12	£177.99	-£83.31	£373.05	£967.46
7IM											£875.50	£875.50
Fidelity	£310.20	£288.89	£62.13	£50.32	£162.61	£24.39					-£172.63	£725.91
Royal London	£105.79	£171.78	£364.89	£2.21								£644.66
HSBC	-£19.26	£117.96	£442.84	£88.15				-£99.75				£529.93
Standard Life											£449.18	£449.18
Scottish Widows	£282.60							-£0.77		£1.21		£283.04
Santander	£225.20											£225.20
SSGA	£0.00	£0.00	£0.00	£0.00			£145.61					£145.61
Aberdeen	£121.59											£121.59
Halifax	£86.63											£86.63
Architas											£50.62	£50.62
Total Clarity											£30.23	£30.23
Old Mutual UK	£2.19				£3.93							£6.12
Scottish Mutual	-£0.61											-£0.61
UBS		£0.00							-£0.68			-£0.68
Clerical Medical	-£0.68											-£0.68
Allianz	-£2.21											-£2.21
RBS	-£3.54											-£3.54
Liontrust	-£6.10											-£6.10
Marks & Spencers	-£16.81											-£16.81
Aviva Investors	-£22.03											-£22.03
Chariguard	-£23.45											-£23.45
M&G	-£20.50		-£4.09									-£24.59
Henderson UK	-£28.40											-£28.40
CAF	-£65.87											-£65.87
F&C	-£69.19											-£69.19
Virgin	-£127.21											-£127.21

7. Source, Morningstar, FinalytiQ's pwn caculations. OEICS/UT only

FUND FLOW: WHERE IS THE MARKET HEADING?

Broadly speaking, Vanguard, BlackRock and Dimensional dominate flow with Fidelity punching well above its weight, having revamped its passive range in early 2014. Fidelity made the decision to outsource the management of the fund to its US independent subsidiary Geode Capital, leaving Fidelity to focus on distribution. Geode doesn't currently have fixed income capability, even in the US, which is an area that Fidelity needs to build on. It will be interesting to see how the business goes about acquiring this capability to expand its product range.

When we look at inflow over 3 years, an interesting trend begins to emerge. The trend shows Vanguard taking more assets than BlackRock and indeed than any provider over the last 3 years. Since it launched in the UK just over 5 years ago, Vanguard has been taking market share from BlackRock and L&G.

Dimensional is unique in its strategy in the sense that it is the only provider that completely avoids the direct-to-consumer channel. This is against the direction of travel and it's the only provider in the market taking this approach. You can't find any of its products on direct-to-consumer platforms and even in the advisory channel, Dimensional is very selective about who it does business with. It takes advisers through a rigorous selection process before they can use its funds. While this might appear counter-intuitive, certainly in retail investment management, it's proven to be rather effective in not only ensuring consistency of flow, but as an important retention strategy. Advisers who buy into Dimensional's investment philosophy tend to use multiple products, and rarely abandon it for a competitor's products. Keeping its funds out of the retail space also means it can concentrate its marketing budget on its strongest channel without spreading itself too thinly.

Vanguard is currently taking about twice BlackRock's inflow. If this trend continues, Vanguard could overtake BlackRock as the largest provider of passive index funds in the UK in the next 3 years. A substantive proportion of Vanguard's inflow goes into its very successful LifeStrategy range, which accounts for around 17% of flow in the last 12 months.

ASSET CLASSES

In the US Equity sector, Vanguard and Fidelity are the winners, while BlackRock and L&G are net losers in terms of fund flow. It is rather interesting to see that despite L&G's superclean play, it continues to lose assets to Vanguard - who have stayed out of the superclean game - and to Fidelity.

In spite of the popular view that the US market is perhaps the most efficient equity market in the world, lending itself to greater use of index funds, this sector lacks action in terms of product range and fund flow. There's a clear indication that investors prefer ETFs for their US equity allocation, given the flow and broader product range available in the ETF space. The lack of variety - small cap, value, income and other smart beta products - in this particular market is noticeable. Inflows into global equity funds offered by Fidelity and L&G is dwarfed by inflows into Vanguard's Developed World Ex UK funds.

Global Small cap and SRI funds are both interesting subsets; Vanguard and Dimensional are the only providers in this space and both are charging a premium for their products. No price war at all here, move on.

The picture is a little more nuanced in the European Equity sector; HBSC, BlackRock and Vanguard are the clear leaders in terms of inflows, while L&G and Fidelity follow. For Index-linked bond trackers, Vanguard is the only provider that has seen meaningful positive inflow in the last 3 years. L&G and BlackRock have suffered probably in part because investors moved funds into active investments due to worries over the bond bubble and what might happen in event of interest rate rise.

KEY TAKEAWAYS

Overall, the winners in terms of inflows are Vanguard, BlackRock, Dimensional and Fidelity. The largest losers have been HSBC, Virgin, Royal London and F&C.

> Over the last 12 months, Vanguard is taking the lion's share of flow, with around 39% of the flow. This is more than twice the inflow to BlackRock, which came 2nd accounting for around 18% of net fund flow. This means that £38 of every £100 invested in passive funds goes to Vanguard. At this pace, we expect Vanguard to overtake BlackRock as the largest retail provider of passive index trackers in the UK in the next 3 years. Of course, BlackRock continues to maintain the top position in the EFT space.

> Dimensional is the 3rd largest in terms of net fund flow and outstrips Fidelity and L&G. Interestingly, L&G, who is currently the third largest provider comes 5th in terms of inflow. Dimensional could overtake L&G in terms of AUM within the next 5 years to become the UK's third largest provider of retail passive funds. Given that it spends very little on advertising and marketing and focuses exclusively on advisers and institutional investors, this is pretty remarkable.

£38 of every £100 invested in passive funds goes to Vanguard. At this pace, we expect Vanguard to overtake BlackRock as the largest provider of passive index trackers in the UK in the next 3 years. Of course, BlackRock continues to maintain the top position in the EFT space.

> Virgin, F&C, CAF and M&G are among the biggest net losers as they have suffered consistent fund outflow over the last 3 years. This supports one of the most important conclusions of this report; active funds houses are better off leaving passive fund investing to providers who have the capability to make it worth their while. Without an adequate fund range and capacity to compete in the increasingly cut-throat world, we struggle to see the commercial viability of active funds houses keeping a foothold in the passive funds space. We are not ignorant as to why active fund house have their own passive funds - even if it's simply just sub-advice mandates to core index fund managers.

Many of them use index funds within their own portfolios and see this as a chance to cash-in on the rise in the use of index products. But in a world where institutional investors can access UK equities for 1 or 2 bps, "branding" the same funds and selling to any investor for 20 times that goes against fiduciary principles, and they risk destroying their brand integrity. And the competitive environment means that even providers like Virgin with their own distribution channels will struggle to continue pulling this off. This is because the majority of the flow into passive funds in the retail and advisory markets will be via platforms. With competitive offerings from core Index fund providers like Vanguard, BlackRock and Fidelity, it's hard to see why investors and advisers would select these products.

Active funds houses are better off leaving passive fund investing to providers who have the capability to make it worth their while. Without an adequate fund range and capacity to compete in the increasingly cut-throat world, we struggle to see the commercial viability of active funds houses keeping a foothold in the passive funds space.

EFTS: AUM AND NET FLOW

As at the end of June 2015, there's £115 billion invested in the ETFs across the 10 asset classes examined in this report; £6.4 billion (or 5.5%) of this is invested in funds that are labeled as "strategic beta" by Morningstar. In terms of dominant players in the ETF market, BlackRock's iShares takes the lead, representing nearly half of the AUM across the 10 asset classes that we looked at. This is followed by db-x, Lyxor and Vanguard at 11%, 11% and 10% of the market share respectively.

Increasing adoption of ETFs over OEICs/UTs presents a particularly unique challenge to L&G, Fidelity and even Dimensional who currently have no ETF offerings. The growth in EFTs in the UK is driven by institutional investors and providers with no EFT capability are missing out on a growing opportunity. L&G is currently considering ETFs, and may use the proceeds of the divestments of its French business to build or acquire ETF capability.

But it may need to think differently about how it approaches this, given the intense competition among vanilla ETF offerings. Across the pond in the US, Dimensional is partnering with John Hancock Investments to bring their own exchange-traded funds to market for the first time. Dimensional will act as the sub-advised manager for 6 equity ETFs under the John Hancock brand name. This may be a sign of things to come for the UK business.

Fidelity is also looking at the ETF market although no decision has been taken yet. Building a fixed income product in the OEICs/UTs may be a more compelling priority. As Geode Capital, the manager of Fidelity equity index funds does not currently have fixed income capability, this task becomes even more challenging.

Increasing adoption of ETFs over OEICs/UTs presents a particularly unique challenge to provider L&G, Fidelity and even Dimensional who currently have no ETF offerings.†

FIG 2.5: AUM OF EFT PROVIDER - ASSET CLASS BREAKDOWN

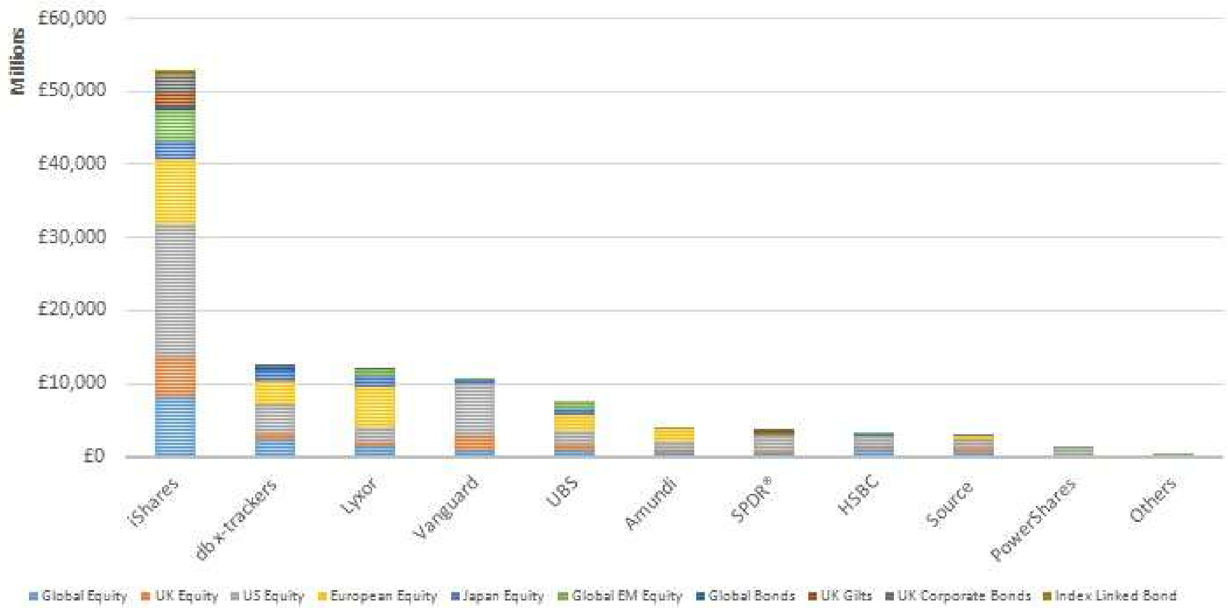
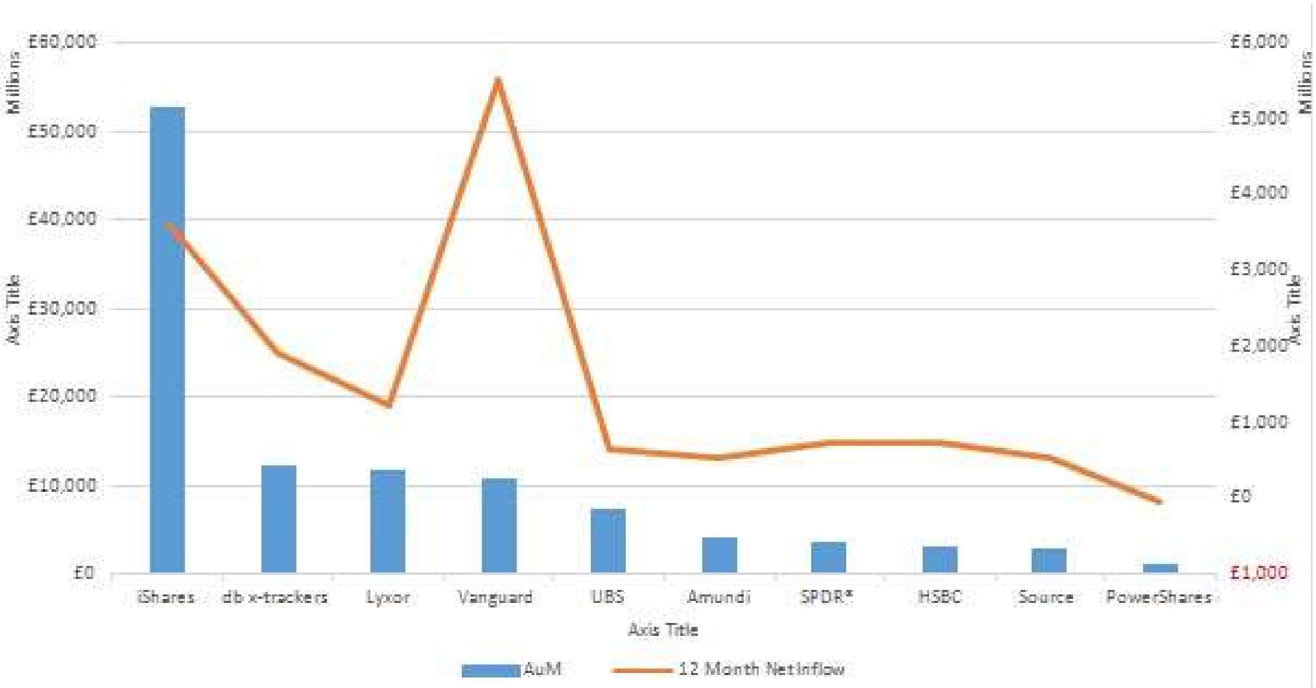


TABLE 2.5: AUM OF ETF PROVIDERS' (£ MILLION)

	Global Equity	UK Equity	US Equity	European Equity	Japan Equity	Global EM Equity	Global Bonds	UK Gilts	UK Corporate Bonds	Index Linked Bond	Total
iShares	£8318.98	£5158.37	£18167.79	£8938.53	£2362.09	£4358.54	£454.67	£2032.98	£2406.74	£659.55	£52858.23
db x-trackers	£2363.84	£584.27	£4127.58	£3201.94	£1365.18		£708.56	£19.45	£7.62		£12378.45
Lyxor	£1374.12	£482.15	£2125.09	£5426.53	£1413.92	£929.65		£16.06	£4.00		£11771.52
Vanguard	£790.52	£1835.17	£7351.35		£380.94	£337.60					£10695.57
UBS	£867.29	£700.22	£1791.06	£2355.19	£719.25	£1009.08					£7442.09
Amundi	£553.65	£321.59	£1244.58	£1613.40		£286.83					£4020.04
SPDR®	£384.65	£305.22	£2104.45			£185.03		£469.02	£244.54		£3692.91
HSBC	£1004.53	£223.04	£1474.67	£80.10	£148.48	£170.52					£3101.34
Source	£690.29	£260.01	£1285.61	£470.89	£138.89						£2845.70
PowerShares	£88.02	£36.41	£959.25			£5.22					£1088.91
Ossiam	£36.04	£37.92				£138.17					£212.14
First Trust		£10.15	£37.60								£47.74
ETF Securities			£24.48								£24.48
WisdomTree			£9.02			£12.89					£21.91
ComStage		£6.62									£6.62

FIG 2.6 - MISSING - EFT PROVIDERS' AUM VS 12 MONTH NET FLOW [9] - £ MILLIONS



Again, in terms of net fund flow into ETFs, Vanguard is taking the lion's share of EFT flows, accounting for over a third of inflow, followed by BlackRock's iShares, which accounts for 23% of net fund flow. This is quite an achievement for Vanguard, which only launched its ETF range in the UK less than 3 years ago. Newer entrants into the UK market WisddomTree and FirstTrust are yet to make a dent in the market as established players are still very much in command of flow.

9. Net inflow and AUM across 10 assett classes

TABLE 2.6: EFT PROVIDERS' NET INFLOW (£ MILLION)

Fund Flow	YTD	1 Year	3 Year
iShares	£540.96	£3627.01	£8116.03
Lyxor	£859.55	£1214.20	£1710.47
db x-trackers	£1103.42	£1920.58	£1600.34
UBS	£845.24	£658.51	£1454.64
Amundi	-£152.23	£520.90	£537.55
HSBC	-£445.63	£742.89	£561.81
Source	£572.99	£547.99	£903.36
ETFs	£2.67	£0.39	-£9.33
SPDR®	£137.53	£734.67	£2147.43
FT	£15.33	£34.14	£0.00
ComStage	£0.00	£0.40	-£17.42
PowerShares	£27.94	-£53.78	-£191.80
Ossiam	-£56.48	£33.08	£135.72
Vanguard	£964.24	£5,516.13	
WisdomTree	£17.85		

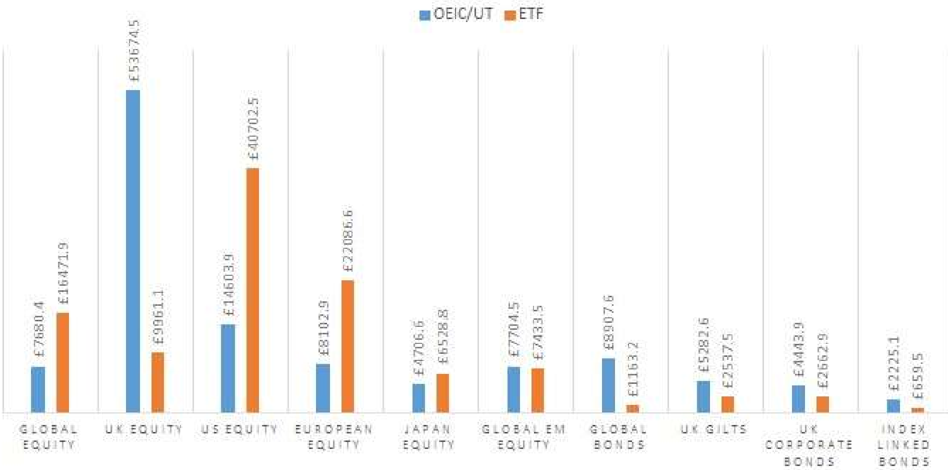
TABLE 2.7: EFT NET FUND FLOW - ASSET CLASS BREAKDOWN (£ MILLION)

TOTAL MARKET*	YTD	1 Year	3 Year
European Equity	£3596.51	£3736.30	£5883.69
US Equity	-£1733.26	£6548.87	£4786.86
Global Equity	£555.45	£2661.22	£3246.57
Japan Equity	£1308.62	£1321.47	£2541.88
UK Gilts	£472.25	£265.69	£573.73
Global Emerging Markets Equity	£85.27	-£200.55	£238.29
Global Bonds	£155.33	£775.26	£369.54
UK Corporate Bonds	£271.16	£425.72	£647.34
Index Linked Bond	-£125.48	-£219.16	-£228.43
UK Equity	-£152.48	£182.29	-£1110.67

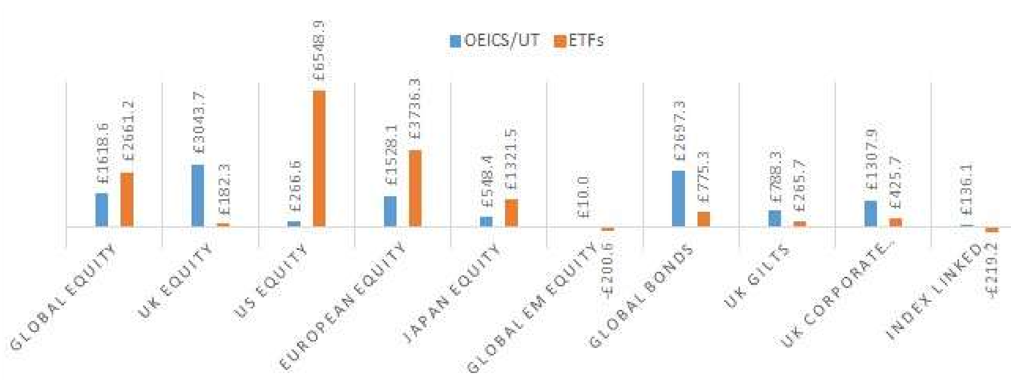
OEICS/UT VS EFTS

One interesting discovery, for us at least, is that there are more assets held in ETFs than in traditional index funds in virtually all equity asset classes, except UK and Emerging Markets. However, investors appear to prefer funds to EFTs for their bond allocation. Even when we consider fund flow, this trend is pretty consistent over both 1 and 3 years.

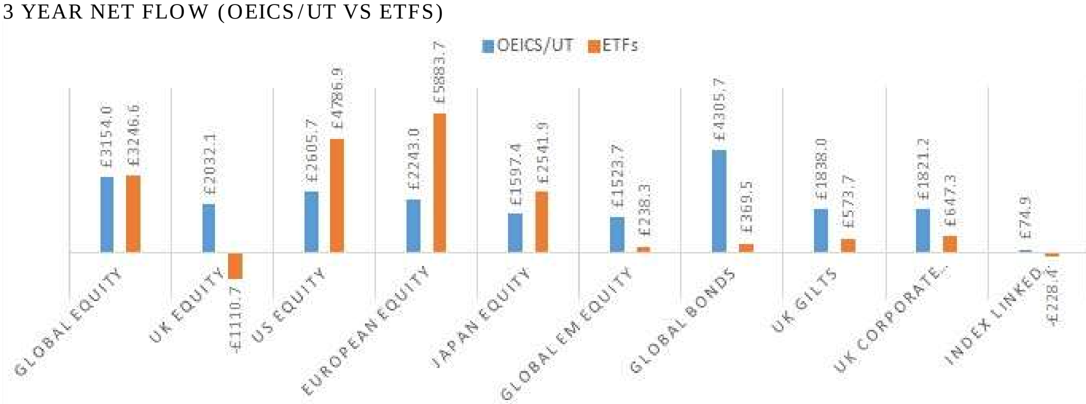
FIG 2.7: ASSET UNDER MANAGEMENT - OETCS/UT VS EFTS (£ MILLION)



I YEAR NET FLOW (OEICS/UT VS ETFS)



3 YEAR NET FLOW (OEICS/UT VS ETFS)



JUST HOW BIG IS THIS PIE?

When we combine ETF and tracker funds, the ranking of providers in terms of AUM changes somewhat, with providers having both ETFs and fund capability likely to have a larger combined market share. BlackRock has 36% of the combined market share, followed at some distance by Vanguard in 2nd place with 15% market share.

FIG 2.9: ASSET UNDR MANAGEMENT - COMBINED ETF & TRACKER FUNDS

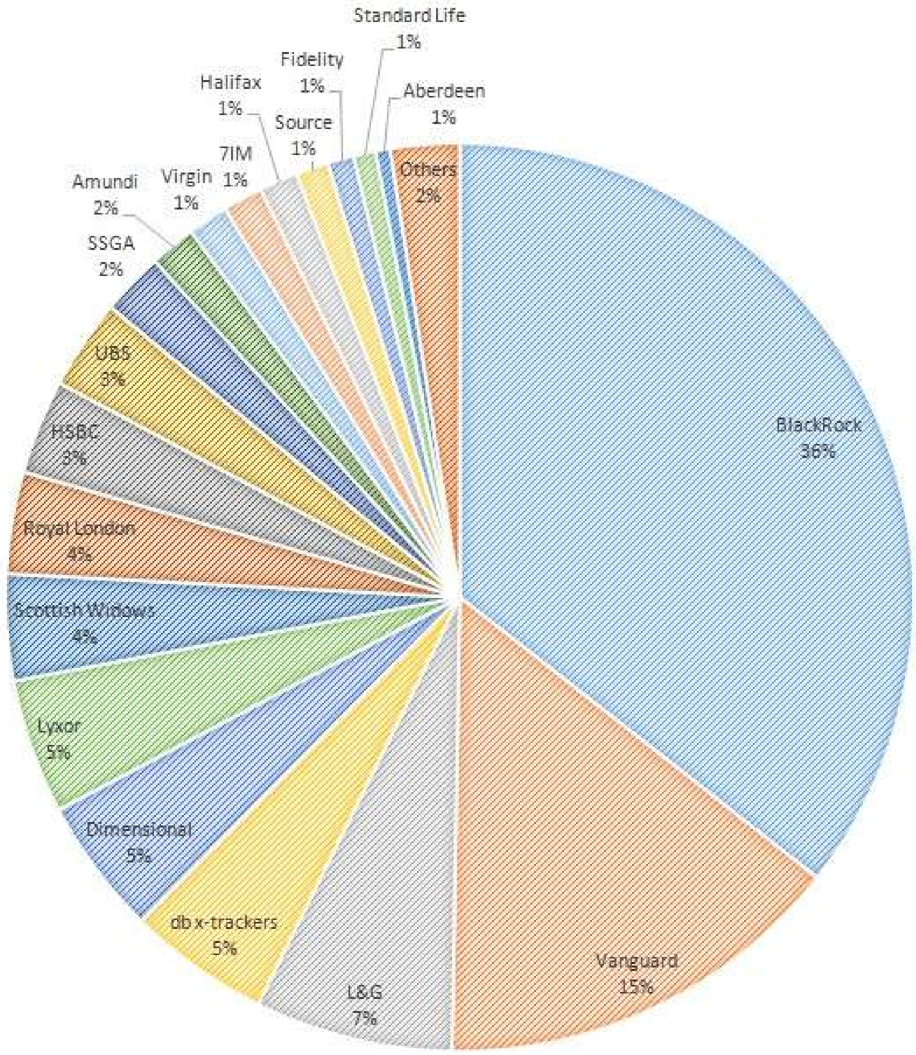


TABLE 2.8: COMBINED EFTS AND OEICS

	AUM (Million)			Net Fund Flow (12-Months) (Million)			No of Funds		
Providers	OEICS	ETFs	Total	OEICS	ETFs	Total	OEICS	ETFs	Total
BlackRock	£34372.23	£52858.23	£87230.46	£2745.00	£3627.01	£6372.01	21	56	77
Vanguard	£25321.71	£10695.57	£36017.27	£6113.13	£5516.13	£11629.26	21	8	29
L&G	£17291.94		£17291.94	£967.46		£967.46	19		19
db x-trackers		£12378.45	£12378.45		£1920.58	£1920.58		31	31
Dimensional	£11921.71		£11921.71	£1487.91		£1487.91	24		24
Lyxor		£11771.52	£11771.52		£1214.20	£1214.20	25		25
Scottish Widows	£9274.95		£9274.95	£283.04		£283.04	4		4
Royal London	£8898.32		£8898.32	£644.66		£644.66	5		5
HSBC	£5145.48	£3101.34	£8246.82	£529.93	£742.89	£1272.82	7	10	17
UBS	£464.01	£7442.09	£7906.10	-£0.68	£658.51	£657.83	2	27	29
SSGA/SPDR	£1789.31	£3692.91	£5482.21	£145.61	£734.67	£880.28	5	20	25
Amundi		£4020.04	£4020.04		£520.90	£520.90		11	11
Virgin	£3525.73		£3525.73	-£127.21		-£127.21	2		2
7IM	£3468.26		£3468.26	£875.50		£875.50	4		4
Halifax	£3353.85		£3353.85	£86.63		£86.63	2		2
Source		£2845.70	£2845.70		£547.99	£547.99		7	7
Fidelity	£2289.80		£2289.80	£725.91		£725.91	12		12
Standard Life	£1939.46		£1939.46	£449.18		£449.18	5		5
Aberdeen	£1273.39		£1273.39	£121.59		£121.59	1		1
PowerShares		£1088.91	£1088.91		-£53.78	-£53.78		8	8
Aviva Investors	£803.39		£803.39	-£22.03		-£22.03	1		1
Architas	£788.03		£788.03	£50.62		£50.62			7
CAF	£574.00		£574.00	-£65.87		-£65.87	1		1
M&G	£518.49		£518.49	-£24.59		-£24.59	2		2
F&C	£359.46		£359.46	-£69.19		-£69.19	1		1
Santander	£344.20		£344.20	£225.20		£225.20	1		1
SSGA/SPDR	£1789.31	£3692.91	£5482.21	£145.61	£734.67	£880.28	5	20	25
Amundi		£4020.04	£4020.04		£520.90	£520.90		11	11
Virgin	£3525.73		£3525.73	-£127.21		-£127.21	2		2
7IM	£3468.26		£3468.26	£875.50		£875.50	4		4
Halifax	£3353.85		£3353.85	£86.63		£86.63	2		2
Source		£2845.70	£2845.70		£547.99	£547.99		7	7
Fidelity	£2289.80		£2289.80	£725.91		£725.91	12		12
Standard Life	£1939.46		£1939.46	£449.18		£449.18	5		5
First Trust		£47.74	£47.74		£34.14	£34.14		2	2
ETF Securities		£24.48	£24.48		£0.39	£0.39		1	1
WisdomTree		£21.91	£21.91			£0.00		4	4
Scottish Mutual	£18.55		£18.55	-£0.61		-£0.61	1		1
Allianz	£16.87		£16.87	-£2.21		-£2.21	1		1
Clerical Medical	£8.44		£8.44	-£0.68		-£0.68	1		1
ComStage		£6.62	£6.62		£0.40	£0.40		1	1

KEY TAKEAWAYS

- The rise in the use of ETFs in the UK is driven primarily by institutional investors and this presents a particular challenge for providers without a foothold in the EFT space. In particular Fidelity and L&G.

- Adoption of ETFs by financial advisers and indeed retail investors in the UK is still very limited. The big adviser platforms Cofunds and Old Mutual still offer no access to EFTs at all. Funds Network, the second largest adviser platform offers access to a very limited range. Even for platform providers who offer access to ETFs, there are inherent barriers; many trade through third-party stockbrokers and the additional costs are often disincentives to advisers and retail investors who may be considering ETFs.

- Advisers receive a fair amount of flack for preferring OIECS over ETFs. But their reasons are fairly obvious and in most cases, logical. Platform availability and the ease of access to OEICs makes them the preferred choice for advisers. In addition, across the major asset classes, there is no evidence that ETFs are more cost effective than OIECS or that they are better tracking vehicles. EFTs naturally have a key advantage where intraday liquidity is required but this is not a key priory for advisers (who often don't have discretionary investment management power to utilise this anyway). And when you add to that, the perceived complexity of ETFs both for advisers and clients, this is no surprise at all.

- To increase EFT adoption among advisers, greater education and engagement from ETF providers is key. ETF providers can learn a thing or two from Dimensional in terms of engaging advisers.

- Another important step in increasing EFT adoption among advisers and retail investors is to remove the obvious barriers to trading ETFs, by working more closely with platforms to improve access and lower trading costs. Some providers have suggested the idea of covering trading cost of ETFs on platforms. With trade aggregation on platform, the overall cost may be a price worth paying but there are fears that this may be against the FCA rules.

- An important consideration for product development teams is the target distribution channel. For products aimed at adviser and retail investors, OEICs are the clear preferred choice. Institutional investors appear to prefer ETFs. This might also explain why the use of strategic beta funds isn't gaining significant traction within the UK adviser community, beyond the use of cap-weighted value and small cap funds, which is dominated by Dimensional.

5. THIS IS WAR! A PRICE WAR!

In March 2014, Fidelity revamped it passive offering, undercutting virtually all the other passive fund providers at the time across its range of 5 equity funds and starting what the industry press later dubbed “the passive price war”. Soon, Vanguard followed with its own price cuts, only to be followed by L&G and then nearly 15 months later in July 2015 (just before going to press), BlackRock threw its hat into the ring.

TABLE 3.1: PASSIVE FUND OCF (CLEAN SHARE CLASSES[10])

	UK Equity	US Equity	European Equity	Japan Equity	Global EM Equity	Int'l Equity	Global Bonds	UK Gilts	UK Corp. Bond	Index Linked Bond
BlackRock	0.16	0.16	0.12	0.12	0.25		0.12	0.11	0.12	0.11
BlackRock (New)	0.07	0.08	0.10	0.12	0.25		0.12	0.11	0.12	0.11
Vanguard	0.08	0.10	0.12	0.23	0.27	0.15	0.15	0.15	0.15	0.15
L&G	0.10	0.10	0.12	0.15	0.33	0.39		0.15	0.15	0.15
Fidelity	0.09	0.10	0.10	0.12	0.17	0.20				
HSBC	0.17	0.18	0.20	0.21				0.18		
SSgA	0.15	0.20	0.25	0.30			0.28			
Dimensional Core	0.25				0.70	0.40	0.30			0.24
Dimensional Value	0.44		0.56		0.62	0.44				
Royal London	0.15	0.23	0.27	0.25						
Scottish Widows	0.36							0.37		0.36
UBS		0.09							0.20	
M&G	0.46		0.72							
Old Mutual	0.30					0.30				
F&C	0.33									
Henderson	0.37									
Scottish Mutual	0.08									
Virgin	1.00									
Aberdeen	0.22									
Allianz	0.79									
Aviva Investors	0.23									
CAF	0.32									
Chariguard	0.30									

10. Note, we use the cheapest OCF of clean share classes widely available on platforms and NOT “Super Clean” or preferential share classes which are restricted to a select number of platforms.

WHO IS AT WAR?

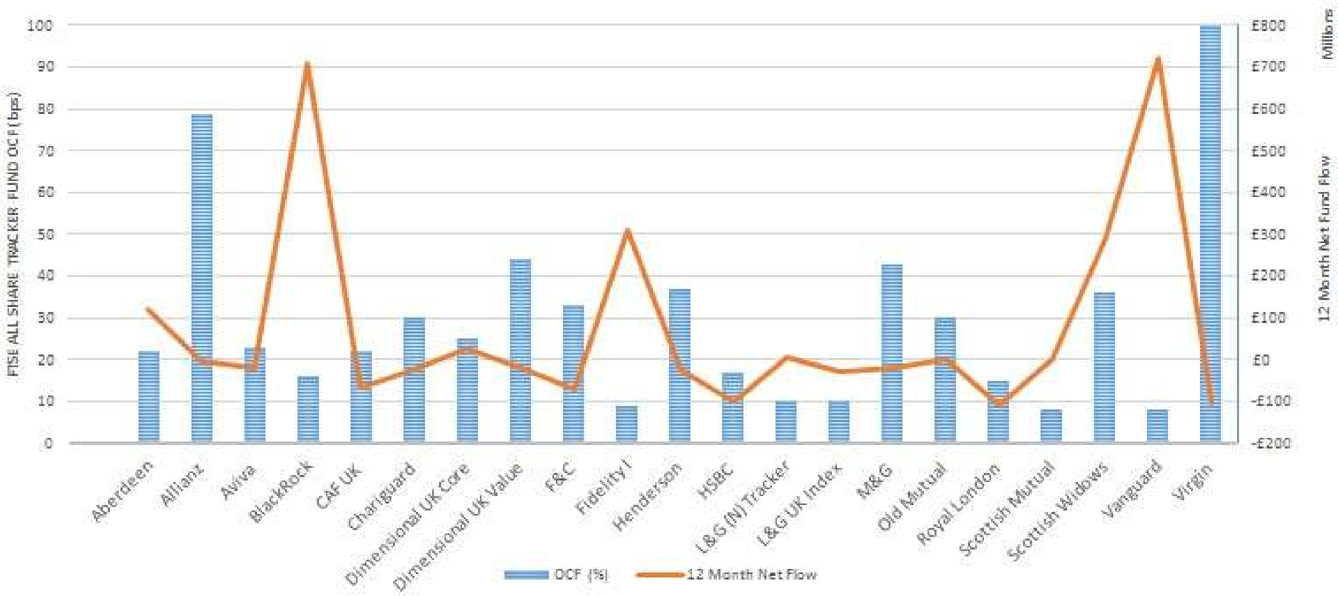
When you look closely at the data, one is tempted to suggest that this isn't a full-blown war, just yet. For starters, the so-called "passive war" is actually being significantly driven by 4 dominant players; Fidelity, LGIM, Vanguard and BlackRock. There are other providers like HSBC, Scottish Widows and Virgin who are simply standing by and not getting involved. For instance, only 4 of 25 FTSE All Share index funds have an OCF below 0.10%. Some of the largest FTSE All Share index funds including HSBC and Scottish Widows have a relatively high OCF and are charging over 100% more than Vanguard and Fidelity.

Providers are picking their fights rather carefully. In fact, what we now call a price war was a result of a rather clever move by Fidelity. Fidelity figured it had very little to lose as its passive fund AUM was pretty meager compared to the likes of BlackRock, L&G and Vanguard. It's pretty easy to cut prices when you don't have a large AUM; but when you have tens of billions of client money already under management, cutting fund prices becomes trickier. This may explain why it took BlackRock months before bowing to pressure, given its dominant position in the market place.

Some other providers like HSBC, Scottish Widows and Virgin are standing by watching this so called war. We see some indication that more inflows are moving out of expensive index funds into the cheaper funds. But not necessarily in droves. The chart (Fig 3.1) below plots net fund flow over the last 12 months against the OCF of funds in the UK Equity All Share sector.

> There is some indication that more inflow into are moving out expensive index funds into the cheaper funds but not necessarily in droves.

FIG 3.1: FTSE ALL SHARE FUND OCF VS INFLOW



HOW DISTRIBUTION CHANNELS INFLUENCE PRICE AND FUND FLOW

We see some bizarre pricing models; for example, passive funds by Virgin, Henderson and Liontrust, which are sub-advised mandates managed by State Street. These funds are priced at double the fees charged by the State Street's own funds and their performance are amongst the worse in the market. This begs the question; why would an investor choose these funds in the first place? While brand names are important when investors select funds, some of the best known brands in the passive funds space offer more competitive products.

Clearly, distribution channels play a vital role in this "price war"; across the 10 single asset classes we examined, BlackRock prices competitively for institutional investors, with institutional share classes typically priced at 1 or 2bps. This is significantly lower than prices retail and advisory clients pay. Following its latest round of price cuts, BlackRock is now the most competitive across the 10 single asset classes that we examined in this report, undercutting Vanguard and Fidelity.

Fidelity and L&G are the biggest players of the "super clean" card. Both providers offered super clean share classes to a select number of platforms and Fidelity has exclusive share classes which are only available on its own platform. But there is little indication that this in itself is having a meaningful impact on flows; over the last 12 months, inflows to L&G trackers have been particularly poor. For L&G, the super clean play is a bit futile. We understand that the minimum inflow required to access the preferential share classes is £100M, as long as the platform handles the marketing of funds. Fidelity is fairing a bit better, but we don't think this is necessarily down to having an influence on distribution via its own

> We see no evidence that offering preferential or "super clean" share class so called is having any major impact on fund flow. Indeed, For L&G in particular, the "super clean" play appears futile.

Indeed, we don't see a direct correlation between ownership of a platform and the level of fund flow. Providers like Vanguard, BlackRock and Dimensional, which have no ownership or control of platforms, have more inflows than those who do L&G, FundsNetwok, Aviva, 7IM, Standard Life and Architas. Having a trusted brand, a broad and competitive product range and a clear distribution strategy trumps platform ownership or control. This should be no surprise; FCA rules prevent platforms from creating any bias in the way funds on their platforms are presented to advisers, significantly weakling their influence over distribution.

The picture is somewhat different though for providers distributing via their own personal and workplace pension products. Scottish Widows is an interesting example of this; its £9billion UK FTSE All Share tracker fund is among the most expensive and one would expect existing investors to vote with their feet. There is little sign of that happening, probably because much of the flow to the fund is via the provider's own pension product range and it's used widely within its own multi-asset portfolios. This is also true for Aviva Investor tracker funds, which are used predominantly within its own product range; for instance its own Multi-Asset fund range. †This shows if the product has some distribution clout or the passive fund is used as a building block for other funds, rather than being sold directly to investors, there is less pressure to reduce price. However, again this calls into question the provider's commitment to fiduciary principles.They are effectively double charging clients i.e charging uncompetitive high fees for index trackers which they include in their own products, which are charged for again!

DIMENSIONAL-THE KING OF 'SMART PASSIVE' BUT FOR HOW LONG?

Dimensional has felt very little pressure to cut prices as much as the traditional index fund providers. There are very few competitor offerings to its smart beta strategies in the mutual fund space and it has a complete commitment to the advisory channel. 7IM recently crashed Dimensional's party, with its "smart passive" value funds, which include UK, European and Global Value funds.

Until now, 7IM remained largely a multi-asset portfolio manager, using predominantly index products to capture asset class return; however, it is now effectively becoming a provider of single asset class passive funds. Of course Dimensional has got a clear advantage; its funds have the performance record that 7IM don't have.† More importantly, Dimensional has the proven methodology for implementing strategies.† Since neither Dimensional nor 7IM track indices in the traditional sense, the only way for 7IM to demonstrate that it's a compelling alternative for investors looking to capture the value premium, is simply to show performance data. Unavoidably, this will take a few years. Having said that, 7IM said it is simply unitising its in-house smart passive baskets of equities that have been running successfully as holdings in the 7IM funds for some time. This means it's been running these strategies in-house for nearly 3 years and it may have some performance data to share with advisers to help them compare against Dimensional's offering. 7IM is undercutting Dimensional and has cleverly priced its products below Dimensional's in these four asset classes.

	7IM (OCF)	Dimensional (OCF)
UK Value	0.35%	0.44%
US Value	0.35%	N/A
European (Ex UK) Value	0.35%	0.56%
Emerging Markets Value	0.40%	0.62%
Global	N/A	0.59%†

Dimensional has a loyal following within the advisory market. While 7IM also has a substantial adviser following, its core users tend to be advisers who outsource investment management to 7IM. This means that since they have already outsourced, they are far less likely to be using single asset class funds to build their own in-house portfolios.

The point here is that it'll take 7IM a lot more than lowering fees to attract Dimensional's core users. However, the fact that Dimensional insists on prospective advisers buying into its investment philosophy before using its funds means that there may be a number of advisers who want to include value index funds in their portfolios but haven't been able to because of the absence of OEICs/UT alternatives to Dimensional. I imagine there's a potential captive audience for 7IM there.

The big coup for 7IM may lie in DIY consumers looking to include value equity products in their portfolios. Dimensional funds are only available via a financial adviser.

So while 7IM's entry to this space is great news, it doesn't appear to be a major threat to Dimensional's dominance. So we probably shouldn't expect a "price war" from these two managers anytime soon.

KEY TAKEAWAYS

Overall, the conclusion we draw is the competition between passive fund providers falls far short of a full blown war, but winners and losers are beginning to emerge. BlackRock, Vanguard and Fidelity are emerging as winners while L&G and HBSC are losing out.

So, what's next for the passive price war?

> Fund prices are still significantly higher for retail and advisory channels, when compared to institutional clients. For instance, BlackRock, HSBC and Vanguard price the institutional share classes of the FTSE UK All share trackers at 1, 2 and 5bps respectively, compared to 7, 8 and 17bps for clean share classes. Overall, advisory clients on platforms pay anything between 40% and 400% more than institutional investors.

> While distribution and marketing costs to institutional clients is lower than retail and advisory, these margins are disproportional and need to come down. With the fund trading aggregation on platforms and the fact a significant proportion of fund inflow is from existing investors (and via the clients of existing advisers), we expect to see the gap between charges for advisory and institutional share classes narrow.

> There are funds whose clients don't benefit from the economies of scale that they should; Scottish Widows, Virgin and Halifax are the worse offenders. Investors in these funds are getting a raw deal from the providers.

> Competition will only become more intense, making it difficult for subscale providers to survive. Where index tracking isn't the core business for the provider, we expect to see these providers leave the market altogether. Some index providers will unavoidably die a slow and painful death unless they change their approach to distribution channel, pricing and product.†This is particularly true for sub £200million funds, which tend to be rather expensive. Small, is NOT beautiful for tracker funds. Consolidation in this space - we are taking fund mergers rather than provider merger - is long overdue. We think (and sincerely hope) some providers will simply put up their hands and admit that they can't make this work.†Yes Scottish Mutual, Henderson, Chariguard and Allianz, we are looking at you! One possibility is for the Vanguards, Fidelitys and L&Gs of the world to take over these funds, but I'm sure no one in their City office is thinking about that just yet. Merging these laggards into larger index funds is good for providers and clients. It helps existing providers get rid of a failing business stream with no future. For the provider taking over the funds, the acquisition costs will be lower than the cost of acquiring brand new customers.†For investors, this should inevitably mean lower fees and better products

OPPORTUNITIES FOR PRODUCT DEVELOPERS

While many core asset classes are crowded in terms of the number of index fund products, leading to intense competition, there is a significant gap in the marketplace for product innovation. We particularly note the lack of fixed income and SRI products.

SOCIAL RESPONSIBLE INVESTING: The UK Market for SRI product tops £15 billion as at June 2014, an increase of 14.5% over the previous year [11]. However, the lack of SRI products for index fund investors is noticeable. Vanguard and Dimensional are the only providers and accordingly, they charge a premium for their products. Dimensional charges 40bps for its Core Global equity fund but 50bps for its Global Sustainability Equity fund, a 25% price premium. Vanguard charges 15bps for its Global Ex UK fund but 35bps for its Global SRI Global Stocks fund, a price premium of 133%. Does it take twice the cost to implement the SRI portfolio? We don't think so. Should the SRI fund attract a premium? Probably; but a 133% premium? Admittedly, the SRI funds attract less assets than the core equity index fund but we think the overall cost differential on the two portfolios should be minimal for an index fund provider. Which comes back to our initial point - where there is little or no completion, index providers charge a price premium. The demand for SRI products is expected to continue to grow driven largely by demand from institutional investors, and the main barrier is the availability of viable products.

EQUITY INCOME FUNDS: The UK Equity Income and Global Equity Income sectors top £59.5 billion and £13.5 billion respectively as at June 2015, according to data from the IA. Vanguard is the only provider with a passive product in this space. Investors can buy the core UK equity fund for 8bps with Vanguard, the Equity Income fund charges 22bps ñ a price premium of 227%! The point here is there has been fierce competition in the core UK equity sector among index fund providers. Admittedly, the equity income funds will attract less inflow than core equity funds but we think the overall cost differential on the two portfolios is small. We don't believe the equity income fund warrants a 227% premium.

There are a number of ETF alternatives, but they are even more expensive than Vanguard. Furthermore, the challenges advisers and retail investors' face in trading ETFs won't go away soon, hence the need for products in OEICs and UT structures.

Fund Name	Index Benchmark	
Vanguard FTSE U.K. Equity Income Index	FTSE U.K. Equity Income	0.22
SPDRÆ S&P UK Dividend Aristocrats ETF	S&P UK High Yield Dividend Arstcr TR	0.30
Amundi - ETF FTSE UK Dividend Plus	FTSE UK Dividend + Index	0.30
iShares - UK Dividend UCITS ETF GBP	FTSE UK Dividend + Index	0.40

This creates an opportunity for passive fund providers and it's entirely plausible to expect some of the £73 billion currently invested in active funds to find its way into index based products.

SMART BETA PRODUCTS: Equity and fixed income smart beta products are another opportunity for index managers. On example of this is small cap equity products. The UK Smaller Companies sector is worth £11.5 billion as at June, 2015, according to data from the Investment Association but the lack of tracker funds in this sector is again significant.

Dimensional remains the undisputed king in the small cap equity sectors, providing the only UK, European (ex UK) and US small cap OEICs. However, iShares ETF offerings are strong contenders. In the Global Small cap, Vanguard has a strong OEICs offering and there are a number of ETFs as well.

11. Vigeo (2014); Green, Social and Ethical Funds in Europe The Retail Market ñ 2014 Review

Dimensional’s product		Competing Offerings	
UK Small Companies	0.65%	iShares - MSCI UK Small Cap UCITS ETF	0.58%
European Small Companies	0.65%	iShares MSCI Small Cap UCITS ETF GBP	0.58%
		Lyxor MSCI EMU Small Cap	0.40%
Global Small Companies	0.60%	Vanguard Small Cap Index Fund	0.38%
		SSgA SPDR MSCI World Small Cap Ucits ETF £	0.65%
US Small	0.44%	iShares - MSCI USA Small Cap UCITS ETF GBP	0.43%
		ETFS - Russell 2000 US Small Cap GO UCTS ETF GBP	0.45%
		SSGA SPDR Russell 2000 US Small Cap UCITS ETF GBP	0.45%
		DB X-Trackers - Russell 2000 UCITS ETF (Prospective DR) 1C	0.40%
		Lyxor - UCITS ETF RUSSELL 2000 C GBP	0.40%

The correlation between competing offerings and price is pretty obvious. In the UK and European small cap categories, Dimensional’s product commands a premium as there is a lack of OEICs contenders. Dimensional’s captive audience is financial advisers and they are far more likely to use OEICS than ETFs. The ETF offerings are more likely to be an issue in the institutional space.

6. SECURITIES LENDING: EACH TO ITS OWN

If George Orwell were to have analysed trends in passive investing, one of his observations would have been that all passive funds are equal but some are more equal than others.íHe would have been spot on. One important difference in the way index funds are managed is the difference in managers' approaches to securities lending and how the providers divvy up the proceeds from such activities. Securities lending is a practice where funds lend stocks or bonds to a third-party (often other asset managers and investment banks) on a short-term basis with the objective of generating additional return for fund shareholders.

Prof Kay's Review of UK Equity markets recommended that all income from securities lending should be disclosed and rebated to investors. And indeed, Esma's UCITS guideline (which applies primarily to ETFs) is that all revenues from securities lending (net of direct and indirect operational costs) should be passed on to investors. The rationale is very simple: the investor bears all the risk associated with securities lending and should therefore be the sole beneficiary of the reward. The practice whereby fund managers cream off some of the income from securities lending (in addition to their fees for managing the fund) is inconsistent with fiduciary principles and provides an incentive to engage in inappropriate lending behaviour.

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THOSE WHO DON'T

Providers such as L&G and Fidelity do not participate in securities lending within their retail tracker funds. The reason often given for this is that securities lending is an added layer of risk to the fund - specifically counterparty risk - which investors in these funds would prefer to avoid. The logic is that one reason investors choose physically backed replication over synthetic is to avoid counterparty risk, so why reintroduce that risk by stock-lending?

Legal and General also points out that it avoids securities lending because it could potentially impair its ability to participate in shareholder activities. This is because the passive fund holding forms part of company-wide shareholder activities and representation, enabling L&G to vote and influence management of the underlying companies on behalf of its investors. This is a particularly interesting point, as research[12] at the Wharton School shows that 'an increase in ownership by passive institutions is associated with more independent directors, the removal of poison pills and restrictions on shareholders' ability to call special meetings, and fewer dual class share structures. Passive investors appear to exert influence through their large voting blocs passive ownership is associated with less support for management proposals and more support for shareholder-initiated governance proposals. While we do not find direct evidence that the increased presence of passive investors facilitates activism by other investors, we do find that ownership by passive investors is associated with corporate policies that are likely to mitigate the prospect of an activist campaign, including less cash holdings and higher dividend payouts. In contrast to conventional wisdom, our findings suggest that passive investors play a key role in influencing firms' governance choices.

Of course, this is not to say that stock lending will definitely impair a manager's ability to influence the investee company's management. But the overall effect of this is much harder to quantify. There is no doubt that securities lending comes with its own risk but this risk is probably best managed than avoided.

12. Passive Investors, Not Passive Owners by† Ian R. Appel, Todd A. Gormley , and Donald B. Keim (2014)†

THOSE WHO DO

Vanguard, Dimensional and Blackrock do take part in securities lending programmes but practices vary significantly. Vanguard and Dimensional pass all proceed, net of cost to the fund investors. BlackRock allows up to 50.00% of the fund's assets to be lent, although the actual amount lent tends to be significantly lower and around 62.50% of the gross proceeds of the securities lending programme is passed on to the fund. The rest is retained by BlackRock's securities lending programme to cover costs. It maintains that, while other providers might outsource this to a third-party (who is paid to implement the programme), BlackRock's programme is managed by a subsidiary and it retains 37.5% of the gross revenue to cover costs (and profits for its shareholder.) It has to be said that the firm has a very robust risk management process in place; it only lends to approved third-parties and all its lending is backed up with high quality collateral that is typically valued higher than the amount lent.

In addition, BlackRock indemnifies clients against potential default and maintains that no clients have experienced a loss in its securities lending through borrower default since inception in 1981.

Another criticism often leveled at index fund managers creaming off income on securities lending is that the fund takes all the risks - and fund managers who benefit from securities lending only share the upside, not the downside. There is a strong case that, if the manager is going to be creaming off some of the proceeds of the securities lending programme, it should also share the downside.

Data are hard to come by but Dimensional and Vanguard supplied us with data of income generated from their stock lending programme, all of which is passed over to the fund.

TABLE 4.1: PERFORMANCE IMPACT OF SECURITIES LENDING - DIMENSIONAL

Dimensional Securities Lending	Performance Impact (bps)			3 year average
	2011	2012	2013	
Global Core Equity Fund	6	7	5	6.0
Global Small Companies Fund	1	4	4	3.0
Global Targeted Value Fund	12	13	9	11.3
US Small Companies Fund	13	12	10	11.7
European Value Fund	21	37	13	23.7
European Small Companies Fund	21	17	9	15.7
Pacific Basin Value Fund	2	3	3	2.7
Pacific Basin Small Companies Fund	6	6	7	6.3
UK Core Equity Fund	0	0	0	0.0
UK Value Fund	1	1	1	1.0
UK Small Companies Fund	2	2	2	2.0
International Core Equity Fund	3	3	4	3.3
International Value Fund	4	4	5	4.3
Emerging Markets Core Equity Fund	2	4	3	3.0
Emerging Markets Value Fund	3	5	5	4.3
Emerging Markets Targeted Value Fund	5	9	9	7.7

TABLE 4.2: PERFORMANCE IMPACT OF SECURITIES LENDING - VANGUARD

Vanguard Stock Lending Revenue	Performance Impact (bps) 2012	2013	2014	3 year average
Eurozone Stock Index Fund	56.4	15.2	11.2	27.6
European Stock Index Fund	29.2	10.7	7.4	15.8
SRI European Stock Fund	26.6	10.9	7.7	15.1
SRI Global Stock Fund	11.2	4.8	4.1	6.7
Global Stock Index Fund	10.5	5.4	4.3	6.7
Global Small Cap Index Fund	8.6	6.1	6.2	6.9
Emerging Markets Stock Index Fund	5.7	2	3.5	3.8
Japan Stock Index Fund	4.6	2.7	3.9	3.7
Pacific ex-Japan stock Index Fund	1.9	2.1	1.7	1.9
US Discoveries Fund	1.6	5.4	14.7	7.2
US Fundamental Value Fund	0.4	0.6	0.4	0.5
US 500 Stock Index Fund	0.3	0.1	0.1	0.2
FTSE Developed World ex UK Equity Index Fund	--	--	1.1	1.1
FTSE Developed Europe ex UK Equity Index Fund	--	--	2	2
US Equity Index Fund	--	--	0.8	0.8

It is interesting to see some commonalities in the data of the two providers; European equities have generated the highest performance impact from stock lending, while UK equities have generated the least.

This data is also an indication of the performance investors could be losing out on where the provider avoids stock-lending completely (although the risk needs to be borne in mind.) It may also be used to estimate the potential revenue withheld by firms who retain income from stock-lending, without disclosing the exact amount to the investors.

KEY TAKEAWAY

> Investors and advisers need to understand each provider's approach to stock-lending and decide if this feels right to them. For advisers, if you believe in fiduciary principles, then you are going to need to take a view on what is in your clients' best interests.

The highest fiduciary standard is that all the net proceeds from stock-lending should go to the client. It's their money; they take the risk and the manager has been rewarded for their service via the fees charged to the client. It doesn't feel right that the manager receives additional income through the backdoor by profiting from lending clients' assets.

> Investing clients' money with a provider who creams off income from stock - lending without bearing any of the risk is completely inconsistent with fiduciary standards and it's hard to argue that this is in clients'íbest interests.

> Given this level of revenue from stock lending, it is entirely feasible to image a world where the actual cost of accessing the equity market become zero because the cost is completely covered by stock-lending. Accordingly, it seems that securities lending is a risk that is better managed than avoided.

7. MULTI ASSET FUNDS: THE NEW BATTLEGROUND

Multi asset funds are increasingly becoming a battleground for passive fund managers. Over the last 3 years, providers have fallen over themselves to introduce multi-asset funds as a “set and forget” solution for investors. In many cases, the passive multi-asset funds are rated or mapped to risk-profiling tools, making it easier for advisers to recommend them.

JUST WHAT IS ‘PASSIVE’ MULTI ASSET INVESTING?

The offerings in the market range from vanilla passive funds from providers like Vanguard and Dimensional who simply adopt a static asset allocation exclusively using their own funds to match, to providers like 7IM and Standard Life (through its MyFolio Market range), Architas and TCF Investments who seek to add value via tactical asset allocation and select funds from the whole of market. L&G Multi Index range sits somewhere in the middle, predominantly using its own index funds but with active asset allocation.

STRATEGIC ALLOCATION, OWN FUNDS > Vanguard LifeStrategy > Dimensional Multi-Factor Funds > BlackRock Concensus	TACTICAL ALLOCATION, OWN FUNDS > LGIM Multi-Index Funds
STRATEGIC ALLOCATION, WHOLE OF MARKET FUND SELECTION	TACTICAL ALLOCATION, WHOLE OF MARKET FUND SELECTION > Standard Life MyFolio Market > 7IM APP Funds > Architas Multi-Asset Passive > Fidelity Multi-Asset Allocator

The important question here is what is passive multi-asset investing? In its purest form, Vanguard Life Strategy fund is the "most" passive you will get - static asset allocation populated by plain vanilla index funds and rebalanced regularly. This is followed by Dimensional's Multi-Strategic Funds, which have static asset allocation populated with its own funds and its signature tilt towards small and value caps equities as well as term and credit tilt for fixed income. At the other end of the spectrum, there are managers implementing active asset allocation using passive funds. Do they count as passive and does it work?

In its purest form, being "passive" means to own the market portfolio of all investments in their equilibrium, market cap weighting. However, this is impractical in the real world; all investors need to make decisions about what asset classes to include in the portfolio and perhaps when. This means stepping away from this global market cap weighting. As Cullen Roche of Pragmatic Capitalism[13] puts it:

The Global Financial Asset Portfolio is the one true "passive" portfolio because it is, by definition, the only index which is not chosen with investor discretion.

This debate must be about more than activity, low fees and tax efficiency. The correct differentiating aspect between active and passive investing is that an active investor tries to 'beat the market' on a risk adjusted basis while a passive investor tries to 'take the market return'. Therefore, the investor who deviates from global cap weighting is explicitly stating that they can "beat" the risk adjusted returns of the aggregate global financial asset portfolio.

The point is that, all investors are "active" to some extent or another; it's a question of degrees, and more importantly being able to identify what adds to investment success and what detracts from it.

13. The Myth of Passive Investing http://www.pragcap.com/the-myth-of-passive-investing/

All investors are "active"íto one extent or the other, it's a question of degrees, and more importantly being able to identify what add to investment success and what distracts from it.

A BURGEONING MARKETPLACE

Over 20% of net inflow into passive funds has been into the Multi-Asset range. This is only set to grow as more and more financial planners adopt this approach, rather than constructing and managing portfolios for clients.

It is clear to see why multi-asset funds are a compelling proposition for providers like Vanguard, BlackRock and L&G. Client demand aside, repacking their own single asset class funds at a mark-up of 100% to create an entirely different product line is a no-brainer.

7IM made its name as one of the providers of multi-asset funds using passive funds and ETFs as the building block of its AAP range, which has now become a fixture in this space with over £3.5billion of assets. It has taken nearly £850million of net inflow in the last 12 months.

FIG 5.1: 12 MONTHS NET INFLOW BY ASSET CLASS

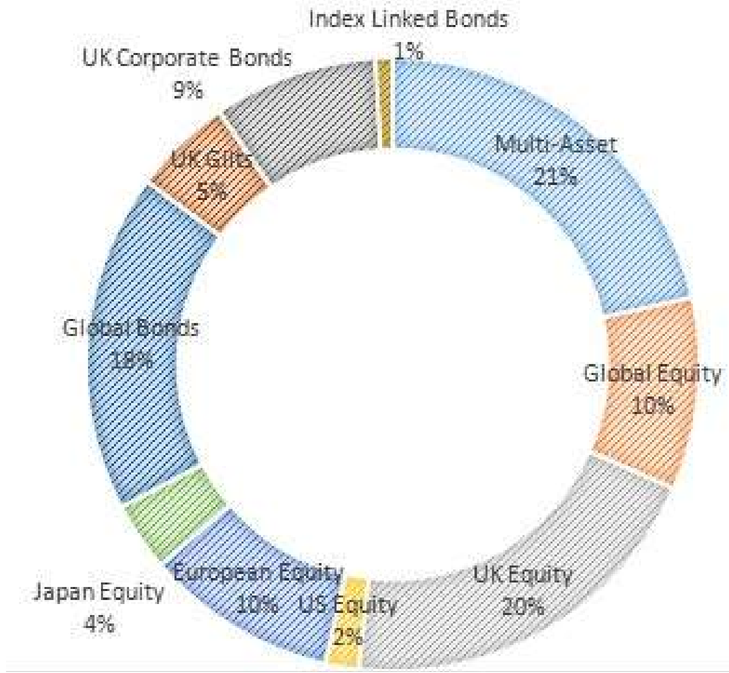
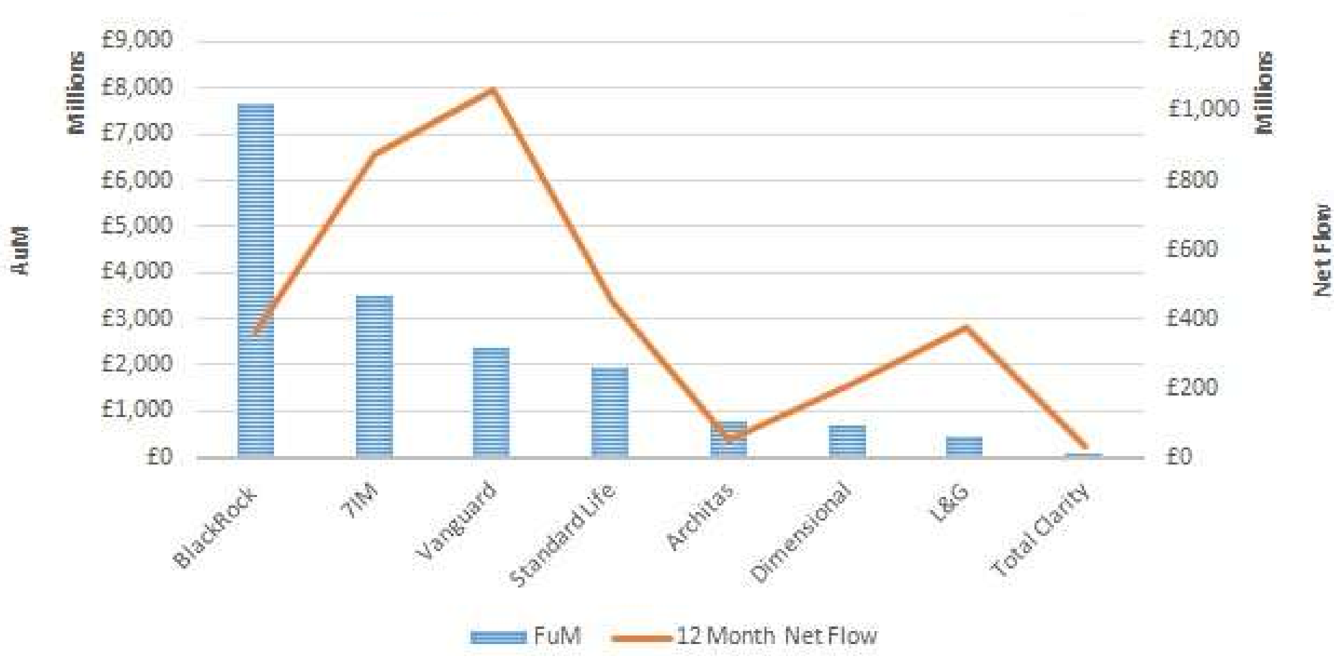


FIG 5.2: PASSIVE BASED MULTI ASSET FUNDS - AUM VS 12 MONTH NET FLOW



KEY TAKEAWAYS

In terms of existing AUM, BlackRock Consensus range is the clear leader, with 7IM AAP and Vanguard's Life Strategy coming in 2nd and 3rd respectively. Vanguar's Life Strategy has taken 30% of the net flow into passive multi-asset funds over the last 12 months, followed closely by 7IM's AAP range at 24% of net flow.

Dimensional is boosting its existing multi-asset range by launching two new multi asset funds in a move that puts it head-to-head with Vanguard LifeStrategy. The existing Dimensional Multi-Factor Equity, Balanced and Conservative funds will now be called the Dimensional World Equity Allocation 60/40 and Allocation 40/60 funds respectively. It will launch two new funds - Allocation 80/20 and 20/80. This places the 5 funds as direct competitors to Vanguard LifeStrategy 20, 40, 60, 80 and 100.

We don't see any direct correlation between flow into a provider's range and the availability of preferential share classes on platforms.†Architas has preferential share classes on Axa Wealth's Elevate platform; Fidelity's Multi-Asset Allocator range has preferential share classes on its own platform FundsNetwork and Cofunds has preferential share classes on the L&G Multi-Index funds. Equally, 7IM AAP range has exclusive share classes on its own platform and the same is true for Standard Life's MyFolio Market range. There is no indication that advisers and indeed investors are swayed by this. What this shows is that unless the fund range is already a success in its own right, availability of preferential share classes on a platform is unlikely to influence distribution significantly. BlackRock Consensus range and Vanguard Life Strategy are doing just fine on their own, without preferential pricing on any platform.

OPPORTUNITIES FOR PRODUCT DEVELOPERS

A natural evolution for the passive multi-asset funds would be products that are designed to meet specific clients' needs particularly around retirement. Target date funds and retirement income products are two great examples of this.

> Retirement Income Products: In the wake of pension freedoms and with more and more financial planners delegating portfolio management, products specifically designed to provide income in retirement are in high demand. According to CREATE-Research, around £8billion of the £12billion a year inflow U.K. annuity market is expected to migrate to other forms of investments. This trend favours the market place for multi-asset income funds with passive funds as the building block because they have the particular advantage of being low cost, as the impact of fees on retirement savings becomes more critical.

> Target Date Funds: The UK market is still very small (only around 0.5% of the DC market) but it's expected to top £10 billion by 2018. These funds are growing in the DC space with BlackRock LifePath, State Street's Timewise, Alliance Bernstein's Retirement Strategies, becoming default options for DC investors. Recently Architas BirthStar (managed by AllianceBernstein) launched in the advisory and D2C channel.

The trend in TDFs increasingly favours passive management, largely because it tends to be less expensive and easy to understand. We expect that a larger proportion of off-the-shelf target-date products will be passively managed.

In the US, there is well over $700 billion invested in Target Date Funds as at Feb 2015, an increase of 12% over the previous year's figures. It's predicted that target date fund assets will top $2trillion by 2020.[14]

Creating a new product range is a daunting task, but we think that providers with a foothold in the target fund market have a better chance. BlackRock has a foothold in the target date fund in the UK DC market through its LifePath range and may make this available to retail and advisory clients.

Vanguard's Target Retirement Fund is one the largest target date funds in the US market and it's only a matter of time before similar products are launched in the UK market.

Fidelity's Freedom Index (its passive target date funds) was recently opened to US retail investors. We think they will also appear in UK retail and advisory channels. The race is on.

14. BrightScope (2015) Latest Trends in Target Date Funds. Available at http://blog.brightscope.com/2015/05/05/latest-trends-in-target-date-funds/Bright

8. SMART BETA: THE NEW KID ON THE BLOCK

'In the short run, the market is a voting machine, but in the long run, it is a weighing machine.'

- Ben Graham

Smart beta, the new kids on the investment block, are investment strategies designed to add value by systematically weighting, and rebalancing portfolio holdings on the basis of characteristics other than market capitalization.

It's a craze currently sweeping the investment world. The prospect of systematic outperformance and the low-cost that smart beta funds offer present an incredible challenge for active managers and a rather exciting prospect for investors - and by implication - providers of index funds.

An interesting question is this; are smart beta funds active or passive? Smart beta combines the characteristics of low-cost, indexing and transparency, but the decision as to the exposure to the underlying risk factor is an active one. This introduces a challenge for investors as to how they go about choosing their factor exposure, given that well over 200 factors have been identified by financial engineers. This proliferation of factors creates a challenge for investors and advisers on how to separate legitimate market factors from data mining. It is impossible to make intelligent choices regarding smart betas without first forming a view on which factors are "for real" and which are data-mined. All the asset managers we spoke to during this research told us in unequivocal terms that they view smart beta strategies as being active.

According to research firm Spencer Johnson, the market for smart beta funds is predicted to grow at an annual rate of 31% over the five years from 2013 – 018. It is incredible that there aren't more providers offering smart beta strategies in OEICs structures. The vast majority of smart beta products are in the form of ETFs.

> All the asset managers we spoke to during this research told us in unequivocal terms that they view smart beta strategies as being active

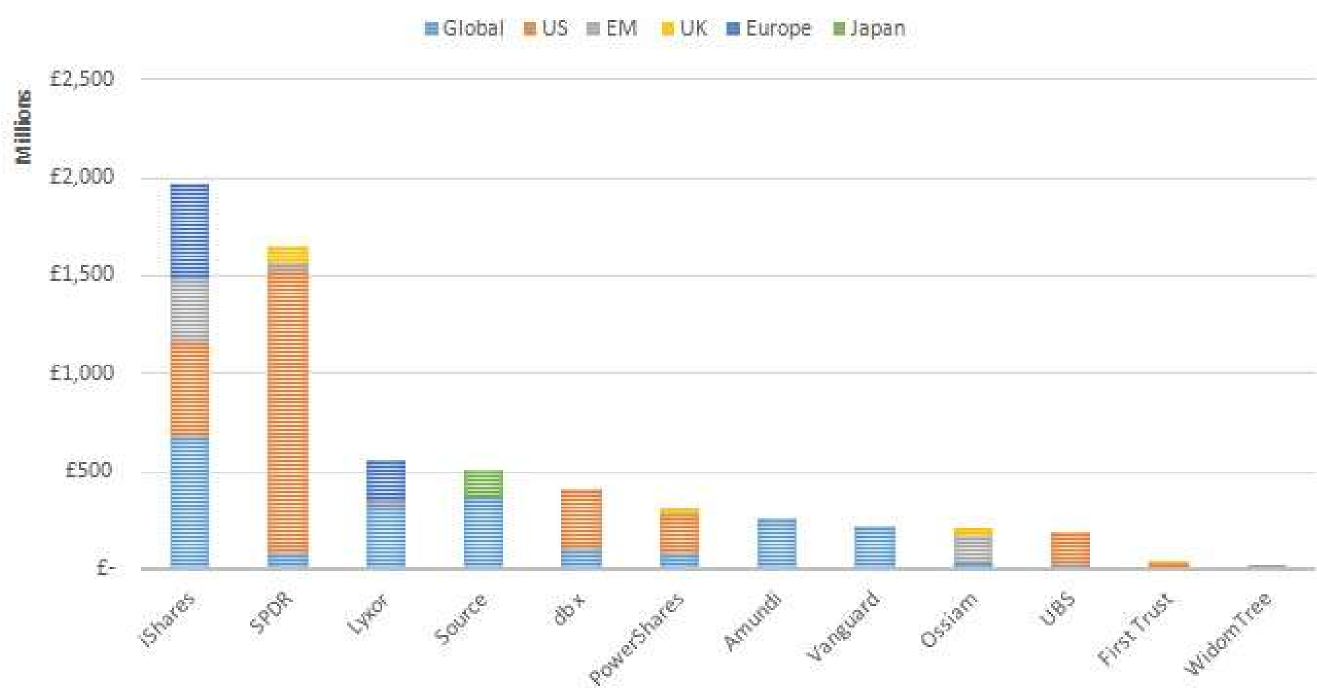
Dimensional is at the forefront of factor- based investing and now runs well-over £10 billion in equity and fixed income strategies. Dimensional has stuck to using OEICs rather than ETFs, although the parent company in the US is now exploring ETFs in partnership with John Hancock. 7IM has recently entered this space and is challenging Dimensional's dominance introducing its own smart beta value strategies to compete head-to-head with Dimensional across 5 equity sectors. It's early days but we are watching closely how this develops.

There is currently over £6.4 billion invested in smart beta ETFs in the 5 core equity sector that we examined in this report, with a total inflow of £600 million in the year to date.

TABLE 6.1: NO OF SMART BETA ETFS PRODUCTS BY PROPERTIES

	Global	US	EM	UK	Europe	Japan	Total
iShares	5	3	2	1			11
PowerShares	3	2	1	1			7
dbX	4	3					7
Lyxor	3	1		2			6
SPDR	1	3	1	1			6
WidomTree		2	2				4
UBS	2	1					3
Ossiam	1		1	1			3
First Trust		1		1			2
Source	1					1	2
Vanguardz	1						1
Amundi	1						1
Total	22	16	7	4	3	1	53

FIG 6.1: PROVIDERS' AUM FOR SMART BETA FUNDS



The smart beta product range in the EFT space is wider than OEICs/UT, although there are still significant gaps in the ETF market. Of the 53 smart beta ETF products we identified, 22 are in the Global Equity sector and 17 in the US Equity sector.

Speaking to providers during our interviews, we get the feeling that many are focusing on building their smart beta ETF ranges, but most are ignoring OEICS and Unit Trust structures for the most part. While this is the right approach for providers keen on attracting flows from institutional investors and discretionary investment managers, there's a danger that providers are ignoring the advisor and direct-to-consumer channels. We have highlighted why the challenges that advisers and clients face in using ETFs won't go away overnight, creating a need for products in the OEICs structure for providers looking to target advisers and retail investors.

KEY TAKEAWAYS

> The smart beta product range in the EFT space is broader than OEICs/UT, although there are still significant gaps in the ETF market. Of the 53 smart beta ETFs products we identified, 22 are in the Global Equity sector and 17 in the US Equity sector.

> We found no smart beta strategies in any of the five fixed income categories that we looked at, presenting a unique opportunity for products that aim to capture term and credit factors in the fixed income space.

> In terms of pricing, smart beta products command a significant price premium when compared to traditional passive funds, with prices ranging from 0.25% to 0.75% for equity smart beta products. There appears to be very little price pressure; certainly not the price war we've seen among the traditional index trackers.

OPPORTUNITIES FOR PRODUCT DEVELOPERS

Smart beta represents an opportunity for asset managers, not only because there are very few established players, but also because managers create or choose their own factors and implement in very different ways. As FT John Authers[15] notes "There are no such entrenched players in smart beta. The field is up for grabs, with a real risk that new entrants could establish themselves."

This opportunity isn't without its challenges, not least educating and engaging retail investors and advisers how best to choose their factor exposure. Fund selection and due-diligence for advisers is another challenge, and providers need to do more to make the data easily accessible.

It's up to providers to get into this game or get left behind. The race is on!

15. Smart beta's new kids on the index block†
http://www.ft.com/cms/s/0/1fb9d574-43c6-11e5-b3b2-1672f710807b.html

9. ABOUT

THE FIRM

FinalytiQ are a vibrant, insanely brilliant research consultancy working with financial planners, asset managers and wrap platforms.

Through our research, market analysis and thought-leadership, we help platforms and asset managers identify their distinct advantages (and weaknesses) and build propositions that are fit for purpose. We spend a great deal of our time spreading the sunlight on the darkest corners of the asset management world.

We support advisory firms with high-quality research and due-diligence that helps advisers to create robust investment propositions and deliver superior client outcomes in a compelling and compliant way. We currently influence well over £750M of client assets through our research and due-diligence work for advisers.

Abraham Okusanya

Abraham is the founder and principal at FinalytiQ. Over the course of a decade in the retail investment industry, he has gained extensive research experience, working at Barclays, RBS, and as independent consultant for platforms and financial planning firms. He holds a Master's degree from Coventry University, as well as the IMC, Chartered Financial Planner and CFP designations. He writes regular features in Professional Adviser, FT Adviser and New Model Adviser and was one of 5 nominees for the Professional Advisers Personality of Year Award 2015.

Karthica Underwood

After a very short stint at the Office for National Statistics - the obvious place to go after a degree in Statistics and Management Studies, Karthica started her career in financial services, in research within in advice firms. Karthica holds the Chartered Financial Planner designation. Outside of work, Karthica enjoyed learning different styles of dance over the years, However, life changes and although her footwear is now far more sedate, she enjoy messing around with her son, red wine and chocolate. The former in abundance.

Jason Hoskyn

Jason joined the FinalytiQ as an Associate in early 2015 and brings with him a working knowledge of fund industry. Before that, we was an Associate at International Financial Data Services (IFDS); a role consisting of fund analysis for over 12 different investment management companies. In his spare time Jason enjoys watching movies and owns a very large collection. He also enjoying watching (and occasionally playing) football. He supports no teams but follows them all.

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