The Evolution of Smart Beta ETFs

Gaining Traction in the Institutional Community

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Introduction

For the second year in a row, Market Strategies International, in collaboration with Invesco PowerShares, examined the growing smart beta exchange-traded funds (ETFs) trend in the institutional market. The results of the latest study --The Evolution of Smart Beta ETFs-- reveal that smart beta ETFs have further penetrated the institutional market and are poised for additional growth moving forward.

Last year was a landmark year for ETFs. In 2014 investors added a record-high $240.4 billion to US-listed ETFs. In addition, the industry has achieved record-high net inflows in each of the last three years, and there are now more than 1,450 US-listed ETFs with a collective Assets Under Management (AUM) of nearly $2 trillion[1]. Standing on the success of this larger ETF evolution, smart beta ETFs have shined in recent years and continue to gain momentum, particularly in the institutional market.

In the simplest terms, smart beta ETFs follow indexes based on alternative weighting methodologies. Many of these alternative weighting methodologies (such as low volatility, high dividend, and fundamentally-weighted) have historically delivered favorable risk-adjusted returns and varying returns across different market regimes. As a result, institutions are increasingly looking to smart beta ETFs as a complement to and a replacement for both their traditional market cap-weighted ETFs and their actively managed positions. Overall, smart beta ETFs accounted for over 17% of US ETF net inflows in 2014, despite representing less than 11% of the total assets. Today there are more than 350 smart beta ETFs available in the U.S. comprising over $230 billion in AUM, up from just 212 products and $64.8 billion in 2010[1].

Over the past year, institutional decision-makers -- including public and private pensions, endowments and foundations, and registered investment advisors (RIAs) who manage institutional assets -- have become more familiar with the smart beta category. Consequently, more than one-third of those currently using ETFs are now using smart beta ETFs, up from 24% last year.

Following are key findings from this year's study:

- 6 in 10 institutional decision-makers are now familiar with smart beta ETFs, up from 54% last year.
- 1 in 3 institutional decision-makers indicate they are currently using smart beta ETFs.
- Accessing specific factors and reducing costs remain the top reasons for using smart beta ETFs.
- Among a variety of available smart beta products, high dividend funds are the most widely-used.
- Lack of familiarity with smart beta ETFs remains the number one barrier to increased adoption.
- Nearly two-thirds of institutions indicate they are likely to increase their use of ETFs over the next three years.
- Over the next three years, institutions plan on increasing their use of smart beta ETFs more than any other category (including market-cap weighted ETFs).

1 Bloomberg L.P. as of Dec. 31, 2014.

The Fastest Growing Category

When looking at the ETF category as a whole, institutional decision-makers have a wide range of options. Despite representing a low proportion of total ETF assets in the institutional market, smart beta ETFs saw the highest year-over-year increase in institutional usage: from 24% in 2013 to 36% in 2014.

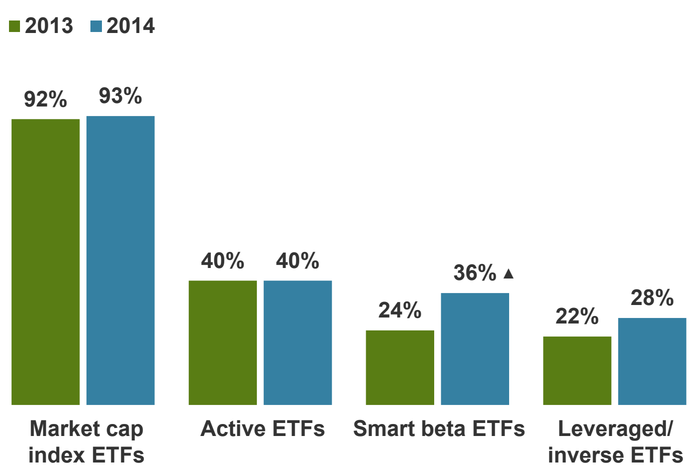
The momentum appears to be shifting towards smart beta ETFs as the industry has introduced more non-market cap-weighted funds. While the proportion of ETF assets invested in market cap-weighted ETFs dropped from 75% to 68% from 2013 to 2014, the asset proportion invested in smart beta ETFs increased from 7% to 13%.

Interestingly, usage of active ETFs (products that mimic traditional mutual fund strategies in an ETF structure) has remained flat year-over-year in the midst of a growing number of active ETF filings and increased Securities and Exchange Commission (SEC) attention.

Smart beta ETFs saw the highest year-over-year increase in institutional usage: from 24% in 2013 to 36% in 2014.

EXHIBIT A

ETF CATEGORY USAGE & ALLOCATION



	Market cap index ETFs	Active ETFs	Smart beta ETFs	Leveraged/ inverse ETFs
2013 mean allocation:	**75%**	**15%**	**7%**	**3%**
2014 mean allocation:	**68%**	**13%**	**13% ▲**	**6%**

Q7. Which of these types of ETFs does your institution currently use?

Please see appendix for important information on Exhibit A

▲/▼ = Significant change from stated year

Reducing Costs and Volatility

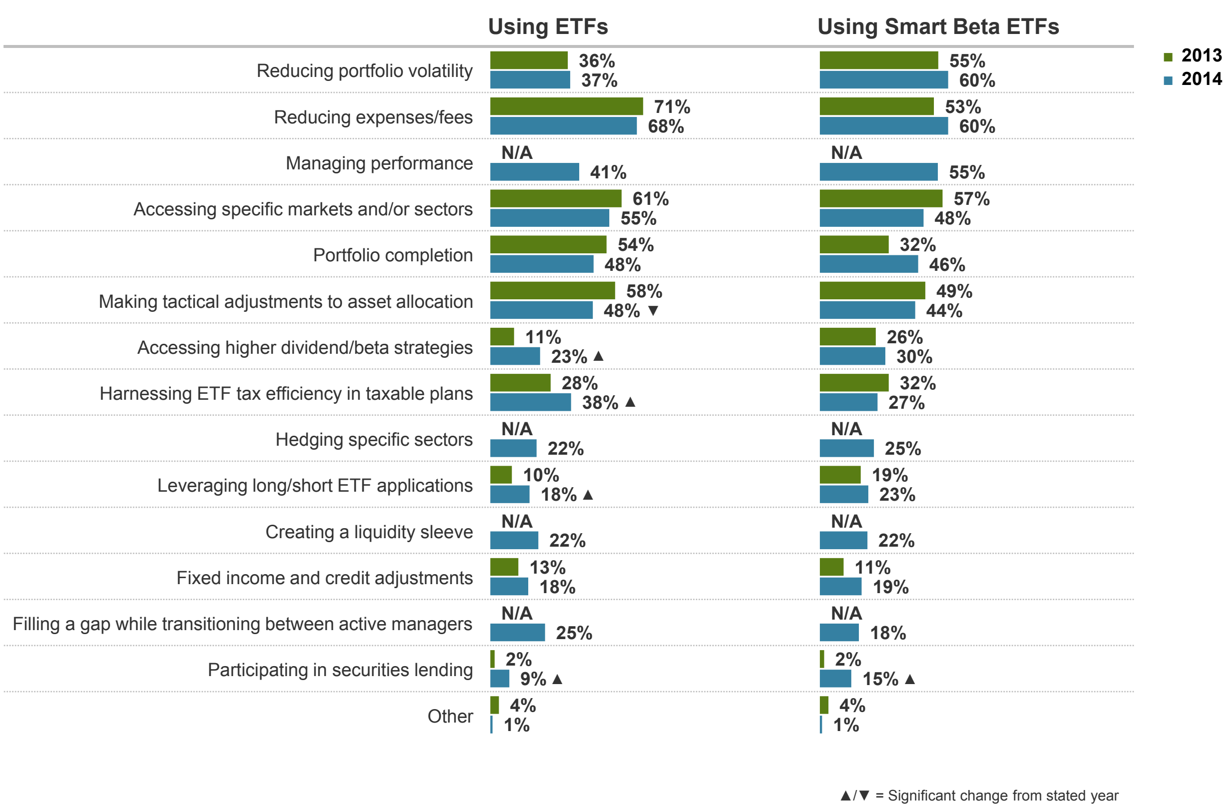
ETFs are generally known for their low costs relative to other investment vehicles; nearly 70% of institutional decision-makers turn to ETFs as a means of reducing expenses. Similarly, fee reduction is also top of mind when using smart beta ETFs as 3 in 5 institutional decision-makers cite fee reduction as their objective for using these products. An equal proportion also points to reducing portfolio volatility as a primary objective for adoption. While volatility is just one factor addressed through the use of smart beta ETFs, it is front and center for many institutional decision-makers, particularly those who suffered through more volatile market conditions in the not-too-distant past.

The survey results also show that secondary objectives for using smart beta ETFs include managing performance, accessing specific markets/sectors, portfolio completion, and the ability to make tactical adjustments to the asset allocation strategy. Lastly, securities lending, in which traders lend shares to other institutions and earn interest, is a growing use for smart beta ETFs. This, along with a wide variety of other applications, speaks to the versatility of smart beta ETFs.

Among institutional decision-makers using smart beta ETFs, 3 in 5 cite fee reduction as their objective for using these products.

EXHIBIT B

PRIMARY OBJECTIVES WHEN USING ETFS VERSUS SMART BETA ETFS



Q5. What are your primary objectives in using ETFs?

Barriers to Adoption Lessen

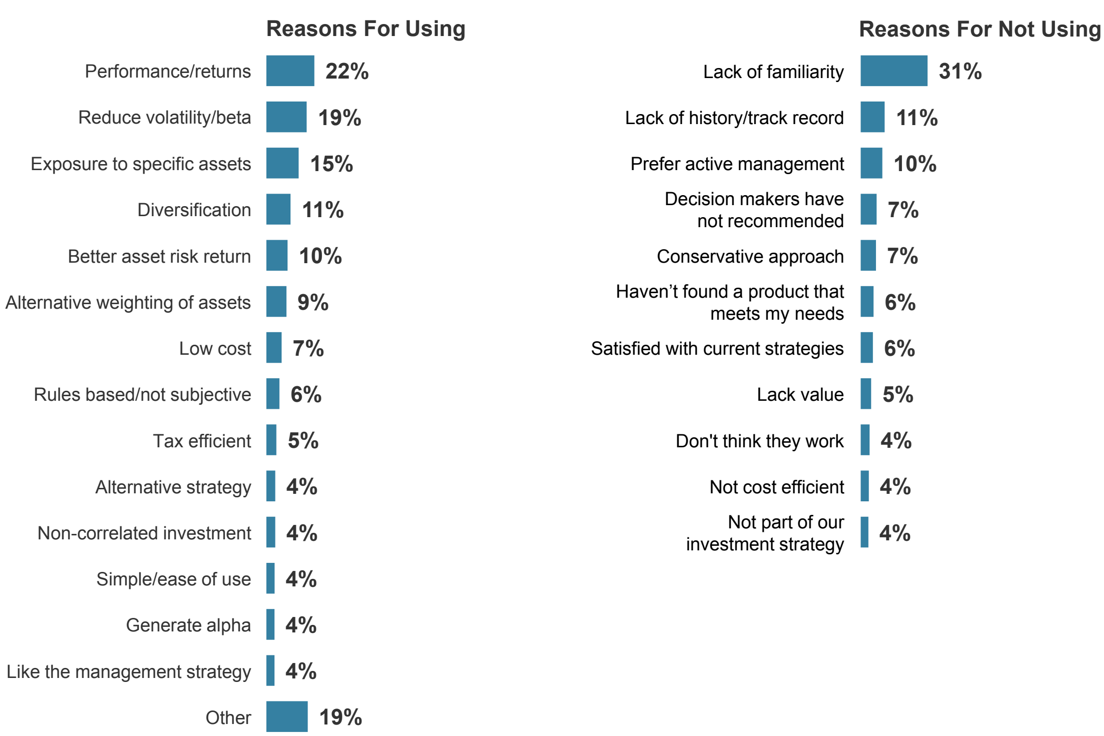
When asked an open-ended question about why they use smart beta ETFs, institutional decision-makers in our study point to performance/returns, reducing volatility, and accessing specific assets or factors as the primary reasons for using smart beta ETFs – very similar to the key objectives identified earlier.

For the two-thirds of institutional decision-makers who are not using smart beta ETFs, the majority once again cite a lack of familiarity as the primary barrier to adoption. However, the data suggests that familiarity is growing steadily and many institutional decision-makers will likely reach a tipping point--in terms of their smart beta knowledge--in the near future. Track records are also still a primary concern among non-users, although to a lesser degree than in the past.

EXHIBIT C

PRIMARY REASONS FOR USING / NOT USING SMART BETA ETFS

Unaided



Q9A. What are the primary reasons for using rules-based/smart beta ETFs?
Q9B. What are the primary reasons for NOT using rules-based/smart beta ETFs?

Continued Growth Ahead

If the last 12 months are any indication of what is to come, we can expect that smart beta ETFs will continue to grow as institutional decision-makers become more comfortable with these products. In fact, nearly two-thirds (64%) of institutional decision-makers expect to increase their use of the broader ETF category over the next 12 months, up from 59% last year. Roughly one-third expect their ETF usage to remain flat while just 1% expect a decrease in usage.

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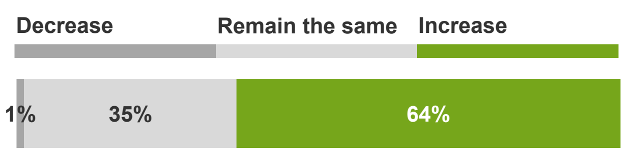
EXHIBIT D

EXPECTED CHANGE IN ETF USAGE IN THE NEXT YEAR



S5_A. One year from now, do you expect your institution's use of ETFs will have…?

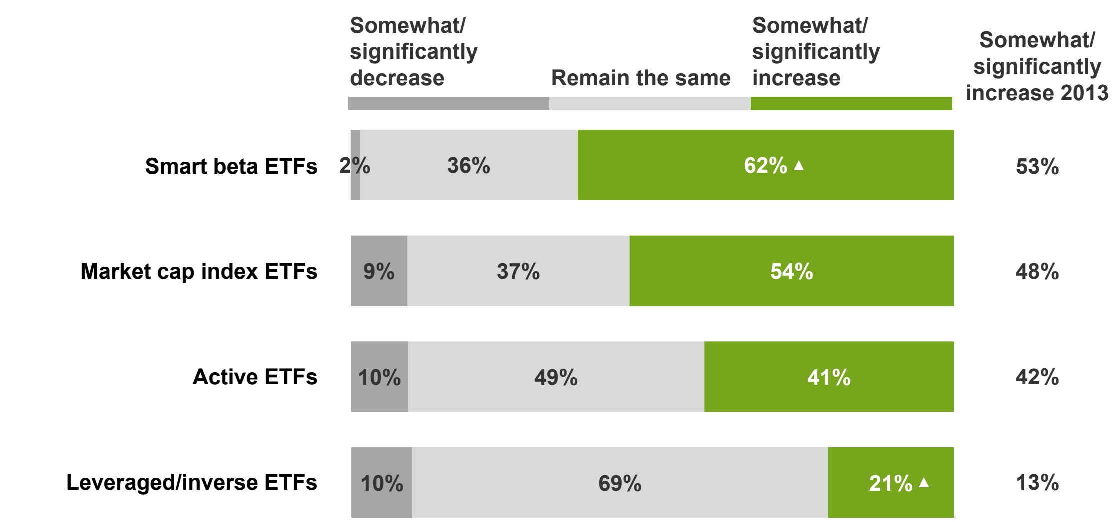
Our survey results show that smart beta ETF providers are poised to see the greatest inflows as a result of the expected growth in the overall ETF category over the coming months. Continuing the trend seen last year, usage of smart beta ETFs is slated to outpace growth in all other types of ETFs over the next three years. Six in 10 (62%) institutional decision-makers expect to increase their use of smart beta ETFs during this period of time.

In addition, over half (57%) of those not currently using smart beta ETFs say they are at least somewhat likely to add these funds to their toolkit within the same time period (up from 46% last year). Institutions with assets in excess of $500 million are significantly more likely than their smaller counterparts to adopt these products moving forward.

According to the survey, smart beta ETFs are poised to grow the most over the next 3 years as 6 in 10 (62%) institutional decision-makers expect to increase their use.

EXHIBIT E

EXPECTED CHANGE IN THE NEXT 3 YEARS



Q19. Three years from now, do you expect your institution's use of each of these types of ETFs will have…?

Demand Across the Board

When assessing smart beta ETFs, institutional decision-makers have a wide array of choices, including high dividend, fundamentally-weighted, low volatility, equal weight, high beta, and enhanced fixed income funds. Each of these smart beta categories is used by at least 30% of institutional decision-makers.

High divided funds remain the most popular smart beta ETF this year, used by 64% of institutional decision-makers. Fundamentally-weighted and low volatility funds follow close behind as decision-makers continue to align their current investment strategies with available smart beta solutions. While enhanced fixed income products were not measured last year, nearly one-third of institutions indicate they're currently turning to enhanced fixed income products and their usage is expected to increase substantially over the next three years.

Survey respondents indicated that the largest increases in smart beta usage are expected from the low volatility segment. Additionally, institutional decision-makers not currently using smart beta ETFs expect their first foray into the category over the next three years to be through the use of a low volatility ETF. The institutions surveyed also indicated that they expect to increase their use of high dividend and fundamentally-weighted ETFs.

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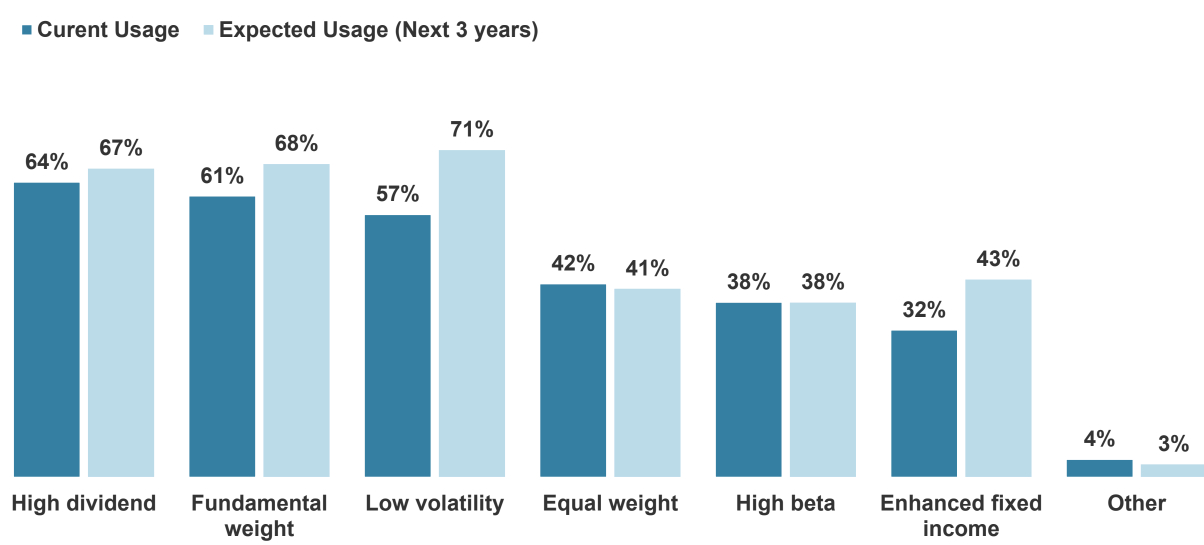
EXHIBIT F

CURRENT & EXPECTED SMART BETA ETF USAGE



Q12. Which of these types of rules-based/smart beta ETFs will your institution most likely begin using over the next 3 years?
Q14. Which of these types of rules-based/smart beta ETFs does your institution currently use?

Please see appendix for important information on Exhibit F

Making the Case for Smart Beta ETFs: A Qualitative Exploration

Institutional decision-makers outline the reasons why they chose a smart beta ETF solution.

Low Volatility ETFs:

Low volatility ETFs track an underlying index comprised of stocks that have the lowest realized volatility over a specified time period (i.e., the S&P 500 Low Volatility index). Low-volatility ETFs have the potential to allow institutions to increase their downside protection* according to a few of the institutional decision makers we surveyed:

"We're looking at a lot of those products. If we think we're headed toward more volatility, this will protect your downside and lock in some of the gains and run-up that we've had the last few years."

-- Institutional Decision-Maker

"We've used the low volatility ETF in the emerging market space because we weren't sure of the timing. We thought we were probably going to be early, so we wanted to mute the volatility in the beta space, and we took a low volatility option there."

-- Large Endowment

* There is no assurance that low volatility ETFs will provide low volatility or downside protection.

High Dividend ETFs:

High dividend ETFs track an underlying index comprised of stocks selected principally on the basis of dividend yield and consistent growth in dividends (for example, NASDAQ US Broad Dividend Achievers Index). According to our study, high dividend ETFs are the most widely used smart beta ETFs. Institutions, like this endowment, see high dividend ETFs as a way to accomplish more than one goal**.

"Back in the depths of the reception, we wanted large cap exposure, but we wanted the income portion for two reasons. We liked the dividend yield. We thought it was a better defensive strategy. And we liked clipping the coupon because we weren't getting any money in the fixed income space. So for a long period of time, we used a high dividend ETF strategy."

-- Large Endowment

** ETFs that pay high dividends as a group can fall out of favor with the market, causing such companies to underperform companies that do not pay high dividends.

Equal Weight ETFs:

Equal weight ETFs weight all companies in the underlying index equally (i.e., Russell 1000 Equal Weight). Some institutional decision-makers find that these ETFs allow them to supplement their existing index strategy to take advantage of potential outperformance by certain types of companies.

"I need to have an allocation to large cap, but you know, my thought at the time was I think smaller or mid cap stocks are going to be doing better than large cap, so I was using an equal weight as a satellite to my large cap ETF to try and pick up some of that mid and small cap performance. It's a way of increasing theoretically your smaller large cap weights without having to increase your mid cap and small cap exposure."

-- Institutional Decision-Maker

"The motivation is so you're not so fully invested in one or two companies. It was spreading it out, kind of you know since Apple and some of those take up such a portion on the index."

-- Medium-Size Endowment

Source: The preceding commentary was extracted from a series of in-depth, telephone-based interviews conducted among a subset of endowments & foundations, mutual fund managers, institutional RIAs, and institutional consultants. The interviews were conducted between June 19 and July 24, 2014. Survey participants' experiences may not be a representative experience of others.

Going Beyond Equities

Overall, institutions use ETFs most heavily for US large cap equity exposure; 3 in 5 institutional decision-makers use ETFs to access this asset class. Within this asset class, nearly three-quarters of institutional decision-makers use smart beta ETFs. Institutional use of smart beta ETFs is also strong within the US small cap equities, US mid cap equities, emerging markets, and the developed markets asset classes.

The biggest disparity between market-cap weighted ETF usage and smart beta ETF usage in the institutional market exists within the fixed income asset class. Fixed income ETFs had a near record year in 2014 with $53.9 billion in net inflows. On the year, fixed income products represented 22.4% of overall ETF inflows, despite representing only 15.6% of the AUM[1]. The rapid growth of fixed income ETFs, coupled with growing smart beta adoption, could make smart beta fixed income ETFs the next area of major growth for the category.

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EXHIBIT G

ETF USAGE

By Asset Class

	Average ETF Allocation	Market Cap Index ETFs	Smart Beta ETFs	Leveraged/ Inverse ETFs	Active ETFs
U.S. large cap equities	60%	73%	74%	38%	31%
U.S. small cap equities	55%	72%	48%	33%	36%
U.S. mid cap equities	42%	55%	43%	23%	26%
Emerging markets	42%	56%	44%	17%	27%
U.S. fixed income	42%	51%	31%	32%	38%
U.S. sector equities	40%	48%	34%	26%	37%
Developed markets	38%	49%	49%	16%	20%
Non-U.S. public equities	34%	43%	40%	12%	22%
Real estate (including REITs)	31%	41%	22%	11%	29%
Cash/cash equivalents	24%	32%	24%	8%	18%
Real assets/commodities	23%	28%	22%	16%	18%
Non-U.S. fixed income	22%	26%	17%	19%	18%
Other alternatives	10%	10%	12%	4%	12%

Q17. What types of ETFs do you use to access each of these asset classes…?

Please see appendix for important information on Exhibit G

Key: Low ≤18% | 19% to 32% | 33% to 46% | 47% to 60% | ≥61% High

1 Bloomberg L.P. as of Dec. 31, 2014.

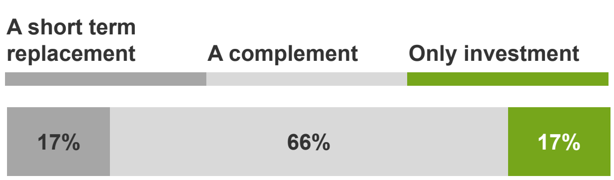
A Complimentary Product

Overall institutional decision-makers are still dipping their toes in the smart beta water in terms of their overall allocation to the category and most perceive this type of fund to be a complement to other investment vehicles. Across all asset classes, roughly two-thirds of institutional decision-makers indicate that smart beta ETFs serve as a complement to other products when incorporated into their investment strategy. In some cases, smart beta ETFs are used as an enhancement or an overlay strategy to take advantage of certain factors in the markets. For many institutions, this places a certain emphasis on the portfolio fit and the need to create custom benchmarks for monitoring the performance of these ETFs alongside existing investments.

The majority of institutional decision-makers use smart beta ETFs as a complement to other funds.

EXHIBIT H

OVERALL APPLICATION OF SMART BETA ETFS



While institutional decision-makers primarily view smart beta ETFs as complementary strategies across all asset classes, some nuances exist. Smart beta ETFs are most strongly identified as complementary strategies within US large cap and US mid-cap equities, suggesting that institutional decision-makers are using these strategies in concert with their traditional market-cap positions. Considering institutional decision-makers cite "lowering volatility" as one of their top reasons for using smart beta ETFs, it stands to reason that institutions use these products to implement single-factor tilts alongside their existing equity positions.

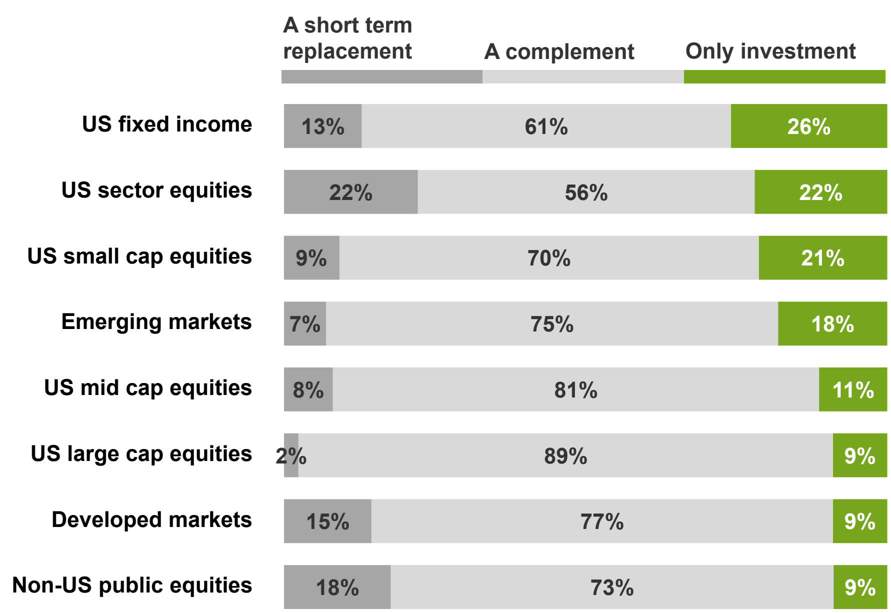
In contrast, smart beta ETFs are most likely to be used as a standalone investment in the US fixed income and US sector equity asset classes. In these two asset classes, smart beta ETFs are also more heavily-used as short-term replacements, primarily due to sector rotation strategies. International public equities are just one more area in which institutions see smart beta ETFs as a short-term replacement.

Smart beta ETFs are most strongly identified as complementary strategies within US large cap and US mid-cap equities.

EXHIBIT I

APPLICATION OF SMART BETA ETF

By Asset Class



Q17A. Are you currently incorporating rules-based/smart beta ETFs into the each of these asset classes as...?

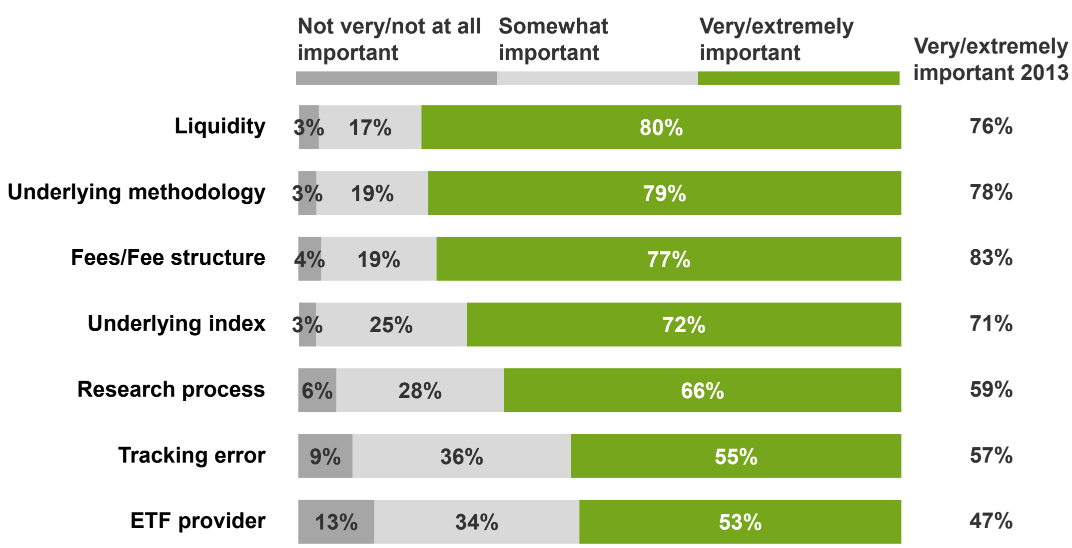
Please see appendix for important information on Exhibit I

With approximately 240 smart beta ETFs available today, how does an institutional decision-maker decide which ETF to use? When asked about their selection process, institutional decision-makers point to liquidity, the underlying methodology, and the fees as the primary criteria for choosing smart beta ETFs. In keeping with last year's results, the underlying methodology came in as the second most important selection criteria. Often more complex than traditional market cap-weighted ETFs, smart beta ETFs require a more thorough due diligence process. Therefore, the methodology plays a bigger role when evaluating these ETFs. In contrast, institutions tend to place a singular focus on the lowest cost ETF when evaluating traditional market cap-weighted products, particularly given the homogenization of that category and the dwindling concerns regarding liquidity.

Institutional decision-makers point to liquidity, the underlying methodology, and the fees as the primary criteria for choosing smart beta ETFs.

EXHIBIT J

IMPORTANCE OF SELECTION CRITERIA WHEN CHOOSING SMART BETA ETFS



Q18. How important or unimportant are each of these criteria when evaluating and selecting rules-based/smart beta ETFs...?

ETF providers looking to take advantage of the smart beta ETF trend and capture new business will likely need to approach the education and positioning of these products slightly differently than that of market cap-weighted ETFs. Institutional decision-makers surveyed expect a greater level of support during the evaluation and selection process even as their familiarity and knowledge continue to grow.

Conclusion

Given their applicability and versatility, smart beta ETFs have become an increasingly important tool for institutional decision-makers. Ongoing product development has opened the door for institutional investors looking to fine-tune their investment strategies by taking advantage of certain market inefficiencies through factor-driven strategies. Further, the recent success of the smart beta ETF evolution is in large part due to the fact that institutional decision-makers also see these products as an integral component of both active and passive strategies. Based on the results of the study, it appears that this is likely to continue to drive adoption in the institutional market moving forward.

The continued growth on the horizon for the smart beta ETF category means greater importance will be placed on education and support from ETF providers. There is a greater onus on ETF providers and advisors to provide more hand-holding during the due diligence process given the complexity of certain smart beta products compared to traditional market cap-weighted products. The ability to provide the necessary education will be a differentiating factor for smart beta ETF providers in coming years.

Methodology

The data contained within this analysis was collected between October 9 and December 2, 2014. A 15-minute online survey was administered to 253 institutional decision makers, including pensions, endowments/foundations, non-profit institutions, mutual funds, as well RIAs who manage institutional business. All institutions had at least $20 million in assets and allocated at least 1% of their assets to ETFs. Institutional RIAs had at least $25 million in assets under management–a portion of which was managed on behalf of institutional investors.

Survey participants experience may not be representative of others, nor does it guarantee the future performance or success of any product. The opinions expressed are those of Market Strategies International and are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. There may be material differences in the investment goals, liquidity needs, and investment horizons of individual and institutional investors.

Invesco PowerShares is not affiliated with Market Strategies International. Market Strategies International is an independent full-service market research provider, specializing in wealth management and financial services market research and consulting.

Invesco PowerShares sponsored this survey. Market Strategies International offered participants an honorarium for their participation.

Glossary

Beta is a measure of risk representing how a security is expected to respond to general market movement.

Liquidity is characterized by a high level of trading activity and is a measure of the degree to which an asset or stock can be bought or sold in the market without affecting its asset price. Assets or stocks that can be easily bought or sold are known as liquid assets.

Smart Beta represents an alternative and section index based methodology that may outperform a benchmark or reduce portfolio risk, or both. Smart beta funds may underperform cap-weighted benchmarks and increase portfolio risk.

Standard Deviation measures a fund's range of total returns and identifies the spread of a fund's short-term fluctuations.

Non-market Cap Weighted Funds assign weights to stocks based on factors other than market capitalization in an attempt to reduce the risk of overexposure to a certain sector or group of stocks.

Volatility the annualized standard deviation of index returns.

Important Information for Exhibit A:

Beta is a measure of risk representing how a security is expected to respond to general market movements. Smart Beta represents an alternative and selection-based methodology that seeks to outperform a benchmark or reduce portfolio risk, or both. Smart Beta funds may underperform cap-weighted benchmarks and increase portfolio risk.

Important Information for Exhibit F:

There is no assurance that such ETFs will provide low volatility. High beta investing entails investing in securities that are more volatile based on historical market index data. ETFs that pay high dividends as a group can fall out of favor with the market, causing such companies to underperform companies that do not pay high dividends.

Important Information for Exhibit G and Exhibit I:

Investing in securities of large-cap companies may involve less risk than is customarily associated with investing in stocks of smaller companies. Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile and may be illiquid or restricted as to resale. The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues. Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that the bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. Investments concentrated in a comparatively narrow segment of the economy may be more volatile than non-concentrated investments.

Risk Information

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There are risks involved with investing in ETFs, including possible loss of money. Index-based ETFs are not actively managed. Actively managed ETFs do not necessarily seek to replicate the performance of a specified index. Both index-based and actively managed ETFs are subject to risks similar to stocks, including those related to short selling and margin maintenance. Ordinary brokerage commissions apply. The Fund's return may not match the return of the Index.

Investments focused in a particular industry are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

Since ordinary brokerage commissions apply for each buy and sell transaction, frequent trading activity may increase the costs of ETFs.

Shares are not individually redeemable and owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Unit aggregations only, typically consisting of 50,000, 75,000, 100,000 or 200,000 shares.

Trademarks and Other Information

S&P 500® Low Volatility Index is compiled, maintained and calculated by Standard & Poor's and consists of the 100 stocks from the S&P 500® Index with the lowest realized volatility over the past 12 months.

The Russell 1000® Equal Weight Index is composed of securities in the Russell 1000® Index and is equally weighted across nine sector groups with each security within the sector receiving equal weight.

The NASDAQ US Broad Dividend Achievers™ Index is designed to identify a diversified group of dividend-paying companies. These companies have increased their annual dividend for 10 or more consecutive fiscal years. The Index is reconstituted annually in March and rebalanced quarterly in March, June, September and December.

Before investing, investors should carefully read the prospectus/summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the Fund call 800 983 0903 or visit invescopowershares.com for the prospectus/ summary prospectus.

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