Lyxor ETF Research – November 2016

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Accelerating inflows on inflation-linked bond ETFs

The acceleration of flows into inflation-linked products both in Europe and the US this year points to the beginning of a new inflation regime. Fixed income investors are increasingly taking an inflation-linked approach in order to protect their portfolio against rising inflation. In this Expert Opinion we look at trends on inflation-linked ETF flows in Europe, as well as inflation outlook in different markets going forward.

Executive Summary

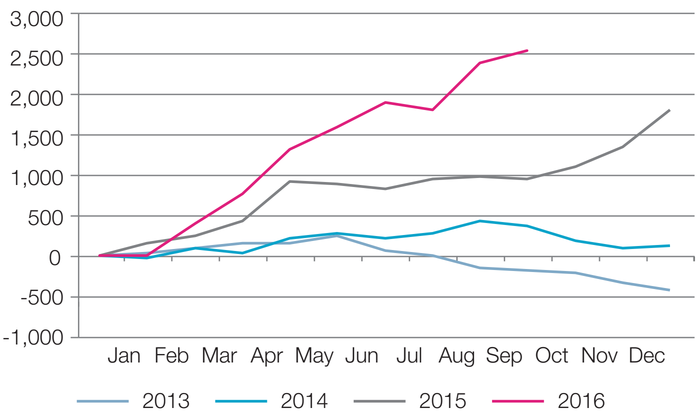
- Flows into inflation-linked bonds are accelerating
- Better economic conditions in the US and the rising oil price were the major catalysts
- The money is going into ETFs rather than active funds
- Little wonder, given just 12% of active funds in Europe outperformed their benchmark last year. Not one has outperformed over a decade

HOW FAST IS INFLATION-LINKED BOND USE GROWING?

European ETF investors started to increase their focus on this segment two years ago. We saw a strong acceleration in inflows in Q1 2015 and since Q4 2015. At the end of September 2016, Net New Assets (NNA) were already above those of 2015 at EUR2.5bn vs. EUR1.8bn. This represents nearly 10% of total fixed income NNA year to date vs. 7% in 2015 and 1% in 2014.

Growth in inflation-linked bonds is amongst the highest in the fixed income space. Year to date fixed income flows are up 21% vs. the same period over 2015, while for the inflation-linked segment they are up 168%. With EUR8.7bn of assets under management, this segment now represents more than 6% of the fixed income ETF space.

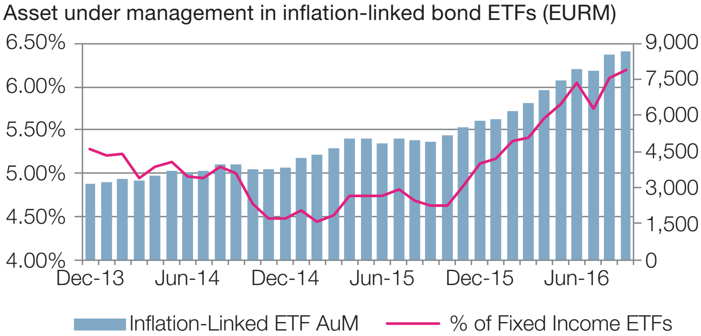
Cumulated Net New Assets (NNA) into inflation-linked ETFs since 2013 (EURM)



Source: Data in EURM, Lyxor, Bloomberg from 01/01/13 to 30/09/16.
Past performance is not a reliable indicator of future results.

In 2016, ETFs on US underlyings gathered most of the inflows.

Asset under management in inflation-linked bond ETFs (EURM)



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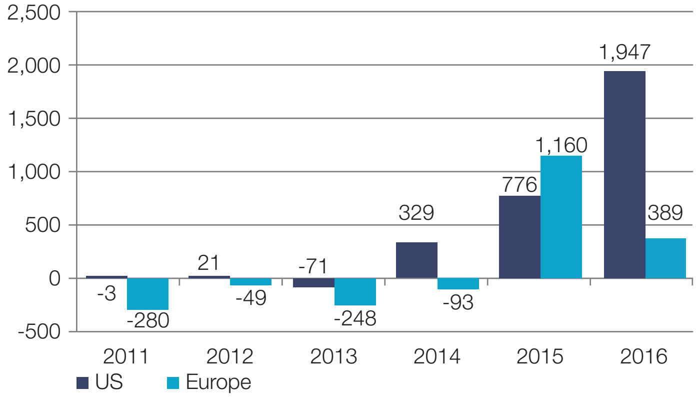
DID THE TAKEOFF OF FLOWS CONCERN ALL INFLATION–LINKED ETFs?

In 2015, inflows were observed for inflation-linked ETFs on both US & Euro underlyings, with most going towards the latter. For the European exposures, in 2015 flows were concentrated in Q1 and Q4 when expectations of European economic recovery were at their highest. In 2016, ETFs on US underlyings gathered most of the inflows due to better economic conditions in the US and the oil price increase.

European inflation-linked Bond ETFs — Net New Assets breakdown by inflation zone (EURM)



Source: Data in EURM, Lyxor, Bloomberg from 01/01/11 to 30/09/16.
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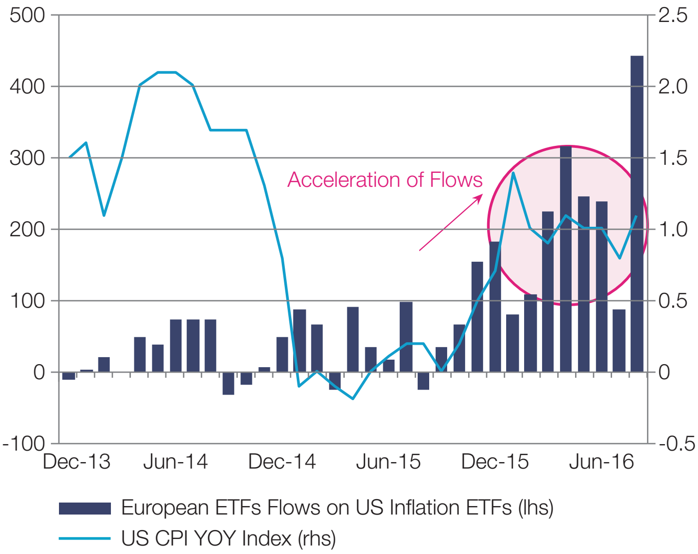
WHAT COULD BE THE REASON FOR THE INCREASED DEMAND?

2015 saw the end of a very low inflation regime supported by years of quantitative easing, especially in the US. Improved economic conditions in developed economies led to a higher inflation regime. Additionally, in 2016, thanks to the rebound and stabilization of oil prices above $45/b, inflation expectations have been quite supportive, triggering sustained net inflows into inflation-protected funds.

ETF flows on US inflation underlyings vs. US inflation



Source: Data in EURM, Lyxor, Bloomberg from 31/12/13 to 31/08/16.
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WILL THE DEMAND CONTINUE TO BE SUSTAINED?

Inflation prints to crawl higher

Given their bullish view on oil over the next 12 months, SG Cross Asset Research strategists believe that inflation expectations in the US are too low compared to fundamentals, while they still expect inflation prints to crawl higher in the next few quarters, particularly in the eurozone where the impact of higher energy prices is finally expected to kick in. This should help spur further significant inflows into inflation-linked products.

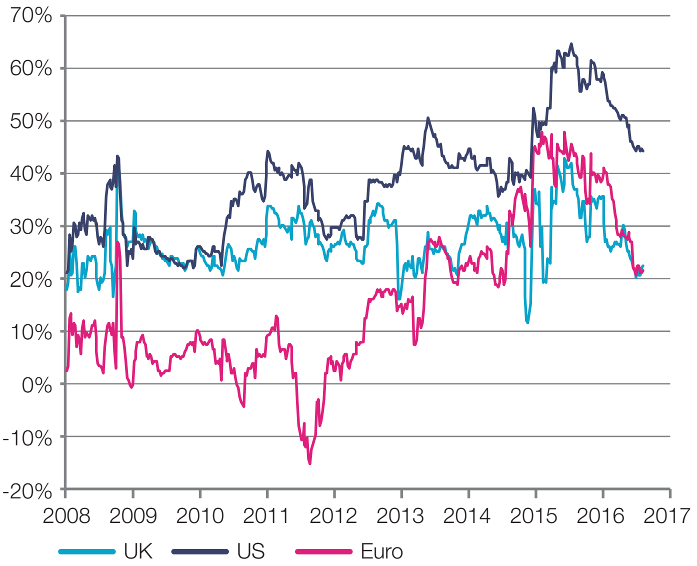
In the UK, the headline Retail Price Index, measure of inflation, has been rising throughout 2016. But the weakening pound could drive this higher. With many everyday goods produced overseas, a weak exchange rate could feed into price rises on the high street. Pricing arguments between UK supermarkets and suppliers have already hit the headlines. Add to the mix a bounce in energy markets, recovering global economic growth – RPI could go much higher.

> SG Cross Asset Research strategists believe that inflation expectations in the Eurozone and in the UK are too low.

Diversification benefits

Another sometimes overlooked advantage of inflation-linked bonds is diversification. A recent paper from the Société Générale Cross Asset Research team focused on the correlation of inflation-linked bonds with other assets, concluding they have strong diversification properties. This could provide some cushion in a time when equity, bonds and credit are looking expensive.

Correlation of inflation-linked bonds with other asset classes



The correlation is calculated over a 3-year period using weekly observations of total return indices (euro) and EWMA methodology. For calculating the correlation, 25 financial instruments across various asset classes have been considered. Source: Datastream, Barclays, SG Cross Asset Research/Global Asset Allocation, data from 01/01/05 to 31/08/16. Past performance is not a reliable indicator of future results.

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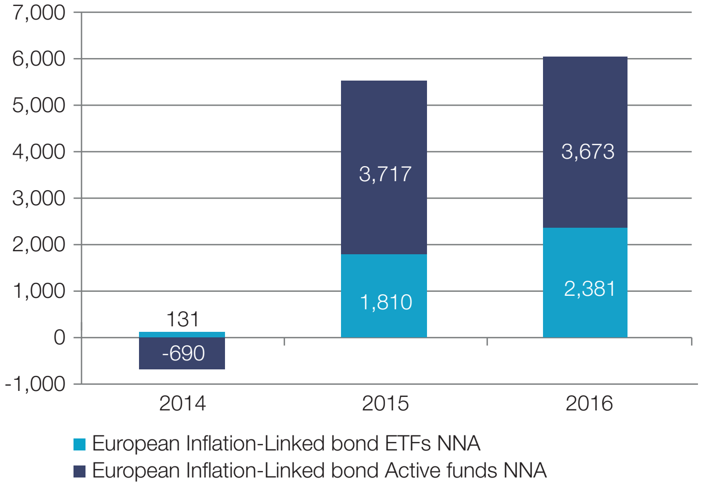
DO WE OBSERVE THE SAME FLOWS TREND FOR ACTIVE FUNDS?

Flows toward inflation-linked products, both active and passive, have significantly increased over the last 2 years totaling EUR5.5bn in 2015 and EUR6.0bn in 2016. In 2016, the growth of ETF flows has been higher than that of Active funds, increasing 32% versus a 1% decline in active funds.

> Flows into inflation-linked products totalled EUR6.0bn in 2016.

Net New Assets into European inflation-linked bond active funds and ETFs (EURM)



Source: Data in EURM, Lyxor, Bloomberg from 01/01/14 to 31/08/16.
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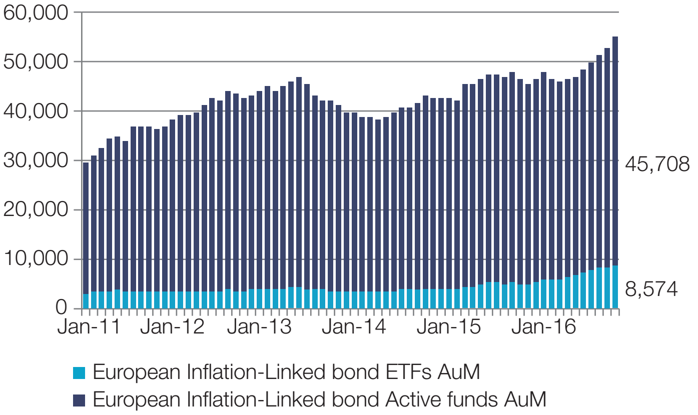
HOW BIG ARE INFLATION-LINKED BOND ETFs COMPARED TO ACTIVE FUNDS?

Inflation-linked bond ETFs in Europe represent EUR8.6bn in assets under management vs. EUR45.7bn for active funds. ETF AuM has doubled in five years and growth should continue to be very sustained over the years to come.

Assets under management in European inflation-linked bond active funds vs. ETFs



Source: Data in EURM, Morningstar, Lyxor, Bloomberg from 01/01/11 to 31/08/16.
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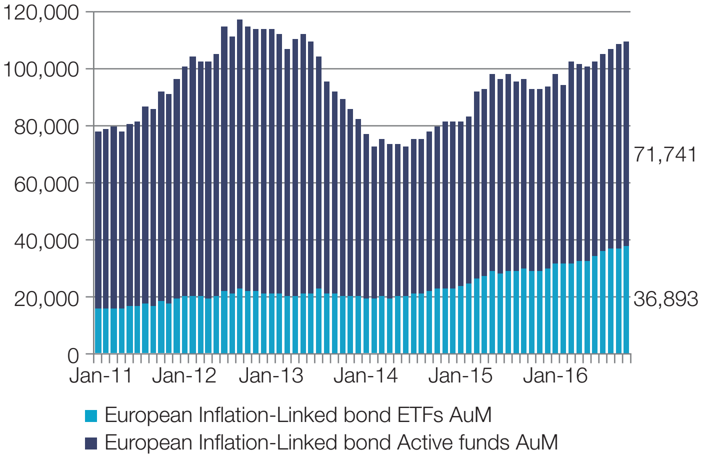
DO WE OBSERVE THE SAME TREND IN THE US?

In the US, the market is dominated by active funds with nearly twice the assets compared to ETFs at EUR71.7bn vs. EUR36.9bn for ETFs. Compared to Europe, active funds are 57% times bigger in the US, while ETFs are 4 times bigger in terms of AuM. In terms of market share, the US ETF market stands at 34% vs. 16% in Europe.

Assets under management in US inflation-linked bond active funds vs. ETFs



Source: Data in EURM, Morningstar, Bloomberg from 01/01/11 to 31/08/16.
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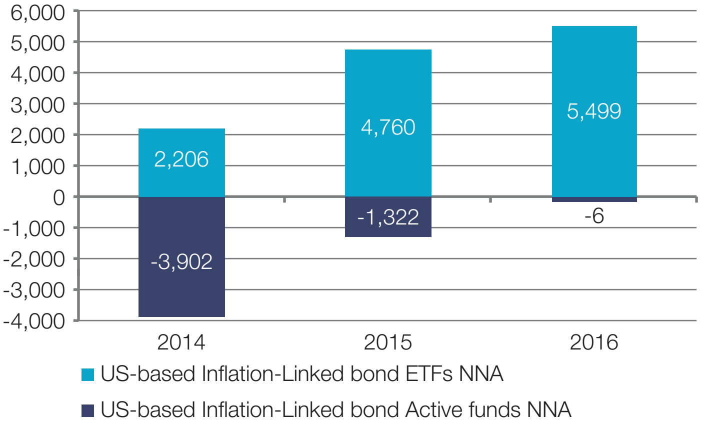
> The US market is dominated by active funds with nearly twice the assets compared to ETFs.

Yet in 2016, ETFs have monopolized all the flows with EUR5.5bn compared to EUR6M of outflows for active funds. ETFs have seen significant flows across all quarters since January 2016. Active funds saw significant outflows in Q1 2016 at a time when inflation expectations were receding. In Q3 2016, positive flows were observed together with an increase in inflation expectations.

Net New Assets into US-based inflation-linked bond active funds and ETFs (EURM)



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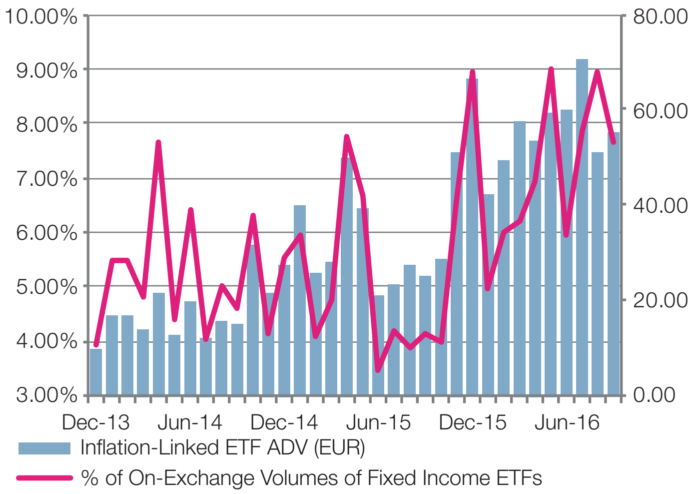
WHAT IS THE MAIN APPEAL OF INFLATION-LINKED ETFs?

The liquidity

On-exchange volumes are significantly up since the end of 2015, reaching 7.6% of on-exchange traded volumes on European fixed income ETFs (average YTD: 7% vs. 5% in the first 9 months of 2015). July was a record month with EUR71M of Average Daily Volumes.

On-exchange volumes on European inflation-linked ETFs (EURM)



Source: Morningstar, Bloomberg from 01/12/13 to 30/09/16.
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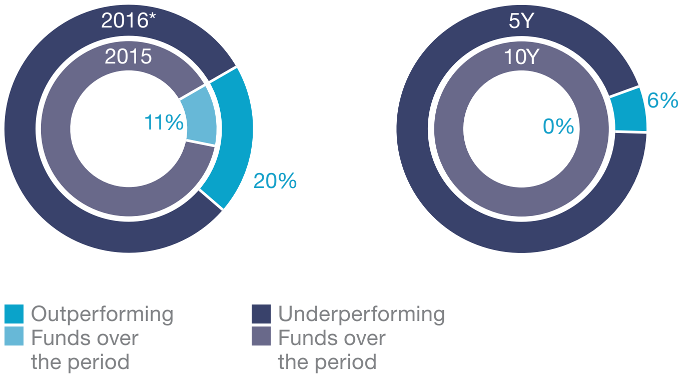
Performance

A key reason for the success of ETFs in the fixed income space relies on performance. Only a small number of active funds succeeded in outperforming the benchmark in this segment. In line with the methodology of our annual study “Active funds vs. benchmark performance comparison” (July 2016), we used Morningstar data on European domiciled active funds on European inflation (64 funds, EUR11.4bn of AuM) to compare their performance with that of the FTSE MTS Eurozone Inflation-Linked bond index. We found that year to date, just 20% of active funds have beaten their benchmark while none of them have outperformed over 10 years. On average over ten years, the underperformance of active funds vs. their benchmark has been equal to 1%.

Just 20% of active funds have beaten their benchmark in 2016.

Active funds vs. the benchmark, FTSE MTS Euro inflation-linked bond index



Source: Morningstar data from 31/12/05 to 31/08/16. European domiciled active funds using FTSE MTS Eurozone Inflation-Linked Bond IG benchmark. THE FIGURES RELATING TO PAST PERFORMANCES REFER TO PAST PERIODS AND ARE NOT A RELIABLE INDICATOR FOR FUTURE RESULTS. THIS ALSO APPLIES TO HISTORICAL MARKET DATA.

NAVIGATE INFLATION WITH LYXOR ETF

5 Inflation-linked ETFs

3 geographical exposures

$1.5bn Assets under Management*

1st ETFs in Europe on inflation expectations

*Source: Lyxor International Asset Management. Data as at 24/10/2016.

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