Planet Tracker

INDEXING:
PREPARE FOR SUSTAINABILITY-DRIVEN DISRUPTION

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An oligopoly of major index providers – MSCI, FTSE Russell, S&P Dow Jones and Bloomberg – are being challenged by innovative competitors. The index 'majors' are some of the most powerful players in the financial markets. If the drive towards self-indexing continues – and financial institutions have been positioning themselves for such a move – investors of all types will be able to choose from a much wider range of products.

The sustainable investor could be the catalyst for this change, providing them with the opportunity to invest in line with their personal principles, rather than taking the templates on offer. And for the braver ones, direct indexing is becoming more widespread. As for the corporates, being included in a popular sustainable index could provide them with a cost of capital advantage. Things are looking up for sustainable investors and sustainable companies.

KEY INSIGHTS

- The index production landscape is evolving to meet the demands of sustainability-based investment products. Declining fund fees, rising competition in index production and demand for greater consumer choice have all arrived at the same time as the upswing in sustainable investing.
- The largest index providers have to balance rising demand for specialisation against the profitability of delivery.
- Asset managers and financial regulators need to ensure new benchmarks are appropriate and true-to-label.
- Investors need to understand the implications of using highly specialised indices when considering their investment goals.
- Corporates will be watching whether index inclusion results in an uplift in their share price, in turn reducing their cost of capital

THE ROLE OF INDICES

There is little doubt that financial markets need indices. There are over three million of them, according to the Index Industry Association.[1] These indices form the benchmarks against which performance is measured, for both passive and active investments. They aim to be objective by providing independent, unbiased data. They are viewed as technically based, built on solid quantitative metrics. (Some commentators challenge this, claiming that subjective political factors are used to formulate indices.[2]) Indices are perceived as transparent with a defined methodology; proposed changes to an index's methodology are normally well signposted and open for consultation. Finally, they need to be reliable by providing regular updated valuations, many in real time.

Without indices, the financial markets would struggle to measure a vast array of products. For example, indices are used in many areas of the investment process, including index-linked product creation (e.g. ETFs, futures and options), performance benchmarking, portfolio construction and rebalancing, risk assessment, broker-dealer structured products and asset allocation.

QUALITIES OF BENCHMARK INDICES

Although benchmarks at their simplest level are cohorts of assets, they are also embedded with certain qualities that make them relevant and useful as performance indicators for investors.

In our view, the primary qualities of a good benchmark are:

1. Transparency
2. Investability
3. Appropriateness
4. Represents investor risk and return goals
5. Priced daily (as a minimum)
6. Specified in advance
7. Measurable
8. Low turnover

These qualities are particularly important when considering ESG or sustainable benchmarks. The index providers will need to minimise any subjective judgements and ensure construction policies remain rules-based. For example, index methodology may need to define issues such as the consumption of single use plastics or human rights abuses. With many climate change indices, the index providers have used carbon metrics as a basis of measurement. What will they use for nature-based measures such as biodiversity?

In addition to these qualities, benchmarks also provide a reference point against which similar investment products can be compared. For example, if an investor wishes to invest in a US Equities fund, direct comparison of a range of competing funds can be achieved by using the S&P 500 as the reference point. Comparisons made can be return-, risk- and factor-based.

INDICES AND PASSIVE INVESTING

With the growth of passive investing, the role of benchmarks and indices has grown.[3] As of March 2020, passive funds accounted for 41 percent of combined U.S. MF[a] and ETF[b] assets under management (AUM), up from three percent in 1995 and 14 percent in 2005 – see Figure 1.

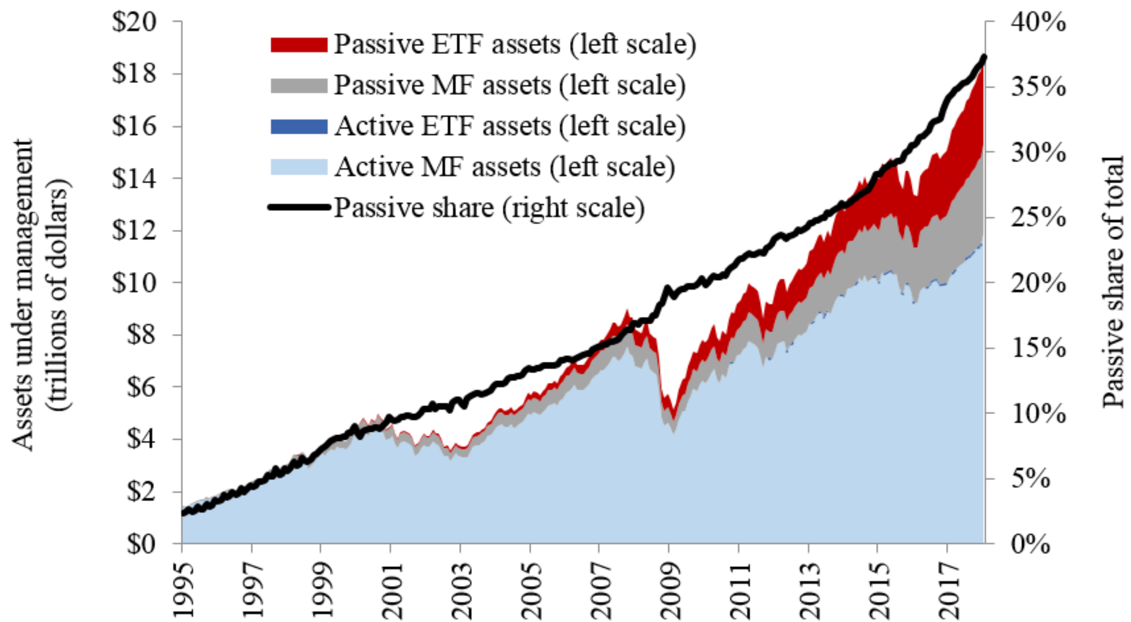

Figure 1: *Total Assets in Active and Passive MFs and ETFs and Passive Share of Total in the US. Source: Morningstar*

PwC, the professional services provider, forecasts that funds under passive management will make large gains in market share, rising from 17% of overall global AUM in 2016 to 25% in 2025. PwC calculated that passive allocation rose from 15.7% in 2015 to an estimated 21.9% in 2020.[4]

Passive investing is usually implemented as a rules-based strategy in which investors and their managers track the underlying index as closely as possible whilst minimising trading costs. The investment goal is to replicate the financial index performance overall, not beat the market. In contrast, active management strategies give portfolio managers discretion to select individual securities, generally with the investment objective of outperforming a previously identified benchmark (i.e. underlying index). However, we should be clear that there is sometimes a lack of clarity in the distinction between these two investment strategies. For example, some nominally active investment funds behave passively by following so-called 'closet-indexing' or 'index-hugging' strategies. In this instance, portfolio managers claim to manage portfolios actively when in reality the fund stays close to a benchmark. Regulators are concerned by this practice, as it may harm investors as they are not receiving the service or risk/return profile they expect based on the fund's disclosure documents, while potentially paying higher fees compared to those typically charged for passive management.[5]

So important is the role of indexing to financial markets that commentators have questioned whether it raises issues about the stability of financial markets. These concerns largely focus on the impacts on funds' liquidity and redemption risks, asset-market volatility, asset management industry concentration and the co-movement of asset returns and liquidity. (Note: These issues will not be addressed in this report.)

a Mutual Fund. A mutual fund is a company that pools money from many investors and invests the money in securities such as stocks, bonds, and short-term debt. The combined holdings of the mutual fund are known as its portfolio. Investors buy shares in mutual funds. Each share represents an investor's part ownership in the fund and the income it generates.

b Exchange Traded Fund. ETFs are a way to invest in a wide range of bonds or shares in one package. They typically track a specific market. They are very similar to index funds which also track a market's performance. The difference between MFs and ETFs is normally the way they are traded (bought and sold) and their fees. Unlike other funds, ETFs are traded on the stock market. That means you can buy or sell them at any time during the day. They generally incur lower fees than MFs.

THE VALUATION IMPACT

Academia has argued that being part of an index is an important driver in the share price performance of a company. Essentially the findings suggest that the inclusion of a stock in an index generally leads to higher returns immediately following the announcement, followed by a further rise until the actual change with a partial reversion in the post change period. Deletions from an index lead to significant negative returns that continue after the change date.[6]

Studies suggest there are a number of possible reasons for this effect. One theory suggests that inclusion in an index, especially a popular one, increases investor awareness of the company[7] and when ejected from the index the opposite happens, as fewer investment analysts research the stock – i.e. they become 'neglected stocks'.

A second idea is that index inclusion leads to improved liquidity, and this in turn boosts stock prices. This theory, however, has been challenged as it does not explain increased correlations with other index stocks.[8]

A third proposal is based on the concept of price pressure. Scholes[9] predicted that prices of included stocks should rise temporarily, to compensate liquidity providers, but would revert back as investors find substitutes. Subsequent research challenged the idea of reversion, arguing the price effect was more permanent.

However, other academics have argued that there is an 'inclusion subsidy' that should be considered when looking at investors' benchmarks. Kashyap, Kovrijnykh, Li and Pavlova[10] demonstrated that for firms that are part of a benchmark, the inelastic demand for their shares by portfolio managers lowers their cost of capital for investments, mergers and IPO decisions. In turn, this has important effects for ESG investments. ***Firstly, their model suggests a direct effect: an exclusion of companies with poor ESG characteristics in the benchmark 'denies such companies the benchmark inclusion subsidy, and therefore these companies would not be able to grow as much'. Secondly, there is an indirect effect. If a company with a poor ESG score (e.g., it is a significant polluter) is replaced in the benchmark with a firm with a higher ESG score (e.g., with low emissions) it will 'encourage firms outside the benchmark to mimic such a firm instead'.***

So, what if management teams become convinced that the inclusion of their company in indices will help their share price performance and lower their cost of capital? As the number of sustainable and ESG-orientated indices rises, executives will be encouraged to adopt more sustainable and ESG strategies to increase their chances of index inclusion. It may be an unintended consequence, but this could well turn out to be one of the most positive developments for corporate sustainability.

THE INDEX PROVIDERS

A small group of companies control the main indices used by the capital markets. As we discussed in *'Exchange Traded Deforestation'* (December 2020) there are four main index providers for ETFs – MSCI, FTSE Russell, S&P Dow Jones and Bloomberg. There is also another tier of index providers across asset classes which are challenging this oligopoly. These include CRSP, Morningstar, Qontigo and Solactive.

The smaller index constructors have a challenge on their hands - inertia and history can protect the large index providers. Take the Dow Jones Index, or more correctly the Dow Jones Industrial Average, owned by News Corp. via Dow Jones & Company. It is widely recognised by investment professionals as a flawed index (see box below), but its longevity gives it value. Established in 1896, few doubt that it is a poorly constructed index, but it remains widely referenced by the media. There are also other factors protecting the index majors. Branding is extremely powerful in the indexing world where technical expertise, accuracy and objectivity are highly valued. The imminent demise of the major indexers has been predicted before.

Despite this, we believe the Index 'Majors' should prepare for disruption and we expect this to be driven by sustainability demand.

The Flaws with the Dow Jones Industrial Index

- It is not a measure of industrial companies (it was originally)
- It is a poor representation of the US stock market (it only has 30 constituents)
- It is not weighted by market capitalization (it is weighted by stock price)
- It does not use a weighted arithmetic mean (a special divisor is used)
- Subjective methodology – e.g., a company's reputation

INEVITABLE DISRUPTION?

There are several reasons why disruption appears likely.

1. FALLING FEES

The management fees for many investment products continue to fall. For example, exchanged traded funds (ETFs) have seen fees fall dramatically. JP Morgan calculates that ETF fees have fallen by 40% in the last eight years[11] - see Figure 2.

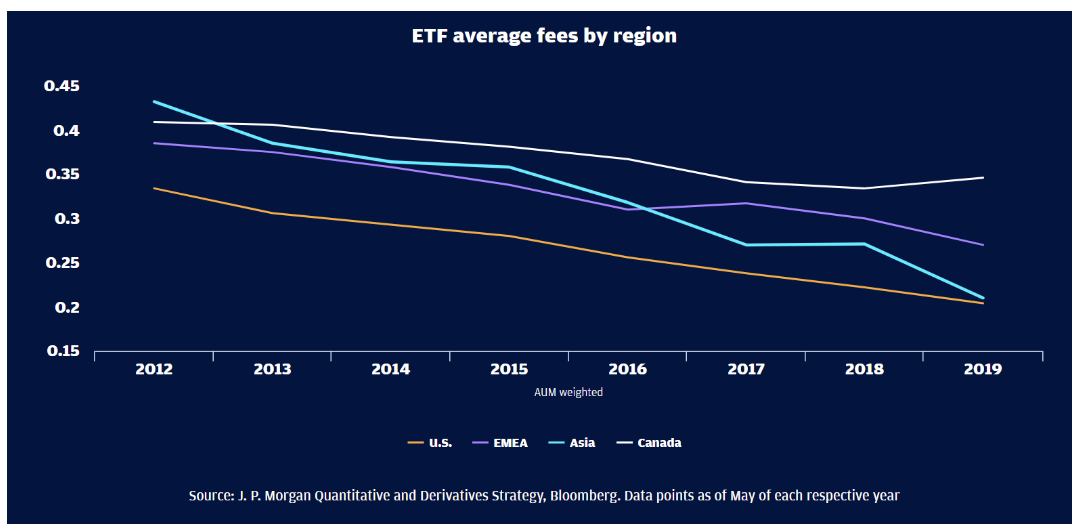

Figure 2: *Falling ETF fee - ETF Average Fees by Region; Source: JP Morgan*[12]

An examination of the wider Asset and Wealth Management industry mirrors this declining fee trend. In PwC's report *'Asset & Wealth Management Revolution: Embracing Exponential Change' (2019)*[13] it comments that *'a new era of full transparency is still evolving. Regulators are forcing the pace on fees and costs'.*

A number of contracts with index providers are calculated as a percentage of the relevant product's total expense ratio ("TER"). As competition increases among the financial institutions that provide index-linked investment products, including ETFs, low fees are one of the competitive differentiators. Therefore, a reduction in the TER may negatively impact the index providers' revenues. Those financial institutions which have index fees based on assets under management will be keen to ensure they remain competitive.

2. PROFITABILITY ATTRACTS COMPETITION

The present profitability of these index providers makes them an attractive hunting ground for new entrants. If we examine MSCI's 2020 full year results, we note that the company reported that its index business segment reported an adjusted EBITDA of USD 766 million, a 14% rise on the previous year. The EBITDA margin for this division is an extremely impressive 75%, compared to 57% for all divisions.[14] It is noteworthy that MSCI has announced that, for the present financial year, it will be reorganising its divisional reporting by creating a new 'ESG & Analytics' segment, which formerly resided in the 'Others' category.[15]

The second tier index providers will be keen to gain some of this market share and offering more customised products appears a sensible strategy. As an example, Solactive sells *'tailor-made' solutions as well as being 'dedicated to developing customized indices'*.[16]

MSCI makes no secret of the competition it could face from its own clients. In its 2020 10-K filing,[17] it states, '*growing competition also exists from industry participants, including asset managers and investment banks, that create their own indexes*' and MSCI reveals dependency on the largest financial institutions with BlackRock accounting *'for 11.0% of our total revenues'. It also warns that clients may 'internally develop certain functionality contained in the products or services they currently license from us' and notes 'a number of our clients have obtained regulatory clearance to create indexes for use as the basis of ETFs that they manage' and that similarly for 'ESG and climate data to analyse their portfolio risk may develop their own tools*'.

More recently, a media company, the Nikkei Inc., has indicated an interest in offering index provision. The Nikkei owns the FT, the latter being no newcomer to index provision. The FT Group sold its 50 per cent stake in what later became FTSE Russell to the London Stock Exchange in 2011. The Nikkei is a leading index provider in Asia – notably the Nikkei 225 – and intends to collaborate with the FT/Wilshire partnership to re-introduce indices. The Wilshire 5000 index series will be relaunched as the FT Wilshire 5000 US Series.[18]

3. DEMAND FOR CONSUMER CHOICE

Demand for greater consumer choice, as in so many markets, is likely to increase.

At first glance the opposite appears to have happened. The Index Industry Association (IIA) reported a decline in the number of indices in 2020 to 3.05 million, falling from 3.73 million in mid-2018. This is explained by the IIA as, '*It appears the lower number is due to the decommissioning of indices, a process which occurs every year to ensure indices are not redundant. Previously, this has been offset by the addition of new indices, but there were a large number of decommissions in both equities and "other" categories in the past year*'.[19] However, there could be a further reason for this apparent decline in indices. These data are collated for members of the Association only, so external index providers are not captured. Are non-members starting to take market share?

A closer examination of this trend reveals two interesting examples of notable increases in index demand: fixed income and ESG (environmental, social and governance). In 2019, fixed income indices rose 7% year-on-year, driven by Europe, the Middle East and Africa (EMEA). ESG indices rose by 14% across both equities and fixed income. The IIA press releases states, '*The number and variety of ESG indices indicate that investors are looking for benchmarks that conform to their investment objectives and beliefs*'. The IIA snapshot for 2020 reveals continued growth in fixed income indices of 7% but a leap in ESG demand by 40%.[20]

It is ESG and sustainable demand which we expect to continue, for both equity and fixed income assets. PwC forecasts that ESG investing is '*the growth opportunity of the century*'.[21] The report states, 'I*n the new decade, ESG has gone from a trend to the biggest revolution in the European* fundindustry since UCITS[c] and AIFMD[d]'.

In the fixed income arena, the Climate Bonds Initiative reported that annual issuance of green debt instruments ended 2020 with issuances totalling USD 1.05 trillion. This cumulative total implies an average annual growth rate of 60% since 2015[22] – see Figure 3.

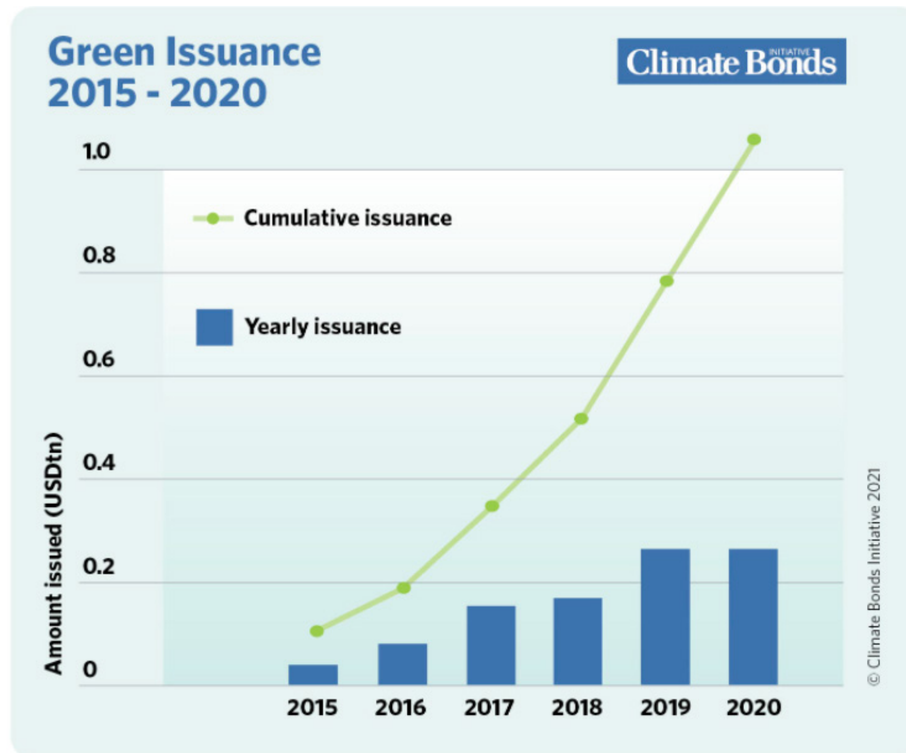

Figure 3: *Includes Green Bonds, Loans, Sukuk and Green Asset-Backed Securities (ABS); Source: Climate Bond Initiative*

But perhaps the performance of such funds and instruments is a more important indicator of future flows. Research from BlackRock has '*established a correlation between sustainability and traditional factors such as quality and low volatility, which themselves indicate resilience. As a result, we would expect sustainable companies to be more resilient during downturns*'.[23] Morningstar analysis concluded that 72% of Morningstar equity indices that incorporate ESG screens lost less than the market during down periods for the five years through the end of 2019.[24] MSCI has also observed that an '*ESG factor shows that a large part of the indices' Q1 2020 performance was attributable to the systematic tilt of these indices toward higher ESG-rated stocks, similar to what we observed over the past five years*'.[25]

This twin push of inflows and performance enhancement would suggest more sustainable investing is likely. In turn, this implies the number of appropriate indices should rise. If demand is maintained, are we reaching the point where investors will be offered more choice, perhaps driven by personal sustainable and ESG preferences?

[c] UCITS are 'undertakings for collective investment in transferable securities' defined in a European Directive (2009) that provides the regulatory framework for funds which are managed and domiciled in the EU and intended for sale to retail clients. If a fund is UCITS compliant, it can be marketed to retail investors across Europe because it adheres to an agreed common standard for risk and fund management.

[d] The Directive on Alternative Investment Fund Managers (AIFMD) came into force in 2011 with the aim of creating a comprehensive and effective regulatory and supervisory framework for alternative investment fund managers within the EU. The scope of the Directive is broad, capturing the management and the marketing of alternative investment funds or "AIFs".

SO HOW ARE THE FINANCIAL INSTITUTIONS RESPONDING?

Moves by some major financial institutions suggest that they too are preparing for a change in index provision, keen to capture the move to sustainable investing.

In some instances, it appears that index providers might be resisting the multiplication of indices. When the UK asset manager LGIM was searching for customised ESG indices, it commented that a number of index providers spoken to, other than JPMorgan, *'couldn't or wouldn't help create LGIM's preferred benchmarks 'because it undermined their existing business'*.[26]

However, some financial institutions are building their own indexing capability. Last October, Morgan Stanley announced its acquisition of Eaton Vance.[27] By purchasing Eaton Vance it acquired among other assets Calvert and Parametric. The former is a pioneer in responsible investing and the latter a leader in custom separately managed accounts. Again, this opens the door for Morgan Stanley to offer customised and self-indexed[e] ESG funds to its customers.

BlackRock soon followed with its purchase of Aperio for USD 1.05 billion, for an estimated 50 times earnings.[28] Aperio is known for managing tax-optimised separately managed accounts. However, it is also a leader in direct indexing[f], which allows BlackRock to customise existing equity indices and create bespoke portfolios tailored to meet client needs.

At the recent OECD Blended Finance Conference, the CEO of BlackRock commented on the need for one global standard for sustainable accounting and stated that 'data gathered according to this would allow the creation of customised portfolios that closely tracked indices'. He went further, commenting that, '***If we then move the trillions of dollars of money away from traditional indexes into these more sustainable or ESG-based indexes, that's going to shape finance in a substantial way'***.[29]

State Street started its self-indexing journey in 2016. It commenced with the self-indexed SPDR SSGA Gender Diversity (SHE) ETF later expanded its do-it-yourself index ETF line-up. Franklin Templeton also launched seven self-indexed smart-beta ETFs a few years ago, as did Invesco in 2018 with fixed-income factor ETFs.

Interestingly, some stock exchanges are active in this area but may take different paths. On the one hand, Deutsche Börse owns Qontigo which comprises the well-known DAX and STOXX indices as well as Axioma, the investment management solutions company. It offers ESG index solutions which include product-based screenings on the flagship benchmarks as well as more thematic versions founded on its leading indices. However, it is testing further customisation with STOXX iStudio, which provides the customer with the tools to build their own index. This suggests Deutsche Börse is willing to become a disruptor. On the other hand, FTSE Russell is a subsidiary of the London Stock Exchange Group (LSEG). FTSE Russell is one of the index majors and is able to join with Refinitiv, another subsidiary of the LSEG and a global provider of financial market data and infrastructure, to offer more extensive desktop provision of its existing index range.

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e Self-indexing is when an asset manager maintains ownership and the associated intellectual property of an index, rather than purchasing the index from a third-party provider.

f Direct investing removes the need for a fund "wrapper." Investors are able to directly hold all the securities in an index or exclude those stocks they do not wish to own. It can also be used to reduce taxes by offsetting capital gains by selling losing stocks and offsetting these losses against capital gains taxes incurred on their winning investments.

INDEXING OR CUSTOMISATION - WHERE NEXT?

So, are the index majors caught between a rock and a hard place? If they provide ever more customisation, they undermine the profitability of their existing business model, especially in relation to their most popular indices – e.g. S&P 500, FTSE 100, MSCI World etc.

But there's a further issue. Will increasing customisation, driven by sustainable demand, lead to greater regulatory scrutiny? Some regulators have already expressed concerns. In 2018, the EU Benchmark Regulation (BMR) was introduced amid fears about the accuracy and integrity of indices used as benchmarks in EU markets, following the LIBOR[g] scandal. BMR imposes requirements for organizations that provide, contribute data to and reference financial benchmarks.[30] To further complicate the issue, regulators will need to ensure that the largest Asset Managers, which may sit on Advisory Boards of the Index Providers or provide advice, are unable to exert influence over the formulation of indices.

Some highly customised indices may be used for a single fund. And what happens when the index and the fund are run by the same manager, as in the case of self-indexing? In this instance, the investment manager is measuring the performance of their own fund relative to their own benchmark.

What will happen if the fund underperforms the benchmark? Will the manager cease active management and in turn, reduce the management fees they are charging, for what would have become a passive investment?

These indices could start to look less like the objective benchmarks investors often believe they are getting. Investors may not understand how the index works or whether it may be susceptible to undue influence.[31]

Index providers are viewed as data publishers by the SEC, rather than investment advisers. Should there be a regulatory distinction between broad indices and the customised varieties? Some commentators think so, arguing index investing is a form of 'delegated management'.[32]

Increasing customisation appears inevitable and indexing will play a measurement role. ESG and sustainable investor demand is a likely catalyst for such a move. Purely from a corporate viewpoint, neither index providers nor financial institutions will want to miss this flow of business. Smaller innovative index providers are already active in this space.

Presently, it appears that only financial institutions and ultra-high net worth individuals (UHNWIs) are reaping the full customisation benefits. Many retail investors are left with limited options when using the fund platforms of the major financial institutions. See our research on *'Exchange Traded Deforestation'* on the opaqueness of deforestation risks in ETFs[h] and *'Online Retail Investors: Can't see the wood for the trees!'* which demonstrates the challenges that retail investors face in identifying sustainable/ESG investment products.. Major sustainable issues such as deforestation, the circular economy, air pollution or water scarcity are often rolled up with more general sustainable objectives and presented as a fait accompli.

This could all change if asset managers and fund distribution platforms create their own benchmarks. But will the consumer prefer an independent indexer or be happy to accept one from a financial institution which may well be managing the portfolio? Even if the consumer doesn't care, the regulator is likely to remain observant. And if there is hesitancy with self-indexing, will direct indexing by investors become more prevalent?

In terms of where this could be heading, one could consider robo-advisors. Robo-advisors are digital platforms which provide an automated-driven financial planning service, using algorithms, with minimal human supervision. Examples include Betterment, E*Trade Core Portfolios, Interactive Advisors or Wealthfront. One can easily imagine an investor submitting their ESG preferences and goals online and then the platform providing the best matched investments.

Perhaps the most exciting development for supporters of sustainability and ESG strategies may be an unintended consequence. If corporate management teams become convinced that the inclusion of their company in an index is one of the most important drivers of a share price, then there could be a scramble by executives to adopt more sustainable and ESG strategies, in order to win access to these indices and possibly lower their cost of capital. A race to the top that would be welcomed by many.

g London Interbank Offered Rate which is to be phased out by mid-2023

h Exchange traded funds

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