Index investing is not index administration

Alan Duffy, Head of Systematic Investing

Peter Leonard, Head of Indexation Equity

'Index 2.0' allows investors to define what they own and why. We examine a route to index customisation that aims to keep the discipline of an index while minimising the administrative frictions of an index provider.

Institutional appetite for customisation has been building for some time. Passive UCITS grew from 13% of the European market in 2015 to 30% at the end of 2025 , and expectations of what a passive allocation should deliver have risen alongside that growth. In a recent industry survey of 300 senior investment professionals in Europe and the US, a quarter of respondents said they wanted index providers to develop more customised indices .

The market usually offers two ways to meet that demand. The first is to license a custom index from a major provider, bringing the advantages of third-party governance. However, this governance comes at a cost. This route often carries higher licensing fees and a greater initial outlay of effort, with limited flexibility to update criteria once the index is live. Build times can extend to multiple quarters, as can subsequent changes, because each one re-enters the same governance process that produced the original.

The second is self-indexing. The manager constructs, owns and calculates its own index. This is fast and inexpensive but also invites the question from an investment committee: if one firm builds the benchmark, calculates the benchmark and is measured against the benchmark, who is responsible for oversight?

There is a third route. Here, the manager constructs the portfolio, an independent calculation agent maintains and calculates the basket and the manager's indexation team tracks it, applying the same tracking-error discipline as any indexed mandate.

The third route

Whenever an index is published, there is automatically a layer of administration. That means a documented methodology, a change-control process, a committee to approve amendments, consultation where constituents are affected and, depending on the index, a set of regulatory obligations attached. An index that many investors track must be stable and predictable, and governance exists to make changes slow and deliberate.

However, an index built for one client and tracked by one portfolio carries the full apparatus but needs very little of it. "I think of passive investing as a wrapper you can put around any strategy," says Peter Leonard, head of indexation equity at Keyridge. "It is a way of managing portfolios efficiently rather than a set of market-capitalisation rules. The only real requirement is that the process can be written as a set of rules. The moment you publish an index, you take on the governance responsibilities of an index provider. Clients generally want a well-governed but flexible portfolio. They do not want the administration."

By way of example, a few years ago, a global organisation approached Keyridge after having already built a bespoke equity solution elsewhere. That build took a year, and because the end product was a published index, each design decision passed through methodology governance and successive layers of management sign-off.

This third approach incorporates calculation independence like the first route and speed and flexibility like the second. What is absent is the published index, and with it the administrative weight that slowed down the client's earlier experience. The investor still receives a rules-based, transparent, replicable exposure with a defined tracking-error budget against a parent benchmark. What they do not receive is a published index anyone else can buy, which for a single-client mandate is not in any case the objective. It is not, in the strict sense, an index at all.

It is the removal of the administrative layer used by the traditional indexation process that changes the timetable. Build periods under this structure are measured in months rather than quarters, because the work is able to focus on portfolio construction and rule-writing rather than methodology governance. In the mandate described above, Keyridge committed to three months and delivered on time.

The relationship continues after the build. The client and the investment team could meet at regular intervals, for example twice a year, to review performance, examine how the solution is impacting the wider portfolio and test whether the original objectives still hold. Where a change is agreed, it is a change to the rules of the strategy, and it can be implemented in a timeframe measured in days.

Rules that can change will draw an obvious challenge about whether any of this remains passive. However, changes are generally agreed in a documented governance forum with the client rather than taken unilaterally, and implemented as amendments to the rules rather than as discretionary trades, whilst calculation remains with an independent third party. Attribution reports back against the objectives that were agreed. The outcome is active management at a passive cost, with the benefits of an index and control always residing with the client.

Mitigating unintended exposures

Institutional mandates are rarely fully specified at the outset; the client begins with a high-level objective, and the initial build reveals the trade-offs required elsewhere in the portfolio. Constraints interact, and this interaction is well documented. Recent research shows that adding constraints without explicitly neutralising residual exposures allocates a meaningful share of tracking error to factors the investor never selected. Long-only construction against a concentrated benchmark produces a size tilt, for example. Although the stated objectives are met, it can leave investors exposed to a set of factors that, at best, they are not interested in and at worst contradict investment views.

Clients may be concerned about mitigating index concentration or, more specifically, exposure to the 'Mag 7'. Allocating to an equally weighted index has been espoused in the investment community. But whilst it's true that you reduce exposure to mega cap stocks and gain exposure to a higher effective number of names with an equally weighted approach, that comes at a cost of introducing second order effects. A brief but not exhaustive list of these includes: higher turnover and trading costs, persistent factor tilts (size, value), material tracking error versus traditional market cap benchmarks, material sector deviations and potentially capacity constraints for larger funds. Working with a client to address the concern (concentration) while maintaining focus on the unintended impacts results in a better solution that, crucially, can be altered over time as the client adjusts their views.

Building in flexibility also allows for intentions and requirements to be adjusted when required. A solution that cannot be changed has to be right at the first attempt, and even on the rare occasions when they are, client beliefs and mandate requirements can change over time. This is why we work on an iterative basis with our clients, simulating the high-level objectives and refining them when we find unintended outcomes.

Customisation: sustainability and beyond

The widening scope for customisation has arisen partly because of a changing opportunity set. Although the infrastructure required to build custom mandates was never sustainability-specific, sustainability has been a key focus. Most European custom mandates built over the past decade have been sustainability-driven: climate pathways, Paris alignment, exclusions and SDG mapping. However, the labelled-product route has become more strictly regulated. ESMA's guidelines on fund names using ESG or sustainability-related terms applied from November 2024, and the authority's subsequent risk analysis found that 64% of affected funds changed their names, in most cases to remove sustainability terminology, while 56% strengthened their investment policies. The appetite for sustainability-themed products has not disappeared but it has increasingly moved out of labelled pooled products and into mandates where naming rules do not apply, and construction can be precisely specified.

Another key trend is providing solutions with reduced tracking error. One independent research firm noted that more than half of its clients' searches for active equity managers in the twelve months to the end of September 2024 were directed towards core, benchmark-aware strategies, against a typical figure of around a quarter over the preceding five years.

However, any objective that can be written as a rule can be built into a portfolio. Yield and income targets, country and currency constraints, factor tilts, completion portfolios sitting alongside an existing manager line-up, concentration management: the same factors, risk models and optimisation discipline underpin Keyridge's systematic strategies. Active risk can be targeted, with sector and country neutrality and explicit limits on individual stock, factor and regional exposure. "It deliberately sits between passive and traditional active," says Alan Duffy, head of systematic investment at Keyridge. "It allows us to target specific outcomes while controlling deviations from the benchmark."

Investors who have found custom index projects slow have potentially chosen a structure that makes long builds inevitable and subsequent change difficult. Index 2.0, if the term is to mean anything, should mean recognising that the discipline of index investing and the machinery of index administration can be separated. Investors can have the first without being obliged to buy the second.

Find out about Keyridge's custom indexation solutions at **https://www.keyridge.com/capabilities/customised-indexation** or contact a member of our team through **hello@keyridge.com**
