

Evolving investment landscape offers index providers opportunity to shine



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The markets are undergoing a period of profound change.

Continued economic globalisation, rising geopolitical tensions, tightening central bank policies and new technologies are combining with changing market structures and regulatory shifts to create a very dynamic landscape. As a result, buy- and sell-side participants alike are facing multiple challenges such as fee compression, a persistent shift toward passive investment and evolving business models for financial firms. And, ten years on from the financial crisis, all of us in financial services must continue our efforts to rebuild the trust in our industry.

These forces are changing the way our money is managed. Investment flows are predominantly into low cost passive funds: a recent report from professional services firm PwC predicts that global passive assets will almost double in size by 2025, from US\$84.9 trillion in 2016 to US\$111.2 trillion by 2020, and then again to US\$145.4 trillion by 2025¹. Active managers, some of whom have been accused of being closet index trackers, are having to take on more active risk to justify their higher fees and deliver performance that beats the benchmark in a meaningful way.

In the light of these factors, many investment professionals are coming to the conclusion that the old operating models are outdated and no longer fit for purpose. We are all adapting to an environment that is significantly more

competitive and increasingly complex. As in all industries, those that do not adapt effectively or quickly enough will not survive.

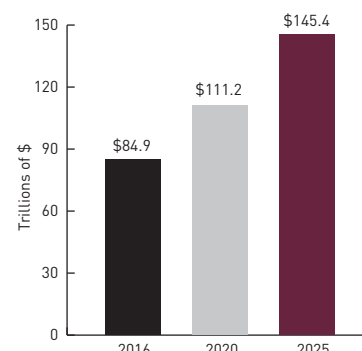
The index industry is a prime example. It sits at the heart of a data eco-system that provides a coherent framework for analysing and investing in global financial markets. Indexes are a small part of the wider information services industry, and the index industry has been fuelled to double-digit growth by the passive investing trend.

There are a number of large global players in the index industry who service asset owners and institutional investors worldwide. Approximately 20% of the money tracking FTSE Russell indexes is passively invested in index funds (including ETFs) and 80% is actively invested with the index set as a performance benchmark². Some \$15 trillion tracks FTSE Russell benchmarks: 80% of those assets are against equity indexes and 20% against bond indexes³.

Some would argue that consolidation in the industry could stifle innovation. But this viewpoint does not hold up under scrutiny. There are also a large number of smaller index providers operating in the industry in numerous jurisdictions resulting in a highly competitive environment. Further, there are a very large number of smaller index providers that deliver low cost, and even free, index calculation services: Bloomberg, Thomson Reuters, and Morningstar are just a few. When coupled with self-indexing by asset managers, you have a very competitive market where the end investors have a lot of choice and, for institutional investors, a strong say in the construction standards and methodologies used by the major index providers.

This level of competition is driving innovation while also enabling index firms to showcase the tremendous value we offer the marketplace. As an index provider, we recognise that it is actually very easy to create a broad market index. With free or low-cost data available daily from numerous sources, virtually any

PREDICTED INVESTMENT INCREASE IN GLOBAL PASSIVE ASSETS



Source = PwC¹

investor could select a group of stocks, create a basket and establish their own index. In fact, FTSE Russell even provides the recipe for how to create our indexes: the ground rules for our indexes are fully transparent and publicly available so that people can understand how our indexes are constructed.

What's difficult is running indexes accurately, in real time, within a regulated environment on a large scale. When creating and maintaining indexes that are used for trillions of investment dollars, the execution, particularly in a regulated environment, becomes crucial. A mistake is a serious issue that can ripple across markets and investor portfolios. Striving to achieve flawless execution, we have built a formidable team of analysts and index managers who maintain more than 250,000 indexes on a daily basis.

Great care needs to be taken in the construction of index methodologies to ensure that they are written clearly and unambiguously. Poorly crafted index methodologies can lead to unexpected changes to index composition that can have a material effect on security prices. Take as an example the potential inclusion of China A-shares in our global indexes. FTSE Russell applies years of intellectual property to assess numerous facets of the Chinese markets and their listed companies. The process also requires a significant level of engagement

with local officials and entities from regulators and exchanges to trading and custody firms.

And needless to say, once we move beyond broad market, cap-weighted indexes and into fundamentally-weighted indexes, indexes screened against ESG factors, or indexes weighted according to risk measures, the resources and sophistication of the calculation infrastructure need to ramp up significantly. This is particularly the case with the ever growing number of smart beta or factor indexes. In just the last five years, the number of indexes – particularly those used to underpin an investment product such as ETFs – has exploded.

As the financial industry continues to evolve, index providers will continue to adapt and innovate. The increasingly competitive index industry creates an environment that rewards the best. Index products that fail to meet investors' or the marketplace's expectations will falter. The rapidly changing investment landscape also focuses attention on index methodology, something we welcome at FTSE Russell. The more investors seek to identify and measure increasingly complex investment factors, the better opportunity index providers are afforded to showcase their capabilities.

FOOTNOTES

¹ Asset & Wealth Management Revolution: Embracing Exponential Change PwC, 2017

² Source: FTSE Russell. Data as of December 31, 2016

³ Source: FTSE Russell. Data as of December 31, 2016



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