ASSET MANAGEMENT FUNDAMENTALS

The Role of Indices in Asset Management

Introduction

Indices play a fundamental role in the investing world, informing investment strategies, serving as benchmarks, and aiding in performance evaluation. Understanding the different types of indices, their attributes, and how they are constructed and maintained allows for a better understanding of how investors and advisers make use of indices.

What is an Index?

An index collects a group of components (such as stocks, bonds, or other financial instruments) together and allows tracking of the performance as a group. Well known examples are the Dow Jones Industrial Average, which tracks 30 large companies listed on U.S. stock exchanges, and the Standard & Poor's 500 which tracks 500 companies listed on U.S. stock exchanges. In each case, the index provider, such as S&P Dow Jones Indices, MSCI, or FTSE Russell sets the index methodology. The index methodology determines how the index is constructed and calculated, including criteria for included instruments, the proportion of each holding in the index, and valuation processes. Over time, some index components may no longer meet the criteria, or new securities or issuers may meet the criteria and are added or removed from the index according to the index methodology.

Investors cannot directly invest in an index. Rather, index providers license the use of their indices for a fee. Multiple managers can license the same index for their products, such as mutual funds, ETFs, and other investment vehicles. Asset managers are typically separate from index providers (who are considered third-party service providers for asset managers) but may provide feedback to index providers on new indices that they would like to license.

Some asset managers may have divisions or affiliated entities that create indexes. In such circumstances those divisions or affiliates are separate from the asset management division and appropriate informational barriers are put into place.

An index often serves as a benchmark - a standard against which the performance of individual investments or portfolios can be compared or measured.

What Types of Indices Exist?

Indices come in various forms, each serving different purposes and tracking different market segments. Some, like the S&P 500, include a large group of securities representing a wide segment of the market. Others focus on more targeted exposures, such as small-cap stocks or emerging markets.

Other types of indices include asset class-focused indices (which focus on segments of the market such as equities, fixed-income, and currencies), geographical indices (which track the performance of securities within a specific country or region), sector indices (which focus on specific industries or sectors of the economy), thematic indices (which track the performance of companies aligned with specific themes or trends such as ESG or religious adherence), and multi-market or blended indices (which combine multiple smaller indices to provide a broader perspective).

What Attributes Do Credible and Durable Indices Have?

An index aims to accurately represent the market segment outlined in its index methodology. The methodology describes how index constituents are drawn from a population of issuers or instruments that reflect the overall characteristics and performance of the market segment.

Information about an index, its components, and their prices are readily available and updated regularly. This transparency in data allows investors to monitor the index's performance and changes in values and weightings of instruments in the index.

Index methodologies describe the criteria for inclusion, weighting, and rebalancing. Index providers aim to ensure that their methodologies are clearly defined, objective, stable, and publicly available and that the process is open and understandable. Rebalancing and adding/removing instruments from the index as instruments that meet or no longer meet the criteria is part of index maintenance. The criteria, however, generally remains stable and unchanged to ensure it continues to reflect the desired market segment. Predictability over the long run informs the market that uses an index as a benchmark.

How are Indices Constructed, Maintained, and Changed Over Time?

Indices are constructed and maintained using objective criteria to ensure they accurately represent the intended market segment. The index sponsor determines and defines the universe of possible assets that could be eligible for the index. Criteria is typically objective and unchanged over time but can evolve with advance notice to the market. Inclusion criteria depend on the asset class, but factors such as issue size and trading volume, sector, and geography are commonly considered.

An equity index might include all U.S. equities with a market capitalization above a certain threshold and an average daily trading volume of at least a certain amount. A fixed income index might include all bonds from U.S. investment grade corporate issuers with remaining maturities below a certain number of years.

Once the components are selected, each security in the index is assigned a weight to determine the relative influence the security will have on the performance of the index. Typical weighting methodologies include market capitalization, price, or equal weighting.

Price weighting means that the prices for all index members are added together. The price of an individual instrument as a proportion of the total is the weighting of that instrument in the index. A key implication is that instruments of higher prices make up a bigger proportion of the index relative to those with smaller prices. The Dow Jones Industrial Average is the most well-known price-weighted index.

Market capitalization is a more common methodology that calculates index weights based on price by the number of instruments outstanding. An issuer with a higher price and more shares outstanding will comprise a larger weighting than issuers with a lower price and fewer shares outstanding. The Standard & Poor's

500 Index uses a market-capitalization methodology that adjusts for shares that do not actively trade.

Equal-weighted indices assign the same weight to each security, regardless of its market value or price.

Index providers conduct regular reviews and rebalances on their indices to adapt to changing market structures and conditions. Quarterly adjustments are common, but some indices update semi-annually or annually. Unusual corporate events can trigger off-cycle changes, but index providers prefer to maintain a consistent cadence.

How are Indices Used in Investment Strategies?

Indices play a role in various investment strategies, providing benchmarks for performance evaluation and informing investment decisions.

Some funds and strategies closely track various indices. There are numerous index funds available as mutual funds and exchange traded funds ("ETFs") in the U.S. The asset manager seeks to mirror the index and minimize deviations from the issuers and weightings in the index, known as "tracking error."

A manager invests new money from clients to maintain the holdings and proportions as the index and minimize tracking error. When they sell to raise money to meet investor redemption or withdrawal requests, they do so in the same manner. With more inflows, funds and strategies inherently grow their holdings of individual securities in a mechanical manner consistent with the composition of the index. Buying and selling activity and corresponding holdings depend on client demand and index composition. When more clients invest in an index strategy with an asset manager, the manager will accumulate larger holdings of individual instruments that comprise the index.

Active investing involves decisions by portfolio managers about where to invest, when to invest, and how to invest. Managers apply judgment and invest (or decide not to invest) as they seek economic returns and manage associated risks in line with the index fund or client's investment objective.

An active manager does not invest to directly track or mirror an index and instead seeks to outperform a particular index. However, an active manager might use an index as a starting point for investing possibilities. Depending on specific guidelines, active managers can maintain holdings within a certain range of index weightings or invest beyond the instruments or issuers included in the index. These practices are often known as "underweighting," "overweighting," and "going out of benchmark." Larger deviations from the index attempt to generate outperformance compared to the index.

The more latitude the guidelines permit, the more likely portfolio returns will diverge from the returns of the index. The less latitude the guidelines permit, the more likely portfolio returns will be similar to returns of the index. In both cases, the management would be considered "active," but the index can impact how a portfolio is managed. Referencing an index in guidelines gives a client or investor comfort that the asset manager will maintain a strategy that focuses on a particular aspect of the market. For example, a strategy using a fixed-income index as a reference point gives clients and investors comfort that the manager is investing primarily in a fixed-income strategy.

The practice of actively managing holdings and making decisions on investment opportunities is a key contrast from passively tracking an index.

An active manager might also offer a strategy that does not utilize an index at all. Unconstrained or total return strategies have no constraints that require the manager to make investments based on index composition or weightings. There may be other limits or requirements, but managers have a wider range of investment opportunities without an index constraint.

How Do Clients and Investors Use Indices?

Investors cannot invest directly in an index. Rather, they examine historical performance and attempt to understand market trends. Indices provide a historical benchmark for expected risk profiles and returns, helping investors make informed choices.

Even if an index plays no role in making day-to-day investment decisions, managers and clients sometimes use a relevant and comparable index to judge the performance of the manager. For example, a client and investor might agree that the performance objective for that client is to produce returns above a selected index. The index may not drive portfolio construction, but both parties can agree to judge the active manager's performance by comparing results to an index that represents a relevant part of the market.

When marketing their services, asset managers often show their own historical track record and include relevant indices as comparison points.

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