INTERVIEW

The role of indices in today's capital markets

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Interviewed by

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Jamie: Arne, thank you very much for coming back and chatting with us again. It's always great to see you.

Arne: Thanks for having me again, Jamie.

Jamie: Now Arne, last time we were talking about the role of indices in markets and how important they are. I want to get a bit of an update from you about how you feel even today, the role of indices in markets. Back then, ESG was such an important topic. The pandemic changed so much including a lot of people's views on ESG, but it drew a lot of capital into that sector and here we are in 2023. I wondered if you could give us a bit of update about how you see indices in the world today and the role they play.

Arne: Great question. There's really two questions there. So I'll start with the big one. Role of indices in capital markets has only increased. The size of passive asset keeps increasing. That's both true in the equity market where there was always a huge trend towards index-tracked investing, so passive investing. But what has happened over the past year specifically as well is that fixed income has come back in a big way. Inflation up, interest rates up, central bank policy changing. Fixed income assets really interesting again. That's the next big wave of passive investing, so large part in equities already, then fixed income growing. We'll see a lot of growth.

Jamie: And you're seeing that demand from clients in terms of new indices or product innovation?

Arne: Absolutely. There's always demand for product innovation, but fixed income quite frankly got overlooked for quite a long time. If you get half a percent interest on a simple index, that's not interesting, if the equity market is delivering 10% per year, which is what some of the indices did before the monetary policy started changing again. So the role of indices, undiminished, only growing in the importance in capital markets.

Then on the ESG topic, that has changed a lot. ESG has always been immature in that the demand from different investors within a region, but especially between regions was quite different.

Different considerations for climate versus governance issues, for example, and that has accelerated. That's increasingly true. That combined with a more focused regulatory efforts to understand what ESG is, what it could be, what it should be, how you need to regulate it. There's a lot of questions about what data sources are being used. Is it clear enough? Is it transparent enough? Is your investment objective clear? Do we actually have the data? Are companies actually disclosing the data that's needed to make assessments in the same way? So that is changing. Doesn't mean less demand, just means that it's maturing, but we are at that inflection point where there's no clear this is the way forward yet.

Jamie: When we spoke last time, specifically on the topic of ESG, I know FTSE and other indices companies were trying to come up with formal benchmarks to get certain requirements, which companies would be allowed into these and which wouldn't? Has the disclosure got significantly better from corporates to allow you to make easier decisions? That's part one of the question.

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Part two of the questions is, do you actually work with countries and governments to talk with them about what kind of factors need to be considered?

Arne: Disclosure is getting better, but what is missing is clear frameworks, standards, regulations that really drive an even playing field of disclosure. Disclosure is getting better all the time, but it's a stop-start and it's very much individual companies also getting up to speed and understanding this is important and wanting to be part of that. It is not, for example, accounting data, which is used in quant investing very heavily, has involved in factor investing or factor indices where everybody is basically using the same accounting standards. That doesn't exist yet there. Which points to the second part of your question, do we engage with countries? Do we engage with regulators? Do we engage with rulemaking stakeholders? Absolutely, very actively so. We engage with the UK regulators, with the American regulators, with Asian regulators. We engage with standard setters organisations that might be formed, for example, by asset owners to drive standards. So heavily involved in that, yes. We continuously provide feedback, but also are the voice of our clients in this is how it really should work from an index perspective.

Jamie: You mentioned passive versus active investing just now and there was a huge rise in inflows into passive investing from 2010 to just before the pandemic. As you said, it looks to continue what it seems to me that a lot of it was driven by just very low rates, huge amounts of liquidity, bringing correlations close to one that obviously you wouldn't want to pay active manager fees when you could get great returns in terms of passive investing. As we look out, there are a number of macro headwinds that we face, where's inflation going to be, tensions with China, the labour market, possible recession. Do you feel that there may be a flip back slightly towards active investing or do you still feel like passive investing will continue to grow?

Arne: I love that question and full disclaimer, I invest in active funds myself.

Jamie: Oh, you do? Okay.

Arne: But the evidence, the empirical evidence history shows that active managers, on average, do not outperform. Every time there's change in the market and there's volatility in the markets, it gets used as a, this time is going to be different. There's change. You need an active view. You need to be very conscious about how you pick your stocks, how you position across asset classes. So far, the evidence suggests that that's not true. On average, almost by definition because most indices are the markets, so to do better than the markets, somebody else has to do less well than the market so it all evens out over time. But I do invest in some active managers, for example, because they have a impact investing mandate. They very consciously invest in climate technology, for example.

Jamie: In terms of product innovation, which happens at FTSE Russell, let's say you had a client who came to you and said they wanted to create an index, which is really focused on AI or on big tech.

How would the conversations go with you internally about how to create a product like that?

Arne: The product innovation process generally is one of either we see a strategic gap and we try to fill it and we'll engage with the market and all that.

Jamie: So that wouldn't come from a client?

Arne: Exactly.

Jamie: Okay.

Arne: Yes, but we might get interest just by going out there and having the discussions and that way, you might get that dialogue going. But the other route is there's a client that has a very specific demand, a specific idea. In the ESG space, it tends to be exclusion industries, for example. Different people have very different views on what companies you should not include in the ESG index. So questions about this is, is nuclear energy green or is it not green? Those types of questions, you could validly argue both ways and different people will take different views. So there, we will just work with them to capture their requirement, but also advise on what works, what doesn't work. It's very easy to come up with indices that don't quite work because there's no liquidity in them or the turnover is strange.

Jamie: Speaking about liquidity and apologies, I was an equity guy when I was a fund manager myself, but I could understand how these big equity indices are very, very liquid. The shares are trading in the millions every day. But when it comes to some of these fixed income products, quite often, they're over the counter. They may trade by appointment. How do you find out what the real price is? How does price discovery work?

Arne: That question of liquidity essentially is a really good one. You can index less liquid asset classes, but you will run into the issue of the price you capture is the price that people see, but might not be the price they can actually trade on on any given moment. So that's just inherent to the asset class. So is the price the price essentially? Sometimes no, but that goes with the asset class and whether you're active or passive or indexed or not indexed. That's just the case. If you have a particular bond that trades once every two years, you're going to find out what the price is once every two years.

Jamie: Right. Actually, that's how indices is helping the credit market by it's actually creating price discovery where previously, there hadn't been that price discovery.

Arne: Fixed income is very complex and nuanced. There are all kinds of different pockets of it that work different than other parts of it, but the evidence certainly suggests that the liquidity in fixed income ETFs drives price discovery in the underlying bonds as well because it drives a lot of flow in those bonds and that just gives better transparency, better visibility.

Jamie: I wanted to ask you about developed markets versus emerging markets. The US has been such an incredible performer. I'm thinking about stocks now. I'm sure there's a lot of fund managers out there looking for where opportunities may lie. Are you seeing an increase in interest in emerging market indices?

Arne: Emerging market indices, not so much. I think that goals with emerging market indices are inherently riskier than developed market indices, certainly in equities, and we are in quite uncertain times. So I think investors really look for that, that there's clear evidence that something is happening that will support the emerging markets. As far as I can tell, we're not there yet. There's always interested in pockets, there's a certain constituent that looks for China access, for example, or other Asian countries are sometimes very popular. It happens based on specific views, but a whole, now is the time to get into emerging markets and we see that in demand.

Jamie: Yes.

Arne: We don't have that yet.

Jamie: Arne, either a professional or a personal question. You can answer either way. Is AI something you're excited about or is it something you're nervous about?

Arne: First and foremost, excited. I think there's a lot of potential that comes with it. There's a lot of potential to make a lot of things easier, more productive, more efficient, data interrogation, conversations about everyday topics that are very well understood. Learning, I think there's a huge potential for having kids, children engaged in different ways to gradually build up their knowledge in a way that you probably can train an AI to help you with. A little bit nervous as well in the sense that jobs will change and who knows how much they will change. That's unclear yet, but I'm not at all concerned about the scenario of a rogue AI that will take offense to the human race.

Jamie: We're not being taken over by the machines yet!

Arne: No.

Jamie: Final question then, Arne. As you look out, there are a lot of macro headwinds, a lot of reasons to be cautious, but are you personally relatively bullish on markets or do you think now's the time to be cautiously more cautious?

Arne: I think there's a lot of uncertainty, but there's also very interesting things happening. Money market funds, so pretty close to entirely safe cash-like investments. Some risk in there, but it's negligible really. They're paying four and a half, 5%. We haven't seen that in a very, very long time. So if you think that the traditional equity premium is probably not that much more than four and a half percent, five and a half percent, somewhere in that range, you can get that from entirely safe investments now. I think what is a bit of a shock is that we're used to equity markets doing double digits for a decade in a row and yes, that probably was never going to continue anyway.

Jamie: Yeah. Arne, it is always so great chatting with you. Thank you for stopping by and as ever, thanks so much.

Arne: Thank you, Jamie. Very much enjoyed it.

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