PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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INDICES AND BENCHMARKS

MADE SIMPLE GUIDE

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INTRODUCTION

THE TERMS “INDEX” AND “BENCHMARK” ARE OFTEN USED SYNONYMOUSLY, WHICH CAN UNDERSTANDABLY CONFUSE INVESTORS.

In simple terms, an index is a hypothetical portfolio of securities designed to represent an asset class, market, or market segment, while a benchmark (often an index) is a standard point of reference against which the performance of an investment can be measured.

Institutional asset owners such as pension plans often use indices beyond such simple benchmarking—this guide explains the various purposes indices can serve and shares some of the important attributes one should consider when selecting an index.

2
INDICES AS BENCHMARKS: WHY INDEX SELECTION MATTERS

INDICES CONSTRUCTED TO MEASURE THE CHARACTERISTICS AND PERFORMANCE OF SPECIFIC MARKETS OR ASSET CLASSES ARE TYPICALLY MARKET CAPITALISATION WEIGHTED.

This means their constituents are weighted according to the total market cap or market value of their available outstanding shares. Indices play an important role in the design, implementation and evaluation of an institutional investment portfolio. Using a defined benefit pension plan as an example, Table 1 illustrates how the use of indices expands beyond reporting on investment performance.

TABLE 1. HOW AN INSTITUTIONAL INVESTOR SUCH AS A DEFINED BENEFIT PENSION PLAN MAY USE INDICES

STEP	EXAMPLE(S)	HOW INDICES ARE USED
Set investment objectives	Maximise surplus or adequately fund liabilities	Indices help the plan, its trustees, and consultant(s) set objectives and make asset allocation decisions. Indices provide a framework for portfolio construction
Determine asset allocation weightings	Usually divided between asset classes such as public equity, fixed income, real estate, and private equity to ensure diversification	
Determine strategic allocation to sub-asset categories	Divide public equities allocation into the separate categories of international equity and domestic equity	
Define ranges, or buffers, around target allocations to allow for tactical investment decisions to be made as market conditions change	Allocation to international equities is set at 10% with buffers +/- 2% to allow for tactical investment decisions	
Communicate investment goals to investment manager(s)	Goals and objectives are communicated to the investment manager chosen for the international equities allocation	Indices are often used to establish the universe of securities from which the manager will likely invest
Determine whether the plan objectives are being met and how (or why not)	Analyse the different components of the investment portfolio to attribute performance to manager success, market growth, strategic positioning or other sources	Indices are used to measure the performance of the entire investment portfolio relative to that of the established asset allocation targets (sometimes referred to as the "policy benchmark"). Indices therefore allow for performance attribution

Given the integral roles played by indices throughout the entire investment process, it is imperative that those with fiduciary responsibility grasp how index selection can impact a plan's ability to meet its objectives. Table 2 lists some of the most crucial attributes a benchmark index should possess and the rationale as to why these qualities are important.

TABLE 2. CONSIDERATIONS FOR SELECTING A BENCHMARK INDEX

ATTRIBUTE	RATIONALE
Comprehensive representation of the intended market or market segment	When utilising indices as tools to help define the mix of asset classes appropriate for a plan or investment portfolio, it is important that each index delivers an accurate representation of its intended market segment. Omitting eligible securities from an index can lead to errors in the asset allocation structure of the total portfolio. It is also important when benchmarking an actively managed investment. Comprehensive coverage of the entire investible opportunity set provides an appropriate basis from which to accurately distinguish alpha (manager skill) from beta. In other words, measuring the success of an actively managed investment using an index that fails to offer complete coverage of the assigned asset class can result in an inaccurate evaluation of manager performance.
Transparent and objective index construction	A transparent, objective approach to index constituent selection provides a more accurate, unbiased representation of the market it is designed to measure rather than a subjective, committee-based method. Objective rules allow users to understand and potentially anticipate why and when changes are made to the index. A subjective, committee-driven method of selecting index members can result in delayed inclusion of newly available securities, which can impact an index's representativeness. If the index is not truly representative, its ability to help define appropriate asset allocation is undermined, as is its effectiveness in providing a means of gauging investment performance as compared to that of the overall market or market segment.
Regularly rebalanced and maintained	Regularly scheduled rebalances and clearly stated maintenance rules to adjust for more frequent changes such as those due to corporate actions like spin-offs and IPOs ensure that indices are always aligned with market conditions. This allows for accurate and up-to-date measurements of markets and market segments.
Modular structure with no gaps or overlaps	Index families designed to represent broad markets as well as more granular market segments should be modular in design. Modular indices can be used as building blocks, offering a precise picture of the market and its segments. This enables accurate asset allocation without unintended over/under-allocations to small, mid or large capitalisation asset classes. A pension plan allocating specific portions of their investment portfolio to large and small capitalisation, for example, should be able to rely on indices to clearly differentiate between these market segments with no gaps or overlaps. If the market cap coverage ranges of the large and small cap indices overlap significantly, the investor could experience unintended overexposure to the midcap market segment, undermining their intended allocations to large and small cap.

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INDICES AS THE BASIS FOR INVESTMENT VEHICLES

BECAUSE AN INDEX IS A HYPOTHETICAL BASKET OF STOCKS, IT CANNOT BE INVESTED IN DIRECTLY. HOWEVER, INDICES ARE OFTEN LICENSED BY FUND MANAGERS TO BE USED AS THE BASIS FOR PASSIVELY INVESTED PRODUCTS THAT TRACK AN INDEX SUCH AS MUTUAL FUNDS, ETFS, SEPARATELY MANAGED ACCOUNTS, SWAPS AND STRUCTURED PRODUCTS.

While many investors prefer actively managed investments, which rely on a manager's stock selection skill, others turn to investing in these passively managed investment products. Rather than making active investment decisions, the passively managed index product designed to track an index is usually comprised of the same securities and at the same weights as the index on which it is based. Passively managed investments that track equity indices are typically less costly than their actively-managed counterparts since they simply track an index, rather than requiring a manager to make investment decisions based on their own opinions and analysis.

For example, an investor may feel strongly that large cap stocks in the US are going to outperform small cap over the long term, so they would like exposure to the entire large cap market segment. Rather than purchasing each US large cap stock individually, the investor may adopt a passive investment strategy by choosing a product that tracks an index designed to represent the entire large cap segment of the US market.

When evaluating an index to be used as the basis of an investment product, market participants may want to consider index design features that make the index easy for the fund manager to replicate and its constituents easy to trade. In addition, they need to determine whether the index captures a comprehensive representation of the market or market segment. Table 3 provides a list of attributes to consider when evaluating an index to be used as the basis of an index-linked investment product.

TABLE 3. CONSIDERATIONS FOR CHOOSING AN INDEX AS THE BASIS OF A PASSIVELY INVESTED INVESTMENT PRODUCT

ATTRIBUTE	RATIONALE
Representative	Since the goal of the investment vehicle is to target a particular market or market segment, the chosen index should be as representative of this market segment as possible.
Cost	Transaction costs are incurred by passively managed investments when changes to the underlying index constituents and weights are made. It is important that the index balances its goal of being representative with the need to keep turnover costs manageable.
Objective and transparent	Because the investment vehicle is replicating the index, it is important that the rules that govern the index design and calculation are published openly and transparently. The fund manager should be able to understand and anticipate changes to the index. If not, replicating the index can be difficult and unintended tracking error may occur.
Investable	The index should limit its holdings to those readily available to the investor. For example, index weights should be calculated using float-adjusted market cap, meaning the index should only include the shares that are freely available for purchase by the average investor rather than those held by employees or other investors who are restricted from selling their shares. If shares not available to public investors are included in the index, replicating the index can be difficult, and the demand for shares from investment funds replicating the index can actually cause unnatural stock price spikes.

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SMART BETA INDICES. WHAT ARE THEY, AND WHAT PURPOSE DO THEY SERVE?

A NEWER BREED OF INDICES OFTEN REFERRED TO AS “SMART BETA” HAS BECOME INCREASINGLY POPULAR IN RECENT YEARS, WITH 58% OF ASSET OWNERS SURVEYED IN FTSE RUSSELL’S 2019 SMART BETA SURVEY STATING THAT THEY HAVE AN ALLOCATION TO SMART BETA STRATEGIES.

These indices aim to reflect a variety of exposures that are academically recognised drivers of risk reduction and return enhancement, providing users with more control as they construct their portfolios to help achieve specific investment objectives. Smart beta indices can be divided broadly into two categories: Alternatively-weighted and Factor. However, all smart beta indices are constructed using a rules-based approach.

ALTERNATIVELY-WEIGHTED

Alternatively-weighted indices fall into two broad categories: risk-based approaches and fundamentally-weighted. Risk-based approaches seek to reduce overall portfolio risk via a reduction in overall portfolio volatility or via a reduction in index concentration through increased levels of diversification. Equally weighted indices, for example, assign constituent weights according to equal market capitalisation; each company in the index is given an equal weight at each scheduled rebalance. This increases the overall level of diversification in the index and the implied risk. A minimum variance index seeks to reduce overall index volatility. The volatility reduction stems from the correlations between individual stocks volatilities.

Thus, a minimum variance portfolio could well contain a number of very volatile stocks that offset each other. Fundamentally-weighted indices are designed to weight constituents using a composite of fundamental measures, such as total cash dividends, free cash flow, total sales and book equity value. In essence, they weight the constituents of the index according the financial health of each of the companies within the index.

Alternatively-weighted indices are typically less prone to excessive concentration that arise from market fads, which can result in over-exposure to individual companies, sectors or countries. They can also alter the parent index’s exposure to factors such as value or momentum. Another type of alternatively-weighted index aims to reduce index volatility while maintaining a full allocation to the relative equity market

FACTOR

Academic research has long maintained that stock performance can largely be explained by several common characteristics such as size, value, price momentum, quality, and volatility. Factor indices are designed to capture these characteristics and are intended to offer more focused exposures to factors than their market cap weighted counterparts in a controlled and transparent way. Single factor indices and factor combination indices, which can be tailored depending on the desired exposure(s), are common tools for market participants. In evaluating the appropriateness of any of these indices, users should take a holistic approach and explore, for example, how well the index design suits their objectives, risk constraints, and beliefs as well as how well it fits with the allocations designated across the rest of the portfolio.

ALTERNATIVELY-WEIGHTED INDICES ARE TYPICALLY LESS PRONE TO EXCESSIVE CONCENTRATION THAT ARISE FROM MARKET FADS, WHICH CAN RESULT IN OVER-EXPOSURE TO INDIVIDUAL COMPANIES, SECTORS OR COUNTRIES

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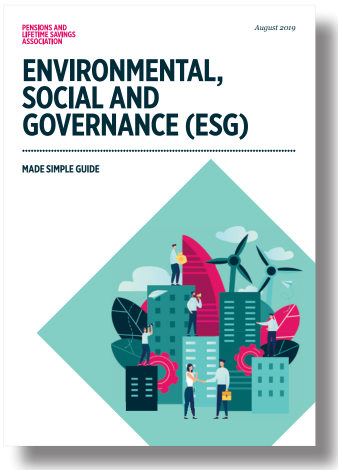
THE ROLE OF INDICES IN SUSTAINABLE INVESTMENT

SUSTAINABLE INVESTMENT HAS EVOLVED INTO AN ESTABLISHED APPROACH TO INVESTING THAT CAN CATER FOR A WIDE RANGE OF INVESTOR NEEDS AND OBJECTIVES. THERE ARE MANY REASONS BEHIND THIS, BUT TWO STAND OUT.

1. Firstly, there is growing recognition amongst investors of the relevance and potential materiality of environmental, social, and corporate governance (ESG) issues when it comes to investment risk and performance.
2. Secondly, fiduciaries of large pools of capital – including endowments, insurance companies, pension schemes, and sovereign wealth funds – are under increased scrutiny by plan members or other stakeholders who want to see sustainability issues taken into consideration.

INDICES CAN SERVE AS A HELPFUL STARTING POINT FOR ASSET OWNERS LOOKING TO APPLY SUSTAINABLE INVESTMENT PRINCIPLES TO THEIR INVESTMENT PORTFOLIOS

There has been a growth of interest in sustainable investment in recent years and many institutional asset owners are considering how to appropriately capture ESG issues within their investment processes. This can be made more challenging given the diversity of terminology and range of implementation approaches, including screening, integration, and engagement. The PLSA's June 2019 publication *ESG & Stewardship: a Practical Guide to Trustee Duties*, provides practical, step-by-step guidance to help trustees meaningfully consider, design and implement ESG and stewardship approaches.



Indices can serve as a helpful starting point for asset owners looking to apply sustainable investment principles to their investment portfolios. ESG indices can be used to define and benchmark different forms of sustainable investing, helping to navigate the often complex nature of evaluating the sustainability of an investment, as well as providing a means of measuring outcomes. In some cases, ESG indices are used to define the investment universe from which asset managers can select securities, by including only those that meet specified criteria. Alternatively, ESG indices can serve as the basis for passively-managed investment strategies, offering a cost-effective, rules-based approach to allocating funds to assets that meet a specific definition of sustainability.

Typically, an ESG index begins with a traditional, market cap-weighted index at its foundation. Sustainability and/or ESG criteria is then applied to the parent index to screen securities for index eligibility. The underlying data used to conduct the analysis can be defined using an index provider-designed, off-the-shelf approach to scoring and ranking securities according to their sustainability or ESG footprint, which can help to simplify the decision-making process for the investor. Conversely, the ESG data can be applied to an index in a highly customised way to match the values and objectives of even the most sophisticated investor.

6 CONCLUSION

ONE OF THE MOST IMPORTANT DECISIONS THAT INSTITUTIONAL INVESTORS FACE TODAY IS ASSESSING THE COST/BENEFIT TRADE-OFF OF ACTIVELY MANAGED OR INDEX-LINKED AND PASSIVELY MANAGED FORMS OF INVESTING. ALSO, WITH THE RECENT EMERGENCE OF EXTENSIVE CHOICES IN SMART BETA INDICES, MARKET PARTICIPANTS NOW HAVE ACCESS TO A SERIES OF FAR MORE COMPLEX AND SOPHISTICATED TOOLS DESIGNED FOR A MULTITUDE OF PURPOSES AND OUTCOMES.

As index solutions continue to expand and evolve, you can rely on your index provider to offer the tools you might need to achieve your investment goals. Index providers should be expected to ensure that users are well informed, providing them with tools and information as they consider their opportunities across markets, asset classes, styles or strategies.

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