Leveling the Playing Field With Index-Linked Investing

INTRODUCTION

Indices generally serve as transparent measures of market composition and trends, making them essential to building investment confidence. In some cases, such as when tradable instruments are available and/or robust structural and regulatory frameworks are in place, indices can make substantial contributions to democratizing market access. Emerging markets are a good example of this dynamic. Benchmark indices defined the emerging market asset class for the global investing community, and now form the basis of many index mutual funds and exchange traded funds (ETFs).

Index-linked products have been a means for smaller investors to gain exposure to markets that might otherwise not be accessible to them. Investment products that use indices for passive investment selection generally have lower expenses than actively managed investment alternatives, and the existence of lower-cost index-linked funds appears to have helped drive down management expenses for actively managed mutual funds.

THE BENCHMARK FUNCTION

Market-based indices level the playing field for the public by supporting the development of investment products that broaden the capital base of markets, serving the needs of investors large and small. Indices also enhance market transparency by defining market composition, return and risk, according to clear and independently governed methodologies. In turn, this enables investors to assess market characteristics, as well as value delivered by investment managers. The appropriate frame of reference (the opportunity set of markets themselves) becomes observable to all stakeholders because of publicly available, market-based indices.

Inspiring Confidence in Capital Markets

At the turn of the twentieth century, a new measure had recently come into existence that enabled investors to gauge the overall performance of the U.S. stock market: the Dow Jones Industrial Average®. Prior to this development, investors holding individual securities had no systematic method of evaluating their holdings in the light of overall stock market performance.

Now in the second decade of the twenty first century, indices are more than a method of measuring market return. They are also the basis of rich fundamental data sets that allow practitioners to assess underlying fundamental variables. Exhibit 1 shows a sample of such data—specifically, U.S stock market inflation-adjusted earnings and dividends since 1871.
Exhibit 1: Indices Track Important Fundamental Data as Well as Price Trends: Inflation-Adjusted Earnings and Dividends of the S&P 500® and Predecessor Indices

Source: Robert Shiller. Dividends and earnings since 1926 from S&P Dow Jones Indices LLC, and prior to 1926 from Alfred Cowles. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

THE INVESTMENT FUNCTION

In situations where underlying markets are publicly traded and investors have confidence in related institutions such as regulatory bodies and clearing houses, indices can be a powerful force in democratizing access to market returns.

Generally speaking, indexing, or passive investing, offers market returns (and risk) at a lower cost than actively managed funds. Benjamin Graham, the distinguished founder of modern security analysis, makes a strong case for indexing in the following excerpt¹ from a 1976 interview published in Financial Analysts Journal:

FAJ: Can the average manager of institutional funds obtain better results than the Dow Jones Industrial Average or the Standard & Poor’s Index over the years?

BG: No. In effect, that would mean that the stock market experts as a whole could beat themselves—a logical contradiction.

FAJ: Do you think, therefore, that the average institutional client should be content with the DJIA results or the equivalent?

BG: Yes. Not only that, but I think they should require such results over, say, a moving five-year average period as a condition for paying the standard management fees to advisors and the like.

Were he with us today, Ben Graham would probably be pleased to find that U.S. investors have, within easy reach, access to index-linked funds that give them the market return. The option, provided by index-linked investments, to avoid active investment risk can be a powerful enabler of long-term wealth creation.

CASE STUDIES

The U.S.

Since 1976, when Vanguard launched the first index-linked mutual fund to offer the total return of the S&P 500, indexing has given countless investors the ability to access the U.S. stock market return. According to data published by the Investment Company Institute (ICI), this trend has accelerated in recent years.

Exhibit 2: Index-Linked Equity Mutual Funds’ Market Share Continues to Rise

Percentage of Equity Mutual Funds’ Total Net Assets, 2000–2013


The first ETF was launched by State Street Global Advisors in 1993, also tracking the S&P 500. Since then, the ETF market has grown handsomely, and when these funds are taken into account the trend toward indexing is even more pronounced.

Exhibit 3: Some of the Outflows Since 2007 From Actively Managed Mutual Funds Have Gone to Index Mutual Funds and ETFs

As indexing has grown in prominence, it has helped reduce investment management fees for all investors, even if they pursue active strategies.

**Exhibit 4: Competition From Index Funds Has Reduced Expenses Across the Entire U.S. Investment Management Industry**

![Basis Points Graph]


**Emerging Markets**

The term “emerging markets” was coined in the 1980s by the International Finance Corporation (IFC), the private arm of the World Bank, creating the initial foundation for a new asset class within global equities. Entrusted with building up private investments in emerging markets, the IFC realized in the early 1990s that a critical component of building capital markets in the developing world was driving global fund flows to emerging markets. While equity market investing was robust in the developed markets and adoption of index-linked funds had already begun, large-scale emerging market equity investments remained outside the purview of global asset owners and investors.

To encourage capital market building, the IFC launched the IFC Emerging Market Indices\(^2\) in 1993. Stock markets existed in these countries and some even had their own local indices. Yet the presence of a globally consistent, transparent and well-defined emerging market benchmark drew global investors’ attention to the potential of these markets. Over the next 10 years, an allocation to emerging market equities became the norm among institutional investors. Allocations grew so much that global benchmarks, which had only included developed markets until then, expanded to include an emerging markets subset. As the designers and calculators of global equity indices, index providers naturally assumed the critical role of classifying countries into developed and emerging markets, providing a standardized framework for differentiating asset classes within global equities.

Once emerging markets became part of standard global equity benchmarks, global fund flows to these markets increased to hundreds of billions of dollars. Emerging market ETFs, mutual funds and other products now proliferate across the board, providing low-cost access to an asset class that had previously been costly and difficult to access. In the last few years, emerging markets have received 10-15% of all global fund flows.

\(^2\) Now called the S&P/IFCI indices.
The development of ETFs and index-linked funds in the late 1990s and early 2000s opened up emerging markets investing to the masses. As of 2001, there was just USD 1.5 billion invested in index-linked emerging market funds. By June 30, 2014, this had grown to approximately USD 330 billion.

Exhibit 5: Growth of Index-Linked Emerging Market Funds

Indexing emerging markets and creating products linked to these indices did more than encourage global investments. Once the benefits of fund flows became visible, it pushed the emerging markets—striving to become developed markets—to improve accessibility, transparency, securities regulations and other trading practices as scrutiny from global investors increased.

Frontier Markets: The Next Emerging Markets?

The IFC was, likewise, at the forefront of defining frontier markets for the investment community. Frontier markets are smaller, less liquid emerging markets that are not yet considered large enough or liquid enough to be included in emerging market benchmarks. Yet these markets have viable growing stock markets and listed equities, as well as the potential to grow into robust emerging markets over time. In 1996, the IFC—recognizing the need for an additional tier of smaller, less liquid markets—introduced the IFC Frontier Indices, cementing the term “frontier markets” in the financial lexicon and creating an additional, distinct equity investment category. In the past few years, frontier market ETFs and other frontier market index-linked products have increased in popularity as investors have expanded their focus to include the next growth markets. As had occurred with emerging markets several years prior, frontier market equities—once esoteric and highly challenging to access—are now readily accessible to all investor segments through low-cost index-linked funds. As of June 30, 2014, AUM in broad frontier market index-linked products was approximately USD 1 billion, up from less than USD 50 million in 2010.

REITs

Over the past two decades, real estate investment trusts (REITs) have emerged as a popular and efficient way for investors of all stripes to access the real estate asset class. REIT indices, likewise, paved the way for the creation of a wide array of index-linked financial products that have served as a major growth catalyst for the asset class by providing both retail and institutional investors cost-efficient access to diversified baskets of REITs.

The legal structure for REITs was initially created in the U.S. through the Real Estate Investment Trust Act of 1960. These investment vehicles were designed to provide a structure for real estate similar to the structure that
mutual funds provided for investment in stocks. To qualify as a REIT, a company must have most of its assets and income tied to real estate investments, and it must pay out nearly all income to shareholders via dividends. In return, REITs are largely exempt from income taxes, making them extremely attractive vehicles for financing real estate investments.

Although the first REITs were established in the early 1960s, it was not until the early 1990s that the structure became widely accepted as a viable asset class, due to some key regulatory changes in the 1980s and a uniquely attractive market environment following the real estate bust of the late 1980s. The Tax Reform Act of 1986 was a key turning point in the development of REITs as it relaxed some key restrictions on REIT activities and ended a key tax shelter for real estate companies structured as limited partnerships. As the real estate sector bottomed in 1990, REITs were able to acquire properties at very low prices, serving to buoy subsequent performance. Between 1991 and 1993, the S&P United States REIT Index generated an average annual return of approximately 20%. As demand for their shares began to rise, many REITs transformed themselves from private entities to public companies in order to take advantage of attractive valuations. In fact, some of the largest REITs went public during this time (e.g., Duke Realty, Kimco Property and Simon Property Group).


By 1994, the estimated market capitalization of the U.S. REIT market had reached approximately USD 44 billion, almost six times its size in 1990. REITs have evolved into a mature asset class, with nearly USD 700 billion in total market capitalization (see Exhibit 6).

The introduction of ETFs and index-linked funds during the past fifteen years has served as a major growth engine for the REIT industry as these investment products serve as a cost-efficient means of gaining broad market access to U.S. REITs. AUM in index-linked funds tracking U.S. REIT indices has increased from approximately USD 1 billion in 2001 to more than USD 60 billion as of June 30, 2014. This represents about 10% of the available market capitalization of the U.S. REIT industry. However, it is important to note that this is an extremely conservative estimate of the impact that passive funds have on the U.S. REIT industry since it excludes global REIT products, which typically would have more than half of their assets invested in the U.S.; separately managed accounts; internally managed assets, which are not publicly reported; and financial sector and broad market funds, which may also include REITs.

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3 The S&P United States REIT was launched on Dec. 31, 1992. All information presented prior to the launch date is back-tested. Back-tested performance is not actual performance, but is hypothetical. The back-test calculations are based on the same methodology that was in effect on the launch date. Complete index methodology details are available at www.spdji.com.
Master Limited Partnerships

Much like REITs, master limited partnerships (MLPs) also experienced a democratization of access and increased penetration by retail investors as a result of the creation of structure.

An MLP is a pass-through tax entity (either a limited partnership or an LLC) that is publicly traded on any of the major exchanges. Unlike REITs, which are required to distribute 90% of their income, MLPs have no such minimum requirement. They are required to distribute all of their available cash but the determination of available cash is made by the general partner after taking care of necessary expenditures, including debt payments and setting aside reserves. In addition, the income that the entity generates has to come from “qualified” sources—generally from the oil and gas production, storage and transportation businesses. Most of the MLPs in existence today (80%) operate in this area and 51% of them are in the energy infrastructure area.

The ability to pass through taxes to “unit holders” allows companies to lower their cost of capital and invest. As such, there has been an increase in the market capitalization of MLPs to about USD 445 billion now from when the first MLP was IPO’d in 1981 (Apache). Similar to REITs, it took a little time for the structure to get accepted but the last decade has seen some impressive growth; there are about 130 MLPs trading at this moment. The investor base for MLPs is largely retail as institutional (tax-advantaged) investors are typically subject to some other tax considerations.

As the number and the complexity of MLP structures have increased, there has been an increased need among retail investors, the primary investors, for a diversified mechanism to access the asset class. Indices, by definition, play a key role here. In addition, the creation of exchange traded notes (ETNs) based on these indices has eliminated the need for investors to deal with various documentary requirements related to investing in individual MLPs (K-1s).

Indices tracking MLPs (mainly energy MLPs) came to the market around 2006 when the number and size of MLPs had become large enough. Products linked to MLP indices started to appear in 2009. Since June 2009, when index-linked products tracked USD 175 million, assets have grown to USD 21.7 billion as of June 2014, representing almost a 12-fold increase over 5 years. Over the same period, the overall market of investment products grew from USD 3.6 billion to USD 83.2 billion. It’s arguable that over this period of time, low interest
rates led investors into asset classes like MLPs, and that may very well be the case. However, the increase in the size of both index-linked products and the overall market indicates that indices have added transparency to MLP investing and provided an additional way to access them. Non-index-linked products have also benefited from indices, which have provided a reference gauge for investors to measure them against.

Exhibit 8: Growth of the MLP Market (2009 – 2014)

Source: Morningstar Direct. Data as of June 30, 2014. Charts and tables are provided for illustrative purposes.

CONCLUSION

While the presence of market-based indices is not a prerequisite for market development, indices can help build confidence in markets by transparently tracking them. They also help democratize market access by forming the basis of index funds and, through these investment products, lowering costs by competing with actively managed funds. We have illustrated this dynamic across a wide variety of asset classes from U.S. and emerging market equities, to real estate investment trusts and MLPs. Through the creation of emerging market equity indices, index providers defined a new asset class, and the development of related index-linked funds and ETFs greatly lowered the cost of investing in these previously inaccessible, high-cost markets. The creation of the REIT structure was fundamental in providing smaller investors a means of accessing commercial real estate in the U.S. However, REIT indices served an important role as a catalyst for growth by serving as standardized benchmarks to measure and define the asset class. They also formed the basis of low-cost index-linked products that have driven growth in the market over the past decade. Finally, MLPs serve as a more recent example of indices’ capacity to democratize an asset class. Thanks to indexing, a broad swath of investors can enjoy the benefits of a diversified basket of MLPs without the hassle of its accompanying tax structure and without the difficulty of understanding the merits of any single MLP.
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