

## The PODfolio Podcast - Season 2, Episode 4: Index Tracking Does Not Equal Passive

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ARUN SINGHAL: And as an index provider we're able to take that data and really identify which company will benefit from the transition and which companies will be negatively impacted.

SPEAKER 2: Welcome to The PODfolio, WTW's investment podcast series aimed at institutional investors industry professionals and enthusiasts alike

LOK MA: Hello, and thanks for joining us for episode four season two of The PODfolio podcast with me, your host Lok Ma. Now, index-tracking funds of various flavors together, I think, hold just under half of all of the assets in the stock market. So we're here today, to talk about how these funds have come about, the different sorts of index-based investing, and also look at some cool new trends and new thinking that's emerging in this area.

And with me, are two expert guests. First is, Sarah Hopkins, our head of Equity solutions at WTW. So welcome to the show, Sarah.

SARAH HOPKINS: Thanks, very much Lok, it's great to be here.

LOK MA: And we also welcome Arun Singhal, who is Global Head of index-product management at Qontigo. Welcome, Arun.

ARUN SINGHAL: Thank you, Lok.

LOK MA: And just to set the scene first, I want to quickly introduce to our listeners Qontigo and also their indexation business STOXX. So that's Qontigo with a Q and STOXX with two x's so very, very high scoring in a game of corporate name Scrabble, I think. Arun, can you just give us a quick summary of Qontigo and STOXX?

ARUN SINGHAL: Exactly, STOXX is an index provider, global index provider. Been around for decades. The Qontigo brand was developed at the end of 2019, to bring STOXX, Dax, and Axioma together. Axioma is the entity that specializes in portfolio construction with industry-leading portfolio optimization and risk modeling bringing that along with the STOXX and Dax, industry leading index brands.

LOK MA: Brilliant, so let's start at the beginning. Index investing has been around for over 50 years, I think. So how did this idea come about, Arun, and how did it develop?

ARUN SINGHAL: Yeah, it's a great question. I don't want to belabor the history here, but we really need to start with mutual funds. If you look at the 1920s and '30s, and that's going back very far, but the transition from single-stock investing to pooled investing, really transpired over decades in the '30s and '40s to the 1970s, where the first index fund was really created.

And that's where the regulatory nature changed to unmanaged investment companies, where you could pull stocks together based on a transparent, index-market barometer. So that's really where the tipping point started in the '70s, but the real acceleration, I believe, happened in the '90s, with the advent of the ETF.

So regulation changed dramatically in the late 1990s, where the regulatory relief from mutual funds allowed for a systematic transparent ETF to be traded intraday. And that's the big difference between

mutual funds and today in ETFs, intraday. And that's really where we see the hypergrowth acceleration happening from the 1990s for index investing.

There's a lot in between those decades that I just described, but really, just to summarize there. Mutual funds were the first index-pooled investment fund, and then ETFs really, I think is where we see the hypergrowth coming from.

LOK MA: As you say, starting in the '70s, growing massively since then. Nowadays, roughly half the equity market. So turning to you, Sarah. Why has it proven, do you think, to be so popular? What are the main attractions of having an index?

SARAH HOPKINS: Yeah, I think it's a great question. I think to follow on from Arun's comments there as well. There's a difference, I think, between index investing, and then what we might think of as market-cap investing. So market-cap investing being investing in line with the biggest companies in the world, investing the most of your assets in the biggest companies and the smallest amount in the small caps at the other end of this size, scale.

And I think one of the reasons it's become so prevalent, especially in the institutional market, is that doing active equity management, or choosing active equity managers, or generally, stock picking investors have just really struggled with that in portfolios.

It's really time intensive to pick active managers that are going to outperform consistently. You see the statistics all the time. Only about 20% of active managers outperform. After fees, that number's even sometimes lower than that.

It's really time intensive for institutional investors to spend a lot of time making sure that they're making good decisions in that space. I think, especially in our market as well, a lot of pension schemes that we work with, they don't have a huge amount of assets left in equity portfolios. They tend to be de-risking. And so you end up spending significant time on quite a small proportion of your assets if you're trying to pick stock pickers and make those decisions.

So instead, investors are choosing to do something a little bit more simple. Indexing is low cost. It's very liquid. It's very easy to change, and there's just less regret-risk in investing in that market. And I think if you look at what's happened, actually, in the last few years. It's been a great decision investing in market-cap equities and indexing.

LOK MA: Yeah, obviously, the advantages of an indexed approach. Let's of course, touch on the potential limitations, as well. So staying with you, Sarah. And what do you think are the main drawbacks of, I guess, the simplest form of passive indexation. What kind of things could be improved?

SARAH HOPKINS: Yeah, obviously, a few drawbacks. And I think the first one of those, is that as I mentioned, you have to-- in the simplest form, you have to invest the most in the largest companies. And that's making a bit of a belief or a statement around a belief that those companies are going to be the ones that perform the best. So the largest companies generally perform the best.

And if we look back over history, that's actually not really what happens. You often see the smaller caps, the small-cap companies outperforming those large cap as they start growing. So that's one of the issues that you've got.

And then you've also got this phenomenon in the market-cap industry where the mega caps, or the very big holdings, are all now in the same industry. They're in the US. They're very tech heavy. So you end up with a pretty concentrated portfolio in a couple of segments of the market, where actually, probably

thinking about that blank sheet of paper. You want quite a diversified portfolio of underlying companies in your portfolio.

LOK MA: Yeah, so let's turn back to you, Arun. We've heard about this kind of concentration and potentially overreliance on bigger companies. So you wouldn't with a blank sheet of paper decide just to invest in the biggest companies, right? And also, I think potentially within there's difficulties of investing in line with your own beliefs. So you just doing what the market's doing. You can't really express how you see the world. How has the indexation industry evolved to deal with these kind of shortcomings?

ARUN SINGHAL: Pick up on what Sarah mentioned around active managers and stock selection. I think a big topic that's not discussed enough is really technology. What technology has done for financial services and asset management. Everything we do in our world has been dramatically affected by technology.

The way we consume goods. The way we deal with our health care. Financial services over the last decade or two has been dramatically disrupted by technology. And what I mean by that, is the transparency and capture of systematic strategies that is able to be done now through technology, is really what the difference is.

We talk about recent developments. We just continue to leverage technology buzzwords like big data, AI. I don't want to go there. But our ability to capture systematic investment strategies in a rules-based, transparent manner, has evolved dramatically.

Sarah mentioned active managers, stock selection. The days decades ago, where you would need to wait for quarterly reports or analysts to tell you why they chose a stock or how they were meeting the investment objective. Today, technology allows for that transparency to talk about why a stock was selected by rules-based, systematic process, or being able to ping that analyst in real time.

So I think when we talk about the recent developments, there continues to be a significant push to accelerate the capture of systematic-investment strategies. And you touch upon personal choice. That's the big topic today, sustainability, investor choice, investor preference.

Now, technology allows us to embed sustainability criteria, and we're going to speak about today, climate type of information ESG within your investment choice and portfolios. So that's some of the recent developments. We talk about smart data factors, but sustainability really is the hottest topic today that everyone on this is engaging on.

SARAH HOPKINS: I guess the technology made the gap between the market cap investing and the active manager stock picking, that's maybe just become a bit more blurry with this development.

ARUN SINGHAL: Completely, right? Five years ago, we're talking about the active-passive debate. Right now, the lines have been so blurred because you could capture active-type strategies in a systematic, transparent manner. So I feel like that active versus passive conversation, we've moved on from, where it's active and passive.

LOK MA: And of course, all this stuff is often described as smart beta, as you said, well, actually it's beta to you and beta to me. So beta, as in gaining that broad exposure to the whole market, which is what an index gives you, but also the smart bit is because you've refined the methodology through technology to try and capture some of those specific investment themes and get around some of the shortcomings of the passive, simple, market-cap type indexation.

And of course, as you say, looking at just recent investment trends generally, we all know the big themes dominating the industry at the moment. The realization, as you say, that ESG issues and sustainability will have that massive impact on the world in general and on investment returns in particular.

So Sarah, I'm aware of this development of course of a new approach based on the Climate Transition Value at Risk, the CTVaR. And I do now want to spend some time talking about that. So can you first of all, give us an idea of what the CTVaR idea is about?

So as I understand it, it's a risk measure, I guess. And then we can link this back to our main conversation about index investing. So let's talk about CTVaR, first of all.

SARAH HOPKINS: Yeah, of course, so CTVaR, exactly as you said, Lok. It's a risk measure. And what we're trying to do with the CTVaR, or the climate transition value at risk, is really pinpoint what the financial risk that companies are exposed to in a transition to well-below two degrees scenario.

So what risk does that individual company have for this change in the way that humans are going to interact with each other, the way that we're going to travel, the way that we're going to change our eating habits. All these things that need to change in order to get to that well-below two degree scenario that was agreed in the Paris Agreement. What's the risk, the financial risk on each company?

And the way that we worked out how to calculate that, is we have a team we brought in-house, and that used to work at the climate policy initiatives in our [INAUDIBLE] Willis Towers Watson. And what that team are doing, is looking at the underlying cashflows of each of those companies that are in index, and they're saying how do those cash flows need to change in order that we achieve this well-below two degrees scenario.

They're then discounting those cash flows back to today to get what the share price should be under that scenario and comparing that with the current share price, and then the difference between those two things gives you your climate transition value at risk.

LOK MA: And obviously, to bring these things to life, I think an example would be helpful. Actually, [INAUDIBLE], can you give us maybe, an example of company that would have a positive metric under this CTVaR measure and also examples of a negative one, and obviously, without naming any names?

SARAH HOPKINS: Yeah, exactly, so I think what's really important about this, the way that we think about this, is we're not just looking at carbon emissions or emissions data to make these judgments on these companies. It's much more forward-looking bottom-up based,

And to Arun's point earlier, analysts are thinking about this as a stock picker would. They're going through and understanding the risk that an individual company is exposed to, and then comparing that to the way that it's currently valued in the market. So one example, would be think of a fast-food chain. What you might think is actually that's kind of low risk. Doesn't have a huge amount of carbon intensity. Restaurant chain, maybe a little bit from transport of food, but really low risk.

But actually, when we go into these models and look at the climate controversy models, how is that company going to be impacted by the way we consume dairy? How is it going to be impacted by alternative forms of protein? How is it going to be impacted by changing diets by increasing amounts of vegans for environmental reasons?

So then you actually start to think, maybe that company is pretty exposed to some of the things that need to happen, maybe taxes on beef importation. Things like that, that actually do start to make a big impact. So a company like that actually does have a bit of risk.

Another company maybe think about this as other way around, say a mining company. You might think that pretty high risk, mining emissions pretty bad. But when you get into the detail of that, let's talk about, maybe a lithium or a nickel mining company. Minerals that are super important for solar panels for electric vehicle batteries to store engines.

So supply of those types of minerals is going to increase. So actually, that mining company versus others, pretty positive in CTVaR versus the market.

LOK MA: And I always find these examples fascinating because there are instances of them where your intuition comes up against some actual proper numerical analysis, and those two things don't always go hand-in-hand.

Arun, you might not know, but in a previous episode, we had a bit of a Christmas quiz. And we asked people to guess-- it's like a higher or lower gain based on the CTVaR. And it's just fascinating how everybody's intuition goes one way, but then when you look at the underlying fundamentals, you draw a different conclusion.

So anyway, the CTVaR, essentially for me, a prediction of future corporate winners and losers, if you like, under this kind of climate transition to a green economy in line with this well-below two degrees scenario. So bringing this metric now, back into our main conversation, Arun. Let's talk about how to incorporate this analysis into an index to invest in. So how do you create an index that allows an investor to tilt their investments more towards the winners and away from the losers?

ARUN SINGHAL: Yeah, exactly, start with what Sarah mentioned. The CTVaR, right? The hard work is in the analysts looking at the future cash flows. So those analysts building the data bottom-up per company on future cash flows based on the transition.

And as an index provider, we're able to take that data and really identify which companies will benefit from the transition and which companies will be negatively impacted by the transition. We do a normal distribution of the data, and we translate that normal distribution into a weighting scheme where we provide more weight to companies that are predicted by future cash flows to be rising in value based on the transition, and then ones that will be declining based on that.

So it's a normal distribution that we mathematically take the CTVaR data into, create a normal distribution, and tilt the index towards companies that we believe will be benefiting from the transition, which will be getting higher weights, and then companies that we believe will be negatively impacted, will be on the bottom end of that normal distribution, and get negative weights within the index.

So some of the examples that Sarah gave, it's very telling. It's very transparent. That's the beauty of indices. In indexes, you can see all the companies. You could see the weights. You can really bring to life the examples, Sarah saw across a broad spectrum of companies.

LOK MA: And what sort of investor is this index intended for? So why would an investor use this index? And how do they add that into their portfolio?

ARUN SINGHAL: Yeah, I could start them and Sarah, I know you talk to clients on a daily basis there. But I think we have to start with the premise that the climate transition is here. Climate transition we can all mobilize around is here, then we have to take the next step to understand the impact.

So if we believe that climate transition is here and here in a significant way, it will impact all companies, and we will see companies that benefit, and companies that are going to have to alter their business practices due to this climate transition.

So back to the question, what investors. This is a core solution within portfolios. It gives you broad-based allocation to a broad set of companies that really tilt towards these winners and losers on the premise that the climate transition is going to happen. So we really believe that when you look at the characteristics of the index, it's a core solution for what the future entails.

LOK MA: Thank you and I know we just spent a bit of time talking about this one index, but I just think it really ties together quite a lot of the themes running right through our podcast. So just one last thing then, and maybe now taking a bit of a step back.

What other trends are we seeing with indexation? Or what do you think we might see in the future, maybe, starting with you first, Sarah? And I'm thinking not just of indexation approaches, but also the types of investors that may be adopting these approaches so institutions versus individual savers, for example.

SARAH HOPKINS: Yeah, and I think it comes back to this blurring of the spectrum between what clients were trying to historically do with stock picking and getting access to specific ideas versus this quite simple passive, market-cap investing. And we're seeing investors, I think, move away from some of those risks in the very traditional market cap, and are on that journey to really work out how to best suit an indexation strategy or smart beta strategy to their beliefs.

And that might be climate or it might be something else. We've had examples with our clients where they've come to us and said, well, we've got specific beliefs around smoking because we're a charity in that sector, we would like to exclude tobacco from our portfolio. And there's now ways to do that through indexation, through a quants liquid, transparent, low-cost approach that really helps clients be able to invest in a way that really aligns with them.

And I think that then moves out of just the institutional space and into the retail space where individuals have a way, have a set of beliefs that they want their money to be invested in a way that suits them. And this indexation world, and all of the different options that are available, makes it quite accessible and feel a bit more relatable, I think, to a lot more people and are in talks about the ETF space at the start. And just the growth in that market has been huge, and you can get access to lots of different stuff really tech heavy, really growth ETFs, lots of different options that are now available to people.

ARUN SINGHAL: It's exactly right. It's mass customization to summarize that. I don't want to harp again on technology, but really, what we're seeing is the ability to massively customize, whether that's a thematic ETF we bring to market, or a custom mandate for institutions.

So our conversations now are very interesting between the institutional retail markets because we see a flattening occurring through this technology as ability to provide transparency into capturing investment exposures. So a couple of public announcements we've had over the last couple of months is, we've built massive, customization-index portfolios for some of the largest pension plans.

One we just announced with Philips in December was a several billion dollar mandate, where it had a customization of sustainability, tracking of your preferences, calibration to different investment objectives. So that mass customization we're seeing at the institutional level, is trickling down into the retail, and we're seeing a flattening across the consumer segments.

LOK MA: I think I'll just sum up by saying that indexation is not going to go away as a trend, although I think there's a strong case to move to these more thoughtful versions of indexation. As we talked about, overlaying analysis around climate transition, as one example.

But more generally, I think the right index gives you a way to express your own investment beliefs and preferences in a very efficient way. So thank you very much for coming on to the show, Sarah.

SARAH HOPKINS: Oh, it's been great. Thanks, Lok.

LOK MA: And likewise to you, Arun, very nice to meet you,

ARUN SINGHAL: Thank you.

LOK MA: And we hope our listeners enjoyed our discussion. Take care until the next time.

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