

Guide to Indexes



Market indexes have been thrust into the limelight with the rising market share of passively managed vehicles, such as exchange-traded funds. Indexes, originally intended as analytical tools and yardsticks for the measurement of active managers, are increasingly serving to underly investment strategies.

With their elevated position on the investment landscape, a small number of index providers have found themselves with enormous power, across several dimensions. Their decisions on issues like market inclusion, sector classification, and governance standards can reverberate across the globe.

An impact of this oligopolistic market is that index licensing fees have risen sharply in contrast to the increased pricing pressure seen within the investment management sector. Investment managers, regulators and policymakers have taken notice. Scrutiny is growing.

What's an Index Really For?

The first capital markets index in the late 19th century was created for a newspaper as an indicator of market direction. To this day, market indexes are heavily cited by the media and followed closely by investors. They are even quoted as barometers of national economic health.

Over the years, market indexes have taken on great utility as analytical tools. They help investors understand risk and return, assemble diversified portfolios, and measure performance. Indexes power portfolio optimization models. They define asset classes, market segments, and economic groupings.

As benchmarks for active strategies, indexes are meant to reflect the investment universe, or the opportunity set for security selection. Many regulators require managed funds to compare their performance and portfolio characteristics against an index. Benchmarks are used to identify where an active manager is taking bets and whether their positioning has added or subtracted value. As such, they can affect manager compensation and even, in the case of performance fees, charges paid by the investor.

Now, with the rise of passive investing, indexes have moved from opportunity set to opportunity cost. "Beta," or market exposure, as defined by Modern Portfolio Theory, is widely available to investors at a bargain price, through vehicles such as index-tracking mutual funds and exchange-traded funds. Nobel Prize-winning economists laid the intellectual foundation for passive investing with the "Efficient Markets Hypothesis," which views a security's price as reflecting all known information about the underlying business. The collective track record of active managers in overcoming their fees and outperforming their benchmarks has bolstered confidence. And the success of low-cost index funds from Vanguard and others—in gathering assets, delivering returns, and holding onto investors through thick and thin—is undeniable. Even gurus like Warren Buffett, who made his fortune exploiting market inefficiencies, has counseled investors to go passive, remarking that index funds "make the most sense practically all of the time."

However, many investors will never be content with "market exposure." For them, there are indexes that are passive in their implementation but active in their goals. They seek to improve returns, reduce risk, or achieve an investment outcome—an income stream through dividends for example. Many of these indexes seek to harness "factors" observed to provide a premium over market returns for either risk-based or behavioral rationale. Various labels "smart beta," "strategic beta," or "scientific beta," these indexes are less reflections of markets and market segments and more like rules-based passive investment strategies.

Quantitative or systematic investment strategies are not new. There have long been investment strategies screening securities for attributes like Value, Size, Momentum, or Quality that academics have observed to produce excess returns across asset classes, markets, and time periods. At best, they combine the best of active and passive management, replicating the toolkit that a portfolio manager uses to produce excess returns. They reduce cost by removing

the need for expensive investment professionals. They also tie an investment strategy to the mast, avoiding the negative impact of human frailties by dispassionately implementing well-defined rules.

At worst, strategic beta is the product of a data-mining exercise cynically aimed at capturing investor assets. Investment managers have a long history of latching onto investment concepts and proliferating product. The term “Factor Zoo” has been coined to describe the multitude of return drivers unearthed through furious back-testing. On the topic of product proliferation, Morningstar’s director of global exchange-traded fund research, Ben Johnson, wrote a piece entitled “Ready, Fire, Aim: The ETF Industry Blasts Its Spaghetti Cannon.”

Limited Index Provider Competition

Not just anyone can build an investment index. Good indexing starts with a long-running, high-quality data set that reflects not just securities’ price movements but also dividends and corporate actions, such as mergers and acquisitions, rights issues, and spinoffs. On the equity side, there are initial public offerings and de-listings to capture. On the bond side, there’s corporate issuance, and the debt of governments, local authorities, and agencies. A vast range of securitizations spans different rates, maturities, and cash-flow structures. Collecting and cleaning this data is a major barrier to entry in the index world.

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Over the years, best practices around benchmark design have emerged. Data must be complete and accurate. Index rules must be clear and published. For market exposure indexes, there are balances to be struck between completeness and investability, between minimizing turnover and providing an accurate reflection of ever-changing markets. It’s not enough for a benchmark to be soundly constructed; it must also be trusted and accepted.

Then on the strategic beta side, rigorous research must underpin the index methodology. Factors should be independently vetted and well established.

Regulators are increasingly taking an interest in setting direction and providing oversight to index providers. The International Organization of Securities Commissions is an important example. In the view of regulators, indexes must be constructed, calculated, and maintained with robust processes and rigorous oversight. Governance is critical, as data quality must be ensured, methodological questions considered, and potential conflicts of interest managed.

Market Indexes are a Commodity and Should be Priced As Such

While creating an index isn’t easy, the end products tend not be exceedingly differentiated — at least on the beta side. Market exposure indexes representing the same market or market segment often look and act similarly. The reason is the commonly employed approach of weighting constituents by market capitalization — the total market value of outstanding shares. Indexes that distribute weight in proportion to security size typically end up with similar composition.

In 2012, Vanguard switched benchmarks tracked by 22 of its index mutual funds and ETFs, declaring, "Through a series of best practices that most of the index providers have converged to over the years, the differences between a lot of the providers are relatively small." Vanguard sought to reduce index licensing fees that ultimately make their way into fund expense ratios that investors pay. The message was that benchmarks are interchangeable and should be priced accordingly.

The observation was echoed by a 2016 paper published by the Spaulding Group in conjunction with custodians BNY Mellon, State Street, and Northern Trust: "There is minimal difference between several index providers that serve the U.S. and global equity markets in terms of performance; while methodology varies among indexes, those variances are largely tempered by capitalization weighting."

Strategic beta indexes, on the other hand, are anything but interchangeable.

Differentiating Investments with Strategic Beta Indexes

Strategic beta indexes require rigorous due diligence. Investors must not only understand the investment thesis, they must also probe index construction. How is the factor defined? How are securities selected? What is the weighting scheme and are there guardrails on sector or regional exposures? Two strategies focused on the same factor can produce markedly different outcomes.

There's also the risk that what worked in the past won't work in the future. Believers in the Value and Size premia have seen their faith tested by the massive outperformance of Large Cap Growth stocks. True believers urge patience. Skeptics claim: "This time it's different." Others worry that with the investor assets pouring into factor strategies, expected returns diminish. If too many market participants invest in the same way, their behavior becomes the market.

Constant Evolution — Sustainability and Beyond

Indexes must also reflect changing investor preferences. Indexes screened on environmental, social, and governance (ESG) criteria have proliferated in response to demand from asset owners, and others mindful of issues like climate change, diversity and inclusion, and corporate governance. Once limited to aligning capital with values and known as Socially Responsible or Ethical investing, sustainability has broadened its tent to include the incorporation of ESG analysis for risk mitigation. The focus has evolved beyond simply excluding objectionable securities from portfolios. Then there's impact investing, which actively seeks to cause societal change.

Indexes must also reflect changing investor preferences. Sustainability is a case in point.

Another example of index evolution concerns goals-based or objectives-driven investing, often involving the combination of multiple asset classes into one package. In the wake of the global financial crisis, many investors want one-stop managed portfolios that target specific goals

like income, retirement, or savings for higher education. Indexes have been created that blend stocks, bonds, and other assets using either static allocations or those that adjust to become more conservative as they approach a target date, for instance, retirement.

The Market Driven-Solution

The market-driven solution to high index licensing fees is increased competition. Investors, advisors, asset managers, and other market participants have much to gain from more choice among indexes. Not only will increased competition lower costs, it will provide a more robust toolkit with which to power investment decisions and asset allocation.

Morningstar is helping in this regard with the introduction of the Open Index Project to provide free access to market indexes. This provides alternatives to expensive indexes such as the S&P 500 and the MSCI World.

Using Morningstar Indexes

Morningstar Indexes launched in 2002. The mission was to turn the company's data and research into benchmarks that help investors measure markets and rules-based passive investment strategies that help them achieve their goals. As a multi-asset index provider, Morningstar offers equity, bond, and alternative benchmarks spanning beta and strategic beta. It also combines asset classes into either static or dynamic allocation benchmarks and offers various flavors of ESG. Many Morningstar indexes underly investment products, such as exchange-traded funds. Others are primarily intended as analytical tools.

Morningstar Indexes as Analytical Tools in Morningstar DirectSM

Morningstar DirectSM is our institutional investment research platform, used by portfolio managers, financial advisors, development, marketing, and research, professionals in asset management and wealth management firms to conduct analysis with our indexes.





Users of Direct can perform sophisticated returns-based and holdings-based analysis using Morningstar Indexes or other indexes as benchmarks. Detailed constituent-level data and index levels enable functions, including performance attribution. Users can also incorporate Morningstar Indexes into Excel-based performance reports or visual charts available in Morningstar Direct.

[A free trial of Morningstar Direct](#) includes access to the full depth and breadth of our indexes offering and industry benchmarks.

Indexes Built on Morningstar's Proprietary Methodologies

Morningstar has developed a wide array of proprietary methodologies over the last 35 years, including Analyst Ratings, Economic Moats, Sustainability, Valuations, and many more. To discuss building investments based on one of these unique indexes, contact us at morningstar@morningstar.com.

Morningstar Indexes Covering All Major Asset Classes

	 Equity	 Fixed Income	 Alternative Investment	 Asset Allocation
Beta	Global/Regional/Country Style Sector	Emerging Markets High Yield Investment Grade Inflation	Single Commodity Long Only Commodity Sector	Target Date/Risk 529 College Savings Real Asset Global Allocation
Strategic Beta	Quality (Economic Moats Dividend Valuation Multi-Factor Thematic	Infrastructure Thematic	Long/Flat Long/Short Diversified Futures	Infrastructure Multi-Asset Alternatives Multi-Asset High Income
ESG	Integration Values Impact	<i>Integration*</i>		<i>Multi-Asset ESG*</i>

**As of June 2020, items referenced with an asterisk are index capabilities, not yet launched.*

Free Access for Benchmarking: Morningstar Open Indexes Project

We're delivering our equity indexes for the purpose of benchmarking active funds—for free. Participants will receive price return, total return, net return, and month-end constituent data from the 125 global equity indexes included in the project.

The goal of the Morningstar Open Indexes Project is to lower the cost of equity indexes and improve outcomes for all investors.

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