Inside Market Data

April 7, 2014

INDEXES

Can Alternative Providers Disrupt Index Inertia?

Though there are almost a hundred mainstream index providers in the industry today, the market remains dominated by a small and elite group of providers—MSCI, S&P Dow Jones Indices, Russell Indexes and FTSE Group. With the industry clamoring for change and innovation, Faye Kilburn examines the barriers to greater adoption of alternative providers.

The fees charged by index providers have risen sharply over recent years, partly due to the increase in complexity of indexes for benchmarking, and partly due to the rise of exchange-traded funds. These hikes, combined with the proliferation of new license types covering areas such as non-display usage, have led many firms to question whether the current cost of indexes is at all reflective of their value.

In October 2012, the largest mutual fund manager in the US, Vanguard Group, responded to these concerns by removing MSCI as its benchmark for 22 funds and replacing it with indexes from FTSE—which has a comparatively small US footprint—and the University of Chicago’s Center for Research in Security Prices (CRSP). In the same year, two boutique fund managers in London dropped FTSE index data and branding from their client literature after FTSE requested that the firms pay an annual license fee of up to £15,000. At the time, it looked like the beginning of a mass migration to new and alternative indexes.

But the exodus never took place. And two years on, dissatisfaction with index providers has continued. In a recent study by the Economist Intelligence Unit (EIU) sponsored by Northern Trust Asset Servicing, titled Beyond The Status Quo: Searching for Value in Index Products, 68 percent of executives surveyed agreed that index providers with the strongest brands charge prices that are high relative to the quality of their services, yet only nine percent said they have discontinued using at least one provider over the past five years. So, why the inertia?

When it comes to index selection, particularly for benchmarking, the supply chain can be broken down into four key groups: (1) banks and custodians who provide investment products and services; (2) asset managers who manage funds on behalf of (3) asset owners and trustees; and (4) consultants hired by asset owners to advise on fund manager selection.

To date, the sell side has been vocal on the rising cost of indexes, though it has little say in the matter of index selection. The decision of which index provider to use is almost always dictated by the asset manager, says a head of data at a US tier-one investment bank. “My job is simple. If the client wants X, I buy X,” he says.

When asset managers were asked about why they use a specific benchmark, most respondents to the Economist–Northern Trust survey said they choose a particular index because it aligns with their key business objectives and meets technical requirements. However, 60 percent also say they want a brand name that creates credibility with stakeholders.

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ers, instead selecting mainstream, brand-name equity benchmarks from index providers with strong reputations and well-known brands, he adds.

Others agree that a provider’s brand plays a key role in index selection. Even if an asset manager can demonstrate that two indexes are statistically identical, overcoming brand recognition is a major issue, says Joe Nardulli, vice president of Northern Trust’s investment risk and analytical services business, which sponsored the Economist survey. “In fact, one of the findings of the recent Economist paper on index value showed that some firms are their own worst enemy when it comes to trying to change index vendors. In many cases, the key decision makers in a company do not want to take a chance on a lesser-known index or brand.”

As a result of this “brand effect,” many asset managers select indexes based on whether they are offering the same “household name” as their peers—though the idea that asset owners are wedded to a particular index may be a misconception.

Nasdaq OMX has provided indexes since 1971 and positions its business as a lower-cost alternative to incumbent index providers. In conversations with potential customers, Sean Wasserman, managing director of Nasdaq OMX’s global indexes business, says asset owners are largely agnostic about index selection. Furthermore, since asset owners are not billed directly by index providers—rather, asset managers swallow the costs—they are often not aware of the cost difference between providers, which is one reason for inertia, he adds.

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Indeed, in November, the Oklahoma Firefighters Pension and Retirement System (OFPRS) became the first major asset owner to adopt the Nasdaq Global Index Family to serve as the benchmark for its equity investments. At the time, Gerald Garrett, chairman of OFPRS’ investment committee, said the Nasdaq Index was significantly less expensive and provided nearly exactly the same market exposure as other benchmarks the group had used.

“There is a lack of awareness of other index providers and we, as trustees, don’t spend time understanding what the benchmark is. [But] I have been elected to do the best job I can for my members, and I can’t do that if I’m not looking under every rock. Any fee taken away by an index provider is part of the overhead, and my members deserved better than what they were getting,” Garrett says.

Nasdaq’s Wasserman goes a step further, calling index data fees an “invisible tax” on pensions, arguing that the people whose money is being managed are those who ultimately pay the price. And the trustees of these funds may not be financial experts, and may have little understanding of the benefits or risks of switching index providers.

Valid Alternatives?

While some alternative providers downplay the risks of switching index vendors, not everyone agrees that the move is risk-free. Many alternative providers claim to offer indexes that track the performance of major indexes with 99.9 percent accuracy, but to some, that 0.01 percentile introduces an element of risk.

“The problem for consultants and managers is that even a small difference can add up to a material return deviation over the period we are judged over,” says a director of research at an outsourced portfolio management provider. “If we employ something slightly structurally different, that’s a risk for us.”

For example, if an alternative index produces a 0.5 percent tracking error in January, it makes little difference over a 10-year period, but consultants and asset managers are often assessed on a monthly basis, so 0.5 percent in January is a material act of debt that introduces noise to the way consultants’ value is measured, the consultant adds.
Another risk factor around switching index provider is providence: For any startup or alternative provider selling indexes at a lower price point, firms need reassurance that (a) the provider will be in business in five years and (b) its business model will be the same.

Carl Bacon, founder of the Freedom Index Company—a startup not-for-profit index provider which launched last year to offer free and independent indexes to asset managers—and chairman of portfolio analytics vendor Stat-Pro, says this is one of the biggest challenges for alternative index providers. “You’ve got to demonstrate that you’ll be around and that you won’t start to charge for data at some point in future… and that takes time to build up,” Bacon says.

Hence, to win business, some alternative providers are incorporating promises into their business model to deliver fair prices in the long term. For example, Vanguard extracted a multi-decade commitment from FTSE that the terms of its deal would not change.

“When we do business, we want to make sure the contract is enduring and long-lasting, so when we went into the new contracts [with FTSE and CRSP], we made sure to have multi-decade certainty with our providers,” says Rodney Comegys, head of investments for Asia-Pacific and head of the Asia-Pacific equity investment group at Vanguard. “That is a lot of the reason why we feel this is the right choice for our investors in the long run.”

**Sharing the Gains**

As the largest fund manager in the US, Vanguard was able to negotiate preferential terms with alternative providers, but not all firms have the same clout. While Vanguard can assume the risk if FTSE and CRSP underperform from one month to the next, smaller firms may not, and could even lose clients as a result of a switch.

To mitigate these concerns, asset managers could find ways to share the cost savings with the asset owners so every party has an incentive to switch, says the director of research at the outsourced portfolio management provider. “I wouldn’t foresee managers offering different prices for different benchmarks... it would have to be the index provider trying to make this happen... but it could be offered at a different fee to the asset owner in a roundabout way.”

Firms will also need to invest in understanding the actual cost savings of transitioning benchmarks, says Steve Ellenberg, product manager at market data inventory management and usage monitoring technology provider MDSL, which is currently developing a service dubbed Index License Manager to help firms manage their index data and make licensing costs more transparent. “Index licenses often span across several funds or baskets of indexes, so it is difficult to figure out the savings and crunch the numbers. But you need to produce those figures, or the business won’t go for the switch,” Ellenberg says.

Northern Trust’s Nardulli agrees that as asset owners become more educated about index products available in the market, they will be more likely to switch providers—providing they can see an impact to their own bottom line. “They need to have a strong incentive to make a change. If one of their service providers or asset managers saves money by using a lower-cost index, then some of the savings eventually should be passed on to the asset owner somewhere along the investment cycle,” Nardulli says.

One catalyst for change could be the emerging requirement for asset owners to sign contracts directly with their index providers. Historically, asset owners have not needed to sign contracts for indexes, but as index providers seek more direct relationships with their end-users, asset owners may finally become aware of the costs. “And it’s the asset owners, in my belief, that have the power to affect change in the index industry,” Nardulli adds.

Indeed, while the Vanguard switch made bigger headlines, it is OFPRS’ decision to move to Nasdaq OMX that hints at an end to the inertia. If alternative providers can win market share directly from asset owners, incumbent providers may at last be forced to review their pricing models, which in turn could reduce the cost of index data to a more reasonable level.