March 2021

CIO Dialogue

With Index Providers

in partnership with

IiAS FOUNDATION INSTITUTIONAL INVESTOR ADVISORY SERVICES

Previous CIO Dialogues

The CIO Dialogue with Rating Agencies held in February 2020

CIO Dialogue with Auditors held in November 2019

CIO Dialogue with Index Providers

Background
Charles Dow created the first index in 1896. Since then, creating and providing indices has become a big business - and a fiercely competitive one at that. From being mere information providers today, indices such as the Dow Jones Industrial Average and the S&P 500, FTSE 100, MSCI, NIFTY and SENSEX are among the best-known brands in financial markets. Index providers determine whether the fund performance has been good – because beating the benchmark is the single most important aspect of asset management. Critically, index providers are the most influential players in equity markets, as they drive asset allocation decisions through their index inclusions and exclusions.

For debt markets, index providers are critical even though they do not seem to hold as much sway. For one, there are not as many funds created against a fixed income benchmark, and asset allocation based on a fixed income index may just drive capital towards the more indebted.

Fund managers, chasing returns over benchmarks, are constrained by several regulations and market structures. For them, while indices may be representative of the overall market, they are not necessarily replicable. To discuss some of these challenges, National Stock Exchange (NSE) and Institutional Investor Advisory Services (IiAS) collaborated to host a roundtable, on 24 February 2021, between index providers and some institutional investors.

This was the third in the series of CIO Dialogues. The first two CIO Dialogues were held with auditors and rating agencies, at NSE. This was the first CIO Dialogue to be held virtually.

Indices: There is one for all

Beating indices is the dominant goal for asset managers. Yet, there is no single index that fits all use cases. The multitude of indices support an equally large thematic fund base. Even so, there are operating challenges on both sides – some regulatory and others market-driven – which will necessarily exist. Product-suited indices will possibly be the best fit benchmark, one that is available for all.

Indices have become critical to the fund management industry. For active funds, indices represent a benchmark that fund managers need to beat. For passive funds, index constituents form the investible universe, and index funds mirror the index components in scrips and weights. Then there are the index-based derivatives, for which the index itself is the underlying asset.

Index-based funds including Exchange Traded Funds (ETFs) and Index funds are gaining popularity in the Indian market since these are expected to provide diversification from an equity portfolio perspective and have lower managements costs. While active funds continue to dominate, the index funds and ETFs have been growing: the assets under management (AUM) of index-based funds has increased by ~46% to Rs. 2.70 tn as on 31 December 2020 from Rs. 1.85 tn as on 31 December 2019[1]. Therefore, having the right index makes all the difference in terms of how the fund's performance is evaluated.

Exhibit 1: Quarterly AUM of Index based funds[1] (In Rs. tn)

Note: Index-based funds comprises of Index funds and ETFs. Proportion of index funds of the total index-based funds has increased to 5.6% as on 31 December 2020 from 3.9% as on 30 June 2019.

The leading indices in India are offered by arms of stock exchanges: NSE Indices, which provides indices in the NIFTY family such as NIFTY 50 and NIFTY 500, and Asia Index, a partnership between BSE and S&P Dow Jones Indices, which provides indices like S&P BSE SENSEX and S&P BSE 500. There are other global providers as well, such as MSCI (MSCI

[1] https://www.amfiindia.com/research-information/aum-data/age-wise-folio-data

India, MSCI India IMI) and FTSE (FTSE India, FTSE India ETF) offering products based on Indian securities.

Indices need to be both representative of the overall market, and replicable, especially for passive funds. Index providers maintain an issuer universe, solely from which securities can enter the index. Indices are created after considering quantitative factors such as market capitalization, free float, impact cost[2], F&O constituents[3].

Apart from broad based indices, there are indices which are specific to a certain sector or a theme. Sectoral indices are created to represent the collective performance of stocks in their respective sector. For example, Nifty Bank Index represents the performance of banking stocks listed on NSE.

With the increased awareness around ESG, index providers have created indices based on the Environment, Social and Governance pillars. Globally, the first ESG index was launched in 1990, today there are at least 1,000 ESG indices[4], stressing the demand around ESG products. These ESG indices play a crucial role in benchmarking against ESG funds and give investors an opportunity to invest in a pool of securities with the best ESG practices or at least a greater focus on this aspect. ESG indices, like the MSCI India ESG Leaders Index and the Nifty 100 ESG Sector Leaders index, aim to incorporate companies with the highest ESG ratings and adjust weights to limit the systemic risk introduced by the selection process. ESG Indices are also expected to play a crucial role in prevention of greenwashing[5].

One of the enduring debates is whether equity indices reflect the country's GDP. After all, the equity markets themselves are considered a barometer of economic well-being. However, the capital markets today are largely delineated from the economics. While the GDP levels is several months away from pre-COVID levels, equity markets are flush with liquidity and global flows are taking them to new highs. Index providers believe that for their main indices to be reflective of the state of the economy, the capital markets need to have greater penetration and more companies across sectors need to be listed. In India, the most dominant generators of GDP and employment are the small and medium enterprises, most of which are not listed. Therefore, for India, much in line with the global scenario, the main indices will not necessarily be a barometer of the country's economic health – only a reflection of its equity markets.

Creating debt indices involves a different methodology when compared to equity indices. Debt markets are more institutional as they focus on larger ticket sizes. Liquidity is the primary filter used when creating a debt index. Debt indices can be sovereign or corporate. Corporate indices are driven by credit rating category of issuers, their maturity profile or duration cut. Currently, there are a limited set of indices that are used for benchmarking, in sharp contrast to equity indices. Globally, debt indices on average have almost 70-80 issuers in the index, with the constant improvement in methodology, more issuers are being accommodated particularly in broad based debt indices.

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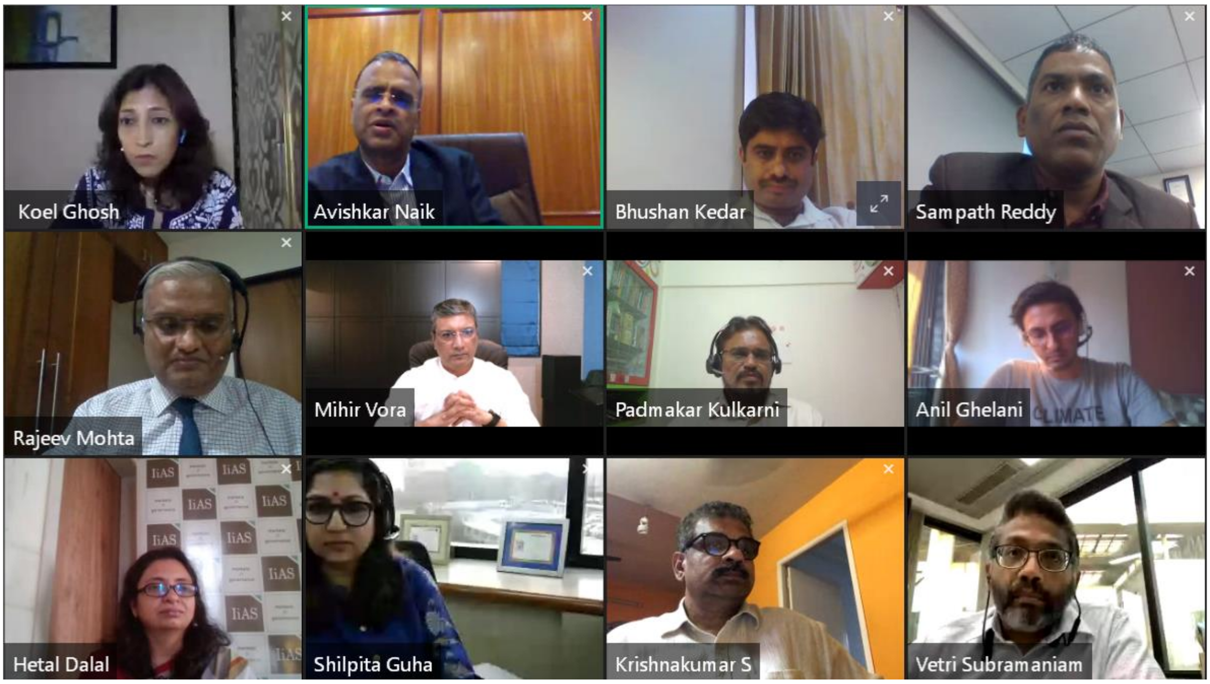
[2] *Impact cost is a cost that an investor is required to incur for executing his buy or sell order as against the ideal cost of that security. Company with lower impact cost suggest the high liquidity as against the company with higher impact cost.*

[3] *Availability of the stock under derivatives segment of the exchange.*

[4] https://www.ishares.com/us/literature/whitepaper/an-evolution-in-esg-indexing.pdf

[5] *Greenwashing is when a company or organization spends more time and money on marketing themselves as environmentally friendly than on minimizing their environmental impact. It is an unsubstantiated or misleading claim about the environmental benefits of an organization's products or services.*



Please note that Mukesh Agarwal, CEO - NSE Indices, is sharing screen space with Avishkar Naik.

Index construction methodologies are largely driven by quantitative data. On the other hand, for investors that need to factor in regulations, exposure caps and several other structural constraints to help manage risk, these indices may not always be perfectly replicable. Some of the dichotomy in what investors want and what indices provide are discussed below:

- **Exposure thresholds and concentration risk for active equity mutual funds**
  Exposure thresholds prescribed by regulation limits the exposure in a single scrip to 10%. Indices may not be subject to such limits. Therefore, sharp share price movements can trigger an under or over-performance viz-a-viz the index. For example, in August 2020, Reliance Industries Limited accounted for 14% of NIFTY 50. In these circumstances, the active fund's performance would have diverged from the index. Sectoral concentration risks also concern investors, as sectors having more weightage in the index would mean that such sector may have higher influence on the overall index returns. For example, in January 2021, financial services represented ~38.1% weightage of the Nifty 50[6]. One can argue that financial services will naturally constitute a higher index weightage because of their higher weightage in the overall listed space on exchanges due to their constant need to raise capital.

  Index providers argue indices need to be representative of the market and to that extent may have higher representation of certain sectors and stocks. However, over longer periods these concentration issues iron out. Global index providers have one more wrinkle to iron out, namely country weights, which are also factored in.

  In January 2019[7], SEBI published new rules on the composition of equity indices. It specified that an equity index should have a minimum of ten stocks as its constituents. For a sectoral or thematic index, no single stock shall have more than 35% weight in the index. For broad based indices, no single stock shall have more than 25% weight in the index. The weightage of the top three constituents of the index, cumulatively shall not be more than 65% of the index.

[6] https://archives.nseindia.com/content/indices/ind_nifty50.pdf
[7] https://www.sebi.gov.in/legal/circulars/jan-2019/portfolio-concentration-norms-for-equity-exchange-traded-funds-etfs-and-index-funds_41588.html

Even as index providers agree that bell-weather indices should not have caps, as they first need to represent the underlying capital markets, the issue of regulatory investment limits on mutual funds is real. Artificially capping weights will lose the index representativeness, and possibly curtail the indices' replicability.

Indices are rebalanced with regular and defined frequency to ensure their continued relevance. Indices are created in a way that they become a standardized general benchmark, while each investor class has different investment objectives and different management styles. Consequently, index providers are keener than ever to create industry/regulator specific indices to help in more relevant benchmarking.

- **The inclusion of qualitative factors in index creation**
  After Yes Bank[8] was placed under regulatory moratorium facing governance issues, the stock was not removed from main indices after the event had occurred. This, along with other such instances in the past, have raised the question on whether qualitative factors, such as corporate governance related issues, or market intelligence, should be factored into the indices.

  Investors remain divided on this issue – but most believe that indices should be mathematically driven, and subjectivity should be avoided. Index providers concur. Even if index providers were to factor in any of these issues, there needs to be tangible and timely regulatory strictures around the company. India errs with delayed regulatory action. For funds looking at value-based investing where fund construction will have qualitative factors, index providers recommend the use of their ESG indices.

  Debt indices, however, operate differently. They use credit ratings, which are arrived at through qualitative assessment by independent third parties, as one of the 'objective' inputs in creating the indices. The other elements of constructing debt indices are liquidity and duration which can be quantified.

- **The impact of index inclusions and exclusions on funds**
  Index providers have different methodologies for stock inclusions and exclusions – some definitive (and therefore predictive), while others less so. Some of the index providers announce the changes to the index well in advance, for others, stock inclusions are a cause for market speculation. Having said so, the challenge for fund managers is that on the day of the index change, they are required to buy or sell sometimes multifold of average daily trade volumes, which can cause stock prices to swing sharply. Investors are divided on whether therefore index providers should stagger the index inclusions and exclusions, or just make all the changes on a given date. But investors agree that the lack of liquidity in the stock and the presence of circuit filters can make it difficult to replicate indices.

  This particular issue brings to fore the debate of free float vs. trading volumes – and perhaps the difference is the equivalent of profit vs. cash. Free float is determined by shareholding structures, but the non-promoter shareholding may not necessarily be liquid. Promoters may control a portion of the non-promoter shareholding. A classic example of this is Life Insurance Corporation of India's (LIC) equity stake in government owned companies; these investments tend to be sticky. The other complexity that index providers now need to deal with is the regulator's openness to allow companies to list with a lower free float threshold.

  The quantum of weight changes is also a concern for investors. At times, there could be weight changes of more than 30% in the constituents of an index. This results in fund managers having to make large quantum changes in their portfolios. While this is being

[8] *Yes Bank is one of IiAS' several shareholders*

acknowledged by index providers, index providers argue that large IPOs will naturally impact indices, for example, when Saudi Aramco listed in late 2019 or once LIC is listed in India. Even otherwise, capping the weight changes artificially will reduce the representativeness of indices.

The way forward for index Providers

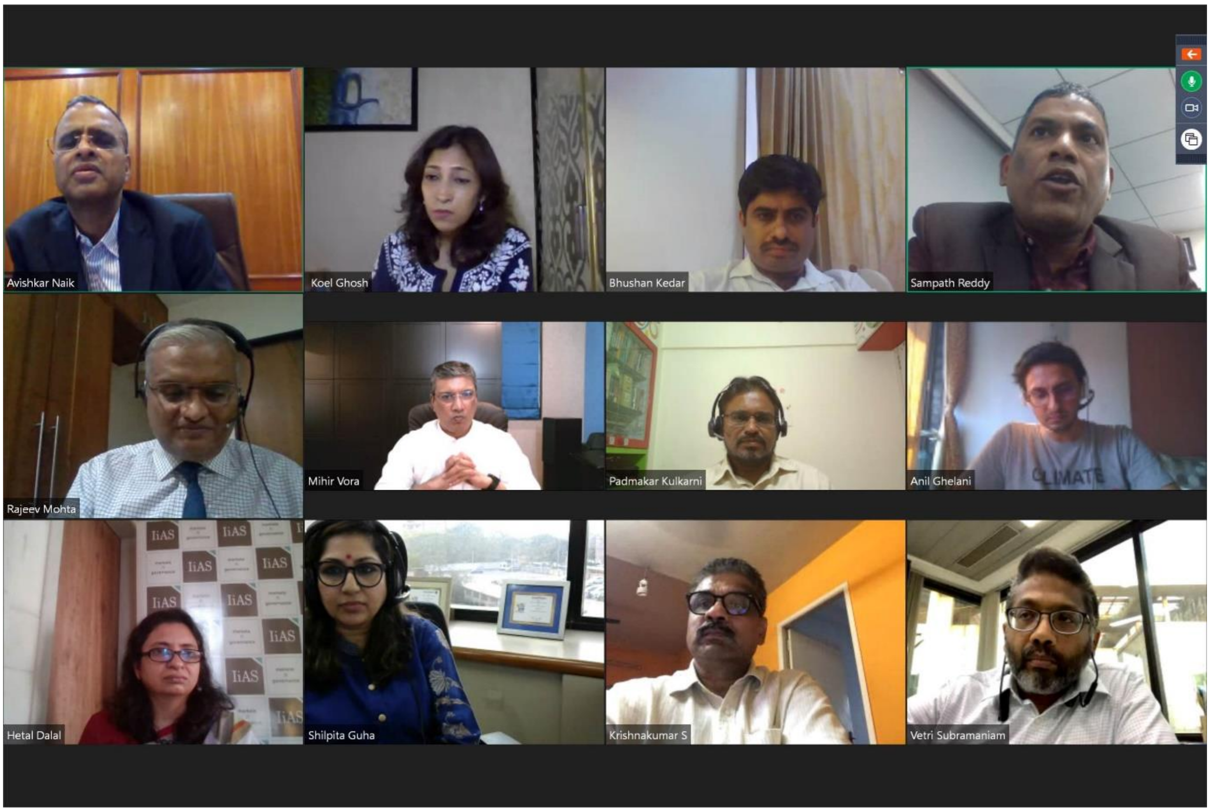
Index providers' stance tends to be a function of their user profile and the exchanges that they track. Whether index providers must take a stance on market characteristics is being debated. For example, stock exchanges have allowed shares with differential voting rights to be traded, much against the backlash of corporate governance flagbearers. Both NSE and S&P BSE indices allow the inclusion of shares with differential voting rights, because they believe these are representative of the market. However, others like the S&P Composite 1500, do not support companies with multiple share class structures.

The issue that most of the global index providers are now deeply considering is climate change. MSCI, S&P Dow Jones Indices, and FTSE Russell have all developed indices that focus on climate change risks and reduction of carbon emissions. Indian index providers do not have indices focused on climate change specifically but have overall ESG indices that address some of these risks.

The next phase of index construction will be with the use of Artificial Intelligence. IBM Watson is being used to experiment with creating a US-Equity index. These technology-driven indices are necessary to process the myriad information available in real time, which will help investors make meaningful choices.

There is no denying that indices have served the markets well and will continue to do so over the foreseeable future. Because of their nature of construction, the occasional challenges for investors to replicate these indices will continue to exist.

With the assets under management of passive funds soaring, index providers will consequently gain more power over the market, and greater will be their responsibility and the scrutiny they will come under. Ultimately their behavior alone will determine their sustained role in the investing universe.



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For the list of participants at the roundtable, please write to solutions@iias.in

About NSE

About National Stock Exchange of India Limited (NSE): National Stock Exchange of India (NSE) is the world's largest derivatives exchange by trading volume (contracts) as per the statistics maintained by Futures Industry Association (FIA) for calendar year 2020. NSE is ranked 4th in the world in the cash equities by number of trades as per the statistics maintained by the World Federation of Exchanges (WFE) for calendar year 2020. NSE was the first exchange in India to implement electronic or screen-based trading. It began operations in 1994 and is ranked as the largest stock exchange in India in terms of total and average daily turnover for equity shares every year since 1995, based on SEBI data. NSE has a fully-integrated business model comprising exchange listings, trading services, clearing and settlement services, indices, market data feeds, technology solutions and financial education offerings. NSE oversees compliance by listed companies with various SEBI regulations. NSE also oversees compliance by trading and clearing members with the rules and regulations of the exchange. NSE is a pioneer in technology and ensures the reliability and performance of its systems through a culture of innovation and investment in technology.

About IiAS Research Foundation

The IiAS Research Foundation has been established by IiAS to serve as a platform for market participants i.e., business leaders, board members, academics, investors, issuers, and intermediaries to interact on the practice of corporate governance and their approach to ESG. It aims and to foster debate around regulations, corporate and investor behaviour, and capital markets.

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for ~ 800 companies that account for over 95% of market capitalization. IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024).

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