The Implications Behind Indexation

Disruptive Forces in Investing **July 25, 2023**

Anu Rajakumar: Index funds, which give investors low-cost exposure to entire swaths of the equity market, have grown exponentially in recent years, allowing investors to build portfolios at a fraction of the cost. Today, Morningstar estimates that index tracking vehicles, including mutual funds and ETFs, now account for nearly 60% of total equity assets under third-party management, up from just 20% in 2011. At Neuberger Berman, we believe there's more to indexation than meets the eye, including potential hidden opportunity costs for investors and, if taken to an extreme, the longer-term breakdown of properly functioning markets.

My name is Anu Rajakumar, and joining me to discuss some of the less appreciated implications of indexation is Doug Kramer, Head of Institutional Equity and Multi-Asset. Doug, thanks for coming on the show.

Doug Kramer: It's a pleasure, Anu.

Anu: All right. So, Doug, set the stage for us a bit. How and why did Indexation come to play such a dominant role in the markets?

Doug: Yeah, we've been studying this for a long time, and the nuances are complex. We outline them in a paper we just wrote called *The Fine Print of Indexation*, which I encourage our listeners to read, but, you know, indices, used to be purely performance measurement tools.

If you go back all the way to the beginning, back to 1884 when the Dow Jones created the first index, which was the Dow Jones Transportation Index, and back to 1957 when the S&P 500 started, these were data services, essentially services that people purchased. And it was something that you contrasted your portfolio against, but it all changed. Essentially, in 1976, John Bogle at Vanguard created the first passive fund, and it was a big deal. And since then, indices and passive investing has taken off. And we think there are wide-scale implications of trillions and trillions of dollars sloshing around in these indices.

Anu: Okay. So we've gone from performance measurement to thousands of investable products. I feel like there's a big "but" coming. So, what's the catch here, Doug?

Doug: Well, over time, trillions and trillions of dollars have gone into these passive and investment products, and as a result, the index companies, let's call it the big three, S&P Global, FTSE Russell, and MSCI, have had to accommodate significant flow of funds into these products. And as they become more and more popular, and as you mentioned, they become a dominant force in the industry, the thing that the indices need to grow over time in this low-fee, high-volume business is scalability. The index have to be able to accommodate trillions of dollars of assets.

And in the investment world, scalability means liquidity, meaning the indices can only grow based upon their least liquid constituents. So what's happened is the index companies have made adjustments to their methodologies in order to accommodate this flow of funds. Now, indexation has done a lot of very good things. It's provided access to investors, but at the same time, we believe that people should read the fine print and understand some of the opportunity costs that this methodology changes have had over time.

Anu: Great. So let's dig into some of those methodology changes. You know, and-and as you said, you got to read the fine print. It sounds like passive investing actually does have some active components that folks may not be aware of. Um, and you also mentioned some hidden opportunity costs. Where do those come from, and how large are they?

Doug: Yeah. I do think that the index companies over time have had to make some active decisions to these products that many investors are not aware of. So for example, most people think that the large broad market benchmarks are market-capitalization-weighted. Well, they used to be market-capitalization-weighted until about 20 years ago. 20 years ago, many of the indices went from market-capitalization-weighted to market-capitalization-weighted float-adjusted. What does that mean?

It means that companies that have high float get higher weightings in the index and companies with lower float get lower weights in the index. Why did they do that? That's to increase liquidity. I'll give you an example. If a company buys in stock, if a company retires stock, which is generally viewed to be positive, that lowers the float, the index actually lowers the weight. Conversely, if a company issues stock that's meant to be dilutive, that increases float and increases the weight.

I think a lot of investors would find that counterintuitive, and what we think about this is that because of this uber scalability that the indices need, it creates a cost, which I'll describe in a second. The second component is what we call inclusion rules. If you go back to the origins of passive investing, it was buy all stocks in the market, buy 'em all and hold them all. Well, that's not actually what the modern indexes do. They actually go out and they're a sample of the overall market, meaning they decide what's in the index and what's out of the index.

And we argue that they generally exclude companies that are smaller, that are less liquid, that may be harder to trade, and over time, that may or may not be good for investors. And I would also add one other thing, to this index inclusion and exclusion concept. I don't know if investors are aware, but over the past 20-odd years, 700 companies have gone into the S&P 500 and 700 companies have gone out of the S&P 500. And if you've studied some of the smaller cap indices as well, um, the numbers are quite large. And the inclusion and exclusion of companies in the index creates front-running opportunities and index arbitrage opportunities where there's a whole set of investors that go out there and try to get in front of, uh, buys and get in front of sales. Now when you add all of this up, whether you look at float adjustment, some of the inclusion-exclusion rules in the index arbitrage opportunities, we estimate, and you see this in our paper, that the opportunity cost to investors could be up to 35 basis points a year.

Anu: Well, that's important to understand. I'm sure some of our listeners who have experienced, you know, the, uh, the tailwinds of passive investment over the last few years are saying, well, that 35 basis points is, you know, a fair convenience fee for me to build these diversified portfolios of rock bottom prices. What are the risks of doing that?

Doug: Well, there are a couple of risks. As more and more people go into the market-capitalization-weighted indices, they keep buying securities based on that factor, which is market capitalization, which is companies that have bigger market caps get more and more of the flow. And so it naturally follows that if market capitalization is the factor, the indices would get more and more concentrated over time. And as we articulate in the paper, the concentration of most of the modern indices continues to get less and less, meaning the bigger cap companies are dominating the index.

And I'd be remiss in not saying in a timely way, last week, the NASDAQ 100 index announced what's called a special rebalance. It was a decision based on the index provider to go out and lower the weights of some of the largest constituents in the NASDAQ 100 because of the concentration. Talk about the fine print, I don't think most investors knew that there were these special rebalancing rights in the indices. And I would assert that the decisions on how to reduce the weights there are really, really active, right? Are they passive? No. Those are active done by people and companies.

The other risk that I foresee over time is the concept around proxy voting and stewardship. Um, in our paper, we-we outline, for example, in the S&P 500 that the large index companies own about 25% of the constituents of the S&P 500. That's a lot of voting power in the hand of a small number of institutions who have to vote on tens of thousands of companies across all these different issues every year. How can they have the expertise to vote on directors and capital allocation and very fine points company by company when their stewardship teams are largely removed from their portfolio management capabilities?

We view that to be a huge risk over time because proxy voting is the official communication mechanism between owners, meaning people that own the stock, and the companies. And we view it to be a critical part of financial stability.

Anu: All right, thank you. And I think that leads to another key concept that you've mentioned in the paper, which is the question of long-term financial stability. What do you mean by that, Doug?

Doug: So in terms of financial stability, with more and more money going into these indices, I think investors need to know that the index does not care about the individual price of a security. The index just buys a basket of securities. And let me contrast that with who determines the price of the securities. Security prices are determined by active investors, meaning investors that do fundamental analysis, quantitative analysis, and determine the worth of an individual security. And if more and more investors go into passive in index-based products where they are indifferent to price, you can see a situation in extremist, right? where the price discovery mechanism in the market breaks down. And that's a risk that I think investors underestimate.

Anu: Right. So I think the key point here is that passive investing needs active investors to really maintain law and order in the market. Um, with that in mind, what are some key thoughts that you'd like to leave our listeners with today, Doug?

Doug: I think the key point of all of this is that with the massive flow of funds into index-based products, they're a large player in the market. And that with such significant assets under management, the people that run these indices have to deal with the realities of liquidity, with the realities of market impact, and that the rules for these indices have evolved and changed over time. And so people should read the fine print, they should realize that people are making decisions about how the index is constructed, what's in, what's out, and that these decisions are made actively. And so what may say passive, they're actually rules-based indices where people are making decisions in a fundamental way, and we think that investors should read the fine print, and quite frankly, apply some of the same due diligence standards that are applied to active managers to the indices themselves. And I'd also make another comment. in a Berkshire Hathaway meeting back in 2021, John Bogle, essentially, the founder of indexation, said, by the way, if everyone indexed, the only word you could use is chaos.

Anu: All right. That's an interesting place to end on, and many important perspectives shared today. To quickly summarize some of your key points today, Doug, you mentioned index companies are making decisions about how to construct their indices and that those decisions are really in fact, more active than many market participants realize. you know, hidden costs, concentration issues, lack of stewardship, and you mentioned questioning the long-term financial stability of these indices are really some of the misunderstood aspects of indexation that investors should be aware of.

I can't let you go today, Doug, without asking you a quick bonus question. Um, we talked a lot about the hidden costs of indices. What I'd like to know is if you have any hidden talents that you'd like to share with us today.

Doug: Hidden talents? Is this a surprise question?

Anu: This is a surprise question. Absolutely.

Doug: Hidden talents, uh, maybe I'll articulate two. Uh, one is I'm-I'm a globe trotter. I seem, uh, pretty immune to timezone changes and jet lag. And number two, uh, I used to be a good rackets player back in the day.

Anu: What-what-- Which racket specifically?

Doug: I was a squash player.

Anu: Okay. Very good. And have you gotten into pickleball yet?

Doug: I have not gotten into pickle, but what's up with all these vegetables and fruits being named racket sports? I don't really get it.

Anu: I know. It seems like, uh, the opposite of the couch potato, but, um-

Doug: [laughs]

Anu: -great. Well, thank you very much for sharing that. And also thank you so much for being on the show today. I think you've given passive investors everywhere some things to really think about.

Doug: Thank you.

Anu: And if you want to dig into this topic further, I highly recommend checking out Doug's paper, *The Fine Print of Indexation*, which you can find on the Neuberger Berman website under Equity Insights. And finally, don't forget to subscribe to *Disruptive Forces in Investing* via Apple Podcast, Google Podcast, or Spotify, or you can visit our website www.nb.com/disruptiveforces for previous episodes as well as more information about our firm and offerings