

# Inside Market Data

April 2013

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# INDEXES

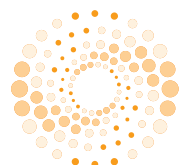
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## Indexes on Deck, or Benchmarks on the Bench?

With the Dow Jones Industrial Average hitting record highs so soon after the recent financial crisis, some investors are questioning whether indexes are a true reflection of the health of financial markets. At the same time, investment firms managing assets that are bound to track these benchmark indexes are questioning the costs levied by providers, while exchanges and index providers dispute who owns the right to list contracts based on an index.

Who would have thought that these financial tools—which essentially group representative baskets of companies together and create an aggregate value to reflect the investment strength or weakness of a particular sector, industry or region—would still have a role in today's markets, at a time when “consumerization” of finance is seeing investors cut out traditional advisors in favor of investing directly.

Yet index use is arguably stronger than ever—in part because those independence-seeking investors are migrating to funds or instruments like exchange-traded funds that are linked to indexes, and in part simply because of the economic recovery and a growing population requiring savings plans and pensions that deliver exposure to growth with limited risk. Also, notes Gareth Parker of Russell Indexes, what else would investors use to benchmark the performance and behavior of their portfolios?

But some consumers feel trapped using indexes that rely on the strength of their brand rather than the value of their index selection methodology, and which are sometimes accompanied by expensive and complex licensing models. “Vendor licensing models have not kept up with the changes in [consumers'] global operating model,” says John Simons, director of market data services at John Hancock, adding that index providers continue to raise fees at levels exceeding the rise of another key index—the consumer price index.

In response, index providers are developing new products that deliver a broader and more sophisticated set of exposures, including dynamic, “alpha-tracking” indexes, new weighting and constituent selection models, such as by fundamental factors including geographic revenue split, or preference factors such as ESG. And more competition from providers such as CRSP—which last year won a big deal with Vanguard—and startup the Freedom Index Company, among other niche specialists, will make it arguably easier to switch benchmarks, and drive further innovation if established vendors are to retain and win business. ■



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## Nasdaq Merges Data, Index Divisions to Create \$400M 'Diversified' Information Business

Nasdaq OMX's decision to combine its Global Data Products and Global Index Group businesses into a single division in January will make it easier for the exchange to develop and distribute new products, while streamlining its operations and the way it approaches clients, officials say.

The new group, dubbed Global Information Services, is headed by John Jacobs, formerly executive vice president of the Global Index group and chief marketing officer, and comprises around 100 dedicated staff, though it can draw on the resources of around 75 more Nasdaq employees in central functions, such as technology and marketing support roles. Brian Hyndman, senior vice president of Global Data Products—who previously reported to EVP of transaction services and president of Nasdaq OMX Nordic Hans-Ole Jochumsen—now reports to Jacobs.

“Ultimately, customers of our index data, indexes and market data tend to be the same customers on the buy side

and sell side,” Jacobs says. “So if [two businesses] have the same customer base, it makes sense to put them together.... Instead of a data guy and an index guy going into clients, now there will just be one person doing that.”

Hence, the consolidation is about enabling the groups to generate new business more efficiently, rather than cutting costs. “For us, this is not about cost-cutting, because these businesses are already very efficient—it’s about revenue opportunities, and being able to deliver lots of things that customers are looking for... which we will be able to deliver more smoothly because we are streamlining the operations,” he says. “That doesn’t mean we won’t find some efficiencies—for example, both groups have support desks—but it’s about how we can make them more efficient.”

Instead, Jacobs says the move will contribute to Nasdaq’s long-term objective of becoming a more diversified provider of marketplaces and associated services—such as the recent deal to acquire

Thomson Reuters’ investor communications business (*IMD*, Dec. 12, 2012)—rather than being primarily a US equities market, by allowing the exchange to create new products and expand into new asset classes. “We’re not just about building products around the markets we trade; we’re about delivering products that our customers want, regardless of what the rest of our business does... For example, 90 percent of our indexes today include stocks not actually listed on Nasdaq... and it may be that our value-added data can lead to [the creation of] new products that we can trade and list,” he says, citing as an example how Nasdaq’s indexes are licensed as the basis for Powershares exchange-traded funds, which have been used to create structured products, and ultimately index options that are listed on Nasdaq’s PHLX market (the former Philadelphia Stock Exchange).

The merged Global Information Services represents just over 20 percent of the exchange group’s total revenues. ■

### CBOE, S&P DJ Indices Extend Index License Deal

CBOE Holdings, operator of the Chicago Board Options Exchange, has extended until 2032 the exclusive licensing agreement with S&P Dow Jones Indices that allows CBOE to list options on indexes calculated and published by the S&P-DJ index business—including the S&P 500 index options listed by CBOE—with non-exclusive rights extended until 2033.

The original licensing agreement was set to expire in 2022. Under the extended deal, S&P-DJ will continue to act as licensor for CBOE’s index products, methodologies and data, including its VIX Volatility Index products. ■

### FTSE, TMX Ally for Bond Index Biz

UK-based index provider FTSE and Canadian exchange operator TMX Group have set up a joint index venture, dubbed FTSE TMX Debt Capital Markets, which combines PC-Bond—the fixed income index business of TMX’s Datalinx information services division—with FTSE’s existing fixed income index business to offer fixed income indexes as well as analytical products and services.

Officials say the venture enables FTSE—which plans to open an office in Toronto—to increase its North American presence, while supporting TMX’s global expansion. FTSE holds a 75 percent majority stake in the venture, while TMX holds a 25 percent stake. ■

### Wiener Börse to Run Kazakh Index

Wiener Börse, the Vienna Stock Exchange, began calculating and disseminating real-time index data for the KTX Local index Jan. 29, on behalf of the Kazakhstan Stock Exchange (KASE), under the terms of a deal signed at the end of last year.

The index comprises the eight most actively traded stocks listed on the KASE, weighted by capitalization, and computed in euros and US dollars, with a starting point of 1,000 points fixed on Jan. 4.

Muchael Buhl, member of Wiener Börse’s management board, says co-operation—such as leveraging the exchange’s experience in index calculation and dissemination—is important for regional stock markets such as KASE. ■



## Freedom Index Co Expands Free Index Coverage

Not-for-profit index startup the Freedom Index Company is expanding the breadth of its free-of-charge products to include indexes for all developed countries, after launching in 2012 to offer free and independent indexes to the asset management community.

The vendor currently provides daily weights (the percentage weight within each country by market capitalization) and total returns (in local currency, pounds sterling and hedged to sterling) for indexes of the top 50, 100, 250, 500 and 1,000 US and UK equities, filtered by country and ranked by market capitalization, as well as a US and UK All Stocks index, which contains all stocks in the Freedom Index security universe, as well as UK and US Equal Weight indexes for the top 50, 100, 250 and 500 stocks.

In addition, the index provider plans to begin providing data on indexes covering all developed countries over the next year, says Carl Bacon, founder of the Freedom Index Company and non-executive chair-

man of portfolio analytics provider Stat-Pro. "We have yet to finalize our list of the next indexes we will deliver, but Australia and Canada will be high priority, as well as industry sector indexes," he says.

The index provider has a five-year rolling contract with an unnamed data vendor that provides it with data going back to Jan. 1, 2008 for free, on the proviso that the firm does not charge any fees for it, Bacon says. "The data supplier wants to remain anonymous. But on the basis that we don't charge for it, they provide daily weights and returns for any security on any equity exchange in the world," he says. The Freedom Index Company also has equivalent bond data, but is a couple of years away from launching bond indexes because of the data-intensive process of compiling the indexes, Bacon adds.

The company provides its data in spreadsheets that users can download from its website, though Bacon says he plans to make FTP file download available at some point in the future, since this is more com-

monly used in the index community.

Bacon set up the Freedom Index Company in February 2012 to offer asset managers, pension funds and custodians an alternative "market barometer" to traditional index providers, many of which have faced criticism and even seen clients cancel contracts over the cost of licensing their indexes, which have often been a barrier to smaller entrants in the asset management market, he says, so the Freedom indexes should particularly appeal to smaller asset managers, though the indexes may also prove interesting to larger players once the provider has built up its reputation.

"Small asset managers have always been priced out of the market as they are unable to buy indexes and their constituents. But I believe that these basic indexes should be free, or nearly free," Bacon says. The company has secured sufficient funding to keep running for five years, during which time it will not charge for using any of the index data, but will instead raise financial support via voluntary contributions, he adds. ■

## Stoxx Grows Minimum Variance Index Data, Eyes US Growth

Swiss index provider Stoxx has expanded its Stoxx Minimum Variance Index family and corresponding suite of index data, with the rollout of new minimum variance indexes for the US and Canada, to help provide asset owners, risk managers and traditional long-only investors with more alternative beta as it looks to increase its North American presence.

Stoxx launched the index family—developed with portfolio optimization and risk modeling software vendor Axioma to provide risk-optimized portfolios based on the Modern Portfolio Theory developed by Nobel Prize-winning economist Harry Markowitz—last May, initially for European markets, and has now added minimum variance indexes based on its Stoxx US 900 and Stoxx Canada 240 indexes, says Rod Jones, executive director and head of North American sales at Stoxx.

The vendor uses Axioma's Portfolio

Optimizer to create both constrained and unconstrained versions of the indexes, and distributes data on the indexes via major data vendors, as well as via its website and FTP download. The constrained version enforces restrictions on factors—such as value, momentum and liquidity—to mirror the underlying benchmark index while minimizing risk; while the unconstrained version enforces a minimal number of restrictions so that the resulting portfolio more purely reflects minimum variance without tracking a benchmark, providing users an alternative strategy index, Jones says. Stoxx launched its Global Index family two years ago (*IMD*, Feb. 28, 2011), enabling it to leverage those indexes to provide the underlying securities necessary for creating alternative beta strategies.

In addition, Stoxx is looking to leverage Axioma's reputation to help it target clients in North America with the Mini-

mum Variance Index family, particularly among institutional investors, Jones says.

For example, Axioma can use its sales force to introduce partners such as Stoxx to potential clients, says Tophur Wurts, vice president of marketing at Axioma in New York. "We include them in presentations that we make to clients and prospects, we partner with their sales force to make introductions where appropriate," Wurts says. "We do this whenever we sign a deal like this—joint promotion is good for us, because for each index they license to clients, we get royalties as part of that license fee. So ultimately, we are helping them help us."

To support its expansion plans in the region, Stoxx plans to double the number of staff it employs in North America during the first half of 2013, to bring its local team up to a total of eight people across product development and business development functions, Jones adds. ■



## A New Era of Benchmarks: Indexes Respond to Calls for Innovation

Indexes perform an invaluable purpose as a barometer of market performance, and serve as the basis for exchange-traded funds and other instruments, as well as providing a benchmark for asset managers to track and evaluate their performance, and to deliver exposure to a range of markets, asset classes, regions and styles. But in a market increasingly dominated by algorithmic trading, and where investors demand control and transparency into their investments, forcing asset managers to justify their roles, how will indexes evolve and continue to add value through new innovations without being cost-prohibitive in a still budget-conscious climate?

**IMD: How has index use changed in recent years as a result of economic forces and changing investment styles—from algorithmic trading to retail investors having access to more sophisticated analysis tools—and how has this affected demand for index data?**

**Erin Heise, senior director, ETF and index services, Interactive Data:** In the last few years, index use has increased as the range and sophistication of financial products for which indexes are built has broadened to include mutual funds, exchange-traded funds, derivatives, structured products and more. While these expanded offerings provide investors with a virtual supermarket of financial product options, educating investors on the more sophisticated or complex offerings hasn't always kept pace.

**Gareth Parker, senior director, index research, design and development, EMEA, Russell Indexes:** There has been a boom in the number of indexes being used, primarily for two reasons. First, investors are seeking in-depth analysis of the performance and behavior of their increasingly global portfolios. To conduct this analysis, indexes and their accompanying time-series histories are

required at the top level, as well as at regional, country and sector levels, and so on.

Secondly, new data-mining techniques have propelled the search for “smart beta,” which in turn has led to new types of indexes being created. These indexes—often categorized as “strategy indexes”—offer targeted exposures to, for example, geographic regions, new style dimensions and alternative-weighting strategies. Strategy indexes have certainly increased the client interest in indexes, especially for structured products and previously actively-managed funds, resulting in the need for real-time data availability for those indexes.

**John Simons, director of market data services, John Hancock Financial Services:** From my perspective at an asset management firm, global growth and product differentiation are driving a surge in demand for equity and fixed income indexes for active, passive and asset allocation products. Areas in which this trend is most evident include: expansion of product families to cover international markets, additional asset classes and broader investment strategies; extension of geographical distribution presence



in international markets; utilization of index vehicles to create diversification in asset allocation products; growing emphasis on near real-time compliance; and rise in daily attribution and risk reporting.

The challenge we face from a buy-side perspective is that index vendor licensing models have not kept up with the changes in the global operating model. For example, an organization might perform pre-trade analytics in one location, compliance in another, data compilation and validation in a third, and risk, attribution and client reporting in yet a fourth—all as part of a virtual team. But, vendor license models typically require multiple user licenses by location. This approach is expensive, inflexible, tough to administer and often requires firms to modify their operating processes to accommodate the licensing rules.

**Jason du Preez, global head, indexes and symbology, Thomson Reuters:** Most investment managers still operate under mandates that demand they benchmark against plain, “vanilla” indexes like the S&P 500. However, regulatory pressure and demands for transparency over the investment process are resulting in the use of new indexes that encapsulate investment strategies. In this way, a hands-free investment approach can be adopted by fund managers with the option of having the index independently priced and calculated by a third party.

Investment products tracking such “alpha-seeking” indexes are becoming increasingly dynamic, requiring a broad range of content not available to traditional index providers. Strategies cover all asset classes, including: multi-asset; aggregated data, such as earnings estimates; evaluated data, such as bond pricing or environmental, social and governance (ESG) ratings; and even news sentiment.

In any event, with the growing realization of the flaws in pure market capitalization-based indexes and on-going innovation in the index space, demand for index data is guaranteed.

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**“We are seeing growing demand for the next generation of products that weight by a broad range of fundamental factors, including estimates, geographic revenue or dividend payments.”**

*Jason du Preez, global head, indexes and symbology, Thomson Reuters*

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**IMD: Indexes traditionally provided a low-risk way to gain exposure to new markets. With indexes available for almost any geography, industry sector and investment style, what areas are yet to be exploited by indexes and related investment vehicles, and what new factors can providers incorporate to deliver more value and differentiate themselves?**

**Du Preez:** With active fund managers under scrutiny, the trend towards leveraging investment products based on indexes is clear. But the vast majority of index-linked investment products, such as ETFs, still track traditional market cap-weighted indices.

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However, we are seeing a growing demand for the next generation of products that weight by a broad range of other fundamental factors, including estimates, geographic revenue or dividend payouts providing investors with the means to efficiently tailor portfolios even further.

A particular area for exploitation is that of “dynamic” indexing—where an index defined by the fund manager reacts to market conditions and adjusts its allocation across asset classes (for example, out of Treasuries and into equities in a bull market). It will be interesting to see how popular these more complex strategies will be among ETF issuers, whose products are traditionally favored for their simplicity.

**Heise:** There has been a proliferation of new indexes using a variety of weighting and/or constituent selection schemes, and we expect this trend to continue as new strategies are developed. The traditional market cap-weighted indexes are still the most widely used, and there are countless variations on these using fundamental schemes, risk measures, etc. Sectors that may still present opportunities for new product development include fixed income, commodities and balanced index types.

With respect to global equity indexes, a key differentiator for index sponsors would be the incorporation of fair-value pricing into index calculations. Even though global equity indexes are calculated in real-time throughout the day, they may still be utilizing the local market closing price and foreign exchange rates at the time of market close in London, for example. This approach may not reflect the impact of current market conditions on the value of international equities, which can close several hours before US markets close. To address this “stale” pricing, many mutual funds utilize a fair-value pricing methodology as an input to their daily Net Asset Value (NAV) calculations, designed to reflect the most recent market information available. As a natural evolution, global equity indexes could adopt the same type of approach to valuation, which could improve the information set available to investors for decision-making, and benefit important risk measures such as tracking error.

**Simons:** There are numerous opportunities for index vendors to differentiate themselves and to grow in the marketplace. Here are a number of areas that I think are promising: First, there remains

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a huge opportunity for inexpensive passive index vehicles to create diversification within other investment products. Why pay a premium for a “branded” index when it will be bundled inside a broader portfolio. In a related vein, there is a limited appetite to pay premium fees for standard indexes that are essentially commodities. Whoever packages a credible offering in this space and markets successfully to consultants will be quite successful.

Fixed income indexes will evolve, given the impact of the current interest rate environment. Also, there is a need for greater transparency in fixed income indexes, given the complexity of the underlying prices. Indexes for non-public assets (hedge funds, various flavors of alternative investments, private securities, etc.) will be increasingly significant. Lastly, “investment strategies in a box,” if coupled with active management concepts, could be an intriguing area.

## Russell Indexes by Russell Investments

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**Parker:** Index providers have a long history of index innovation, which is often fuelled by developments at active fund managers. For example, style indexes were invented by Russell Indexes following analysis of the actual investment behavior of managers.

Today, we are seeing the development of portfolio strategies into indexes—volatility control, momentum, defensive strategies, and so on—and we can reasonably assume that this process will continue. However, a number of asset classes remain poorly served by indexes, such as hedge fund investing and private equity, which are areas open for exploitation.

Perhaps the most interesting area where we are seeing progress currently is that which focuses on the actual location of a company’s businesses. This follows recognition that where a company is headquartered or traded is an incomplete indicator of a company’s exposure to global business. New, more sophisticated data-mining techniques are now available to dissect these companies by revenue source rather than by location, and index providers are starting to create new indexes based on different criteria, such as the level of emerging markets business, or the sector(s) that a company derives its revenue from.

This allows providers to build indexes of developed-market companies that are highly exposed to emerging markets—for example, to give investors a new indirect path to emerging markets investing. It also means that it is possible that major global

indexes could be redrawn by the origination of revenue, profits and assets, regardless of the location of the headquarters of listed companies. This could open up new diversification opportunities and reverse the trend toward increasing correlations between markets when conventionally measured.

**IMD: How critical to developing and growing an effective index family is an individual underlying classification schema? What are the benefits and drawbacks of multiple proprietary classification schemas for index providers and consumers?**

**Du Preez:** It is fundamental to index construction. Sector classifications help investors identify companies with similar revenue sources and demand characteristics, and they are used to create indexes that analyze these groups at varying levels of detail.

Building and maintaining an effective classification is labor-intensive: extensive training is needed for analysts that need to read through local language filings and news reports for all index constituents and assign a dominant industry for each company according to an agreed rule set. Schemes become stagnant if analysts do not regularly monitor companies, or if the schema does not reflect new emerging industries such as Smartphones or Renewable Energy.

Using multiple schemas is problematic, as it can result in concordance errors, especially when trying to analyze and compare performance across different markets. For example, Danish wind turbine manufacturer Vestas Wind Systems is classified in our proprietary Thomson Reuters Business Classification (TRBC)—which covers almost every listed equity in 130 countries down to five levels of sector detail—as Renewable Energy Equipment, but in the Global Industry Classification Standard (GICS) as Heavy Electrical Systems. So analysis of Vestas’ peers using GICS in Europe and TRBC in Asia would result in a comparison of different, but overlapping sectors. Cross-referencing between sector classifications can help, but there is clear benefit to using a single scheme that covers your full universe.

**Parker:** Obviously it is vital to have respected industry classification systems such as the Global Industry Classification Standard (GICS), Industry Classification Benchmark (ICB) or the Russell Global Sectors (RGS). Although there are a variety of local exchange classification systems, at the global level, virtually every globally investable stock is classified under GICS, ICB and RGS which allows for easy like-for-like comparisons across markets. As to which system, investors can pick and choose as they wish. There would, of course, be simplicity advantages from having only one system—but then, there would be no flexibility either, and no means for identifying and improving best practice in industry classification.

**Heise:** On the surface, multiple classification schemes make it difficult for end-users to easily compare index families. However, increased demands for transparency of the constituent data and classification selection criteria are key factors in the creation of like-for-like comparisons. The European Securities and Markets As-



sociation (ESMA) has recommended increased transparency into index calculation methodology and index composition, which would make it easier for consumers to conduct comparison analysis. Multiple classification schemes may appear to offer consumers more choice, but in reality, the ability to switch index benchmarks is quite time-consuming and costly. Consequently, it is the larger firms that have the resources to make a significant change, while smaller firms are often confined to their existing index benchmark, since once an initial benchmark is selected, it becomes embedded in a firm's overall process, which can include everything from marketing, financial portfolio management, and administration to operations. As a result, key benchmark indexes tend to have little competition once they've been established within a product sponsor's business operations.

**Simons:** My initial inclination is to state that “the more, the merrier” as far as classification schemes go. Diversity is generally good, as it provides choice and the potential for innovation. Nonetheless, I will acknowledge that classification models can get out of hand. Just because computers give us the ability to sort and categorize indexes in an almost limitless number of permutations, it does not necessarily follow that we should go down that path. In the end, each firm will pick a few standards and run with them. Let the cream rise to the top.

**IMD: Who owns the data? Should any exchange be able to list and trade contracts based on publicly-available index data, or any firm be able to offer investment vehicles benchmarked to market “standards”? How is the industry dealing with the competitive and legal pressures of index licensing and compliance?**

**Simons:** “Who owns the data” might be the ultimate meta-physical question perhaps best left to the philosophers. Or, more prosaically, it is a real “taffy pull.” All joking aside, this question is really an extension of the current turmoil related to copyright, patent and IP rights. My view is based on a simple principle: ownership should be based on value, innovation, service quality and real brand equity. If an index provider creates truly innovative and differentiated products and delivers them consistently in a flexible, timely and accurate manner, then they should be reasonably compensated for that effort. However, if an index firm asserts broad ownership rights for an obvious concept or idea that is readily commoditized, then premium pricing is unwarranted. We should pay for innovation, and not the ordinary!

**Du Preez:** This is an area of hot debate. Exchanges are increasing the price of the data they provide to index providers, index providers are accused of misusing exchange data, and our clients complain about index providers' rigorous over-policing and high cost of index content.

This makes for interesting market dynamics. Content providers certainly have rights over their intellectual property: the underlying data for listed index constituents belongs to the exchanges,

and Thomson Reuters employs a rigorous governance process to ensure that this valuable content is used correctly within our indexes. Likewise, we believe that if exchanges want to list and trade index-linked contracts, they should pay a fee to the index provider for adding value to the underlying exchange data.

Since firms developing index-linked investment vehicles reduce the cost of managing asset allocation through use of the index, it is only logical that index providers realize part of this benefit through index licensing fees.

The key, however, is that while there are leading indexes in each market, there are a growing number of alternative options provided by reputable providers. An energetic debate could be had about “leading” products turning into market standards, but I would advocate a shift instead towards looking for competitive alternatives that match the accepted benchmarks and provide exciting options for generating alpha.

**Parker:** Some indexes do indeed become standards, but most don't, and even market reference indexes sometimes get replaced by others through normal competition, such as the replacement of the Eurotop indexes by the Euro Stoxx 50, or the S&P 500 as a fund benchmark by the Russell 1000.

In such a competitive environment, index providers commit significant effort and institutional knowledge to the creation, management and calculation of indexes. This results in intellectual property that needs to be respected for indexes to retain their independence and accuracy, and to encourage the innovation that has been put into their provision.

That said, the index providers seek to have their indexes used as the underlying for investable products, both on-exchange and over-the-counter. The providers sometimes restrict listings to individual exchanges or products to concentrate the often relatively small liquidity and open interest, and thereby secure the continued future of that product.

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**Heise:** The index methodology is the intellectual property (IP) of the index sponsor, but there are other elements of the index, including underlying data, that may be the property of various third parties. For example, the constituent pricing data within the index may come from an exchange or third-party pricing

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provider; or the classification scheme could be licensed from a third-party provider.

Freedom Indexes and the Edhec Risk Institute offer “free” index data, and include methodology and composition transparency. These new entrants may provide smaller asset managers and consumers with cost-effective options, if they are prepared to forgo certain benefits associated with larger providers.

With regard to the creation of new investment vehicles and products, a lot depends on the investment strategy and what an index sponsor can offer in terms of IP, branding and education. We have also seen a “self-indexing” trend, where firms such as WisdomTree and Northern Trust have created their own indexes. On the compliance side, independence and transparency are recurring themes, particularly in fixed income. Using an independent pricing source is becoming more important as the regulatory landscape continues to focus on valuation in general.

**“Once a benchmark is selected, it becomes embedded in a firm’s overall process.... As a result, key benchmark indexes tend to have little competition once they’ve been established within a product sponsor’s business operations.”**

Erin Heise, senior director, ETF and index services, Interactive Data

**IMD: What effect has Vanguard’s high-profile benchmark switch had on an industry struggling with competitive challenges around sourcing and management of index data? Are firms more willing and able to switch suppliers to meet their needs, and how are vendors responding to potential new competitive challenges?**

**Du Preez:** Vanguard’s switch illustrates that using the “leading indexes” in each market is no longer mandatory, and brings to the fore the industry’s discontent with growing costs in a world where firms have committees tasked with reducing index spend.

In the ETF licensing industry, investors are increasingly recognizing the value of the fund manager over the index provider alone (i.e., in this case, investors place more trust in Vanguard than in MSCI). The same applies to benchmarking and performance management—especially for fund operators that work on a lower-margin basis than asset managers. Many no longer wish to absorb increasing index costs, and are left with no choice but to pass them on to their clients in the form of higher custody fees.

I expect we will see the shift away from the exclusive use of the major incumbent index providers gain momentum as firms take advantage of vendors that are able to offer broader service, more content and competitive commercials.

**Heise:** Vanguard’s benchmark switch has proven that it can be done. We think it is likely that more firms will consider alternatives as the competitive pressures continue. Although larger ETF sponsors may shift the focus to their own brand and rely less on

their index sponsor, smaller firms may not be able to do so because they rely on the index sponsor for more than just the index calculations. Another consideration for firms thinking about self-indexing is the cost involved in managing an index operation, which includes the costs of data management, and real-time, intraday calculation and dissemination. One possibility for firms that wish to pursue self-indexing is to utilize an independent index calculation agent that already has the infrastructure in place. Vanguard is using the CRSP (Center for Research in Security Prices) Indexes for some of their domestic equity ETFs, and Interactive Data is the calculation agent that works with CRSP to provide cost-effective and high-quality intraday, real-time calculation, dissemination and other services, while CRSP maintains full management of the universe and client notifications of changes and results. Interactive Data offers a wide range of index services that can be tailored to a sponsor’s needs.

**Parker:** The Vanguard decision has highlighted the fact that switching index provider is a feasible proposition, and has encouraged the providers to compete even more vigorously. This is entirely to the benefit of index users. Not all indexes are created equally, and index products have notable differences in philosophical underpinning, leading to notable differences in methodology, construction, and ultimately outcomes. The benefits to clients of providers differentiating themselves are more obvious in today’s global investment markets than ever before. Indexes are transparently controlled, well-designed, effectively-managed, and built after lengthy, informed research and innovation processes, supported by expertly equipped and competent client services teams.

**Simons:** The “Vanguard shuffle” is profoundly important because the leading industry player made the move—which makes it legitimate. While the other shoe has not dropped yet, change is coming; it will be gradual, but inexorable.

The reason is that the pricing and licensing practices of the incumbent vendors are not sustainable. Consistently raising prices at a rate greater than the consumer price index and adopting restrictive licensing practices will no longer work in the current competitive environment. The barriers to entry are not that great, and many indexes are just not that complex to develop and maintain. Plus, the brand cachet of the existing players is eroding, and the alternative suppliers generally have stellar reputations. New suppliers will gradually gain share as investment firms and consultants become more comfortable with the new options. And the incumbents will become more flexible in their licensing and pricing terms. ■



**John Simons,**  
John Hancock Financial Services

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