pi roundtable

INDEX INVESTING FOR DEFINED CONTRIBUTION

BlackRock®

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DISCUSSION: INDEX INVESTING FOR DEFINED CONTRIBUTION

A group of key players discuss how index investing can benefit DC investors in the current environment and over the long term.

portfolio institutional's index investing for defined contribution (DC) roundtable explored many facets of the market, which could be condensed into six important themes.

First to be covered was the objectives of the market. Second was the construction of such products, followed by the performance of index investing. Then came challenges of regulation, the importance of stewardship and finally the big index investment themes for 2024 were analysed.

To address the first point on market objectives, the panel was asked what DC investors should consider when looking at index investing.

Jenni Kirkwood took a step back and asked: why invest in indexation? "Well, because it's cheap. And active fund management doesn't necessarily always work," she said answering her own question.

Kirkwood then added that there are two problems within the DC universe. "One is that switching the managers around on a quick basis is difficult. And secondly, because DC is small and growing, we don't necessarily have the purchasing power that the big defined benefit clients do. Therefore, we don't necessarily get as good deals. So when you look at active management you have to ask: 'is it worth it?'"

Efficient access

Which naturally leads many DC investors towards indexation, because the answer for many DC schemes is active is not always worth it.

But she then posed another issue concerning index investing. "With indexation the challenge is you get the whole market – and is that right?" she questioned. "We are seeing more and more products coming out like that. And a lot of our clients have just gone into those."

But there are market challenges for index investing with this development. "There is the challenge of the magnificent seven companies dominating the index, and when we try to do innovative things the seven dominate and you may not receive a good return as a result."

Building on Kirkwood's central point, Callum Stewart noted that something more fundamental exists for DC investors. "Index investing is the efficient access to markets," he said.

Market efficiency

This is important for DC investors, Stewart said. "For a DC strategy context, it is important that we have that opportunity to invest efficiently in markets. The strategic asset mix is what drives the majority of the long-term outcome for a DC fund."

Although Stewart observed that from a DC point of view most strategies have a heavy weighting in equity markets, which can be a challenge for some DC investors.

Sam Burden said it is ultimately about the outcomes for DC investors. "As a trustee, I want good outcomes and security for the members," he said. "The universe we are in at the moment means, even if you want to invest in active management, the price cap [as a DC investor] prohibits you from doing that," he added.

That drives DC investors to use index investing in all asset classes, Burden said. "Index funds represent the most practical and efficient way to provide value."

For Jonathan Parker, indexing is the purest way of expressing investments beliefs or achieving a set of investment objectives.

"Whether that is seeking to achieve a great return, or dampen risk, or exclude a particular sector, because of the huge innovation that has taken place within the index market you can pretty much express any investment belief and achieve any set of investment objectives via an index," Parker said.

Index building

BlackRock's Mo Masood then addressed the issue of how to build an index. "The first step is to determine the starting point". "Are we including only large and mid-sized companies or do we want small cap exposure? The starting universe is important as several strategies use it as an anchor for their risk, sector and country profiles. It also serves as a reference point for comparative performance," he added.

The second is around stock selection. "While traditionally market capitalisation has been a criteria for stock selection, investors can now target specific portfolio outcomes such as style factor exposure or sustainable objectives," Masood said.

The third component is around weighting: "It is about finding the balance between providing exposure to the investment

THE PANEL

Sam Burden
Client director
Zedra Governance

Jenni Kirkwood
Senior investment consultant
Mercer

Mo Masood
Director, sustainable investing
BlackRock

Jonathan Parker
Managing director, head of DC
Redington

Callum Stewart
Head of investment proposition distribution
Standard Life

objectives whilst ensuring liquidity and capacity as well as managing transaction costs."

Sustainable impact

Moreover, the topic of sustainability can be said to have transformed index investing. "It has required more choice," Masood said. "The complexity of index construction has increased, which is a reflection of the different objectives investors are looking to achieve."

> **"We are investing in the DC world for the long term and index investing allows you to set a clear strategy at a low cost.**
>
> Sam Burden, Zedra Governance

Parker agreed with the point that indexing has fundamentally changed. "Having this debate shows how indexing has evolved, especially over the past 20 years," he said. "DC advice used to be around a 50:50, or a 60:40 global equity portfolio which was about the extent of the investment choice."

Now the issue of index investing is becoming more nuanced and deeper in its thinking, development and approach.

Measuring it

But how do investors measure success within the whole index-investing arena? "There are so many measures," Stewart said, "and we need to look at them all. But it has to equate to money in the pocket at the end of the day. That is what we are here to provide."

Another important question surrounds the differences in creating developed world indexes compared to emerging market products. "There is a greater need for estimations in certain emerging market data sets as the level of reporting is not at par with developed markets," Masood said, identifying a major difference.

"Also, the distribution of data sets can be different," he said. "You may not be able to achieve the same percentage improvement in an ESG metric in emerging markets, as you can in developed markets. This can lead to portfolio construction approach being different to that of developed markets."

The blob

Parker also noted another problem. "There is an issue that we look at emerging market as some homogenous blob," he said. "There are many different countries with different positions in respect of transparency of data.

"There could be heightened political risk, yes, but some more nuanced thought is perhaps required from DC investors towards developing countries."

Whatever the issues, Stewart said emerging markets have an important part to play within indexing. "I would always, from a starting point, include emerging markets and then follow the [index] process," he said.

Peak performance

When addressing the performance of index investing, the panel explored the themes that outperformed during the turbulence we witnessed in the markets last year.

"In the first quarter of the year, the top seven tech stocks in the US drove a high percentage of overall returns," Stewart said, revealing there is no getting away from the so-called magnificent seven.

> **Active fund management doesn't necessarily always work.**
>
> Jenni Kirkwood, Mercer

Looking at timescale within the market environment is important when looking at index investing. "What has happened in the last year, the last three years and even the last five years, is not that meaningful," Stewart said. Given its nature, at least from DC investor perspective, index investing is a long-term pursuit.

And Masood commented on the variety within index investing. "There are so many different flavours, it does depend on which strategy you look at. For example, there are certain products with exclusionary screens on oil and gas. In a year like 2022, such exclusions would have contributed negatively towards relative performance versus the benchmark. But not all sustainable products implement oil and gas screens – index methodologies matter."

When it comes to performance, Kirkwood offered some straight talking advice. "Before you go into an index, find out what you are getting," she said.

The long-term picture

For a DC investor the role of index funds should be seen in terms of improving member outcomes. On this, Burden said: "A key driver is around cost. We are investing in the DC world for the long term and index investing allows you to set a clear strategy at a low cost."

So looking a little deeper, what sort of returns should DC investors expect index investing will produce going forward? "It is hard to put a number on it," Stewart said.

Burden added that there is a concern over a lack of member understanding of what index investing means. "Everybody is encouraged to look at past performance, but members don't fully understand that the performance of index funds is simply a product of the selected indices. We need to educate members so they better understand what is happening in practice."

Regulation change

Moving on to regulation, the panel explored how it has changed the index investment environment, with one theme dominating: sustainable investing.

"Massive," Parker said about the impact of regulation on index investing. "The Paris-alignment is an international legal framework and has been co-opted into UK law and all this then filters down and hits the likes of the investment industry, which has to take that net-zero regulation and translate it into a set of investments structures, which is very hard."

> **The complexity of index construction has increased, which is a reflection of the different objectives investors are looking to achieve.**
> Mo Masood, BlackRock

On what the Paris alignment would look like in an index investing scenario, Parker added: "If you built an index today that had net-zero carbon metrics, it would be quite unusual, and you may not want to invest in it."

Who's responsible?

The changing regulatory environment also raises stewardship challenges surrounding index investing. "The amount of data is vast," Burden said. "It is important that we are thinking about stewardship, but in reality, it is not really working."

Parker added that it was often the case that pension members, trustees and platform providers don't hold the ultimate voting responsibility. "Having an open dialogue with those that undertake the voting and engagement with companies is important," he said.

Kirkwood said stewardship has moved on from being something that was essentially a tick-box approach to something more pro-active.

> **You don't automatically associate illiquid assets with index investing.**
> Jonathan Parker, Redington

"We are now having challenging meetings, with constant questions asked: 'why did you do this?' 'Why did you do that?' 'What is your policy on that?'

"The world has changed – but I would say in a good way," she said.

Stewart noted though there is a problem given the lack of a unified framework across the industry on how to best undertake effective stewardship. "There needs to be an industry answer to this," he said.

As yet, the industry has failed to convincingly pick up this particular baton and run with it.

Masood made the point that BlackRock takes a constructive, longer-term approach to stewardship. "While we do get questions from investors asking 'where is the change'," he said, it is important to keep in mind what the purpose of stewardship is. "Ultimately, BlackRock's role as stewards on behalf of our clients is to promote sound corporate governance and better understand a company's management of risks and opportunities, with a view to supporting its ability to deliver the financial value for their investors." he said. "It's not about telling companies what to do."

The outlook

Looking at the year ahead, one big index-investing theme dominated the panel's outlook for 2024.

"It is the flavours of sustainable investing that will come through," Kirkwood said. There is a challenge though, she added, in that if we have too many indices and too many products there is a possibility some of those will close because they will not get the money behind them. "I have seen that happen before," she said. "But there will be more choice for members."

Parker said that illiquids and private markets will be an interesting area to keep an eye on within index investing. "You don't automatically associate illiquid assets with index investing," Parker said. "But there is a big push to get DC more involved in the [private] markets and I am sure there will be innovation within the index space to perhaps allow easier access to the financial characteristics of illiquids rather than buying the assets themselves, which can be quite hard for some schemes."

Stewart thinks that factors such as measuring impact will influence the changes in the index market. "How we can make improvements and limit the costs we pay down the line as a society is going to be interesting," he said.

Capture active techniques

But more than anything, Stewart is hoping for more evolution. "There are already different flavours of index approaches, but the mainstream is going to move to more insights in the tilts of what we do, maybe with better ways to measure the Paris alignment," he said. "And then moving the dial up – how do we capture techniques active managers use," Stewart added.

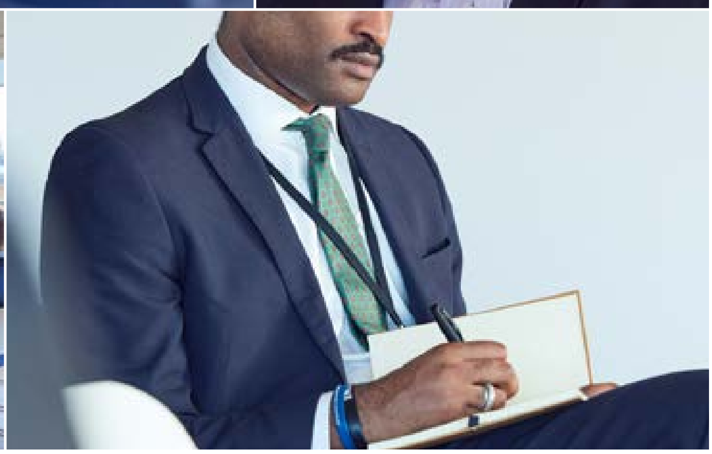
Masood also said we will be hearing more about biodiversity. "This is an emerging theme for several clients. The data sets are quite nascent at this stage and need to go through appropriate levels of due diligence."

Companies evolving their business models to align with the low-carbon transition will remain an on-going topic to track. "Businesses are increasingly looking to reduce emissions. Taking into account company specific targets or forward looking emissions projections is an important consideration for some investors."

> **Index investing is the efficient access to markets.**
>
> Callum Stewart, Standard Life

He also highlighted a topic that gets neglected, one around resilience and adaptation. "There is still the impact of climate change that everyone has to deal with, which means that greater investment in products and solutions that build climate resilience will be needed," he said.

Burden concluded the discussion by pointing out that within the space there is still much room for improvement. "DC investors can certainly do much more on climate change," he said.



FROM UNDERSTANDING TO ACTION – THE EVOLVING LANDSCAPE OF SUSTAINABILITY

David Hickey
Head of sustainability for BlackRock's UK business

Mark Guirey
Executive director of asset owner and consultant coverage at MSCI

What does this mean for investing?

Over the past five years, environmental, social and governance (ESG) considerations have moved from the periphery to the centre stage as an important component of investment and asset allocation decision-making for many asset owners. Societal changes and international agreements, such as the Paris Agreement, have helped to foster greater awareness about how climate and broader ESG concerns can impact financial markets.

David Hickey, head of sustainability for BlackRock's UK business, and Mark Guirey, executive director of asset owner and consultant coverage at MSCI, shed light on the shifting tides of sustainable investing and where they see the industry moving.

The past five years – rising expectations

Sustainability has become an important issue for many regulators and investors. Regulations have come thick and fast with Securities Financing Transactions Regulation (SFTR) and Sustainable Finance Disclosure Regulation (SFDR), as well as Task Force on Climate-related Financial Disclosures (TCFD) having been implemented.

In addition to changes in the regulatory landscape, each and every investor has different objectives. Hickey explains: "With greater understanding of how ESG factors can impact asset valuations, many asset owner clients – particularly long-term investors like pension funds – are asking how to mitigate risk and capture opportunities associated with sustainability and the transition in their portfolios. Some want to increase their exposure to the transition, some want to align their portfolios with a net-zero pathway, and some want to achieve impact or sustainable outcomes in addition to financial return or to limit exposure to specific sectors. Others may choose not to invest using strategies that have sustainable investment objectives."

For asset managers like BlackRock, Hickey explains: "As a fiduciary, our approach to investing is grounded in three principles. One, we start by understanding the client's investment objectives. Two, we seek the best risk-adjusted returns within the scope of the mandate they give us. And three, we underpin our work with research, data, and analytics.

Hickey adds: "That means being as rigorous in analysing the impact of ESG factors on portfolios as you would any other investment factor. If you're incorporating ESG-related risks and opportunities, it's not only about being more sustainable, but making sure you can monitor your risk more fully."

There has been a need to develop products that enable greater climate risk integration to meet client demand. Guirey explains that data providers have a key role to play in having decision-useful information ready across multiple asset classes. This can be a challenge in less liquid segments such as private markets and infrastructure.

Indexes provide a medium through which pension schemes can reflect their objectives, either by meeting and aligning with climate transition benchmarks or Paris-aligned criteria set out in the EU Taxonomy or by employing more specific low carbon indexes and other customised criteria in a rules-based index methodology.

The range of available indexes on the ESG and climate front has expanded to offer greater choice, to meet the ever growing needs of the market.

Additionally, data providers play a key role in helping clients seeking to further harness data supplied to them and keep up to date with regulations such as TCFD and SFDR. The sustainability landscape is constantly evolving, meaning index and data providers need to stay at the forefront of regulatory demands if they are to assist their clients.

The role of the indexes

For ESG data to become integrated into more investors' portfolios, widely adopted indexes may need to capture more climate risk factors. Hickey and Guirey see a future where themes that were once the focus of niche funds, will become core components of major index funds too. Guirey said: "A key area to watch for me is biodiversity. As biodiversity impacts are becoming visible, consider deforestation, wildfires, ongoing ocean pollution."

On top of this, Hickey explains that there will be greater granularity to the climate risk provided, with factors such as carbon and natural capital being captured. The aim is that more clients and investment managers will be able to see different parts of the investment ecosphere and have a comprehensive view of their climate risk exposure.

The next five years

However, while ESG data integration is becoming more readily available, it doesn't make it easy to implement. Guirey and Hickey acknowledge that data providers are working hard on how to define material issues and improve data availability on themes such as deforestation.

Guirey said: "There has certainly been a change in investors sentiment away from action that solely decarbonises their portfolio and into the impact their actions are having on real world decarbonisation. This has an impact on how they engage and the information that pension schemes and Investors require.

"Challenges also persist in other forms. Regulatory harmonisation is an ongoing process and the need for collective action remains key."

Hickey concludes: "We're aware of how much investment is required to make the transition happen. If we can provision the product choice that allows that money to flow, for me, being just a small part of that machine, is extremely exciting."

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