White Paper
Index Investing

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5 Key Trends in Indexing

STATE STREET GLOBAL ADVISORS

In the past dozen years, the indexed investment management industry has survived two great stress tests — the financial crisis of 2008 and the pandemic of 2020. It has emerged not merely unscathed but strengthened.

The underlying structure appears to be more resilient than originally thought and the pandemic has actually accelerated the tectonic shift towards integrating climate/ESG considerations into index portfolios, driven by investors' conviction that climate transition presents a paramount investment opportunity.
We identify five key trends that are likely to affect investors everywhere.

Trend #1

Asset owners will lcontinue to increase allocation to indexed funds for the foreseeable future.

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Trend #2

Increased focus on sustainability to drive investment process.

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Trend #3

Sustainability disclosures will matter ever more.

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Trend #4

Shift to bespoke equity portfolios – Direct Indexing.

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Trend #5

Industry consolidation trends likely to accelerate.

Trend #1 – Asset owners will continue to increase allocations to indexed funds for the foreseeable future

The industry's global AUM is likely to grow as the shift towards indexed funds continues. Accordingly, indexed vehicles' lead in the approximately $14 trillion US domestic equity fund market will likely expand. US index equity funds overtook active around August 2018 and its market share stands at about 55%, driven largely by the growth of funds tracking the S&P 500, the total US stock market and other broad US indexes. US large-cap stocks are widely recognized as comprising the world's most efficient equity market, further contributing to indexing's dominance.

The same trend is true for fixed income. While active is still very much there and dominant, it is no longer the automatic default choice for fixed income investors, especially in the more complex parts of the market such as emerging market and high yield sectors. Take for example the US fixed income funds' share of passive portfolios — it is lower than indexed equities at 31%, but with new technologies, data and processes making it more open and efficient, indexing's share of the bond market is set to continue to rise.

While the US remains the global centre of indexed investing, Europe has rushed to join the indexing boom, with assets held in ETFs surging beyond the $1tn mark in January 2020 for the first time, as discontent with active managers grows. ETFs listed in Europe have attracted close to $450bn in new cash over the past five years, and most industry observers believe further significant growth is to come.

The growth in index investing has also been aided by regulatory changes in Europe. The UK, the Netherlands and Switzerland have all banned financial advisors from taking commissions for recommending actively managed funds, creating a more level playing field. We would expect this trend to accelerate in the coming years.

Trend #2 – Increased focus on sustainability to drive investment process

There has been an increased focus on sustainability, shareholder engagement and sustainability-related regulations and initiatives. While ESG been on the agenda of the most sophisticated investors for some time now, investor interest continues to expand and the key issues impacting investing decisions have changed in recent years, especially in regards to climate risk.

We expect these trends to accelerate as the ethos of the next generation of investors comes to predominate, alongside asset managers' increasing ability to integrate climate data and ESG into their processes across the investment universe.

The growing availability and affordability of sustainable investment options will continue to be essential for this increasing focus. Until only recently, building climate-aware portfolios was a cumbersome endeavour, available only to the largest investors. This has now changed and we would expect it to continue to evolve, owing to the ever-improving innovations in sustainable index solutions, driving large sums of capital towards those companies that are better prepared to address climate risk.

Trend #3 – Sustainability disclosures will matter ever more

Assessing sustainability risks and opportunities requires that investors have access to consistent, high quality, and material public information. For example, Task Force on Climate-related Financial Disclosures (TCFD) reports are the global standard for helping investors understand the most material climate-related risks that companies face, and how companies are managing them.

Given how central the energy transition will be to every company's growth prospects, asset managers will be increasingly asking companies to disclose a plan for how their business model will be compatible with a net zero economy — that is, one where global warming is limited to well below 2°C, consistent with a global aspiration of net zero greenhouse gas emissions by 2050.

The Sustainability Accounting Standards Board (SASB) is another example and covers a broader set of material sustainability factors, which we expect more asset managers to endorse their alignment with, urging companies to issue their sustainability disclosures in a standardised transparent format before the regulators impose them. This is in the interest of both companies and investors. Every investor, company and consumer should know that fossil fuels will largely disappear from our economic system by 2050 and be taking action to assess the risks and identify the opportunities.

Trend #4 –Shift to bespoke equity portfolios – Direct Indexing

Investors increasingly demand customised equity portfolios that have traditionally been the preserve of wealthier clients. Direct Indexing allows investors to own a group of stocks that mimic the performance of an established index, and to customise the portfolio in order to manage tax losses or include environmental, social and governance preferences. New technology is now making personalised portfolios possible for a broader audience, not only the wealthy.

In other words, a more bespoke approach to off-the-shelf investment products is coming. We believe this may mark the next stage in the democratisation of finance, and may put pressure on traditional products such as equity index pooled funds and ETFs. According to a recent report from Morgan Stanley and Oliver Wyman, by the middle of this decade, Direct Indexing is forecast to account for $1.5tn of global assets, up from less than $500bn now, by taking share from other indexed products such as equity index pooled funds and ETFs.

The beauty of Direct Indexing is its simplicity: A financial advisor via a computer can easily tailor a portfolio that mimics an index, like the S&P 500, while including specific tilts such as ESG, rebalancing between winners and losers and also reducing tax exposure. Over a 10-year horizon, more people will be able to walk into an advisor's office and get a customised portfolio of securities. In turn, we expect that asset managers will face disruption in how advisors expect products to be constructed and distributed.

Trend #5 – Industry consolidation trends likely to accelerate

A wave of asset manager consolidation is enveloping the global index management industry. The benefits of consolidation include synergies in terms of expenses, access to different geographies and enhanced product capabilities. We expect this trend to continue in the coming years, with several more global mega-asset management firms being created. Over the medium to long term, we expect the industry to continue to consolidate with large players on the indexed side benefiting from increasingly larger-scale market operations.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigour
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.86 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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