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SERIOUS IDEAS FOR SERIOUS INVESTORS

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LEGENDS OF INDEXING

15 PEOPLE WHO CHANGED THE FACE OF INVESTING

Henry Fernandez

The head of MSCI discusses his company's evolution

By Lara Crigger

Since 1998, Henry Fernandez has served as CEO, president and director of MSCI, one of the world's largest index providers. In 2007, he also became the company's chairman. Fernandez was at the helm when MSCI split off from Morgan Stanley to become the first publicly traded independent index company. During his tenure as the head of MSCI, the index provider has expanded the breadth and depth of its coverage of global markets, making stronger pushes into the domestic indexes space, among others; adding new methodologies, particularly in the area of smart beta; and steadily growing the amount of assets indexed to MSCI benchmarks.

You've been with MSCI more than 16 years now. What has been the biggest development you've seen in the indexing industry over that time?

One of the most significant things that has happened, I think, is the acceleration of innovation, both in the creation of indexes and also how those indexes are used by asset management firms.

Free enterprise and progress is sometimes measured by the quality of choices you have. There is now an abundant quality of choices in this industry. That wasn't always the case. For the first 10 or so years I was involved in the industry, the pace of innovation was relatively slow, and much of it was just a continuation of existing ideas in different formats. But now you see the industry going in a lot of different exciting directions to provide that choice to investors.

The latest direction is factor investing, or smart-beta investing, as some people call it. But that's not all. You've also seen the expansion of the market beta, or market representation, indexes into emerging and frontier markets. Many institutions, like ourselves, have also gone deeper into market capitalizations, from large-caps to small-caps to micro-caps. Clearly, more countries have come into play too. And in MSCI's case, we have expanded our indexes into environmental, social and government themes; we've even created Shariah-law-compliant indexes to provide more value to religious investors. So there have been a lot of directions.

Why now, though? What do you think was the catalyst (or catalysts) for this recent acceleration?

There were a variety of forces at work. One is that the world has become really large in terms of the choices of the investments you can make. You now have thousands and thousands of securities you can invest in, and it's no longer possible for many individuals and portfolio managers to analyze, understand and create portfolios of such large magnitude. So the ability to package those investments into another form of security—in this case a tradable fund based on an index—was a huge impetus for change.

But no industry grows without the ability of creators to get funding; it's their motivation to create things. Exchange-traded funds have provided a lot of that economic payoff. In the index fund space and the mutual fund space, a lot of the economics were not the same; you were paying flat fees; and there wasn't a lot of financial reward for the index provider. For ETFs, though, there is. And while running an ETF business is not easy, a lot of entrepreneurial firms have launched ETFs and have been successful at it, and that has given financial rewards to whoever provided the indexes to those organizations.

Earlier you mentioned smart beta. Lately there's been a lot of debate over whether smart-beta indexes should be considered passive or active management. How do you see it?

Well, to begin with, keep in mind that indexes are actually actively created. It's an active management process: Index providers actively manage the creation and maintenance of indexes so that asset managers can then replicate them passively. There's a shift, so to speak, in the division of labor. In active management, the portfolio manager does all the heavy lifting to figure out the investment thesis, how to put the portfolio together, how to buy the stocks, how to maintain that and create performance and manage risk, so on. But in passive management, the index provider takes on at least part of what the active manager was doing.

I think smart beta is just a continuation of that. Before smart beta, most indexes were market betas, market representations. People would say, "Give me the market beta of emerging markets, or of Japan, or of small-cap, or growth" or so on. Now you take some form of strategy—i.e., value or growth, small-cap or large-cap, international versus U.S., whatever—and take it to the next level. So now it's, "Give me momentum; give me high yield; give me an index of low-volatility stocks," and so forth. The indexer is providing a little more active strategy to the investment. In the past, these strategies were less available to passive investors; with the factor indexes being created now, though, these strategies can be accessed by either passive or active investors.

Do you think there's still room left for more innovation in indexing? Or are we close to petering out?

I think we're only just getting started. You know, a lot of people ask me, "How many more indexes can be created?" Here's what I say: There are probably 20,000, 25,000 investable securities in the world. There are many more in the wider universe, but we're only looking at institutionally investable, with float and liquidity and size and all of that. So how many permutations can we create out of 20,000+ securities? Millions.

So I think we're really only just getting started here. The sky's the limit. You can create an index for almost anything now, as long as there is an investment thesis associated with it, and you can backtest and demonstrate that investment thesis, and codify it into a set of formulas and principles. From here, we can expand dramatically.

And of course we've only been talking about equities up to now. But this is being applied now to fixed income and commercial real estate, and so on. Then you can mix and match those asset classes: With the push of a button, you can purchase an ETF that buys the whole equity world, or the whole equity world combined with the whole fixed-income world, or now you can combine it with a portfolio of real estate, or a portfolio of commodities, a portfolio of this or that. So I think we're only getting started with this revolution.

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If the index provider is shifting some active management onto its own shoulders, where do you think active management still has a place in an investor's portfolio?

There has been a lot of talk, especially over the past five years and during the depth of the financial crisis, about the decline of active management. In my opinion, that's just been a cyclical issue. Clearly, many of the world's equity markets were being driven by macro forces and monetary forces, so in that environment, the act of stock picking—that human judgment on the creation of a portfolio—became a little less relevant. Come into a more normal environment, where stock values are once again defined by fundamental factors and forces, and you'll see active management coming back in force.

Generally, I believe there is no monopoly on wisdom or creation or innovation. There's no reason there couldn't be a lot of innovation that takes place with active portfolio managers; they could create investment strategies that are as good as, or sometimes even better than, those that the index providers create.

And there's a spectrum of human interaction involved in the creation and management of a portfolio. You look at an asset manager licensing an index for a portfolio as one extreme, and then the other extreme is an asset manager who engages only in individual stock-picking, and in between, there's a wide spectrum of active approaches. You've got people who use quantitative tools; those who use top-down approaches or bottom-up approaches; those who use equity long/short strategies. So from what I see, there has been a major expansion of the choices investors have to do what's best for them.

So is there an endpoint? Do you see a moonshot to all this?

The moonshot is, I think, the index itself. With the advances in modeling and technology, the ultimate question remains, "Can I customize my portfolio to exactly my specifications?" A lot of what happens in the investment world is still one-size-fits-all. Not totally, but, well, take a pension fund. A pension fund has a laser focus on exactly what its liabilities are. And it wants a set of investment products that will exactly match that set of liabilities. It's a challenge, because the very nature of customization means not everybody's going to want to buy it. But we're far from providing these highly targeted, outcome-oriented investment solutions to investors around the world.

Another moonshot is total transparency. How can we provide total transparency to the investment process? As an industry, we're far from that, very far. Most investors still don't know where the performance attribution comes from in their investments. They don't know what the risk of their portfolio is. They don't know what the hidden costs are, and the like.

However, we're definitely better off understanding the things that we buy and how they behave, and I think a lot of these new products are a major step in that direction. They don't solve every problem, but they do provide a huge level of huge transparency relative to where the industry was even five, 10 years ago.

CONTACT US

AMERICAS

Americas	1.888.588.4567 (toll free)
Atlanta	+ 1.404.551.3212
Boston	+ 1.617.532.0920
Chicago	+ 1.312.675.0545
Monterrey	+ 52.81.1253.4020
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Mumbai	+91.22.6784.9160
Paris	0800.91.59.17 (toll free)

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China South	10800.152.1032 (toll free)
Hong Kong	+ 852.2844.9333
Seoul	00798.8521.3392 (toll free)
Singapore	800.852.3749 (toll free)
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