

Future of Fixed Income Indexes - Factors and ESG

Featuring: **Hitendra Varsani**, Executive Director, Core Research; **Lee Phillips**, Managing Director, EMEA Client Coverage

Interviewer: Joining us today is Hitendra Varsani, Executive Director from MSCI's Core Research Team and Lee Phillips, Managing Director EMEA Client Coverage who will discuss the evolution of fixed income and latest innovations in fixed income indexes. Thank you very much for coming today. Hitendra, let's start with you. How has the fixed income evolved over time and also, what had been some of the challenges within the asset class preventing innovation?

Hitendra: Sure, so the fixed income market is going through some transformational changes in the current environment. This comes down to the availability of data on one hand and transparency on the second hand. Now, when we look at academic studies related to asset pricing, there's a considerable amount of literature on equities and equity factors and equity risk return drivers and sources of risk and return. While traditional factors are well known within the fixed income market, very few studies go beyond that. And that's due to the fact that academics as well as practitioners have had very limited data sets to be able to run extensive studies. Now, what we've concluded in equities based on the historical data that we have is that equity active managers have on average underperformed their benchmarks after transaction cost. However, with fixed income markets in contrast, active managers have outperformed their respective benchmarks after cost. And so the need for passive hasn't been there on the same scale as what we've seen with equities. However, with now data and transparency, we have more research emerging and what other drivers of those excess returns on those managers. And that's having a profound impact in how investors will allocate going forward.

Interviewer: So Hitendra, what have been some of the challenges preventing innovation in this fixed income universe?

Hitendra: So we've seen the acceleration in data technology in financial markets, and equity investors have embraced that trend and incorporated these trends into their investment process. Within the fixed income market it's not quite the same. We see a certain level of opaqueness in the investment process, but however, that's now changing as due date sources become available, we see more academic studies investigating the risk and return drivers of fixed income market. We now see more practitioner studies along similar lines. So MSCI is leveraging its research, its analytics and core strengths in bringing fixed income index solutions to the marketplace.

Interviewer: And Lee, what has been driving those innovations and what is the MSCI doing within the fixed income universe?

Lee: Yeah, I think if you look at some of the key themes in which investors have focused on in 2020, and focus on two of them. First of all, market conditions, 2019 was a very strong year for fixed income assets. But has left us in a very low yielding environment with extremely tight credit spreads. And clients are also concerned about threats of recession and also other geo-political risk measures as well. And second, sustainability. It is absolutely clear that sustainability is fast becoming the third dimension in the investment paradigm. It's now return, risk and sustainability. And we're very excited to have launched indexes in fixed income space to help investors address both of those issues.

Interviewer: Well, since you've mentioned the sustainability and ESG as you said is more and more important, but how are you applying ESG solutions to fixed income indexes?

Lee: Yes, so clearly sustainability and wider ESG considerations are fundamental. And so that's what we try and do through our indexes, allow investors to understand the impact of the financial risks from ESG and also to ensure that the benchmarks have aligned to investor values as well. And so-- and there are two main ways in which people can do that. One is via engagement. So what this means is that you have small exclusions, so exclude certain issuers. And then second, take the MSCI/ESG ratings which will rate a company according to how well it's doing along the ES&G measures. And what we would do is tilt the index constituent weights until have a higher percentage weighting to those ESG leaders and a lower ESG rating to those laggards in the market. So that's one example. A second one is for those investors who actually want to have a bigger exclusion and really focus on the leaders in the market. And so-- and this index flavor allows investors to focus on the top 50% of the ESG leaders within each sector. And so those are two ways in which we can help investors express their ESG views and through fixed income indexes.

Interviewer: And Hitendra, factor investing within the fixed income universe, how does that work?

Hitendra: So factor investing is actually a multi asset class concept. So we've seen significant growth within equity market factor investing over the last 10 years. A lot of that has been driven by the movement towards lower cost with the potential of outperformance. In fixed income, factors-- traditional factors like duration in credit risk, or major market risk or currency risk are very well known. But the market hasn't seasoned beyond that and that's due to the lack of studies in the past. However, new studies are emerging which show that factor investing can also be extended to fixed income. So the concept of dialing down risk through low volatility or low risk bias or security screening, searching for value within a particular universe, or tilting towards higher quality. So issues with stronger balance sheets, more sustainable income. So these are the themes that are emerging more recently.

Interviewer: And Lee how are the clients embracing all of these innovations?

Lee: Yes, so ultimately we're here to provide solutions for our clients. And so through the fixed income building blocks be they factors or ESG, or different standard market segments in fixed income, we allow clients to take those core benchmarks and customize them in a highly flexible way to ensure that we can create an index which is very much focused on what the clients and investment objective is. So, you know, that flexibility and customization is key.

Interviewer: And Hitendra, how are the clients applying this ESG and then factor investing in the investment process?

Hitendra: So in the past, asset classes and researchers and practitioners typically sit in silos. So rarely did you find, say 20 years ago, an equity portfolio manager would be speaking to their counterparts in fixed income. Factor investing and ESG considerations has changed the landscape. So these are two concepts that apply uniformly across asset classes. So we're at a pivotal point in the industry where investors are looking to implement solutions linked to factors in ESG across the board. Now clearly the market has already evolved in terms of equity adoption in ESG. However, fixed income is a more-- ESG investing is a more recent trend and we're seeing now more solutions come to the market. But what's key is to have that consistent approach across asset classes. So for example, if a particular issue within the equity portfolio has a triple A rating, you'd expect the same rating to be applied within the fixed income portfolio and that's effectively bridging the gap between the two asset classes.

Interviewer: And Lee, how are the clients embracing those fixed income innovations?

Lee: So we've spoken to a huge number of clients about our fixed income indexes and it is-- I think the message is loud and clear. And there was a need for customization and innovation. And it is important for us as an index provider to be really able to provide those tailored solutions to meet our clients investment needs. That's the gap in the market in which we're looking to provide a solution for.

Interviewer: Hitendra Varsani, Lee Philips, thank you for sharing how the fixed income in this space is evolving. And we look forward to discussing further fixed income solutions for investors.

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