CANNEX RESEARCH

Conversations with CANNEX Q&A: Laurence Black of the Index Standard

Cannex's Tamiko Toland had the opportunity to talk about index design with industry insider Laurence Black, founder of the Index Standard, a firm that provides ratings on indices. His work in index design gave him the know-how for his business and a deep understanding of the process—and how to assess the end product. This experience also made it clear there was a need for more transparency and tools to facilitate index selection for all products that make use of indices. Laurence has a bird's eye view of trends and the analytical chops to see what strategies have merit and which ones are smoke and mirrors.

Q&A

Who is Laurence Black?

Laurence is a former investment banker moved into index design after getting his MBA. In his role at Barclays, he collaborated with noted economists, including Robert Shiller, Joel Greenblatt and Jim Rogers, to build novel indices. He started the Index Standard in response to a need in the market for independent analysis and rating of indices.

"I did an MBA and I moved into index structuring, where I was creating and designing indices. It was a really interesting time in the industry because it was evolving very rapidly. I was involved in the beginning of the factor indices and a number of thematic indices."

What is the Index Standard?

The Index Standard provides objective ratings of indices that incorporates design factors that indicate sustainability of results. For example, the ratings take into account whether the index is overly complex and how well the back-testing performance correlates with live performance. The ratings can be used by any individual or enterprise that needs to make decisions about using an index, either on its own or as part of a product such as an annuity. In addition, the ratings can serve as an accreditation—a testimony of product quality—that firms are fulfilling their fiduciary duties by acting in the end clients' best interests.

The Index Standard also provides forecasting to support forward-looking selection of those indices. Strategies favor particular market conditions or sectors and this conviction is an important factor in choosing an index.

"I founded the Index Standard because I'd noticed in my career that there were now thousands and thousands of indices and the complexity was really increasing and I felt investors needed someone to guide them and really help make sense of all these complex mechanisms."

How Big is the Index Market?

Even though many people associate indices with ETFs, these funds don't comprise the lion's share of the index market. According to Laurence, there are more than $20 trillion invested in indices across the globe. ETFs represent $7 trillion of that figure and structured products account for $2 trillion. Current assets in annuities are around $500 billion, with estimated sales of $150 billion per year. Investment bank swaps from their custom indices represent around $400 billion.

Pensions, such as sovereign wealth funds, US state and other public retirement systems, make up the remaining chunk (conservatively $10 trillion), but many people believe this figure is much larger. The pension category includes defined contribution, though few 401(k)s invest in ETFs and indices, Laurence explained.

"If the US 401(k) market opens up to ETFs, you can see a lot of growth from that as well."

Where are the Index Opportunities?

Right now, there is $106 trillion invested in the fixed income market worldwide, of which $60 trillion currently trades at less than 1%.

"I think the index market is in a very healthy state and I think it's going to grow and you're going to see a tremendous amount of innovation. Now, where do I think it's going to grow? I think the biggest opportunity is really around fixed income replacements."

How Do You Build an Index for an Annuity?

Designing an index for the annuity market is "the most complex and interesting" with a process that takes six to 18 months because "you're trying to solve for a lot of things." First, designers have to consider both illustrations (back-testing) as well as good performance going forward. Given these competing forces, "you become tempted to put more parameters in" to get an even better back-test or illustration. However, this optimizes for the past and can "hurt your chances of performing well in the future."

Secondly, in the annuity world, it is important to have a theme or story that is backed by academic rigor. "That's a good story because it's been validated by academics."

Lastly, a designer needs to consider the liquidity and tradability of the instruments backing the index. For example, if an index includes a company with a limited market cap, a large hedging position may move the price up to the detriment of the end investor.

> *"Designing all these products requires a lot of computational power. The banks and the index providers have large quant teams and researchers trying to bring all these factors together to create an index that works and that performs well in the future."*

How Are Active Managers Joining the Index Trend?

Increasingly, active managers are getting involved in index design leveraging their allocation expertise, Laurence explains. These managers may identify several factors that shape future performance and build these views into systematic index rules.

> *"Really what they're doing is they're taking their allocation skills and codifying that in a rules-based format and then they're applying that to an index."*

How Do We Draw the Line Between "Active" and "Passive", Even with the S&P 500?

Laurence argues that the line between active and passive is blurred. Even the S&P 500, which is not simply the largest 500 companies, has an active component in the form of the index committee that selects which stocks end up in the index. There is an active choice in the factors that go into building value or quality indices, so he sees it as more of a continuum that is not meaningful on its own.

> *"I think a lot of these smart beta indices verge in the middle of active, so I'm thinking about the more practical elements of getting these indices out there."*

What Are the Current Trends in Risk-Control Indices?

Laurence says we are in the third generation of risk-control indices. The initial design used an allocation between an equity index and a LIBOR index to keep the volatility within a certain range. With more innovation came increased complexity, leveraging multi-asset baskets and mean variance optimization. In this case, the risk-control is layered on top of that basket.

The nascent third generation leverages daily or intraday risk control to drive allocation shifts rather than the 20- or 40-day volatility window used by earlier designs. Some examples of this exist in the market but more will emerge because this design offers more accurate realization of the volatility target, so the bank can sell the option at a lower price.

It's also likely that we'll see more structured indices, where puts and calls are incorporated into the index itself creating a buffered payout.

Looking to the future, Laurence predicts we will see decrement indices in the US and Canada. These are already popular in Europe because they provide more attractive option pricing rather than other strategies in a low interest rate environment. These work by extracting a synthetic dividend (for example, 5%) from the index return, making the option very cheap and increasing the participation rate.

> *"As long as interest rates remain low relative to historical levels, there will be a strong need and demand for risk-controlled indices."*

Do Risk-Control Indices Work?

It is natural for investors to be skeptical about new risk-control indices. Laurence decided to look at their performance over the COVID crisis and saw that they did their job, reducing the effect of market declines.

> *"My takeaway is that risk-controlled indices performed very well over the recent COVID-19 pandemic market falls, proving their worth to end clients"*

Would You Recommend Risk-Control Indices to Your Mom?

Laurence said he would recommend one to his mother. Those that have been around since the early 2000s have got a 20-year track record and they have a proven track record through both the financial crisis and the more recent COVID crisis. Furthermore, he thinks that the academic principle behind the strategy is valuable. That said, the view of future market performance also plays a role in selecting one index over another.

When designing indices, Laurence said he adopted a "fiduciary mindset" that takes into account the individual, perhaps somebody's mom, who is investing in the index. This perspective struck home when a friend called to ask about one of his indices on behalf of his mother.

> *"She had bought the index, which kind of hit me hard that there is a need for a fiduciary mindset and a forward-looking perspective when designing or recommending products."*