Ashmore

Passive is active: the EM index problem

By Jan Dehn

In a recent article about China's inclusion in the MSCI benchmark index the Financial Times columnist John Authers made the following astute observation:

> *"There is something ungainly in the way [China's index inclusion] has been outsourced to MSCI, a relatively small for-profit organisation based in New York. Such a momentous matter… might seem more naturally to belong to democratic or governmental institutions. As it is, the big multilateral organisations do not seem to be providing …leadership."*[1]

What makes Authers' observation interesting is not just that he recognises the enormous problem of poor index representation for Emerging Markets (EM) assets, but also that he explicitly links this problem – a classic market failure – to international financial institutions (IFIs).

Index provision is a public good, which is why current provision by the market is grossly inadequate. The costs to the financial system of poor index provision include lower returns, excessive volatility and insufficient diversification.

One particularly quirky consequence of the inadequate index provision is that investors, who believe they are taking passive exposure to EM by closely tracking the main benchmark indices, are in fact taking very active bets, since the index-providers filter nine out of ten bonds in the EM universe from the indices.

Ashmore has raised the EM index problem in previous publications.[2] This report provides an update on the scale of the problem with specific reference to EM fixed income markets, outlining the associated costs and proposing ways to resolve the problem with an explicit call on IFIs to take this problem seriously.

The index problem

EM benchmark indices are extremely poor reflections of the underlying fixed income universe. This is illustrated in Figure 1 opposite, which shows that across all EM fixed income markets fewer than one in ten EM bonds, 9% to be exact, is currently included in the main benchmark indices. Contrary to popular perceptions most of the excluded bonds are not un-investable, though some require a modest effort on the part of the asset manager to first access the market.[3]

EM fixed income markets are also woefully under-represented in global bond market indices. While EM now accounts for nearly 60% of global GDP and about 20% of global fixed income, global bond indices, such as the Barclays-Bloomberg Agg and Citibank's WGBI index, still only assign about 2-3% weight to EM fixed income assets.

JP Morgan recently launched a new index (GBI-AGG Div), which assigns a 20% weight to EM. This is a clear improvement, but so far very little capital actually tracks this index compared to the incumbent global bond indices.[4]

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Fig 1: **EM index representation (based on data at the start of 2016)**

Asset class	Index market cap (USD bn)	Asset class market cap (USD bn)	Index coverage (%)
All EM fixed income	1,672	18,507	9%
USD sovereign debt	445	835	53%
USD corporate debt	399	2,627	15%
Local currency government debt	707	7,003	10%
Local currency corporate debt	122	8,043	2%

Source: Ashmore, JP Morgan, Bloomberg.

[1] John Authers, *'MSCI holds the whip hand over Chinese A-shares rollout'*, Financial Times, 21 June 2017.
[2] For example see *'Are Emerging Markets bond indices public goods?'*, Occasional View, 21 May 2014.
[3] For example, investors can access both Indian and Chinese bond markets with a modest investment in quota access.
[4] *'Putting the world into global bond funds'*, Market Commentary, June 2017.

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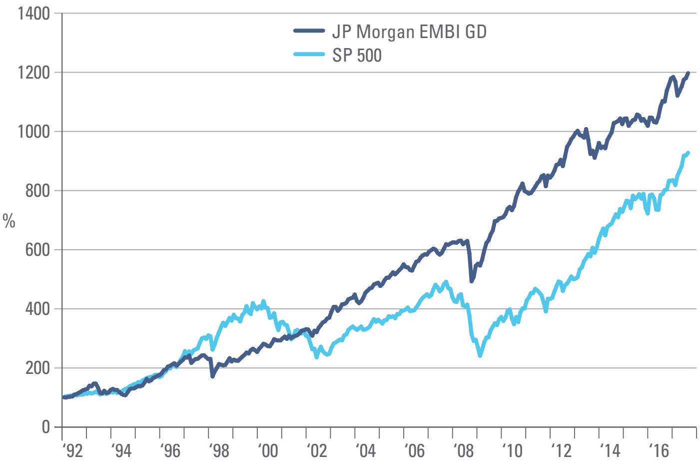
Four reasons why good indices matter

Inadequate index representation is a growing problem due to the rise of passive investing and a strengthening trend towards benchmark-hugging on the part of institutional investors. But why should this worry investors? We see four reasons to be concerned:

a) Misallocation of capital

When benchmark indices do not accurately reflect the underlying investment universe investors make inefficient investment decisions if their allocations closely track indices. One particularly gratuitous example of such misallocation is illustrated in the chart below. The chart shows the total return to EM external debt and the S&P 500 index since 1992. What is startling is that EM external debt, a fixed income asset class, has significantly beaten the S&P 500 with lower volatility over this period. Given this relative performance, investors should clearly have had more money in EM bonds than in US equities over this period, but how many investors did? Poor indices result in too much money being channelled into markets that are fully represented in the benchmarks, such as US stocks, while insufficient capital finds its way into under-represented markets, such as EM debt.

Fig 2: **Total returns: EM external debt versus US S&P 500**



Source: JP Morgan, Bloomberg, Ashmore.

b) Inadequate diversification

Portfolios which track the indices also become inadequately diversified. Many EM markets are not even included in the indices at all. The situation improves every year, however. Ten years ago the JP Morgan EMBI GD index covered about 30 countries. Today the index has 65 members. But there are some 165 EM countries in the world and most of them have local markets of some kind or other. The non-Euroclearable local currency corporate bond market of about USD 8trn does not even have an index yet. Inadequate diversification translates directly into lower returns, greater volatility and could ultimately be a source of global financial instability.

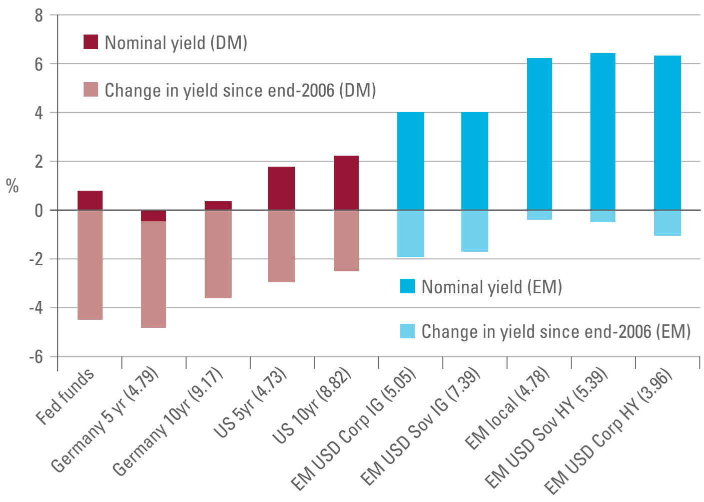
The next major financial crisis may well happen precisely because investors allocate in accordance with indices, a practice, which ensures that investors allocate ever more to countries which issue the most debt

c) Financial stability risks

Financial instability risks are arguably on the rise in DMs. Investors have been chasing returns in the QE-sponsored fixed income markets in developed economies for several years. This has amplified the pre-existing over-allocations to developed markets due to their better index-representation. Financial repression has pushed in the same direction. Valuations are sky-high in DMs both in absolute terms and relative to non-QE sponsored EM markets as the chart below shows.

The fundamental context is of course important here. Growth has failed to take off decisively in DMs due to neglect of reforms and deleveraging. With populism on the rise the fundamental outlook remains challenging in most countries. Governments are increasing fiscal spending to keep stagnation at bay, but this means more supply of bonds, even higher levels of debt and of course greater index weights. The next major financial crisis may well happen precisely because investors allocate in accordance with indices, a practice, which ensures that investors allocate ever more to countries which issue the most debt.

Fig 3: **Yields in EM and selected developed markets: levels and changes since pre-crisis (2006)**



Note: Duration in parentheses.
Source: Ashmore, Bloomberg, JP Morgan.

d) Passive is active

One of the most quirky consequences of the large discrepancy between benchmark indices and the underlying investment universe is that funds, which purport to track EM closely clearly do not do so! Rather, they are in fact highly actively managed funds, since index providers have excluded vast swathes of investable securities. Moreover, as the next section explains the criteria used to exclude securities can hardly be classified as conventional.

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Why is there an index problem in the first place?

EM fixed income indices are mainly designed and managed by large investment banks, which naturally favour their core business areas, which predominantly revolve around the US as well as European and Japanese markets. By contrast their involvement in EM tends to be small and has in fact been getting smaller due to regulatory changes imposed since 2008/2009.

The priority banks assign to DM over EM is also reflected in construction of benchmark indices. For example, take the Kenyan fixed income market. This market is not included in the JP Morgan GBI-EM GD index. This is not because Kenyan bonds do not exist. Instead, the reason is that JP Morgan does not trade the Kenyan bond market and therefore has no incentive to buy the pricing data from local Kenyan market-makers which it would need in order to populate its local currency benchmark index. It would not be able to recoup the cost of buying local pricing data and thus Kenya is not in the index.

It would be wrong, however, to blame the investment banks for the woeful index-representation in EM bond markets, particularly in local markets. The truth is that the index groups in most of the index-providing banks are strongly committed to improving their products.

The reality is that index provision is subject to a classic market failure. Index provision has a public good element not unlike, say, provision of broadband services in rural areas. It is simply not part of the core business model of profit-maximising investment banks, so they do not provide it. Of course, poor index provision in turn means less liquid markets due to narrower market participation, which then becomes a justification for not including the market in the index in the first place.

How can the index problem be remedied?

It is the responsibility of governments, not market participants, to address market failures. Unfortunately, governments and international financial institutions (IFIs), such as the World Bank, the International Monetary Fund and the International Finance Corporation, have either been unaware of the problem or have simply chosen to ignore it. This is precisely the point John Authers alludes to when he talks of lack of "leadership" in reference to China's MSCI inclusion. The failure of IFIs to recognise to recognise the index problem, let alone fix it, is nothing short of a travesty, in our view.[5]

The silver-lining is that IFIs could fix the problem at a surprisingly low cost. The cost of purchasing daily pricing data from local market-making banks in all the world's countries and hiring a small team of analysts to organise and publish comprehensive benchmark indices can probably be measured in the thousands of Dollars, i.e. a sum which would barely register in the budgets of most IFIs.

Of course, it can be debated whether IFIs are the appropriate institutions to provide index services, but this is very much a minor issue. For example, an alternative model would see the IFIs outsourcing index services to the index-banks or, say, to MSCI or Bloomberg with an appropriate subsidy to cover the costs they incur in covering markets where they do not trade.

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Implications for asset managers

Would asset managers be adversely impacted if index provision was extended to a much broader range of markets, including markets that are not currently traded by the main global market-making banks? Probably not, though some asset managers may have to make some minor adjustments to their trading practices.

Specifically, asset managers would have to establish counterparty relations with local market-makers, but this is already standard practice among specialist EM managers. It would be healthy if trading became more local, because financial markets would be less exposed to the risky global investment banks, while greater integration of EM banks into the global financial markets would carry numerous positive externalities.

Will MIFID II help?

The European Union's 'Markets in Financial Instruments Directive' (MIFID II) is intended to ensure that asset managers act in the interest of their clients. This may include a requirement that banks charge for index services. Mindful of the risk of being accused of market-manipulation banks have already begun to migrate index-services to third party price providers and external calculation agents. However, forcing banks to charge for index services would not in itself induce investment banks to cover more markets. As such, there is a risk that costs merely rise for the very consumers MIFID II is meant to protect without actually giving more choice or better services. Hence, as MIFID II evolves it is critical that regulators understand the nature of the index problem and that they design effective measures to broaden coverage.

Conclusion

Fixing the EM index problem is a low hanging fruit, which really ought to have been plucked a long time ago. IFIs could focus more on the problem than they have done so far. Everyone will pay if no action is taken: savers will end up with excessively concentrated bets in overbought DM fixed income markets, which could translate into losses in the coming years. This is clearly unfortunate, since pension funds in most DMs are already struggling with funding problems due to demographic challenges.

EM countries would also suffer, because inadequate access to finance remains one of the most important constraints to growth in EM. Without proper indices capital will continue to be denied to developing countries, which have the greatest potential to lead the global economy out of its post-2008/2009 growth slump.

[5] The index providing investment banks explicitly and habitually use liquidity conditions as a basis for excluding countries from their indices. Less liquid bonds, they say, means that replicating indices is more difficult. This may well be the case, but it should be up to asset managers to determine if liquidity risks are adequately priced or not and hence how much exposure they wish to take in a given market.

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