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ICI VIEWPOINTS

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Understanding Indexes and How Funds Use Them

By Matt Thornton

Market indexes are one of the most visible elements of investing. Numbers from the S&P 500 or the Dow Jones Industrial Index frequently feature prominently in headlines about the US stock market.

Beyond the well-known indexes that we encounter daily lie more than three million indexes designed to reflect the performance of underlying investments, from broad markets to niche subsegments. Indexes vary widely with regard to their specific objectives, the methodologies on which they are built, and the underlying investments they reflect. At the same time, they each have design, administration, and governance features that guide their creation and ongoing operations, and they are not purely objective, self-contained, predetermined constructs.

Indexes do more than serve as a proxy for market performance. For funds, advisers, and investors, they can offer a benchmark for evaluating the performance of actively managed funds, a template for constructing index funds, or even a tool for regulatory agencies.

Finally, evolving investor demands have shaped the fund and index industries in similar and interconnected ways. For instance, the rise of ESG and smart beta investing have spurred innovation and growth in investment strategies, funds, and indexes.

Increased Interest

As the connections between indexes and market activity have become more apparent, policymakers, regulators, and other financial market observers have shown an increased interest in indexes, index providers, and the ways funds and investment managers put indexes to use. Electric vehicle maker Tesla's entry into the S&P 500 in late 2020 drew attention to index inclusion criteria and rebalancing and showed that index methodologies can be both art and science. And actions taken by index providers in response to the Trump administration's executive order prohibiting transactions in certain Chinese securities by US persons demonstrated how emerging policy issues intersect with index providers' work.

To properly ground discussion and examination of issues surrounding indexes, ICI published a primer to provide both investors and regulators information about indexes and the ways funds and their advisers use them.

Background Information on Indexes

ICI's paper provides an overview of the marketplace for indexes. To aid in a general understanding of how indexes work and how they get used, it also describes:

- Common features of indexes, illustrated with prominent examples
- The contractual relationships between index providers and fund complexes
- How and why an index gets created, and the role that fund advisers may play in that process

How Funds Use Indexes

The paper also details some of the principal ways that funds, advisers, and other parties currently use indexes:

- *Performance assessment*—Indexes offer a convenient benchmark against which investors, fund managers, and third parties can

measure the performance of a fund.

- *Regulatory purposes*—Regulatory agencies such as the US Securities and Exchange Commission (SEC) require funds to use indexes in certain contexts (e.g., in certain performance presentations, or to calculate performance-based fees, for those funds that pay them) and permit funds to use them in others (e.g., a fund may use a "designated index" to comply with a leverage limit in the rule governing funds' use of derivatives).
- *Portfolio construction, management, and investment policies*—To varying degrees, indexes may influence funds' portfolio construction and management, with indexes most significantly affecting index funds.
- *Multi-asset class portfolio construction*—Certain funds such as balanced funds or funds of funds may use indexes as proxies for the asset classes contained within the funds themselves and then implement their asset allocation strategies using active or passive strategies or funds.

Read the primer on indexes and how funds use them.

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