Index trackers and cluster munitions

A briefing note prepared by Profundo[i] for IKV Pax Christi and FairFin, 15 October 2012.

Introduction

Financial institutions that exclude investments in producers of cluster munitions often make an exception for investments in index trackers. This briefing note explores this topic a bit further: what are the arguments for this exception, what counter-arguments can campaigners use, and are there good alternatives?

1 What is an index?

To understand *index trackers* or *index funds*, it is necessary to first understand what a *market* index or *stock exchange* index is. Basically, a *market* index or *stock exchange* index is a weighted list of shares or bonds, that represents a particular stock market or a portion of it. The basic idea behind a market index is that the financial performance of companies is determined only partially by the particular characteristics of each company (i.e. its products, management, marketing, etc.). To a large extent, companies are just ships on a tidal wave, which can move all companies up and take them all down. This tidal wave is the economy, national or global. So when the economy goes down most companies go down, and vice versa. As the economy is composed of thousands of companies and millions of individuals, a market index aims to provide a representative sample of the economy of a certain country. The index should therefore follow the movement of the economy: going up when the economy goes up and going down when the economy goes down.

As the financial performance of companies is not solely dependent on the economic tide, the index also serves as a benchmark to measure a company's performance against: the company can *outperform* the benchmark or can *underperform* (relative to) the benchmark. This also holds true when the index goes down: even when all companies' share prices go down, some go down less than the index and therefore are deemed to do relatively well.

The oldest and most well-known index is the *Dow Jones (Industrial Average)*, which is composed of 30 large American companies. As the number of companies in this index is fairly small, it has lost its role as benchmark for the American capital market to the *S&P 500*, which covers 500 American companies. The *Russell 2000* index is a well-known index covering only smaller American companies.
Other well-known indices are the *MSCI World Index*, which covers stock markets globally and the *Stoxx* indices for the European stock market. For the UK market, the *FTSE 100* index is the most important and for the Japanese stock market the *Nikkei index*. The *Lehman Aggregate Bond Index* tracks the American bond market.
But an index can also focus on a specific segment of the companies traded on one or more stock exchanges: large companies, Small- and Medium-sized Enterprises (SME), mining companies, consumer product companies, sustainable companies, etc.

[i] www.profundo.nl

Indices are not managed by financial institutions but by independent publishers, such as Dow Jones, Standard & Poor's, Stoxx and MSCI. These publishers have numerous other indices, which cover (segments of) all kinds of stock market. Sometimes they outsource part of the work, such as the research for the Dow Jones Sustainability Index which is outsourced to the Swiss company SAM.

When an index is constructed, the index publishers give much attention to the composition of the index (which shares or bonds are included) and to the relative weighting of each share or bond (which can be based on the market value of the company or on the number of shares of the company which is sold on average per day). Through a broad composition and careful weighting of the shares or bonds, the index should be representative for all companies traded on the stock exchange to which the index is linked.

At the time of its launch an index has a value of 100 points. Then the share or bond prices of the companies in the index go up and down and the index is recalculated, with the weighting of each company determining how influential a change in its share or bond price is for the index.

While indices are representative for (a segment of) a certain stock exchange, they are not necessarily very representative for the real economy of the country where the stock exchange is located. As indices are composed of companies listed on a stock exchange, they do not cover individuals, state-owned enterprises, foreign-owned companies and private companies, all of which play a role in the tidal wave of the national economy.

2 What are index trackers and why are they popular?

An *index fund* or *index tracker* is a type of mutual fund with a portfolio constructed to match or track the components of a *market index*. Investing in an index fund is therefore a form of passive investing: the fund manager simply invests in the shares or bonds which are included in the index. As the asset manager does not have to make many choices and does not have to incur high transaction costs on buying and selling shares, management costs for index funds are low. Of the gross return of the index fund, which is equal to the increase of the index, only a small percentage is deducted for management costs.
The fund manager of an actively managed mutual fund, in contrast, chooses on a daily basis in which funds to invest. His management costs are therefore higher. In theory these higher costs can be more than compensated when the fund manager chooses only companies which outperform the index. But in practice, this is often not the case. When you look at net returns (gross returns minus management costs), index funds often outperform actively managed funds.

Apart from the returns, another reason for the popularity of index trackers among investors is that they reduce risks - both financial and reputational. Index funds guarantee investors that they do not to perform worse than the index, while an actively managed fund could yield much higher results but could also result in large losses. The financial risks of actively managed funds are higher, while the average gross returns are not much better. And as is stated above, after the management costs are deducted, net returns are often even lower.

And there is another advantage: institutional investors such as pension funds and insurance companies know that if the index goes down, their investment returns will also go down. But in that case they can blame the economy: yes, they have lost money, but not because they made the wrong investment decisions. This limits their reputational risks in relation to shareholders, customers, media and supervisors.
Finally, in some markets the financial supervisors (that supervise financial markets on behalf of the government) explicitly demand institutional investors, such as pension funds and insurance companies, to only invest in index funds.

As index trackers are popular among investors, they are also popular among asset managers. Asset managers want to earn mandates of investors to manage their funds and many investors want to invest at least part of their capital in index funds. So there is a strong commercial logic for asset managers to offer index funds.

3 Index trackers and exclusion policies

Financial institutions that exclude investments in producers of cluster munitions often make an exception for investments in index trackers in their exclusion policies. Not all financial institutions make this exception, but this is also because not all financial institutions are actively investing in (or offering) index trackers.
Many investors and asset managers that work with index funds make this exception, although not fully based on the same arguments:

- Investors such as pension funds and insurance companies argue that they have a fiduciary duty[i], or at least a commercial necessity, to optimize investment returns while minimizing risks. As investments in index funds offer the best opportunity to achieve these goals (see paragraph 2), they are investing in index funds. Some index funds, especially those focussing on the stock markets of the United States, South Korea and Singapore, include a small representation of shares of cluster munitions producers. As the asset managers do not offer index funds which exclude these investments, the investors argue they have to make an exception for index trackers in their exclusion policies.

- Asset managers argue that they have to offer a broad range of index funds to attract mandates from institutional investors. And their clients demand that these funds follow the index in a strict way, not leaving room for exclusion of a few individual shares included in the index. The asset managers claim that, as long as the indices themselves have not changed, they have to follow them with their funds. So asset managers generally claim they are stuck between the demands of their clients and the contents of the indices offered by the index publishers.

4 Options campaigners can propose to financial institutions

To counter the arguments of financial institutions to make an exception for index trackers in their exclusion policies, campaigners could propose a number of options, both in discussions with investors and in discussions with asset managers.

In discussions with asset managers, the following options could be proposed:

[i] The person or organisation managing investments on somebody else’s behalf is expected to act in the best interests of the person whose investments he is managing. This is known as “fiduciary duty”.

1. **Replace a few cluster munitions producers in the index fund's portfolio by a few other companies**: Indices promise to replicate the movement of stock exchanges, which is also achievable with a slightly modified selection of companies. As index funds promise to match the results of an index, they do not promise that their portfolio is an exact copy of the index composition. With other words: the asset manager *could* choose to replace a few cluster munitions producers in his portfolio by a few other companies, as long as the performance of the index fund continues to match the movement of the index and thus the stock exchange.
   This would hardly make the management costs higher, but might be limited by legal requirements which can oblige time consuming procedures to allow these changes in the investment universe. Financial market regulations often demand there needs to be a waiting period of a few months after a change in the investment policy of the fund is announced. This would allow investors to sell their participations in the fund before the change is implemented, as the change might influence the price of these participations.

   In the United States, each fund has a separate board of directors, some of which are not employed by the asset manager which is managing the fund. These directors may oppose changing the fund's investment policy. In that case, the asset manager could end its management contract with the fund.

2. **Switch to another index which does not include producers of cluster munitions**: In June 2011, index publisher MSCI launched nine "MSCI Global ex Controversial Weapons Indices". These indices are slightly modified versions of the MSCI World Index, the MSCI All Countries World Index, MSCI USA Index, and six different MSCI Emerging Markets indices. The only difference with the original indices is that these versions exclude companies involved in cluster bombs, landmines, depleted uranium weapons and chemical and biological weapons. Immediately after these indices were launched in June 2011, the large American asset manager BlackRock started to offer index funds based on the nine "MSCI Global ex Controversial Weapons Indices". [1]

   Another, more radical, option is to switch to one of the many Socially Responsible Investment (SRI) indices on the market. These indices also aim to replicate certain stock markets, but also use various environmental and social criteria to select companies. This means that a SRI index for a specific stock market, may include quite different companies than the mainstream stock index for the same market. A recent overview counted 116 SRI-indices worldwide, all of which exclude producers of cluster munitions.[2]

   If an existing fund managed by an asset manager cannot switch to another index because of legal obligations, the asset manager could at least offer a new index fund based on a cluster munitions-free index. The asset manager could offer its client to switch to the new fund for free. But if this would not convince all investors, the asset manager after some time could end its management contract with the fund, after giving timely notice to its clients.

In discussions with investors, the following arguments could be used:

1. **Investors can pressure their asset manager**: Investors can pressure their asset manager to offer index funds based on cluster munitions-free indices as an alternative to the present ordinary index funds. Investors can do so on an individual basis, or team up with other investors who share the same goal.

2. **Investors can switch to another asset manager**: If their present asset manager is not prepared to offer funds based on cluster munitions-free indices, investors can decide to switch to another asset manager which does offer such funds.

3. **Investors can switch from a passive, index-based investment strategy to a really sustainable, active investment policy**: While a passive investment strategy might mitigate some financial and reputational risks, it will increasingly generate sustainability and reputational risks related to investments in cluster munitions and many other issues. The alternative is to focus on less companies, invest more per company, understand the risks associated to these investments in a profound way and engage with the management of companies to strengthen their sustainability policies.

When confronting asset managers and investors with these arguments, campaigners could ask them to adopt one of the options and change their investment policies. If they are not willing to adopt one of these options, campaigners should ask them to explain what prevents them from agreeing with the arguments and from changing their investment policies.

As discussed in paragraph 3, asset managers and investors often argue that index publishers are not responsive to this discussion and still include cluster munitions producers in their indices. Some asset managers and investors then conclude that because of the unwillingness of the index publishers they need to include an exception for index funds in their exclusion policies.
To counter this argument, campaigners could argue that listed cluster munitions producers are only to be found in the United States, South Korea and Singapore. So the issue is only relevant for global index funds and for index funds focussing on these specific stock markets. For index funds focussing on other important stock markets, such as Japan and the European markets, there is no problem.
And with respect to the global stock market and the stock markets of the United States, South Korea and Singapore, the good news is that the main index publisher for these stock markets - MSCI - has published cluster munitions-free versions of its indices. For the global stock market and for the national stock markets of these three countries, cluster munitions-free indices *do* exist now and can be used for index funds.
It is true that other index publishers for the American market, such as Standard & Poor's and Dow Jones, have not yet followed this example. Campaigners could join forces with asset managers and investors to pressure these index publishers to follow the example of MSCI and develop cluster munitions-free versions of their indices.
But at the same time campaigners can stress, in discussions with asset managers and investors, that **for all stock markets in the world indices now exist which are completely cluster munitions-free.** Asset managers and investors can hardly continue to blame index publishers when they continue to include an exception for index funds in their exclusion policies.

References

1 MSCI, "MSCI Global ex Controversial Weapons Indices Methodology", *MSCI*, June 2011; Ali, M. "BlackRock to create index funds on new MSCI ESG series", *Structured Products*, 28 June 2011.

2 Sun, M., Nagata, K. and Onoda, H., "The investigation of the current status of socially responsible investment indices", *Journal of Economics and International Finance Vol. 3(13)*, 7 November 2011, pp. 676-684.