Redefining the Indexing Landscape: Introducing a New Era for Benchmarking Costs and Index Derivatives

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Institutional and individual investors today are paying substantially lower investment management fees than when Morningstar opened its doors more than 30 years ago. This is due to a number of factors, including more investment options, greater access to information and demand for transparency from asset owners, regulators, media and firms like ours. The dramatic rise of lower-cost passive investments such as exchange-traded funds and passive open-end mutual funds is evidence of this trend. In Europe, passively managed funds have captured 16% of the market, up from 12% in 2014.

Global regulations driving change

We know that financial services firms throughout Europe will see sweeping regulatory changes as a result of the revised Markets in Financial Instruments Directive, known as MiFID II. Morningstar has been actively talking to industry bodies and clients across the continent to weigh in on how these changes can be good for investors and good for the industry. We expect that MiFID II and other regional regulations will continue to drive the trends toward outcome-oriented solutions, automated advice and a preference for low-cost investing.

An opposing force

One cost that's moving in the opposite direction, however, is the fee charged for benchmarking investments and related licensing costs paid by asset managers, wealth managers and asset owners. While costs are generally coming down across the industry, the fees for licensing index data have increased in multiples beyond what would be justified by inflation.

Fewer providers mean higher fees

The index industry has become concentrated, with just a handful of dominant index providers that control the vast majority of the global market. When the EU Benchmarks Regulation takes effect in 2018, we believe that will lead to more industry consolidation and fee increases in response to the higher costs of complying with the new rules.

Examining the funds with a primary benchmark listed in their prospectus, 53% of European mutual fund assets are benchmarked against one of just five index providers. In the United States, 73% of mutual fund assets are benchmarked against one of just three index providers, according to the *Financial Times*.

Essential, yet interchangeable

Proper benchmarking is a powerful tool for increasing an investor's chances for success. Benchmarks give investors the ability to manage risk, understand the drivers of return and cost in their portfolios and compare investment performance. Yet today's market cap-weighted equity indexes are virtually identical and track similar securities. They should be priced accordingly, but they're not.

Multiplying licensing costs

Many investment managers tell us that fees they pay for benchmark data have doubled or tripled in the past five years, with little justification for the increase. I've heard several anecdotes that benchmarking data is one of the top-five data expenses for asset management firms. We're concerned that the market relies on a small number of index providers charging a premium for this critical information.

An update on the Open Indexes Project

In late 2016, we launched an initiative called the Morningstar Open Indexes Project. It was inspired in part by the concept of open source, a powerful model that has created meaningful change in the price and accessibility of software.

The Open Indexes Project comes from our belief that the means to measure investment performance should be accessible. As part of this effort, we have offered a subset of Morningstar's own global market-cap equity indexes to financial services firms for general benchmarking purposes at no cost. We've also developed tools that allow market participants to choose the correct benchmarks to assess their success. We've formed an Open Indexes Advisory Council to explore the forces shaping the indexes industry today.

New indexes launched

More recently, we worked to help create an affordable, appropriate solution for risk management using our indexes available through the Open Indexes Project. We launched two new indexes, which will have associated derivatives contracts on Euronext.

Our two new indexes are float market-cap weighted indexes designed to provide exposure to the largest and most liquid companies in the eurozone and European regions, while maintaining sector weights that are similar to the European indexes in Morningstar's Global Equity Index family.

Our indexes will be used to launch derivative products on Euronext, and will also be included with the Open Indexes Project for clients to use as benchmarks.

Progress in lowering index costs

Broad interest in the Open Indexes Project suggests that costs are becoming more important than the brand of an index provider. We see this as a possible path to lowering costs at the firm level and, ultimately, reducing charges to institutional and individual investors.

The Open Indexes Project has the potential to change the index landscape. The firms that have engaged with us are working together because we believe that investment performance measurement should be reliable, transparent, accessible and affordable. Join us.

About Morningstar Indexes

Morningstar combines the science and art of indexing to create a comprehensive offering of global equity, fixed-income, alternative and multi-asset class indexes. Whether beta or strategic beta indexes are required, we deliver flexible solutions built on our ecosystem of high-quality data and proprietary research.

About Euronext

Euronext is the leading pan-European exchange in the eurozone, a blue-chip franchise consisting of 24 issuers in the Morningstar® Eurozone 50® benchmark index and a strong and diverse domestic and international client base. Euronext operates regulated and transparent equity and derivatives markets. Its total product offering includes equities, exchange-traded funds, warrants & certificates, bonds, derivatives, commodities and indices.

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