The Index Investing Revolution:
How Passive Strategies Are Reshaping Markets

Contributor

Sue Lee
Director, APAC Head of Index Investment Strategy
sue.lee@spglobal.com

The rapid growth of passive strategies, i.e. index-based investing, has been extraordinary.

In 2023, passive fund assets globally surpassed active fund assets,[1] driven by the proliferation of exchange-traded funds (ETFs), whose diversification, ease of access and cost efficiency appealed to both the growing retail investor base and institutional investors.

ETFs have democratised access to broad markets, much like stocks. Initially marketed to retail investors for their low fees, ETFs are now being embraced by institutions managing large, diversified portfolios.

While the shift started in equity markets, it has spread to other asset classes, with fixed income ETFs becoming increasingly popular.

The increasing availability of bond index data over the past decade has boosted this trend. Its sufficient track record, given the first bond ETF was launched in 2002, has also made investors more comfortable using an index-based approach in bonds.[2]

The result is the transformation of investment opportunities across markets and asset classes, as growing availability and liquidity of index-based products make them an integral part of the overall financial market structure.

[1] It's Official: Passive Funds Overtake Active Funds | Morningstar

[2] The Hare and the Tortoise: Assessing Passive's Potential in Bonds, S&P Dow Jones Indices.

“If you look at the liquidity of ETFs listed in the U.S., many of them have the highest turnover among all listed securities,” says Sue Lee, Asia Pacific Head of Index Investment Strategy at S&P Dow Jones Indices (S&P DJI). “That shows that these passive products are not just a buy and hold vehicle, but individual investors, hedge funds and institutional investors are increasingly using them to access and trade, taking advantage of the ample liquidity around indices.”

Global Phenomenon

The U.S. has long been the largest and most liquid market for index-based investing, but passive strategies are also proving popular in Asia.

Take Taiwan as an example. Given investors’ preference for income, the ETF market initially developed on fixed income but has expanded to income-driven equity strategies in recent years. Multi-asset ETFs are expected to be launched next year, making the investment choices even more diverse.

South Korea, meanwhile, is among the more innovative markets, witnessing a recent spurt in options-based strategies. This year, an ETF was launched based on a systematic call-overwriting strategy using zero-day to expiration (0DTE) options, which are contracts that expire on the same day they trade, pushing the market to new heights.

Lee says the 10-year compound annual growth rate of the global ETF market, by assets under management, is about 18%—with Asia Pacific mirroring that—according to Bloomberg data. Taiwan has seen stellar growth of more than 40%, while China has risen 31%, Japan 21% and Korea 20%.

She explains different usages of index-based products, including ETFs and index futures/options, among institutional and retail investors.

ETFs are increasingly being adopted by intermediaries to help clients build diversified portfolios based on their goals and risk appetite. Institutional investors have passive mandates, and there is also growing interest in rejigging portfolios using ETFs more tactically to take advantage of low costs, ease of access and the buoyant liquidity that ETFs provide.

On index futures and options, Korea has long been active, while India has fast surged into the limelight, driven by flush retail trading demand looking for new investment opportunities.

Diversification and fee savings are big draws. Investors can also ride on the better performance of passive funds over many active funds. According to the S&P Indices Versus Active (SPIVA®) Scorecards, global equity active managers had a challenging first half of 2024 with 70%-85% of funds studied underperforming their relevant benchmarks. Although fixed income active managers had much better results over this six-month period, a majority of them ended up underperforming their benchmarks over the long term, supporting the case of indexing in fixed income.

Asia Implications

As the financial market becomes globalised and global exchanges extend their trading hours, Asia's investors have wider access to global market products. Having the ability to trade in their own time zones means risk management becomes easier, allowing more local asset managers to bring global market products into Asian local markets.

"This global liquidity also enables price discovery," said Lee. "In case of the S&P 500® futures/options and ETFs, they trade quite actively during Asian hours when the U.S. market is closed. They are relevant to investors in Asia and also to the rest of the world."

Alternative weighting approaches may also help to address some of the current market challenges. For example, the dominance of certain mega-cap stocks, the so-called "Magnificent Seven," has increased in the U.S. equity market and consequently in the S&P 500. This may pose concentration risks, as those select stocks may have outsized influence on the overall index. Such challenges may be addressed by other indices, such as the S&P 500 Equal Weight Index, which aims to mitigate the concentration risk of the market-cap-weighted index in a simple, yet systematic way.

Artificial intelligence and machine learning tools are also making their way into indexing. Lee said S&P DJI is leveraging Natural Language Processing technology in the design process of the S&P Kensho Indices. Incorporating this technology helps identify companies relevant to different thematic categories and sometimes detect companies with big future potential in an early stage. Machine learning also comes into play given the availability of vast amounts of data that can be easily broken down by technology for index construction, all with the oversight of the team's analysts.

Another possible trend: Direct indexing could be coming soon, reckons Lee. Direct indexing has risen in popularity in the U.S. for the autonomy and flexibility it offers.

Asia could follow suit, with early-stage discussions with partners already underway.

"Our role is bringing our global expertise and knowledge into the local markets," said Lee. "By building strong partnerships with local exchanges and asset managers, we can connect Asian local markets with foreign investors and can connect Asian investors with global market opportunities. Asia remains one of our key growth areas. We aim to bring innovation, educate the market and work closely with the local managers and exchanges to further develop the capital markets here."

As passive investing continues to gain ground, it will be pivotal in helping Asia's investors navigate an increasingly complex financial landscape. From broad-market indices with active trading ecosystem to more targeted, complicated strategies, index-based investing's next chapter in Asia is poised to be dynamic and transformative.

General Disclaimer

It is not possible to invest directly in an index. Exposure to an asset class represented by an index may be available through investable instruments based on that index. S&P Dow Jones Indices does not sponsor, endorse, sell, promote or manage any investment fund or other investment vehicle that is offered by third parties and that seeks to provide an investment return based on the performance of any index. S&P Dow Jones Indices makes no assurance that investment products based on the index will accurately track index performance or provide positive investment returns. Index performance does not reflect trading costs, management fees or expenses. S&P Dow Jones Indices makes no representation regarding the advisability of investing in any such investment fund or other investment vehicle. A decision to invest in any such investment fund or other investment vehicle should not be made in reliance on any of the statements set forth in this document. S&P Dow Jones Indices is not an investment adviser, commodity trading advisor, commodity pool operator, broker dealer, fiduciary, promoter" (as defined in the Investment Company Act of 1940, as amended), "expert" as enumerated within 15 U.S.C. § 77k(a) or tax advisor. Inclusion of a security, commodity, crypto currency or other asset within an index is not a recommendation by S&P Dow Jones Indices to buy, sell, or hold such security, commodity, crypto currency or other asset, nor is it considered to be investment advice or commodity trading advice.

Closing prices for S&P Dow Jones Indices' US benchmark indices are calculated by S&P Dow Jones Indices based on the closing price of the individual constituents of the index as set by their primary exchange. Closing prices are received by S&P Dow Jones Indices from one of its third party vendors and verified by comparing them with prices from an alternative vendor. The vendors receive the closing price from the primary exchanges. Real-time intraday prices are calculated similarly without a second verification

These materials have been prepared solely for informational purposes based upon information generally available to the public and from sources believed to be reliable. No content contained in these materials (including index data, ratings, credit-related analyses and data, research, valuations, model, software or other application or output therefrom) or any part thereof ("Content") may be modified, reverse-engineered, reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of S&P Dow Jones Indices. The Content shall not be used for any unlawful or unauthorized purposes. S&P Dow Jones Indices and its third-party data providers and licensors (collectively "S&P Dow Jones Indices Parties") do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Dow Jones Indices Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON AN "AS IS" BASIS. S&P DOW JONES INDICES PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Dow Jones Indices Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the Content even if advised of the possibility of such damages.

S&P Global keeps certain activities of its various divisions and business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions and business units of S&P Global may have information that is not available to other business units. S&P Global has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

In addition, S&P Dow Jones Indices provides a wide range of services to, or relating to, many organizations, including issuers of securities, investment advisers, broker-dealers, investment banks, other financial institutions and financial intermediaries, and accordingly may receive fees or other economic benefits from those organizations, including organizations whose securities or services they may recommend, rate, include in model portfolios, evaluate or otherwise address.

The Global Industry Classification Standard (GICS®) was developed by and is the exclusive property and a trademark of S&P and MSCI. Neither MSCI, S&P nor any other party involved in making or compiling any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.