iShares
by BlackRock

INDEX INVESTING: THE ROLE OF INDEX PROVIDERS

Authors

Samantha Merwin, CFA
Head of ETF Markets Advocacy

Shreya Adiraju
ETF Markets Advocacy, US

Alec Woodworth, CFA
ETF Markets Advocacy, US

An index is designed to represent and measure the performance of a specific market, asset class, sector, or investment strategy. The S&P 500 Index, for example, tracks 500 of the largest U.S. stocks by market capitalization.

Unlike individual securities, market indexes aren't directly investable. Instead, most investors use index funds, which are designed to track the performance of designated indexes, less fees.

The role of an index

Indexes are used in both index and active investing.

- **Index investing**: This includes mutual funds and exchange traded funds (ETFs) that seek to track the performance of a specified index. These "index" funds provide simple, low-cost ways to gain exposure to the market.
- **Active investing:** Indexes are typically used to measure performance of active funds. Alpha-seeking managers attempt to "beat the market" by outperforming their benchmark—which is usually an index.

Indexes come in all shapes and sizes

Indexing began in equities but has grown to encompass much more. There are millions of indexes spanning all major asset classes, including fixed income, currencies, commodities and real estate (**Figure 1**).

Indexes can be broad—like the Russell 2000, which focuses on small-cap U.S. equities—or track narrower segments of the market, including single countries, specific sectors (e.g., technology), or themes (e.g., clean energy).

Figure 1: Sample indexes by asset class

Equity	Fixed Income	Currency	Commodity	Real Estate
Dow Jones U.S. Health Care Index	ICE U.S. Treasury 7-10 Year Bond Index	ICE U.S. Dollar Index	S&P GSCI Crude Oil Index	Dow Jones U.S. Real Estate Index
MSCI Japan Index	Bloomberg US Corporate High Yield Total Return Index	Bloomberg Euro Index	Bloomberg Precious Metals Subindex	Fundamental Income Net Lease Real Estate Index

The above table is for illustration purposes only. It serves as a general overview and is not exhaustive.

Index providers create and maintain indexes

Index providers, like MSCI and S&P Dow Jones Indices, are responsible for constructing and monitoring a wide variety of indexes.

Each provider uses a unique, rules-based methodology to build their indexes. This methodology is used to define the scope of the index, such as which securities or financial instruments are included and their respective weightings.

Index providers monitor not just the market but also regulatory and corporate events for ongoing index maintenance. For example, providers may need to rebalance the index—or adjust the weighting of constituent securities—based on corporate actions (e.g., stock splits) or changing market conditions.

The composition of indexes changes frequently

During periodic reviews, index providers may make changes to their indexes. For example, a provider will remove securities that no longer meet the criteria for index inclusion as outlined in its construction methodology.

Alternatively, an index provider may add a security if it becomes eligible for inclusion (e.g., if a private company takes its shares public).

Index providers also contend with macroeconomic events, like geopolitical tensions that result in country-wide or firm-specific sanctions, and adjust their indexes accordingly.

Fund managers manage funds, not indexes

Index fund managers often engage with multiple index providers. The top index providers for U.S.-listed index ETFs and index mutual funds are shown below (**Figure 2**).

Index providers license their indexes to asset managers and other financial institutions for a variety of uses, including benchmarking investments.

Index fund managers outline their investment objectives and determine which index benchmarks will best align with those objectives—and, ultimately, the needs of investors.

Figure 2: Top index providers by AUM[1]

Index ETFs		
Provider	**AUM**	**Market Share**
S&P Dow Jones	$2,189,638,572,298	42%
FTSE Russell	$850,465,503,999	16%
MSCI	$750,257,593,403	14%
Bloomberg	$731,183,442,717	14%
CRSP	$656,922,137,423	13%

Index Mutual Funds		
Provider	**AUM**	**Market Share**
S&P Dow Jones	$1,704,062,199,887	35%
CRSP	$1,365,574,831,755	28%
Bloomberg	$935,759,026,790	19%
FTSE Russell	$648,244,211,455	13%
MSCI	$246,945,675,136	5%

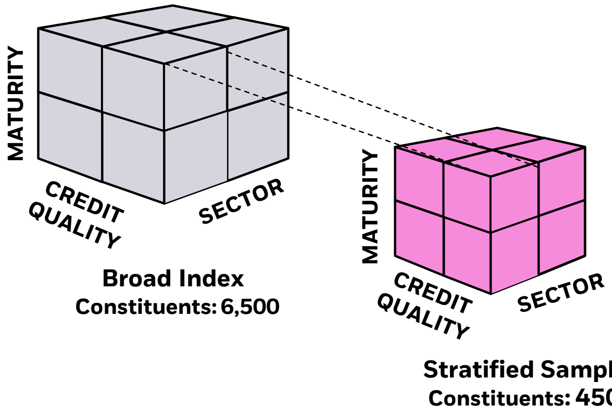
1 Source: Markit, Morningstar as of 30 April 2023. AUM and market share of U.S-listed index funds only; does not include AUM of active funds that are benchmarked to a particular index.

iShares by BlackRock

Managers of index mutual funds and ETFs strive to track the performance of a fund's underlying index as closely as possible. This can be achieved in two ways:

- **Full replication.** A fund may exactly match the composition of the index by holding every security at the same weight as the index.
- **Owning a subset of the index.** In some instances, such as funds that transact in less liquid fixed income markets, it may be difficult or impossible to purchase every index component. (In fact, some bond indexes have thousands of securities.) Instead, portfolio managers may seek to deliver index-like risk and return characteristics by holding and managing a representative sample of index securities (**Figure 3**).

Figure 3: Example of sampling



For illustrative purposes only.

There's nothing 'passive' about index fund management

Some people think that index funds are managed by computers. In reality, a lot of work gets done behind the scenes by skilled portfolio managers.

For example, during index rebalances and reconstitutions—reweighting and deleting or adding securities, respectively—index fund managers must rebalance or reconstitute their portfolios accordingly.

While indexes assume an immediate, frictionless, and costless implementation of changes, index fund managers are faced with transaction costs, risks, and other frictions when they execute trades in their portfolios.

At the same time, when trading around index events, index fund managers have control and exercise discretion in seeking to track the index and maximize shareholder value.

This means that index fund managers must review information about upcoming index changes and have an implementation plan in place to buy or sell securities to align their portfolio with the index in a way that balances risk, return, and cost.

Other responsibilities may include tracking corporate actions that can impact the composition of an index, reinvesting dividend or interest payments received from a fund's portfolio holdings, and monitoring risk in their portfolios and in the market.

In instances where a portfolio holds a sample of an index's securities, portfolio managers have discretion over security selection and can choose which securities to add or remove from the portfolio in order to continue tracking the index while aiming to minimize transaction costs and taxes.

Two distinct roles of equal importance

While index providers and index fund managers play different roles, they are equally important to the index investing landscape.

Index funds provide a way for investors to build diversified portfolios in a cost-efficient manner. This would not be possible without the efforts of index providers to build and maintain the index methodologies that underlie these funds.

As index investing continues to grow, it will be important for investors to understand the crucial, yet distinct, roles that these market participants play.

ETFs and mutual funds: Know the differences

- **Strategy:** Fund management styles are typically categorised as “active” or “index”. Active funds (most mutual funds) seek to outperform market indexes, while “index” funds (some mutual funds and most ETFs) seek to match the fund’s performance to an established market index, such as the S&P 500.
- **Trading:** Mutual funds are bought and sold directly from the mutual fund company at the current day’s closing price, or the Net Asset Value (NAV). ETFs are traded throughout the day at the current market price, like a stock, and may cost slightly more or less than NAV. Mutual fund transactions do not include commissions to a brokerage, while some ETF transactions do.
- **Transaction fees:** For mutual funds, transaction fees may include sales charges (sales loads) or redemption fees. These are paid directly by investors. ETF transactions may include brokerage commissions (like stocks), which are paid directly by investors.
- **Tax implications:** Mutual fund shareholders redeem shares directly from the fund, so the fund manager must often sell fund securities to honour redemptions, potentially triggering capital gains for the fund’s remaining shareholders. Because ETF investors buy and sell shares with other investors on an exchange, the ETF manager doesn’t have to sell holdings – potentially creating capital gains – to meet investor redemptions. ETF shareholders can incur tax consequences when they sell shares on the exchange, but that tax consequence is not passed on to other ETF shareholders.
- **Transparency:** ETFs generally disclose holdings daily. Mutual funds generally disclose holdings quarterly.

	Mutual Funds	Index Mutual Funds	ETFs	Stocks/Bonds
Diversified	✓	✓	✓	
Traded on exchange			✓	✓
Intraday pricing			✓	✓
Intraday trading			✓	✓
Management fees	✓	✓	✓	
Commission fees			✓	✓
Tax management*			✓	✓

* Due to fund structure, mutual fund holders may be subject to taxable capital gains distributions due to other investors’ redemptions directly to the mutual fund. Taxable capital gain distributions can occur to ETF investors based on stocks trading within the fund as the ETF creates and redeems shares and rebalances its holdings. ETFs and stocks will also distribute taxable capital gains when an investor sells their own shares. Certain traditional mutual funds can also be tax efficient.

iShares® by BlackRock

Carefully consider the Funds' investment objectives, risk factors, and charges and expenses before investing. This and other information can be found in the Funds' prospectuses or, if available, the summary prospectuses which may be obtained by visiting www.iShares.com or www.blackrock.com. Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal.

This material represents an assessment of the market environment as of the date indicated; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular.

This material is provided for educational purposes only and is not intended to constitute investment advice or an investment recommendation within the meaning of federal, state or local law. You are solely responsible for evaluating and acting upon the education and information contained in this material. BlackRock will not be liable for direct or incidental loss resulting from applying any of the information obtained from these materials or from any other source mentioned. BlackRock does not render any legal, tax or accounting advice and the education and information contained in this material should not be construed as such. Please consult with a qualified professional for these types of advice.

Shares of ETFs may be bought and sold throughout the day on the exchange through any brokerage account. Shares are not individually redeemable from an ETF, however, shares may be redeemed directly from an ETF by Authorized Participants, in very large creation/redemption units. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained. Buying and selling shares of ETFs may result in brokerage commissions.

Prepared by BlackRock Investments, LLC, member FINRA.

iShares® by BlackRock