GPIF Working Paper

Breaking Down the Elements of Passive Management to Enhance Sophistication: GPIF Initiatives

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EXECUTIVE SUMMARY

- Due to its massive size, by necessity, passive management comprises the foundation of the GPIF's investment style. Enhancing investment sophistication is therefore impossible without also improving the quality of passive management.
- The functions (or structural elements) of passive management can broadly be defined as (1) the benchmark index, (2) fund management, and (3) active ownership. Among these elements, the benchmark index is a particularly crucial factor that has a direct and significant impact on investment returns. Despite their importance, however, the GPIF and other participants in the investment chain have not traditionally devoted substantial resources to index selection.
- The GPIF has engaged in several different initiatives to remedy this, such as (1) introducing the "Index Posting System," (2) pushing to improve governance at index providers, and (3) contracting directly with these providers.
- Particularly with respect to (3), direct contracting not only enhances alignment between index providers and the GPIF, but also leads to better passive manager revenue structure transparency. Enhanced transparency is a step towards the establishment of a remuneration system that rewards asset managers appropriately according to their individual contributions.

GPIF's Position

The Government Pension Investment Fund of Japan (GPIF) is prohibited from managing equity investments in-house and therefore consigns all management to external asset managers. Achieving excess returns through active management tends to become more difficult as the level of assets under management increases, and thus given the vast size of the fund, passive management has been the main investment approach taken by the GPIF. Furthermore, the GPIF's 3rd medium-term management plan states that "except for reasons such as cash-outs, in principle, the GPIF will utilize both active and passive management. Active management will be conducted on the condition that sufficient evidence exists that doing so can be expected to result in excess returns."[2]

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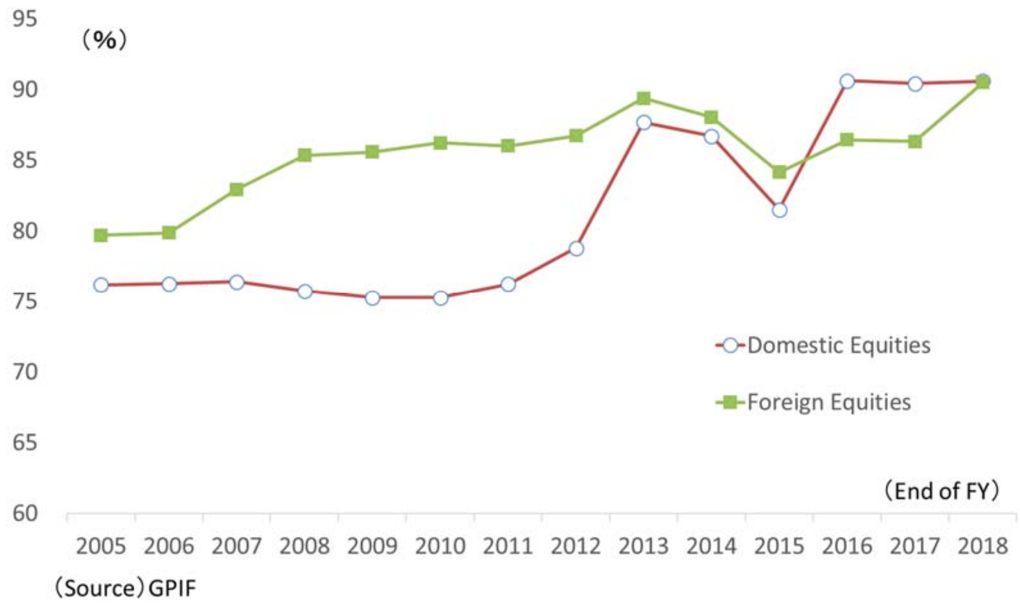
[1] Any opinions expressed within this document are those of the author and do not represent the position of the GPIF.
[2] Within the previous (2nd) Medium-Term Management Plan, Section 3 (Management Methods) states, "The size of the Pension Reserve Fund is immense, and due consideration must be taken with respect to its influence in the market. Additionally, the market is thought to be generally efficient over the long run. Taking these points into consideration, passive management comprises the main method of management for all asset

Figure 1: Ratio of Passive Management for Domestic and Foreign Equities



For example, if all JPY38.6 tn. invested in domestic equities as of March 31, 2019 were managed actively, and assuming that an appropriate size for a given fund was around JPY 3 bn. on average, the GPIF would have to seek out and select around 130 outstanding funds in which to invest. In addition to the massive cost involved in selecting and managing such a large number of funds, even after accounting for diversification, the risk-return profile of the managed assets as a whole would largely reflect passive management based on a market capitalization-weighted index. The fees would also more than likely far surpass those of passively managed funds.

A heavy emphasis on passive management is therefore the most logical choice for the GPIF, which is both the world's largest pension fund and is also prohibited from in-house management. Passive management reaps the benefits of long-term economic growth and the expansion of corporate profits through dividends and capital gains, and thus enhancing the sustainability of the economy, capital markets, and society as a whole is crucial in bolstering the foundation of GPIF's investment management. We have engaged in a variety of different initiatives to this end, mainly by promoting ESG (environmental, social and governance-based) investment. This paper provides an overview of the actions GPIF has taken to make its passive management more sophisticated by examining and addressing the different functions that make up this investment style.

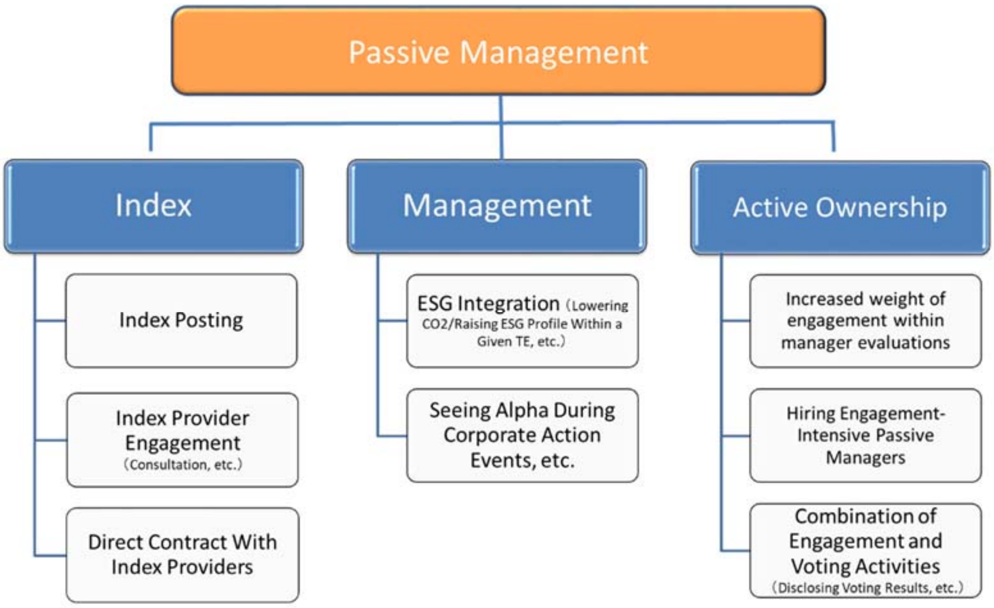
classes. Furthermore, in consideration of active management results until now, this will only be employed if the GPIF deems there to be a high possibility of obtaining excess returns after a thorough examination of an asset manager's management style, track record, and organizational structure."

Breaking Down the Elements of Passive Management

In modern portfolio theory, the Capital Asset Pricing Model (CAPM) and other models assume that the market portfolio is the most efficient. In practice, the quintessential manifestation of this idea is passive investment based on a market capitalization-weighted index. Passive managers up until this point have devoted most of their energy to reducing index tracking error and keeping costs as low as possible, but this situation is quickly changing. For example, the massive growth in passively-managed assets is amplifying the impact on supply and demand imbalances around index rebalancing and other important dates, and more than a few hedge funds and other players view this distortion as an opportunity. In recent years, accurately assessing these imbalances and effectively timing moves into and out of stocks has become a vital component of a passive manager's skill set. An even more advanced way a manager can set themselves apart is by reducing climate change and other ESG-related portfolio risk while remaining within a certain tracking error.

Furthermore, there is no one prescribed definition of what exactly the "market portfolio" consists of. Theoretically, the market portfolio would be defined as an index that encompasses the entire market, but after taking issues such as market impact and trading costs into account, an index that includes every single stock may not be the best option for an investor. On the other hand, the barriers to building and distributing indexes have come down dramatically thanks to technological advances, and disruption within the industry has sparked a sharp realignment of costs and a proliferation of new benchmark options. For asset owners, selecting the right index – not only smart beta and ESG indexes but also traditional market cap-weighted indexes – is a crucial investment decision.

Figure 2: Breakdown of Passive Management Elements



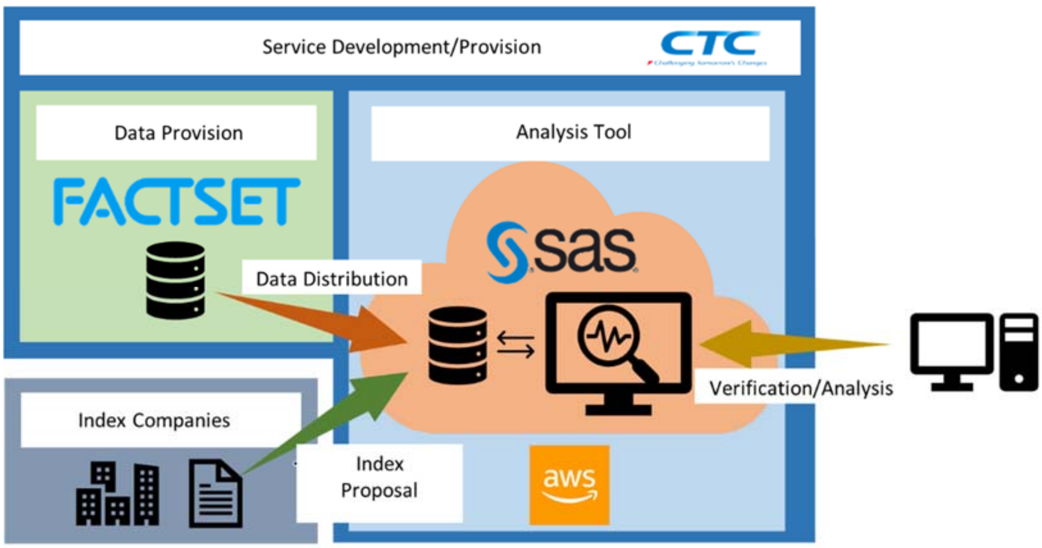
Introduction of Index Posting System

Even though benchmark selection has a far greater influence on the success or failure of a passively-managed fund than the manager's skill level, the amount of resources the GPIF and other asset owners (i.e. end investors such as pension funds, SWFs and individual investors) have devoted to selecting a good index until now has not necessarily been commensurate with the importance of doing so. From the "performance measuring stick" aspect of indexes, active fund managers would tend to prefer a benchmark that is easy to outperform (i.e. a poor benchmark). On the other hand, passive fund managers would mainly be concerned with being able to accurately track the benchmark regardless of its quality. Within the investment chain, therefore, asset owners are the ones whose performance and appraisals are impacted the most by proper benchmark selection and quality improvement.

With this in mind, the GPIF launched the provisional version of the Index Posting System (IPS) in 2019 in order to enhance fund management by effectively gathering a wide variety of index information on a continuous basis. The full version of the system is scheduled to go online during FY2020.

In tandem with this, the GPIF is currently developing the Index Data Entry and Analysis System (IDEAS), which will serve as the technical infrastructure for efficiently aggregating information posted through the IPS and combining this with ESG and other non-financial and financial data to enable deep analysis of new index ideas.

Figure 3: Index Data Entry and Analysis System (IDEAS)



Note: The logos within Figure 3 denote companies/services actually used within IDEAS.

Index Provider Governance

As the GPIF devotes significant resources to the selection of ESG indexes and other benchmarks, we are keenly aware of the importance of assessing the quality of index providers' corporate structure and governance. Traditionally, equity indexes have been constructed in a relatively mechanical manner, with constituents being selected based on market cap, liquidity, or other company attributes. One prime example of this is Japan's TOPIX, where companies listed on the 1st section of the Tokyo Stock Exchange are automatically included in the index. Global indexes such as the MSCI All Country World Index, on the other hand, are slightly different: despite being market cap-weighted indexes, important decisions such as which countries to include in the benchmark are made by the index provider. These are critical judgment calls that can have a significant impact on passive investment returns.

These decisions have the potential for political repercussions, as determining to include the companies of a particular country in an index can dramatically alter the flow of world investment capital. This was evidenced when MSCI came under heavy political pressure from US Republican Senator Marco Rubio and others when it decided to include China A shares in its flagship MSCI All Country World Index. Similarly, ESG indexes are also subject to significant subjective judgment by the analysts and others who determine ESG ratings and draw up index calculation methodologies. This means that for all intents and purposes, passive investment targets are selected not by the asset management company but by the index provider.

In the past, evaluating the quality of an index provider primarily meant investigating whether or not the company could accurately calculate and efficiently distribute index values. Now, however, asset owners need to assess ESG rating companies and index providers with ESG rating divisions using a similar approach as the one they use to assess asset managers. These companies' governance structures and conflict of interest management in particular are extremely important in ensuring the continuity, transparency, and neutrality of ESG ratings. From this perspective, the GPIF conducts thorough due diligence of these firms, with a specific focus on the relationship between the ESG rating company or index provider and their main stakeholders (shareholders, major clients, etc.), their decision-making processes (whether or not independent committees are in place, past discussions, etc.), and whether or not the company is engaged in business lines that can potentially result in a conflict of interest, such as providing paid consultation to companies. As the prominence of index providers grows year by year within the investment chain, these companies have an increasing responsibility to establish robust governance frameworks and make decisions from an investor's point of view. Specifically, global indexes that are linked to trillions or tens of trillions of dollars in investment funds have the power to direct international capital flows, and thus the companies that provide these indexes must naturally bear a high degree of accountability for the decisions that they make.

Moreover, whenever index providers and ESG rating companies conduct user consultations when proposing changes to their index calculation or ESG rating methodologies, the GPIF proactively comments on these changes from the perspective of an asset owner and requires our asset managers to engage in a similar manner.

Strengthening Collaboration with Index Providers and Asset Managers Through Direct Contracting

As we strengthen our commitment to indexing, the GPIF is also reviewing our approach to contracting with index providers. The contracts the GPIF have traditionally made with index providers only cover the usage of index value data. On the other hand, contracts covering index licenses that include the deeper information necessary for passive management have been made not between the GPIF and index providers directly, but between index providers and the asset managers receiving a mandate from us. Index license fees are thus paid to the provider out of the management fees that the GPIF pays the asset manager. These fees are calculated as a percentage of assets under management, as opposed to the flat fee that is charged for general index data usage. Obviously, the former results in significantly higher fees.

A situation in which the GPIF plays a central role in selecting indexes but has a tenuous contractual relationship with the actual index provider and has no insight into how much is actually paid to the company is not necessarily advantageous.

Conversely, a situation in which the GPIF directly pays license fees to the index provider leads to better alignment not only between the provider and the GPIF, but also between the GPIF and our passive managers. Index license fees account for a significant portion of fund management costs for passive managers, while the contract terms and conditions differ from manager to manager. Since index license fees have been a black box from the perspective of the GPIF, we have not been able to accurately gauge the actual revenue level – excluding index license fees – for passive managers. By paying these fees directly, the GPIF can compensate managers properly according to the contribution they actually make in terms of management and active ownership. If we are able to get the correct incentives in place by paying passive managers a fee according to their actual contribution, this will result in a better alignment of interests between the GPIF and our managers.

Partnering With Engagement-Intensive Asset Managers

Even previous to directly contracting with index providers, the GPIF has taken steps to push stewardship to the next level such as requiring all of our asset managers to enhance their stewardship activities and by selecting two "engagement-intensive" passive managers in 2018. These managers are required to establish plans and set goals for their engagement activities on a yearly, medium-term and long-term basis, in addition to implementing more robust organizational structures and methods for engagement than other passive managers.

Conclusion

Due to the massive size of the fund, by necessity, most of the GPIF's assets must be managed passively. It is therefore impossible to enhance the overall management of the fund without enhancing the quality of passive management. Up until now, however, a commensurate amount of resources have not necessarily been devoted to selecting the indexes that account for the bulk of investment performance and engaging with the companies that provide these indexes. The GPIF has taken several steps to address this issue, such as requesting proposals for domestic equity ESG indexes (Jul. 2016) and environmental global equity indexes (Nov. 2017), and most recently introducing the Index Posting System to more efficiently and flexibly gather and analyze various index information for benchmark selection.

Additionally, we compel index providers – whose influence continues to grow year by year – to make decisions from a neutral, investor-focused standpoint, and expect them to consult with asset managers and asset owners to gather a wide range of opinions whenever making a change to index rules. We are also improving incentive alignment by paying index license fees directly to providers rather than through asset managers. This leads to greater passive manager revenue transparency, and is a step towards establishing a more logical fee structure in which managers are rewarded according to their actual contribution. These initiatives are just the beginning of GPIF's endeavor to make fund management more sophisticated, and we welcome constructive feedback on how we can do more.