The Hierarchy Of Financial Superpowers – Who's Really On Top?

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Some firms wield outsized power in the financial system. But the real superpowers are not the ones that dominate the headlines. Banks, asset managers, credit rating companies all contend – but the top rank goes to the companies that construct and license financial indexes.

The Lower Rung: Banks and Asset Managers

The phrase "financial superpower" — applied in the private sector (so the Federal Reserve doesn't count) — calls to mind the iconic firms that own, manage and control large holdings of financial assets, powerhouses like JP Morgan, Goldman Sachs, and BlackRock. JPM is the largest bank in the free world, with adjusted assets of nearly $3.2 trillion, equal to 15% of the total Gross Domestic Product of the United States. BlackRock is even bigger – $7.4 trillion in Assets Under Management, a figure 45% larger than Japan's entire economy. And Goldman Sachs, while "smaller" (only $1.8 Trillion AUM), is …well, Goldman Sachs, the nonpareil of contemporary finance.

NEW YORK, NY - APRIL 01: As a trader looks on, Captain America poses for photographers on the floor of the New York Stock Exchange GETTY IMAGES

This layer of the financial world's power structure is familiar to everyone. It is likely that most Forbes readers can name the CEO's of all three companies. Jamie Dimon and Larry Fink (of JPM and BlackRock respectively) are the two most prominent candidates for the title of "Unelected Minister of Finance" – their personal and institutional influence in New York and Washington is immense. BlackRock has been engaged to manage the Federal Reserve's growing portfolio of corporate bonds and ETFs. JPM was the Fed's go-to white knight in 2008 to bail out first the crippled investment bank Bear Stearns, and then Washington Mutual (the huge bankrupt savings & loan). Thus both JPM and BlackRock serve as auxiliaries of the U.S. government.

And Goldman Sachs looms in everyone's imagination as the cleverest of them all, and for some as perhaps the most sinister expression of finance capitalism that has ever existed. Goldman alumni have served in power positions in all recent American administrations, at the Federal Reserve and the European Central Bank. They carry a very big stick in the equities markets. Just last week, for example, a Goldman analyst published a new price target for the audio-streaming firm Spotify, and conjured $6.5 billion for the company in added market value overnight. Just on his say-so.

Goldman Re-sets Spotify's Valuation CHART BY AUTHOR

The Higher Powers: The Credit Rating Agencies

But financial markets acknowledge the existence of still more powerful deities –

- "There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful." *– [A widely cited 1996 quip by New York Times pundit, Thomas Friedman]*

In 2011, *The Guardian* declared the matter settled:

- "Fifteen years on, the answer is clear: it's Moody's....Along with its main rivals Standard & Poor's (S&P) and Fitch, the so-called big three credit rating agencies have succeeded in bringing national governments, including the US, to heel."

With regard to the U.S., that turned out to be an overstatement. S&P did indeed downgrade the Treasury's credit in 2011, during one of our periodic budget squabbles. Despite the worries of many (including President Obama) it had no apparent effect on the government's ability to sell its paper. But for smaller or more distressed economies, the ratings decisions of Moody's and S&P can be much more significant. In 2010-2011 Greece's credit rating was downgraded repeatedly by Moody's and S&P, which crushed the Athens stock market, and helped bring down the government. It significantly complicated the EU's plans for a financial rescue. The effect was felt across Europe and beyond. The *BBC* reported that:

- "Global stock markets tumbled after Greece's debt was downgraded to 'junk' by rating agency Standard & Poor's."

This year it has been Italy trembling under the downgrade threat. In late April, S&P decided *against* a downgrade – and the markets exhaled in relief. The Italian 10-year bond price rose 25% in just one week. But, in a surprise move a few days later, Fitch did downgrade Italy to one notch above junk. "We are a step closer to that ultimate cliff edge," said one observer. (The effect of falling below the "junk" threshold would be potentially catastrophic. "Its bonds would be ejected from major indices, forcing some investors to sell.") The ECB (to its credit) saw the danger and immediately hinted that it would consider buying junk-rated sovereign debt –that is, Italian debt. This countermove neutralized the Fitch news, and calm was restored. But consider the power of a single private American firm that can cause the European Central Bank to jump so.

The immense power of the ratings agencies is well understood. Their ability to rattle governments, and move entire markets, arguably surpasses anything that JPM or Goldman could accomplish. Nevertheless, the rating agencies have a lower profile. They don't swagger or seek publicity. They almost seem to adopt the character and habits of a public utility. They project sobriety, grayness, public purpose. Even the way they are referred to – as rating *agencies* – suggests that they are not really what they are – extremely profitably corporations working for their shareholders. Bonus points for any Forbes reader who can name the CEO of Moody's, or S&P.

The *Highest* Powers: The Index Providers

As mighty as all these monsters may be, there is an even more formidable species lurking in the foliage of the financial ecosystem. The members of this species are mostly reclusive, and poorly understood. Many ordinary investors aren't even aware of their existence. And yet, these elusive players have the ability to thwart or favor the plans of not just the sick puppies among nations (like Greece), but those of the great and powerful, even those of quasi-hegemons – like China.

The species in question is the small group of companies that build and license financial indexes.

An index seems a simple thing, at first glance. It starts with a list of companies, stocks, or other assets (e.g., bonds), and a method of combining their individual prices to take an "average" price of the group. The S&P 500 Index – probably the most widely referenced index today – is a list of "500 large publicly traded companies in the United States equity markets."

Except that it is not quite that simple. There are in fact many specific criteria for inclusion or exclusion from the list – 41 pages of criteria and conditions, in fact – too many even to summarize here. Applying these criteria creates much room for judgment, and sometimes unusual choices. For example, there are actually 505 members of the S&P 500 (and I won't even try to explain that here). The process can produce counterintuitive results: Warren Buffett's company, Berkshire Hathaway, was not admitted to the S&P 500 index until 2010 — although it was by then larger than all but 20 of the companies already on the index. Tesla is not a member yet, although its market value is greater than Ford, GM, and Chrysler combined. The S&P 500 index is constructed upon a complex foundation. Moreover, the index list changes frequently — companies merge, falter, or are bumped off by newcomers — the average tenure of a company as a member is less than 15 years and going down. This means that the index structure and composition must be managed actively (in the case of the S&P 500 it is attended to by a committee of nine members whose identities, other than the chairman, are secret).

The S&P 500 is a fairly straightforward index, conceptually. Of the thousands of other indexes that track countries, sectors, styles (e.g., growth vs value) etc. – many have even more complex structures and require even more active management. The turnover on some bond indexes is close to 100% per year. Companies that use an index as the basis for building an index *fund* – a passive investment fund designed to simply track the underlying index as closely as possible – would prefer to license, and pay for, the use of an index that is designed and curated by someone who specializes in that art – the index provider.

As passive and quasi-passive investing have grown to dominate the market, the index construction and licensing business has boomed. The S&P 500 Index alone underlies at least $10 trillion invested in index funds, exchange-traded funds, and "active" funds that use it as a benchmark.

The Players

The indexing business is dominated by a small number of companies: S&P (a sister division of the S&P credit rating business mentioned above, which also includes the Dow Jones indexes), MSCI, and FTSE/Russell. They are enormously profitable (see below), and they are also beginning finally to attract some attention - not so much because of the money they make, but because of their inordinate and unexpected power to influence markets and beyond that, to force changes financial system structure and governance.

Two cases will suffice to make the point.

China and MSCI's Emerging Markets Index

The rise of China as an economic power has been hampered by the underdevelopment of its financial markets. Trading rules, financial disclosure requirements, constraints on foreign investment, and other governance rules and policies are still not fully aligned with international standards. One of the goals for China's financial systems development has been to qualify for inclusion in indexes like MSCI's Emerging Markets index, which tracks equity markets in countries like Korea, Taiwan, Brazil, Mexico, Russia, and South Africa. It is the benchmark for $1.7 Trillion in managed investments. Until 2017, China was not included in this index, despite its economic weight. MSCI turned them down twice in 2015 and 2016, which provoked threats and "heavy pressure" from Chinese government. But Chinese exchanges and regulators also moved to adjust their practices to conform more closely with international norms - that is, to meet the requirements MSCI imposes for including a country in the index. It became a national priority for China. The outcome of this wrestling match between the 2nd economic power in the world and a smallish American corporation in lower Manhattan was an agreement by China to introduce "market opening measures, [and greater] accessibility and transparency" in the financial system. In return, MSCI began a staged process of adding China to the index – at first China had less than a 1% weighting. It will come up to full proportional weight over several years. (American diplomacy has pursued similar goals – more open and transparent financial markets – for some time. It would be interesting to compare the success MSCI has achieved in inducing China to improve its financial system with the results of the geopolitical campaigns waged by the U.S. government.)

Turkey

This week the *Financial Times* reported on a crisis in Turkey, triggered by the possibility that MSCI may "downgrade" the country, in a manner of speaking. It is not a credit downgrade, but the transfer of Turkey from the Emerging Markets index to the so-called Frontier Market Index – a lower ranking assigned to countries with less developed financial markets, inferior in structure, policy, and governance. Turkey would join countries like Vietnam, Morocco, Kenya and Nigeria, in this quasi-probationary status. The downgrade is under consideration (according to MSCI) because of "a deterioration in investability" – Turkey has "suffered substantial deterioration in market accessibility." The effect of this index change would drive billions of dollars of capital outflows from the Turkish stock market (which is already down more than 50% since 2012).

Profit & Power

MSCI is not a very large company by current standards. It reported about $1.6 billion in revenue (about what Apple sells in 2 days), and employs 3300 people (vs 250,000 for JPM). But it is a true financial superpower. The company dominates in particular the market for indexes tracking international equities, which is why it is in the center of the China controversies. The *Wall Street Journal* reported that:

- "In 2018, more than $13.9 trillion in investment funds had stock portfolios that mimic the composition of MSCI indexes or used them as performance yardsticks, and nearly all investments by U.S. pension funds in global stocks are benchmarked against MSCI indexes."

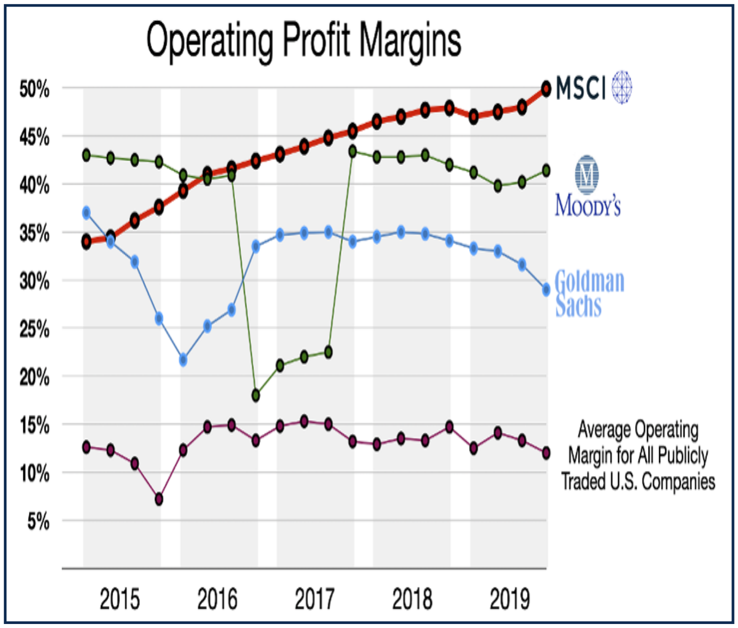
And MSCI is not the largest of its kind. By most measures, the company trails (slightly) its chief competitors, S&P Dow Jones and FTSE/Russell. The industry has boomed. According to the Financial Times:

- "The huge shift from traditional, active asset management to passive, index-tracking funds since the financial crisis has made the major index providers enormously powerful."

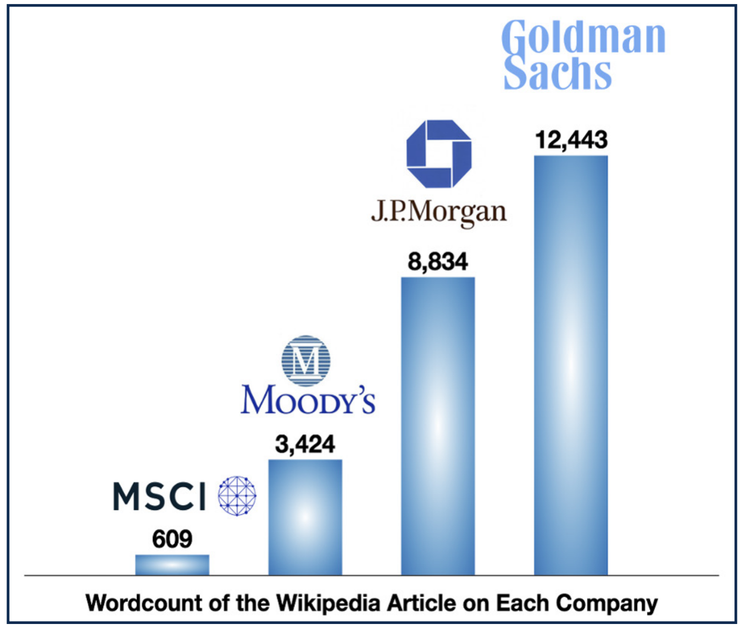
- "The global index fund industry has grown fivefold over the past decade to $11.4tn… [with] another $6.8tn in index-tracking strategies managed internally by sovereign wealth funds, endowments and pension plans…. There are now roughly $20tn of investments that strive only to mimic an underlying index."

They have been called "the new gatekeepers of capital." In other words, through their design and selection decisions to construct and manage these indexes, the index providers now "steer" capital equal more or less to the annual output of the entire U.S. economy — 3 times the AUM of BlackRock, and 10 times that of Goldman Sachs.

Indexing is also unspeakably profitable — as befits the "superpower" label. If we compare MSCI (a pure-play indexer), Moody's (a pure-play credit rating company), and Goldman Sachs – well, the trend is clear. MSCI's operating margin is higher than Goldman or Moody's, twice as high as Apple and Google, a third higher than Facebook and Microsoft, and about four times higher than the average U.S. public company.



Operating Margins for the Financial Superpowers CHART BY AUTHOR



Word-counts of the Wikipedia articles related to the Superpowers CHART BY AUTHOR

Despite these incredible numbers, and despite the muscle-flexing episodes (China, Turkey), the Index Providers still operate if not actually out of sight, then largely out of mind. Most investors are likely still unaware of exactly what they do, or their importance in shaping the financial markets. As a very rough measure of the "mindshare" the index providers command, compared to the lesser superpowers of banking and credit rating, consider the disparity in the word-counts for the Wikipedia articles on MSCI, Moody's, JPM and Goldman Sachs.

This may be changing, however. MSCI's inclusion of China in its flagship index, however partial so far, has generated political controversy in the U.S., as even politicians begin to realize that if they want to influence Chinese financial practices, the index providers may have more clout than anyone else right now.

The invention of modern indexing, and the perfection of the art and science of creating effective indexes over the last several decades, has become the great enabler for the rise of passive investing to its current dominant position in the financial markets. Index development also turns out to be just about the best business there is at this moment in the history of capitalism.

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