INTERVIEW

AI and Indices: What's next?

FTSE RUSSELL CONVENES

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Interviewed by

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Jamie: David, it's always great to have a conversation with you, so thanks so much for stopping by.

David: Well, thank you for inviting me again.

Jamie: So, if you don't mind, I'd love to start with the topic of AI. Very much in the news right now. I think a little unknown fact about you is that you started, or you at least were working on AI in the 90s, is that right?

David: That's right. I studied artificial intelligence in the 90s at the Vrije Universiteit in Amsterdam, which at that time was a relatively unknown term. If I said AI, people look a bit funny, what is it about? And I tried to explain, well, it's a mixture of maths and perhaps logic and psychology. But of course, nowadays, AI, you can't escape it. You see it everywhere in the news, in every sector it's playing such an important role.

Jamie: What were the thoughts, even back then? Was there always this idea that this would be a huge force for good in the world? Or were there even reservations that we didn't know whether AI would take on a life of its own or what dangers there might be?

David: I think AI, and you can say when did AI actually start? Meaning different people have a different view on when AI started, but you could trace the origins of AI to the second World War when the bright people in Bletchley Park tried to…

Jamie: Alan Turing?

David: Alan Turing, absolutely, with a group of very bright men and women tried to decipher the encrypted codes from Nazi Germany and effectively combined the wisdom of linguists, mathematicians and psychologists to find a way to crack them. So, in one way, AI was born trying to figure out how we can also better use computers. Computers were kind of born then at the time to decipher very complicated problems and do that relatively quickly. Of course, there was an enormous sense of urgency to do so at the time. The nature is a bit different to what we're talking about now, but the idea of using computer power to solve problems very rapidly and also sometimes use human type thinking. So, heuristics, rules of thumb, is definitely what is behind AI nowadays.

Jamie: Do you have a particular view on ChatGPT? How useful it's going to be, how it's going to be used?

David: Well, I'm experimenting with it myself. I mean, I'm playing with it to try and understand. I'm very impressed. If you think about the speed with which you can get an answer its incredible. And coming back to Alan Turing there is something called the Turing test. The Turing test is about whether a computer can mimic human behaviour and use it as a metric to decide whether a computer is as intelligent as a human being.

Jamie: So how does the Turing test work?

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David: Imagine you have a room or two rooms, effectively in one room is someone who's posing a question and in the other room is either a human being answering those questions or a computer, but you don't know. And so, the idea of the Turing test is, for someone posing questions can you differentiate or know that depending on the answers you get, whether you're dealing with a computer or with a human being? Now with ChatGPT it's becoming very difficult. I mean, you know it's a computer because it's incredibly fast, that no human being will compose, but the quality of answers, although in certain cases are nonsensical, it's incredible. The language, especially the way it's being articulated is incredibly impressive.

Jamie: The more media I've been reading recently, the more terrified I got of the idea that this AI could take on a life of itself. You know, the dawn of robots could come and we should be very nervous. But speaking with some other AI experts more recently it seems very much contained. Where do you sit on the spectrum of feeling that the dawn of AI is a complete positive on markets and on society, to being something that we need to be nervous about?

David: I think even among the AI experts of different views those who are very concerned about it. I mean, very recently about a thousand experts wrote a letter in which they expressed concern about AI including people like Elon Musk and professors. I do think that the whole development of ChatGPT and other AI technology begs the more fundamental question about who we are as human beings. I mean, if you can see how the technology develops, the difference between how we think as humans and how we understand machines to be, it is very difficult sometimes to really distinguish the intelligence of ChatGPT or other systems and can we call that intelligence? And especially in these deep learning systems. I think the philosophical question of who we are as human beings is now at the forefront and it's being forced by this technology. Whether we should fear it or not. I don't know. I think it's definitely a reason to think and ask some very important philosophical and also ethical questions about where these developments can go to.

Jamie: Some other experts I've been speaking to seem adamant about the fact that AI will be an enhancement to most people's jobs by 10 to 20%, let's say. And then there are others who fear that it's going to replace a huge amount of jobs. I mean, maybe with reference to FTSE Russell, where you work but how do you see it playing into the labour market, for example?

David: To be precise is a very difficult question to answer. I think it's probably a bit of both. Where technology on the one hand will be complementary to what we're doing, it will make processes more efficient, be faster, hopefully even reduce certain errors. And this is general 'speak'. But it's probably also true that it'll replace certain types of jobs as we've seen that automation has done so over the last hundreds of years. I think we need to see what is the impact of automation on processes and how businesses are organised.

Jamie: And how about as it relates to FTSE Russell, are you already trying to incorporate AI into what you do?

David: We have run an AI impact assessment. So what we're trying to say is, where and how do we use AI? We also try to understand the AI regulation. There's a bit of development there this year, the EU has come out with the EU AI Act. There's other legislation that we're trying to understand the scope of and how that impacts our business. I would say FTSE Russell itself, we are dealing with companies, right? So less about individual personal data. What is important in our world, of course, is that our data is accurate. So although I love ChatGPT, we also know that it can generate nonsensical answers. Our business is all about accuracy and validation of data. Although we can kind of observe what is happening it's not something that we use to generate indices that need to be run according to a very strict process. The answers need to be 100% reliable.

Jamie: So much of your business is about creating indices and deciding, or should I say building, benchmarks to see which companies get into the index and which don't. Can you talk a bit about those kind of conversations that you're having now with companies who you're talking to when it comes to designing these indices and what kind of criteria that people need to pass to sort of get into them.

David: With relation to AI, or just in general?

Jamie: Well, I was going to start with more in general how that would look.

David: Well, the criteria that we use for companies are published, right on our website. We call them the ground rules. And we spoke about the analogy of the recipe book. And so in that sense what it takes for a company to be included in an index is typically things such as the market capitalisation. If you think about an index like the FTSE 100, we are looking at the largest 100 companies based on the market capitalisation. That's effectively the market price times the stock that's outstanding. Of all the companies that have a premium listing on the London Stock Exchange. So those are the criteria. And then there's some other criteria such as free float but big picture based on those criteria companies are either in or out of the index. We do that for the FTSE 100, but we also do that for more than I said last year, one million. We have now 1.4 million roughly, indices that we have effectively a recipe for.

Jamie: We were talking earlier when you talked about country classification. Can you talk a bit about that?

David: FTSE Russell has a country classification framework, so every company gets assigned a nationality and that nationality gets associated with it, with a particular market. Now, depending on what market a company falls into it affects the index eligibility. For equities we have four different markets. We have developed markets, advanced emerging, secondary emerging and frontier markets. Now depending on, in which of those four buckets you fall you will have a certain type of membership. Of course, the membership impacts also the type of flow. So, if you are a frontier market you have a certain amount of flow. If you are in a developed market you have probably more flow. So, the idea being to get promoted to the developed market status because that is most likely leading to more flows into that particular market. Now, what is it that we are looking at? For us, we try to assess the accessibility for international investors to a particular market. We try to understand what is the regulatory framework. How are, for example, minority shareholders treated in in a particular market? We try to understand how the FX market works. Is it a well-functioning FX market? How does the equity market itself work? And think about things such as transaction costs. Are they reasonable? Are there punitive tax costs involved? We also look at things like clearing and settlement and we use a so-called quality of market matrix to assess and score a particular market. And we do that by actually engaging with stock exchanges. We talk to stock exchanges and also sometimes ministries of finance or treasury departments and say these are the conditions that are conducive for international investors. So, if you meet this type of criteria you're more likely to get promoted to a market where you'll get more flow. There is a lot of engagement with various stock exchanges across the world.

Jamie: And how about on a topic like ESG, and there's a company that would like to be considered an ESG stock. They feel that they meet the criteria. How would they go about sort of lobbying you or trying to persuade you that they deserve to be in it? And how do those conversations go?

David: Well, it's an interesting choice of words. It's not the matter of deserving, it's either they meet the criteria or they don't. We try to avoid exercising subjective and discretionary judgment, but rather what we can do is explain to a company about the criteria that they have to meet.

Jamie: A certain percentage of their revenues need to come from green?

David: From green revenues, for example. Exactly, and, and then it also goes how are green revenues defined? What type of activity? So again, we have a document that explains that and based on indeed the data coming from that company they either meet those criteria or not. What sometimes happens is companies come to us and ask, well, we think we met the criteria, but you know what happened? We're not in the index. And of course we then try and explain where they're falling short, for especially our "FTSE4Good" index, it is the longest running index that we have, it's more than 20 years that we've been engaging with companies, trying to explain the type of things that are important to get a better score. And there we have criteria of having an ESG score of at least 3.3. I mean, the score goes between zero and five but if they're above 3.3, they're in the index. If they're not, they're out of the index. Companies are trying to understand what does it mean? How do I get a higher score? And what are the factors that contribute to a higher score? What are the factors that will detract them from the scoring?

Jamie: We talked about this last time, I feel that from the period of about 2010 to 2020 there was a huge pickup in passive investing driven a lot by new indices that were coming to the market. How do you feel the world of passive investing is going? Do you think that the, the rise of passive investing will continue or it's now time for active investing to come back into the limelight?

David: I think there will always be a market for both active and passive investing. It ultimately comes down to what investors feel is good value for them. I would say definitely the growth in passive investment is also about cost, right? Passive funds, ETFs, have become much, much cheaper over the years. So that's been one of the driving effects of the growth of the passive market. But, I know you've been an active manager yourself so have I been, and I think there'll always be a market for active investors but ultimately it's the end consumer needs to decide what offers value for him or her based on their own criteria, on their own risk appetite and of course on their own budget. That is what they'll have to consider.

Jamie: David, just before we finish up, what are the kind of things that come into your mind as we look out into 2024, 2025, any big thematics that investors should be thinking about considering with portfolio construction?

David: I think there's still continuation of geopolitical risk. I don't think that's going away anytime soon. I think that will probably be a big driver for a lot of investors.

Jamie: Including the role that China's going to play in the world.

David: The role China's going to play, we are still dealing with the tension in Russia and Ukraine. I don't think that's going away anytime soon unfortunately. So geopolitical risk is we having elections in many regions across the world. U.S. of course, very important. So are going to play a big role. Energy of course is still playing a role. Inflation, I think is a big theme. Central bank policy. We've seen higher rates. And with that come all kind of questions around how do you construct a diversified portfolio? 60, 40, how does that work? In this environment? How would we think about correlation between equities and fixed income? What is the liquidity premium that investors should get in this type of environment? So lots of challenges, I would say over the next 12 months. It certainly won't be boring.

Jamie: Well, if there's one thing about markets that they're never boring. Thank you so much for your conversation.

David: Thank you, Jamie. I much enjoyed it.

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