



Overview

MSCI has been asked to comment on CESR's issues paper *Can hedge fund indices be classified as financial indices for the purpose of UCITS?* In this letter, MSCI seeks to provide information relating to the construction and maintenance of its hedge fund indices for the working group to consider as it investigates the potential suitability of such indices for inclusion in UCITS. The letter is divided into three sections. The first section provides background on MSCI and its experience with financial indices in general and hedge fund indices in particular. The second section addresses the specific questions which the issues paper introduces. And the third section provides comments on an academic paper which the working group has referenced in its issues paper.

I. MSCI and its Experience with Hedge Fund Indices

About MSCI

MSCI has been producing indices globally for over 30 years across equity, fixed income and hedge fund asset classes. Close to 2,000 organizations worldwide currently use MSCI indices and MSCI estimates that over USD 3 trillion are currently benchmarked to MSCI Equity Indices on a worldwide basis. In addition, there are over 80 ETFs based on MSCI Equity Indices trading in the U.S., Europe and Asia with over USD 50 billion in assets.

MSCI's Approach to Index Creation and Maintenance: Independence and Transparency

MSCI's editorial decisions are made completely independently of all interest groups, including its shareholders. The fact that MSCI is editorially independent and objective does not preclude MSCI from considering the views and suggestions of its clients and other users of its products and services. To the contrary, MSCI believes in fully engaging all stakeholders by frequently soliciting feedback received from various constituencies, and final decisions are taken independently of any single interest group or stakeholder and have the sole objective of preserving or enhancing the quality of the MSCI Indices.

In conducting these consultations, MSCI often receives disparate feedback from the marketplace in reaction to important product features and specific methodological considerations. As an example, certain clients may focus exclusively on 'representivity' of an opportunity set and welcome a very large numbers of constituents while others strongly favor 'investability' and would prefer including fewer index constituents to facilitate product tracking. MSCI expends a considerable amount of resources to gather sufficient market feedback to strike the right balance between often-competing index objectives.

Once indices have been created, MSCI strives to operate in an open and transparent manner. The methodology for index construction and maintenance is objective, rules-based and fully disclosed. In the case of hedge funds, constituent information is made available to qualified investors only. Methodology and constituent additions, deletions and weight changes are announced in advance of their implementation.

MSCI's Experience with Hedge Fund Indexation



MSCI began calculating hedge fund indices in response to requests from its institutional client base. MSCI first introduced a family of hedge fund indices in July of 2002. This set of indices was designed to provide institutions with a better understanding of the available opportunity set of hedge funds. Over the last four years, these indices have been used to perform high-level performance attribution for portfolios of hedge funds, peer group comparisons, and individual hedge fund research. This family of indices is calculated using data that is voluntarily reported by the constituent hedge funds and, as such, is subject to certain data biases (including survivorship bias, selection bias, and backfill bias). These biases make this family of indices unsuitable to serve as the basis for investment vehicles.

In response to market demand for a suite of hedge fund indices that could serve as the basis for investment vehicles, MSCI undertook an extensive industry consultation with a wide array of industry participants. In order to design a suite of indices to overcome the challenges that existed with its first set of hedge fund indices, MSCI determined that it would need a consolidated source of constituent hedge fund pricing. In July of 2003, MSCI contracted with an established provider of a managed account platform of hedge funds, and began to produce indices that are free from certain data biases. This platform allows MSCI access to uniform and reliable hedge fund pricing similar to that which exists in other asset classes. Over the last three and a half years, these indices have successfully served as the basis for tradable hedge fund investment vehicles.

II. Response to the Questions Posed in the Issues Paper

Q1: What are your views on the potential biases described in this section and on how they can affect HFIs? Please explain your comments.

Non-investable hedge fund indices and related databases are commonly believed to be subject to numerous biases due to the private nature of hedge funds and the specific methodologies that have been employed to create certain non-investable indices. Hedge fund index biases have been widely discussed in recent academic literature. Much of the research has attempted to identify, isolate and then estimate the impact of these potential biases. While it is useful to consider these potential biases separately in order to understand them qualitatively, it must be remembered that they are highly inter-related. To estimate the possible impact of these biases, one must consider them together. There are three general types of potential biases that we will discuss here: survivorship bias, back-fill bias, and selection bias.

1. Survivorship bias

Survivorship bias might be present in an index or database that includes only funds that continue to operate at the time the sample is taken. Such an index or database would ignore the contribution from funds that existed for some portion of the period considered. If the excluded funds exhibited performance characteristics different from the included funds, then a bias may be introduced. Estimates of the possible impact of survivorship bias in a broad index or database vary widely, with common predictions ranging from 1.5% to 3.0% per annum. Studies that have considered the effects on return characteristics other than the mean have found that survivorship bias generally caused traditional risk measures such as standard deviation and kurtosis to be understated.

The MSCI investable hedge fund indices are live indices reflecting the performance of all funds that are constituents at each point in time. The historical performance of

discontinued funds is an integral part of the performance of the index. As such, there is no impact from survivorship bias on the investable indices for the period of time that they have been calculated.

2. Back-Fill Bias

Back-fill bias is potentially caused by including historical performance for a fund back to its date of inception, regardless of the date when the fund joined the index or database. This is also sometimes referred to as instant history bias because funds that enter the database in this fashion have an “artificial” history associated with them, as the decision to submit the fund is ex-post. The issue of back-fill bias may be exacerbated by selection bias. For example, because fund managers could select not only if, but also when, a specific fund would enter an index or database (and have its performance history recorded as if it were contributed in real time), a manager might include only those funds that historically have been successful. Again, this could possibly result in the index overstating historical returns for hedge funds generally.

New constituents to MSCI investable hedge fund indices only impact the index performance from the date of their introduction forward. There is no back filling of historical information which could lead to biases.

3. Selection Bias

Selection bias is the most direct manifestation of the problems associated with voluntary participation in hedge fund indices and related databases. It refers specifically to the fact that funds are able to self-select for inclusion into an index or database. It is impossible to quantify the effect, if any, that this bias has on returns since the full universe is unknown. It is even difficult to estimate the possible direction of this effect given the different reasons that individual funds may have for choosing not to participate in an index or database. For example, some funds may choose not to participate if they have superior performance and are closed to new investment. Others may choose not to participate if they have poor performance and do not want to reveal their returns. If many underperforming funds were missing from an index the index would overstate the performance of the entire hedge fund universe generally, and if many outperforming funds did not participate then the index would understate the performance of hedge funds generally. As the relative proportions of these two groups are unknown, the net effect of this possible bias in non-investable broad hedge fund indices remains unknown. A corollary to selection bias is sometimes referred to as reporting bias. Reporting bias occurs when a fund stops reporting to an index or database for reasons other than terminating its operations. As above, the reasons for discontinuing reporting may vary greatly. For example, performance may have been adequate to excellent but fund capital may have reached its capacity. A fund may also have begun to perform poorly and caused the manager to stop disclosing its results. The impact of reporting bias could be even more pronounced if a fund ceased to participate suddenly upon experiencing exceptionally poor performance -- any missing month's performance skews average performance, as extreme data points that are not reported remain excluded from the index returns. By not including unreported poor fund returns, an index could potentially overstate the aggregate performance of hedge funds generally.

The potential for selection bias will continue to be present with any sample of the total universe of hedge fund constituents. MSCI seeks to mitigate this bias in its investable family of indices by using an objective, rules based inclusion and weighting policy for the hedge funds on a given platform. MSCI does not use an opaque selection criteria (e.g. statistical selection techniques) in order to select individual funds for index inclusion. Rather, MSCI

uses the approach that is similar to that used in other asset classes – which is to represent the opportunity set through an inclusive approach. As a result, the MSCI Hedge Invest index currently includes 143 actively participating hedge funds.

Q2: Are there any other material sources of bias affecting HFIs that CESR should consider?

MSCI does not have any further suggestion for potential biases for the working group to consider.

Q3: Should an HFI have to meet certain additional quantitative criteria other than level 2 requirements, or should compliance with the level 2 requirement of sufficient diversification be left to the UCITS to assess? Please explain precisely the grounds underlying your comments. & Q4: What requirements on weighting should HFIs have to fulfil to qualify as financial indices? Please explain precisely the grounds underlying your comments.

MSCI does not believe that specific quantitative criteria such as weighting schemes or minimum constituent levels ought to be mandated by regulation. MSCI currently creates non-investable indices based upon asset weighting and equal weighting and investable indices based on a hybrid weighting scheme that is largely equal weighted, but makes adjustments based on the typical size of hedge funds following a particular strategy. This hybrid weighting scheme results in a weighting methodology that is more stable than asset weighting (which can fluctuate based on fund flows that are unrelated to performance). MSCI is actively investigating a new weighting scheme that would mitigate the quarterly readjustments that follow from an equal weighted scheme which are contrarian in nature, and may not be consistent with an environment in which constituents exhibit persistence with respect to their performance. MSCI recommends that the marketplace be permitted to innovate in order to create products that will meet investor demand – and that regulators not create mandates which would likely stultify such efforts.

Q5: Is the definition of the representative group of underlyings made by the index provider sufficient to satisfy the criterion of “adequate benchmark” ? Please provide comments.

The term benchmark, as defined by the CFA Institute, has a very specific meaning with a particular set of requirements, including that any potential benchmark be Investable, Measurable and Specified in advance. In constructing its investable index series, MSCI sought to address issues related to each of the requirements from the CFA. Of particular importance is the fact that the indices represent ‘achievable’ performance – a cornerstone to the index construction.

Q6: Is there a role for any quantitative assessment of the 'breadth' of coverage of the HFI? If so, how would this work?

MSCI does not generally use quantitative assessments to create its indices. If quantitative tools were to be used, MSCI would encourage the working group to ensure that adequate samples of data were used and assurances that no fundamental changes to the nature of the fund occurred in order to determine the veracity of any results.

Q7: Should backfilling be banned for HFIs to qualify as financial indices? If not, why not? Please explain precisely the grounds underlying your comments.

Currently, backfill bias does not exist in any hedge fund index which MSCI publishes (although for the first 18 months of operation – the non-investable index series was constructed with back-filled data). Although MSCI does not believe that indices which use backfilled data result in the best indices for use as the basis of tradable products, MSCI believes rules which are this specific may be the wrong level of detail to target in promulgating index rules.

Q8: Should CESR set criteria for the treatment of defunct funds by HFIs for them to qualify as financial indices? If so, what should they be? Please explain precisely the grounds underlying your comments.

MSCI does not construct any index in which defunct funds are removed from the history of the index (for more detail see Q1). MSCI believes that rules to this effect may prove to be at the wrong level of detail in order to be fully effective.

Q9: Is disclosure of the index revision methodology sufficient or should controls be placed on the frequency, method or amount of due diligence the index provider must carry out regarding ongoing constituent classification? If so, what should they be? Please explain precisely the grounds underlying your comments.

MSCI uses the following process to classify funds in the MSCI non-investable hedge fund index: marketing material is collected from the hedge fund, an MSCI classification analyst speaks with a representative of the fund to understand the investment process, and finally a classification is assigned by the classification committee. MSCI determines the classification, not the fund. For the investable hedge fund index series, the process is essentially the same, however, the managed account platform allows for an additional level of review of a manager's trading style. It should be noted that in addition to allowing the platform manager to see the all the trading positions, managed account platforms also typically employ trading guidelines which reduce the likelihood of managers drifting from their designated trading styles.

Q10: Can the UCITS assess the revision methodology of the HFI adequately or should an independent third party be required to review the HFI's methodology? If the latter, how would this work? Please explain precisely the grounds underlying your comments.

MSCI has no view on who is best placed to review the methodology of hedge fund indices.

Q11: Is passive versus active selection of constituents the key difference between an HFI and a fund of hedge funds respectively? What could be the other differences? Please explain precisely the grounds underlying your comments.

MSCI follows the same guiding principles in the construction of its indices across asset classes. MSCI is not qualified to comment on the portfolio construction techniques of funds of funds.

Q12: Should only HFIs where constituent selection depends solely on publicly available objective rules qualify as financial indices? If not, why not? What sort of subjective judgments could be used to select underlying constituents? Please explain precisely the grounds underlying your comments.

MSCI strives to make its methodologies publicly available and operate in as transparent a fashion as practicable. Currently, Methodology Books for MSCI's non-investable and investable hedge fund indices are available to the public.

Q13: Are there any competition aspects CESR should consider in the context of hedge fund indices compared to funds of hedge funds? Please explain precisely the grounds underlying your comments.

The specific uses of indices generally vary by client. They range from understanding an opportunity set, measuring performance, to, in some instances, obtaining exposure to index movements through investment products.

Q14: Do respondents agree that the ability to verify the value of the index given price data and the HFI methodology satisfies the replicability criterion? If not, why not?

MSCI investable indices are based upon NAV values. Institutions that would like to replicate the performance of the index are permitted to do so after obtaining a license from MSCI.

Q15: Should CESR set requirements for verification of NAV calculation and independent custody arrangements/robust governance structures for the underlying constituents of HFIs to qualify as financial indices; or as an alternative, should the UCITS be required to assess the due diligence procedures of the index provider in respect of the underlyings in this regard? Please explain precisely the grounds underlying your comments.

MSCI conducts due diligence upon the hedge fund platforms upon which it intends to base investable hedge fund indices. The purpose of this due diligence is to evaluate whether the platform provider is conducting its operations in a reliable manner and has hedge fund available that meet the index methodology requirements. In addition, MSCI uses outside auditors where needed to supplement its own due diligence efforts.

Q16: Should a minimum monthly publication frequency be a requirement for HFIs to qualify as financial indices? If not, why not, and what frequency would be suitable?

MSCI currently produces daily indicative and weekly actual index levels for its existing family of investable hedge fund indices. MSCI does not believe that a particular publication frequency should be mandated by regulation.

Q17: Should CESR require an independent audit of the calculation of HFIs to qualify as financial indices, or should the market be left to decide whether this would be an attractive option for an index provider to put in place? Please explain precisely the grounds underlying your comments.

MSCI does not have a position on requirements such as the one proposed above.

Q18: Should it be a requirement for an HFI to qualify as a financial index that its full rules are publicly available (rather than just material rules)? If not, why not?

MSCI publishes two detailed Hedge Fund Methodology Books (one for its non-investable indices and another for its investable indices). MSCI believes that a requirement for such disclosure is not unreasonable.

Q19: To qualify as financial indices, should HFIs be required to disclose at all times details of their constituents (eg list of underlyings, their classification, and the weight applying to them, if appropriate)? Is there other information about the HFI that should be disclosed? Would this be done via the index provider's website? Please explain precisely the grounds underlying your comments.

MSCI does not publicly disclose the names of constituents in any of its hedge fund indices in order to respect the concerns of regulators in certain jurisdictions and for commercial reasons. However, daily information relating to the constituents and weights – in addition to announcements of index changes made in advance of their effective date - are made available on a subscription basis to qualified licensees. However, public disclosure would not be a reasonable requirement given regulatory restrictions and commercial requirements.

Q20: Should a UCITS which intends to invest in derivatives based on HFIs have to disclose this fact in its prospectus or other documents? What degree of information should a UCITS which intends to invest in derivatives based on HFIs have to disclose in its prospectus? Please explain precisely the grounds underlying your comments.

MSCI has no view on this.

Q21: Do you have any other comments relating to hedge fund indices that CESR should consider? What are they?

Additional comments are included in section III of this letter.

Q22: From the regulatory and retail investors' point of views, how do you assess the situation of competition between funds investing in derivatives based on HFIs and funds of hedge funds? Please explain precisely the grounds underlying your comments.

MSCI has no view on this.

III. Comments on the Academic Paper cited in the September CESR Issues Paper

MSCI believes that the academic paper¹ which is cited by the working group in its issues paper dated October 2006 introduces a number of important topics related to hedge fund indexation and, in appendix B, makes several suggestions concerning minimum criteria for hedge fund indices that the working group should strongly consider. However, MSCI would also like to bring to the attention of the working group that the paper contains a number of factual misrepresentations relating to MSCI's hedge fund indices, and that several of its arguments rely upon a postulate with which MSCI does not agree.

'Defunct Funds' Bias

The first issue relates to the assertion that MSCI “adjust[s] ex-post the official historical performance of their index as if it had never included the defunct fund. Since the majority of defunct funds are poor performers, this re-calculation biases upward the performance of the index.” In fact, MSCI does not now, and has never, removed defunct funds from either its investable or non-investable indices. In fact, MSCI stated in a document submitted in the previous public consultation that “The MSCI investable hedge fund indices are live indices reflecting the performance of all funds that are constituents at each point in time. The historical performance of discontinued funds is an integral part of the performance of the index. As such, there is no impact from survivorship bias on the investable indices for the period of time that they have been calculated”. By extension, the suggestion that the author makes that a decision to remove defunct funds was made by MSCI because the result “is great for marketing purposes” is obviously neither based in fact nor accurate.

Published in an Appropriate Manner

The second issue relates to the assertion that MSCI indices are not ‘published in an appropriate manner’ since they do not disclose the constituents or weights of the index. It should be noted that MSCI does not publicly disclose the constituents of its indices in any asset class – but rather, makes such information available on a subscription basis. Weekly information relating to the constituents and weights of its investable hedge fund indices – in addition to announcements of index changes made in advance of their effective date - are available on a subscription basis to qualified licensees. This information, which is currently available free of charge to properly qualified investors, is distributed to a wide range of institutions spanning a number of different client segments. Maintaining a tight control of data delivery is particularly important for hedge funds in order to comply with the requirements of regulators in certain jurisdictions. In fact, MSCI expends considerable effort to ensure that it discloses fund-level information only to properly qualified investors. While we agree with the author’s statement “While there are [sic] maybe good reasons for an active fund of hedge fund manager to not disclose the content of his portfolio, we believe that there should be no secret in an index’s composition”, we would also encourage the working group to understand that MSCI makes every reasonable effort to operate in a transparent fashion with regard to its calculation methodologies and index constitutions subject to regulatory restrictions and commercial practices.

‘Classification’ Bias

The author segregates index providers into three types, where the third type “uses the managers’ self-proclaimed styles and eventually validate them by an index committee (e.g. CS/Tremont, MSCI).” To clarify the process used to classify funds in the MSCI non-investable hedge fund index: marketing material is collected from the hedge fund, an MSCI classification analyst speaks with a representative of the fund to understand the manager’s investment process, and finally a classification is assigned by the classification committee. MSCI determines the classification, not the fund. For our investable hedge fund index series, the process is essentially the same, however, an additional level of review is provided by having an independent party (such as a managed account platform provider) monitor the trading positions of the fund. In addition, third party programs for hedge funds (such as managed account platforms) often employ trading guidelines which reduce the likelihood of managers’ trading styles drifting from an agreed upon strategy into an unapproved strategy.

Representivity and ‘Private’ Funds

To address the issue of representivity, the author begins with the premise: “Ideally, an index should represent 100% of its universe” and that “...whatever its origins, [a database or managed account platform] will always provide a partial and therefore biased representation of the overall universe of hedge funds.” He goes on to suggest that the relevant universe includes all hedge funds regardless of their desire to participate in databases or be included in managed account platforms. If we look to the equity asset class for a parallel, and extend this logic – it would follow that the ‘overall’ equity universe would include both publicly traded and privately held equity. As it stands today, equity indices intend to represent those equities that are traded on exchanges and do not capture those equities that are held privately (the proportion of which can vary considerably from country to country – but is difficult to determine with any certainty). Though substantial differences do exist, if one were to view third party monitored programs of hedge funds (such as managed account platforms) as exchanges of hedge funds, then the model of tracking the constituents of these programs have similarities to the indices constructed in other asset classes such as equities.

Suggestions for Hedge Fund Index Criteria

With some exceptions and clarifications, MSCI substantially agrees with the points made in Appendix II of the paper. In addition, MSCI would suggest four more:

- ***constructed such that investors can replicate their performance through index tracking vehicles:*** This requires that the indices should be constructed from a reliable source of constituent information. Only ‘live history’ should be used in which changes to the index are announced in advance of the effective date. As a result, such indices would not be subject to back fill or survivorship biases.

- ***neutral with respect to constituent selection:*** This requires that indices are designed to passively represent an opportunity set and are not based on fund selection principles based on expected performance.

- ***produced by an independent and objective index provider:*** This requires that editorial decisions are made completely independently of all interest groups.

- ***diversified with respect to constituents:*** This requires that the index methodology be designed to ensure that the indices are not excessively concentrated in any single fund or fund management organization. At the composite level, the indices must also intend to remain diversified across investment segments. At the strategy level, fund and fund management organization concentration limits must also be applied; however, given the more narrow focus of these indices, concentrations may be higher than for composite-level indices.

Of the points highlighted in Appendix B of the paper, MSCI concurs with the following criteria for adequate hedge fund indices (subject to the clarifying points highlighted in brackets).

2. Constituent transparency: In the case of an index based on individual hedge funds, the list of components, their strategy (based on the classification used by the index provider) and the weight assigned to each component should be disclosed [to a group of qualified licensees]. [Changes to the index should be announced to qualified licensees in advance of the effective date].

3. Construction transparency: The methodology for an index construction, e.g. its component selection criteria, its asset allocation rules, its guidelines for altering the index, its components or their weights, should be specified in advance, clearly described and readily available for the investment community. They should be reasonable according to common sense.

7. Index audit: The prices or returns used to compute the indices should also be available – possibly for a fee – so that index returns can be independently verified.

8. Measurability: The index should be calculated on a reasonably frequent basis and the information should be available in a reasonable amount of time.

9. Passively managed: The index should forgo active management and discretionary decisions, and should correspond to a passive buy and hold strategy.

10. Final index values: Once published, the estimated performance of an index may be updated retroactively only during a limited time period.

11. Stability of performance over time (backfill bias): In no case a change in the composition of an index should imply a change in its past performance.

Endnotes

1. Hedge Fund Indices for Retail Investors: UCITS Eligible or not Eligible?