

OPINION

of the

GERMAN ALTERNATIVE INVESTMENT ASSOCIATION (BAI)

on

**CESR's Draft Advice on Clarification of Definitions concerning
Eligible Assets for Investments of UCITS (Dated October 2005;
Ref: CESR/05-490b)**

Section 2: The eligibility of derivative instruments on financial indices

Question 14: Do you agree with the approach as suggested in Box 14? Please give your view on the possible impacts of the proposed approach to your activity/more broadly to the UCITS market, based on your experience.

In Box 14 Figure 2 it is mentioned “that given the complexities of hedge fund indices and the fact that they are still developing, CESR cannot recommend, at this stage, allowing hedge fund indices to be considered as financial indices. However, CESR is monitoring the issue and is willing to reconsider its position in 12 months, after gaining sufficient experience”.

In note 122 of the Draft Advice (page 48 and 49) CESR notes that indices based on hedge funds raise many specific issues including:

1. Survivor bias, i.e. the fact that underperforming hedge funds tend to close down and therefore may not be included in the indices;
2. Selection bias, i.e. how does the index avoid under or over reporting by unsuccessful or successful hedge funds;
3. Consistency of the sector of hedge funds of which the index is deemed to be representative;
4. The policy regarding backfilling bias, i.e. permitting newly included hedge funds to backfile their performances, thus potentially generating a bias in favour of the best performing hedge funds;
5. Treatment of investable/not investable (because closed to new investments) hedge funds.

Furthermore the Draft Advice refers to the fact that these issues are not dealt with by the IOSCO criteria and that relevant criteria for hedge funds index construction have not been considered at international level.

A. Investable hedge fund indices

The critical issues mentioned by CESR regarding hedge fund indices in general do apply to many non-investable hedge fund indices which are not suited for derivatives anyhow due to lack of traceability. However the BAI disagrees with CESR’s assessment of hedge funds indices as a potential underlying of a derivative instrument in UCITS as to investable hedge fund indices. Most of the investable hedge fund indices (consisting only of hedge funds open for additional investments) comply with the respective CESR- and IOSCO-criteria of adequate indexation such as the ones calculated and published by CSFB, Dow Jones, Feri, MSCI, HFR, S&P and FTSE. Several of these indices fulfil all of the criteria mentioned in note 121 of the Draft Advice (page 26 for financial indices).

Art 19 (1) g of the Directive does not provide for any details on the nature of the financial index as an underlying of derivative instruments explicitly. The most common vertices forming an adequate financial UCITS-index are specified in notes 120 and 121 of the Draft Advice (pages 46 to 48). Subsequently financial indices have to comply with the criteria set by Art. 22a (1) of the Directive, which means that they are sufficiently diversified, represent an adequate benchmark for the market to which it refers and that they are published in an appropriate manner. In addition the Draft Advice notes that CESR is of the opinion that for the purpose of UCITS' investments, financial indices have to comply with the relevant provisions set out by the IOSCO in its document "Indexation: securities indices and index derivatives" (February 2003), whereupon IOSCO promotes (1) a contract design that minimizes the scope for manipulation and facilitates the orderly convergence of derivative and cash market prices at the time of contract expiry (2) adequate controls for ensuring orderliness in and between derivatives and cash markets in conditions of turmoil in the financial markets and (3) proper arrangements for the effective coordination of oversight between the index derivatives market and the underlying cash markets.

Many of the investable hedge fund indices cover different styles that broadly represent hedge fund investing (Arbitrage, Event-Driven and Directional/Tactical). Hedge Fund Index construction usually uses rigorous quantitative and qualitative methods to determine fund selection. As a general rule the index construction process involves different complementary procedures. Initially the number of funds required to construct a representative and investable index is determined. Standard & Poor's for example has used stratified sampling and bootstrap simulation techniques to conclude that a portfolio of 30 to 40 hedge funds represents the risk/return characteristics of broader portfolios of hedge funds. These hedge fund indices types are thus representative.

In further procedure a universe of suitable candidates for inclusion in the index is determined. This process begins with the examination of strategy consistency, screening the hedge fund sample for self-reporting bias and inconsistency to create a candidate pool cohesively defined in terms of styles and strategies. The candidate pool is then further screened for length of track record, assets under management, and investment capacity to ensure investability. Should a hedge fund which is part of the index be closed, that particular hedge fund is replaced at the next rebalancing point.

CESR' concerns regarding selection bias are unfounded. In general, it is impossible to under report a poor hedge fund performance because their returns are reported on a regular basis and reporting failure would usually mean expulsion from the index. Index reporting on a daily basis may not be implemented in either case because many hedge funds do not provide day-to-day reporting systems. At the same time over reporting by successful hedge funds generally may not appear since hedge fund and strategy weightings are usually fixed as you will find exemplary at the S & P Hedge Fund Index.

In general the different hedge fund indices equally weight the styles and strategies, providing investors convenient means to achieve broad diversification across the major hedge fund strategies. This is consistent with creating a representative index that reflects a passive investment approach that diversifies both hedge fund strategy risk and manager risk over time. The rules governing construction and

maintenance of the index — e.g. (annual) rebalancing to equal weights and the procedure to change index constituents — are clear and publicly announced.

As to fund removals and additions index funds are generally required to undergo regular due diligence reviews. Representativeness analyses are periodically repeated on the “universe” which includes new qualifying funds. A fund can be removed from the index if it becomes closed to new investments, if it fails to continue to represent its respective strategy or if it does not continue to pass certain due diligence reviews. The decision to remove a fund from the index is either purely rules based or made by an Index Committee. A fund can or even must be added to the index if it meets all the qualifications and is considered to produce a more representative group of funds for a strategy. This may occur with or without the removal of another fund. To minimize survivorship bias, funds are generally not removed from the Index until they are fully liquidated or fail to meet financial reporting requirements. At a point a hedge fund closes to new investments (due to failure or capacity constraints), the hedge fund is generally replaced at the next rebalancing opportunity. The index continues to reflect the actual returns generated by the hedge fund in question until such a time as it is replaced. At the time of replacing, the historical data is not adjusted.

As to CESR’ concerns on consistency of the sector of hedge funds of which the index is representative, the BAI considers that there is a well defined universe of hedge funds. Selection criteria usually start by looking at hedge funds with a certain track record during a defined period of time and those which have at least a certain amount of assets under management. Hedge fund index providers doing ongoing market analysis, basing their research on the complete universe of hedge funds drawn from all the major hedge fund data bases determine how and where assets are being allocated across the entire hedge fund universe.

To provide constant consistency the index construction is to examine the cohesiveness of the hedge fund sample. Because there is inconsistency in style reporting in many investable indices, funds from different strategies are blended, so the cross-sectional dispersion of returns within a strategy is high. Such a spectrum of returns necessitates a larger sample of hedge funds for a given level of sampling precision. To strengthen strategy cohesiveness, hedge fund indices use a number of quantitative screens.

Exemplarily the BAI is indicating the S & P Hedge Fund Index screens whereas other index providers use similar effective mechanisms:

1. For each fund in the proprietary database compiled by Standard & Poor’s from a number of commercially available databases and industry sources, S & P computes two correlation distributions: correlations with funds in the same strategy, and correlations with funds in all other strategies. S & P computes the Kolmogorov-Smirnov p-statistic, to test whether the two correlation distributions are different.
2. Then S & P tests whether the median of the correlations with funds in the same strategy is higher than the median correlation with funds in all other strategies.

3. At this stage they evaluate the degree of correlation of the individual funds with the appropriate hedge fund indices similar to the strategy in question.
4. Finally, S & P compares the standard deviation of a fund to its peer group. To reflect differences within a small group of strategies, several strategy-specific adjustments to the quantitative screens are to be made.

In terms of CESR' concern on the policy regarding backfilling bias the common hedge fund policy is to not alter any data at a time of rebalancing or hedge fund replacement.

Interesting, most investable hedge fund indices show very similar risk/return characteristics with very low risk and low correlation with established asset classes. Given the diverse nature of hedge funds and the lack of worldwide complete hedge fund databases, this in our opinion shows the suitability of such indices for derivatives. Through the low correlation with traditional but also other alternative investments the inclusion of such derivatives in UCITS in general can be used to reduce the risk of UCITS by giving the fund managers additional options to diversify their portfolios.

B. Conclusion

CESR should consider investable hedge fund indices as financial indices and thus allow them to be included in UCITS if they comply with the provisions for financial indices in general, as it does with all other kind of indices. There should be no negative bias regarding hedge fund indices whereas other indices are not discriminated against.

This opinion was issued on the 21st November, 2005. For any further information on this opinion please contact:

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