

FTSE's Response to the CESR Consultation Paper on Hedge Fund Indices ("HFIs")

General Background:

FTSE Group constructs global benchmark and tradable indices to provide representative and accurate coverage of markets. International investors use them as a tool for asset allocation, for developing investment products, for performance measurement and for investment analysis. Our fundamental belief is that the performance of our indices should represent achievable, replicable performance for investors. We believe that this is particularly important for UCITS funds, where we agree with CESR that using indices that cannot be replicated leads to increased risk for investors.

The relationship between equity indices and HFIs:

Indices calculated by FTSE, and by most other index providers, are constantly being updated to ensure that replicating them in portfolio form is as easy as possible. Where early indices often incorporated all companies on a market, or merely selected a small subset at an equal weight, making them unsuitable for portfolio creation, modern equity indices have developed over time into representative, investable and achievable portfolio tools. These developments include the exclusion of companies which are illiquid and therefore difficult to trade, and the exclusion of that percentage of a company's shares that are not available in the market, for example those held by venture capitalists or the company's directors. (This process is known as "free float market capitalisation weighting.") The process for achieving this is clearly explained in transparent index rules that are often available to all.

In that different calculation, selection and weighting methodologies can and are used by index providers, even broad benchmarks such as the FTSE or MSCI Global Indices, or the FTSE All Share or Stoxx 600, could be said to be "active" in that they actively seek to exclude uninvestable companies, and also entire markets where information is not available to make accurate company assessments. In addition, all indices have a stated weighting methodology which results from the index calculator's active decision not to use a different methodology. FTSE, and most other equity index providers, choose to weight index constituents according to the amount of money invested in those companies, which is of course the multiple of the company's shares and its price, excluding (as mentioned above) those shares that are not available for investment. However, other methodologies are available, such as equal or price weighting, and they can give useful indices. But, the resulting indices do not reflect the performance of the total investable, achievable market.

So, different index providers and their indices use different methodologies, have different levels of success in achieving their objectives, and live or die in the market place in accordance with whether they meet investors' requirements. Hedge fund indices, we feel, are not intrinsically different. HFIs use different weighting methods and different selection criteria, but they will also be used, or not used, according to how well they meet investors' needs. However, HFIs do provide a particular challenge, in that many hedge funds are not open for investment, and data is often not available, or not available as regularly as would be preferred. These problems are not usual in the world of equity indices, and FTSE does believe that there is a role for CESR to highlight the issues that surround HFIs and to encourage investors to compare the way different index providers resolve them. Fundamentally though, FTSE believes that various index providers should be permitted to resolve the various questions of bias, methodology, pricing regularity, historical calculations, auditing etc as best they can, and the market should be able to choose the most appropriate indices for its use. If HFIs are left to develop, we believe they will reach the same achievable, replicable status as equity indices, and will be as useful in the hedge fund area as the equity indices are in their own area. For the record, FTSE's approach has been to create HFIs in the same manner as its equity indices – by clearly defining its objectives, and then creating rules that select the most

representative, investable set of HFI constituents that meet those objectives. We believe that this approach is as close as is possible to be to an 'ideal' passive selection of hedge funds.

Specific Comments:

FTSE agrees that the starting point for the creation of HFIs should be the broadest possible database of hedge funds. We also concur that the definition of a hedge fund can be problematic. However, we believe that this problem can be avoided by identifying and then specifying the trading strategies that are to be represented within the HFI. By identifying the key strategies, it is then possible via appropriate, independently-carried out due diligence, to identify funds that are statistically accurate in following those strategies. By doing this, defining "hedge funds" themselves is not necessary. Henceforth FTSE would not object to independent due diligence being a requirement for a UCITS-compliant HFI.

As FTSE believes that it is necessary to include in an index only entities that are available for investment, FTSE's HFIs remove funds that are not open for investment, or that do not meet other investability requirements, such as a minimum sum of assets under management, and a minimum fund age. We believe that to include all funds, and therefore funds that are not available to investment, would lead to UCITS providers taking on increased investment risk, in order to attempt to match or exceed the performance of the index, in the same way that an active equity manager will tend to trade more often, and have a less diversified and higher-risk portfolio than a passive manager.

As the number of funds actually open for investment is only a small subset of the total number of funds, it might be thought difficult for HFIs to reflect the overall performance of the hedge fund market. It is worth noting that this is not unusual; the DJ Average uses 30 companies to represent the performance of some 25,000 US companies. But FTSE believes that, as for equity indices, there is an appropriate weighting methodology that achieves this for HFIs. In much the same way that a number of equity index providers weight constituent stocks in such a manner that the overall sector or regional representation of the index matches that of the broader market, it is possible to ascertain the total capacity of hedge funds across the most commonly used trading strategies. This knowledge can then be used to weight the HFI's constituent funds that are active in each strategy, in order to reflect the overall capacity of each strategy across the universe of all hedge funds. This then achieves the same result as free float market capitalisation weighting in equity indices – the index reflects the possible performance that could be achieved by investors taking up this available capacity.

This said, FTSE does not believe that it is necessary to legislate a particular weighting methodology. We have seen within the equity space that various weighting methodologies each have benefits for all types of investors, including the most cautious, and that indices using many methodologies have become useful tools for prudent investing. As such, FTSE would prefer that the requirement is for each HFI to carefully state its investment objective, and the weighting methodology that is being used to allow this.

Regarding the creation of performance backhistories, FTSE fully agrees that the practices of removing defunct funds and of measuring the past performance of the existing funds within an HFI, are entirely inappropriate. We fully support the requirement that index providers take appropriate measures to create histories that avoid both of these biases.

FTSE believes that given quantitative, transparent rules such as those explained above, many of CESR's concerns regarding self-reporting biases, database selection biases and others, are addressed. We fully accept that the rules are, in this particular asset class, more complex than those for many indices in the equity asset class, however we do not believe that this added complexity is outweighed by the benefits of providing accurate, achievable indices for what is a complex, poorly understood asset class.

Conclusion

To conclude, FTSE is convinced that carefully constructed indices provide huge benefits in all asset classes, by providing independent measures of the available performance from each asset, and by simplifying complex investment strategies. Such indices allow the creation of tools, such as UCITS funds, which allow the investor's interests to be better served.

FTSE is grateful to have had the chance to contribute to CESR's thinking in this area. We are of course very willing to help CESR as much as possible, and we would like to note that we are entirely happy to discuss these matters further, by direct meetings or any other form of communication.

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