

## Spring 2007 FTSE CONTACTS

### FTSE RESEARCH

Andy Harvell  
Head of Research  
andy.harvell@ftse.com  
+44 (0)20 7866 8986

David Hobbs  
Director  
david.hobbs@ftse.com  
+44 (0)20 7866 8030

### FTSE PRODUCT MANAGEMENT

Lillian Goldthwaite  
Business Unit Head - Equities  
lillian.goldthwaite@ftse.com  
+44 (0)20 7866 1805

Gareth Parker  
Business Unit Head - Alternatives  
gareth.parker@ftse.com  
+44 (0)20 786 1805

Mike Bruno  
Business Unit Head – Fixed Income  
mike.bruno@ftse.com  
+1 212 641 6120

### FTSE MARKETING & COMMUNICATIONS

Andrew Buckley  
Director, Marketing & Communications  
andrew.buckley@ftse.com  
+44 (0)20 7866 8029

Sandra Steel  
Head of Media Relations  
sandra.steel@ftse.com  
+44 (0)20 7866 8987

MSCI has confirmed its post-consultation plans to transition its two sets of global equity indices – Standard and Small Cap – to a new single set of Global Investable Market Indices. FTSE has been asked by a number of market participants to comment on the implications of these proposed changes, as well as on the broader trends within the field of global benchmarking.

Whilst FTSE supports a move that brings MSCI's methodology closer to that of its own, we nevertheless believe that there continue to be significant flaws in the MSCI approach:

- **Decreased coverage:** Although substantial portfolio restructuring will be required, Large/Mid Cap managers will not benefit from MSCI's changes as constituent and market cap coverage will actually decline across most regions for both developed and emerging markets
- **Less accurate representation:** MSCI is prioritising turnover management over accurate representation of the global opportunity set, by introducing large buffer zones and by allowing different minimum cap size and liquidity rules for Developed and Emerging Markets
- **Lack of transparency:** in attempting to reconcile the conflict between representation and turnover, MSCI has created a set of rules that are at times complex and that may leave too much room for discretion, making it difficult for managers to predict changes or replicate the index

FTSE argues that it is time for Plan Sponsors/Pension Fund Trustees to review their benchmarks to ensure that they continue to represent a true reflection of their chosen investment strategy:

- **Market coverage:** would trustees benefit from using an index that allows a more granular categorisation of Emerging Markets; or a Developed ex US index that includes Canada; or an index that allows multinationals to be separated out from companies who are primarily focused on their domestic market?
- **Custom indices:** would trustees' investment objectives be better served by adopting custom benchmarks that, for example, exclude certain stocks, limit exposure to specific countries, introduce cap limits or enable tax adjustments and currency hedges to be used?
- **Socially responsible investment:** are trustees under pressure to adopt socially responsible investment principles by, for example, using an SRI index such as FTSE4Good?
- **Alternatives to market cap weighting:** should trustees be considering diversifying their portfolios by using fundamentally-weighted and wealth-weighted indices such as the FTSE RAFI Index Series and the FTSE GWA Index Series?
- **Alternative asset classes:** should trustees capitalise on recent developments in indexing which have introduced the benefits of a consistent and transparent methodology to alternative asset classes, such as hedge funds, commercial property and REITs?

## 1.0 INTRODUCTION

Equity benchmarking:  
the trend is "go global"

The field of equity benchmarking is undergoing a period of significant evolution and can be characterised by a trend to "go global", with more providers entering the global benchmarking arena for the first time and existing players extending their global coverage. This includes proposed changes to MSCI's methodology, as well as recent product offerings from Russell and Dow Jones Wilshire. As a result of these recent developments, there is an increasing debate about what constitutes best practice in global equity benchmarking. Some elements of this debate include:

Is more always better?

- Is more always better?**
- In the race for market coverage, are we significantly improving the representation of the investable opportunity set and its relevance to investors?
  - In the quest for coverage, are standards being sacrificed with regard to minimum cap size, liquidity and country criteria?
  - How important is Emerging Markets micro cap to the investment equation?

Benchmark or trading vehicle?

- To what extent should a benchmark be a consistent market measure versus a trading vehicle managed for turnover?**
- At what point do turnover management techniques such as cap buffers and reconstitution limits begin to distort the accurate representation of the investable universe?

Are clear rules really important?

- How important is it that plan sponsors, consultants and fund managers can actually understand the index construction and maintenance rules?**
- Is there a risk of overcomplicating the index rules to the extent that managers can no longer anticipate index changes or replicate index membership?
  - Can one have confidence in a methodology that one can neither understand nor replicate?

Representation is key

FTSE has been asked by a number of clients and other market participants to comment specifically on the implications of the proposed MSCI changes, as well as more generally on developments in the field of global benchmarking. In so doing, we think that it is useful to contrast FTSE's approach and why we consider our methodology to represent best practice. We believe it is also important to raise the broader issues of asset allocation and benchmark selection in the context of using the right tools to support specific investment strategies, such as liability-driven approaches.

FTSE believes that the primary objective of a benchmark index should be to achieve a dispassionate overall representation of the global investable universe and applies the following guiding principles in its approach:

<b>REPRESENTATIVE</b>	FTSE benchmarks are carefully designed to accurately represent the relevant investment opportunity set and changes that occur within it in a timely fashion
<b>COMPREHENSIVE</b>	FTSE seeks to achieve exhaustive coverage of the investable universe
<b>INVESTABLE</b>	FTSE benchmarks cover both markets and securities that are freely available for investment, as measured by free-float market cap, liquidity and market accessibility
<b>TRANSPARENT</b>	FTSE index methodology is clear, understandable and widely disseminated. The rules are applied in a consistent and predictable fashion, under the objective governance of independent market practitioner committees

## GLOBAL BENCHMARKS: TIME FOR A REVIEW

In the first section of this paper, we highlight the approach MSCI has taken and examine the implications of the transition from the current MSCI methodology to their “Enhanced” methodology and compare it to FTSE’s established Global Equity Index Series (GEIS). The results of our analysis are based upon publicly available data from the consultation presentations and documentation released by MSCI Barra concerning the changes.

In making these changes, MSCI has recognised that global investors require a more comprehensive coverage of the investable universe than they have previously offered. It appears, therefore, that MSCI is aligning itself with FTSE’s top-down approach to target 98% coverage as provided by FTSE GEIS, which was introduced in 2003. This covers all stocks from Large to Small Cap, across both Developed and Emerging Markets, in one comprehensive, consistent index series. FTSE GEIS was designed specifically to give as accurate a representation as possible of the global opportunity set and has been adopted by many major US, Asian and European pension fund providers and Asset Owners.

While FTSE supports a change of approach that brings MSCI’s index series closer to its own in terms of coverage, we nevertheless believe that MSCI has failed to fully seize this opportunity, for three key reasons:

- **Decreased coverage:** the change from a bottom-up industry level approach, to a top-down methodology which targets 99% coverage and which has removed the overlap between the MSCI Standard and Small Cap Indices. This has resulted in an overall decline in constituents and market cap across Large/Mid Cap indices for developed and emerging markets. The MSCI All Countries World Index for Large/Mid Caps will lose 451 constituents, with EASE losing 192 stocks and USD12bn in market cap
- **Less accurate representation:** although MSCI’s coverage has been expanded, the methodology places a premium on turnover management through the use of large buffer zones and 5%-10% limits on name changes at reconstitution. This is fundamentally at odds with accurate and timely representation of the global opportunity set
- **Lack of transparency:** we believe that, in order to reconcile the two aims of market coverage and turnover management, MSCI’s rule set is at times complex and may leave too much room for discretion, making it difficult for managers to predict changes or replicate the index

In the second section, we examine the broader aspects of asset allocation and benchmark selection, and pose questions that are often omitted from consideration in benchmark reviews. Due to the increasing sophistication and capability of index providers, we believe that they can be of greater assistance to Asset Owners in providing tailored solutions across multiple asset classes to implement mandated investment objectives. This extends to areas that have hitherto fallen outside traditional index capabilities, such as alternative asset classes or non-market cap weighted indices.

MSCI...finally a more representative index series  
...but are there still flaws?

Large buffer zones reduce turnover but distort representation

Different standards for developed and emerging markets. Why?

Reconciling the irreconcilable. Clarity or confusion?