

# Morningstar® MSCI Hedge Fund Indexes

## Institutional Uses

- ▶ Benchmarking for various hedge fund strategies and manager styles
- ▶ High-level attribution for a portfolio of hedge funds
- ▶ Research tool for portfolio allocation process

Hedge funds, with nearly \$2 trillion in assets, have become a significant force in the financial markets. Once thought to be an investment for only the ultra-wealthy, hedge funds have been sought out more and more by pensions and other institutional investment committees as a way to diversify beyond the traditional equity markets.

## The Importance of Hedge Fund Benchmarking

Having a reliable benchmarking system is one of the biggest challenges that institutional investors face when selecting and evaluating hedge fund managers. Institutional investors are interested in analyzing how hedge fund strategies correlate with and compare to broad market indexes for portfolio construction, optimization, and asset allocation purposes.

While some may claim that hedge fund managers' extremely diverse set of alpha-driven strategies are difficult to measure and compare, Morningstar believes that the returns of many hedge fund strategies are largely driven by several common factors. The Morningstar MSCI Hedge Fund Indexes were created in 1994 to more precisely capture the driving forces behind hedge fund returns. The MSCI categorization approach begins at a very granular level, incorporating investment process, geographic, asset class, and sector biases. MSCI's goal when they created these indexes was to create investment strategy groups that were numerous enough to capture all the nuances of strategy among hedge fund managers, but also large enough to represent useful peer groups.

## Morningstar MSCI Hedge Fund Index Family

When Morningstar acquired MSCI's Hedge Fund Index Family in 2008, we agreed to apply their industry-leading categorization and index methodology to our vast hedge fund database. The result is a family of 193 hedge fund indexes that can be broken down into four levels. *(See graphic below)*

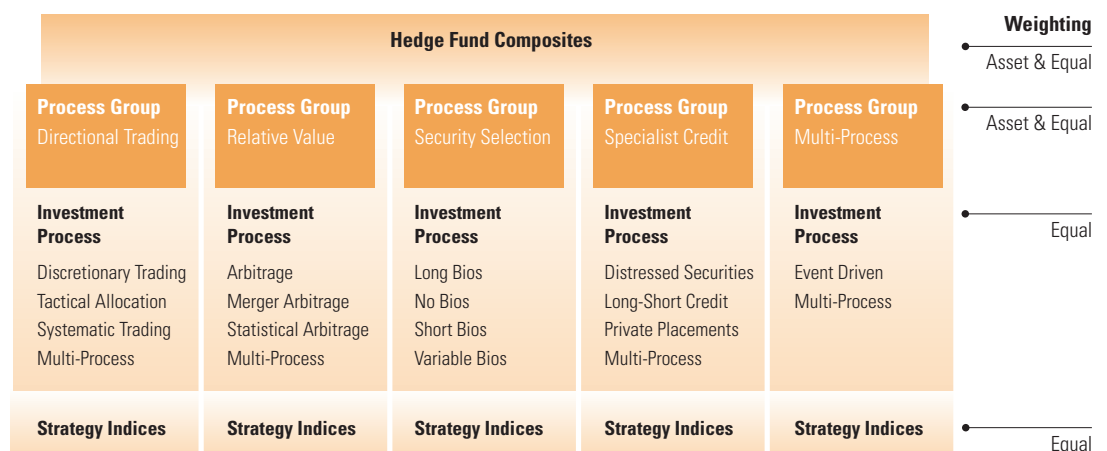
For the purposes of the Morningstar MSCI Hedge Fund Indexes, Morningstar counts funds with shared portfolios but different share classes as a single master class. When calculating the equal weighted indexes, Morningstar asset weights the returns for each underlying share class and then rolls that up to the master class level. The MSCI Hedge Fund Indexes only include single-strategy hedge funds. These indexes provide a way for investors to track the performance and characteristics of the hedge fund industry. And while these indexes are not investable, third party vendors can license them to provide investable versions of the indexes.

## Index Eligibility

Index constituents are drawn from the universe of single-strategy hedge funds that submit regular returns and assets under management information to the Morningstar database. Other eligibility requirements include \$15 million in assets under management (AUM) for inclusion in the broad index and \$100 million in AUM for inclusion in the core index. The index family does have buffer zones to allow existing constituents below minimum AUM requirements to be eligible for 12 months in order to avoid index volatility. Closed funds are eligible for the index as long as they meet the other criteria.

## MSCI Index Hierarchy

The MSCI Hedge Fund Index classification structure can be broken down into four levels. The Strategy indexes are the most granular, while the Composite indexes are the broadest.



### Currency Hedging

Performance data that is required for indices or analysis in currencies other than the fund's base currency will be converted into the required currency in a manner that assumes that the currency risk is fully hedged. Under this assumption, the fund is treated as if at the start of each reporting period, an investor entered into a spot transaction to purchase a nominal amount of the currency in which the fund is denominated. The proceeds of this transaction are then invested in the fund for the period. Simultaneously, a forward currency transaction is entered into, selling back the amount of currency purchased into the investor's required currency. At the end of the reporting period, the investment into the fund is redeemed for cash, the proceeds of which are used to settle the forward currency transaction; this converts the currency back into the investor's base currency. Any surplus or shortfall to the amount of currency sold forward is met by entering into a spot transaction, buying currency to meet a shortfall or selling surplus currency. In this manner, the investment is protected from currency fluctuations, but will be subject to any cost of carry (due to the difference in interest rates in different currencies). However, the profit or loss of the fund over the month is at risk from currency fluctuations.

### Returns Reporting

Hedge funds report performance to Morningstar in one of two ways: month-end NAV or monthly return. These values may be reported as either estimated or final. Because most hedge funds claim (and we assume in our database) that the NAVs or returns that they report are net of all fees, Morningstar assumes that all hedge fund performance is net of fees.

### Rebalancing and Reconstitution

The indexes are rebalanced monthly. New funds are added if they have reported the most recent performance and AUM, and meet AUM threshold and MSCI classification requirements.

### Calculation and Dissemination of Index Values

Morningstar begins collecting hedge fund returns for a given month on the first business day of the subsequent month. We calculate a preliminary value at mid-month (when 50% funds report) and a final value at month-end (when 90% of funds report). Morningstar will accept revised or confirmed returns reported by a fund up to the last day of the subsequent month, after which the index value is locked.

Data for the Morningstar MSCI Hedge Fund Indexes is available as a Data License or in Morningstar Direct, our institutional research platform.

### Learn More

For more information on the Morningstar MSCI Hedge Fund Indexes, please call +1 312 384-4039.