

Morningstar 1000 Hedge Fund Index Rules and Methodology

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Introduction

The Morningstar® 1000SM Hedge Fund Index ("MHFI 1000") is a rules-based, equal-weighted, non-investable index designed to capture the performance and behavior of the hedge fund universe in as representative a fashion as possible. The MHFI 1000 comprises 90% of the eligible hedge fund assets in Morningstar's universe, which contains approximately 4,500 single-strategy hedge funds.

Principles of Index Construction

Morningstar has constructed its index with several key principles in mind. We believe that a hedge fund index should be rules-based, transparent, representative, and accurate.

Rules-based criteria:
The criteria by which funds are selected for the index should be defined by a clear set of rules and calculations, and overseen by a well-qualified committee.

Transparent process:
The methods by which Morningstar constructs and maintains the MHFI 1000 will be fully disclosed to the public and accredited users of the index. There are no "black box" components to the index.

Representative reach:
We believe that a non-investable index should reflect as much as possible the true character of strategies and performance of managers in the hedge fund universe. The MHFI 1000 achieves this through several means. First, by using 90% of eligible assets in our universe, we reach a vast cross-section of funds. Second, by equal-weighting returns we avoid overemphasizing the contribution of larger funds, and give greater relative weight to the many smaller hedge funds.

Accurate and timely data:
Integrity of an index depends on accurate and timely reporting of returns, assets under management, and other key data point. We eliminate noncompliant funds from the index, and although returns are not audited, our team of analysts performs rigorous quality analysis on the monthly returns reported by hedge funds.

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Inception Dates and Base Market Values

The inception date of the Morningstar Hedge Fund 1000 Index is December 31, 2007. The base market value of the MHFI 1000 at inception is 1,000.

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. Index values for the previous month are calculated internally daily at the close of business, based on hedge fund returns submitted to that point. 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.

The values will be available publicly beginning on the eighth business day of each month. The published index value will be calculated to two decimal points. Internally, Morningstar will maintain the value to the maximum level of precision.

Index Value Currencies

The closing value of the MHFI 1000 is calculated in United States Dollars (USD). Hedge fund index returns will be published in multiple currencies. See Appendix for details of the conversion formula.

Index Committee

The Index Committee is responsible for constructing the rules of the index, maintaining the index, and determining any changes to the rules or constitution of the index. The Index Committee is composed of members of Morningstar's hedge fund research group along with senior executives of the firm.

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Index Construction

Definition of Terms

AUM
Assets under management. The figure is reported to Morningstar by the hedge fund companies.

Constituent Master Classes
Master Classes that are currently included in the index.

Cutoff Date
The last day for a fund to report its return and still be included in the index value for the previous month. The Cutoff Date is the last business day of the month following the previous month-end.

Eligible Assets
The combined AUM of all Eligible Strategies.

Eligible Master Classes
Eligible Master Classes that meet the minimum requirements for inclusion in the index, though they may not be included in the final index.

Master Class
Morningstar will group together multiple funds from the same investment advisor that pursue identical trading strategies (such as share classes denominated in different currencies, onshore vs. offshore, etc.) and that share the same distributor. Each of these groupings, as well as individual funds that do not have multiple share classes or versions, will be called a Master Class. If one or several funds that share a strategy do not report returns, the funds that do report will be averaged to constitute the Master Class. Note that funds which share the same underlying portfolio but use substantially different amounts of leverage will be classified as distinct Master Classes.

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Total Return
Each hedge fund reports its monthly performance to Morningstar in one of two ways:

1) Month-end Net Asset Value per ownership unit (NAV). When performance is reported this way, Morningstar calculates monthly total return (MTR) as the percentage change in NAV from month-end to month-end, stated in decimal form.

2) Monthly Total Return. If the fund reports MTR in decimal form, Morningstar takes it as it. If it is reported in percent form, Morningstar divides it by 100 to state it in decimal form.

For the purposes of the MHFI 1000, hedge funds may report their NAVs or MTRs to Morningstar on two different levels:

a) Estimated. The fund may provide Morningstar an estimated value for the month-end NAV or MTR during the first few weeks of the subsequent month. It may or may not later provide a final value.

b) Final. The fund may provide a final value for month-end NAV or MTR.

Since most hedge funds claim (and we assume in our database) that the NAVs or returns that report are net of all fees, Morningstar assumes that all hedge fund performance is net of all fees.

Defining the Eligible Universe

The eligible universe of Master Classes is created from single-strategy hedge funds that submit regular returns and AUM information to the Morningstar Database. Closed funds are eligible for the index as long as they meet the other criteria. Since most hedge funds claim (and we assume in our database) that the NAVs or returns that report are net of all fees, Morningstar assumes that all hedge fund performance is net of all fees.

Eligible Master Classes must meet the following criteria:

1) Single-Managed
Funds of funds are excluded from the index.

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2) AUM Reporting

AUM figures must be no more than three months old at the time of an index constitution or reconstitution. If a Master Class does not have an AUM reported within the previous three months, it will be ineligible for inclusion in the index. As long as at least one fund within a Master Class reports an AUM, the Master Class will be considered compliant.

3) Returns Reporting

Regular reporting of returns is critical to maintaining an accurate and meaningful index. Therefore, beginning on the launch date, any Master Class that has failed to report returns twice within the previous 12 months in reporting its returns will be ineligible for the index. For Master Classes with multiple share classes, this policy applies to a Master Class that fails to report returns for all funds within the Master Class for a given month twice during the previous 12-month period.

Going forward from the launch date, any Master Class that has been noncompliant twice within any rolling 12-month period will be ineligible. A Master Class is considered noncompliant if it fails to report returns for all funds within the Master Class for a given month.

If a Master Class consists of multiple funds and at least one of those funds reports its return, the Master Class is considered compliant. If a fund reports returns but no AUM, as long as the overall Master Class is compliant for AUM as defined above, the individual fund's returns will be included in the Master Class return.

All remaining strategies are considered Eligible Master Classes.

Selecting the Final Index Constituents

Once the eligible universe has been created, selecting the final index constituents is a relatively straightforward process.

1) Compute the Eligible Assets.
2) Rank all Eligible Master Classes by AUM.
3) Select all Eligible Master Classes from largest down, until 90% of Eligible Assets has been reached. Those selected are the Constituent Master Classes.

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Weighting the Index

The MHFI 1000 is an equal-weighted index. If there are n Constituent Master Classes for which returns are available, each Master Class' weight will be 1/n. The index will be rebalanced monthly.

Category Indexes

Simultaneously with the launch of the MHFI 1000, Morningstar launched 17 distinct category indexes that represent 17 strategy-specific hedge fund categories Morningstar has defined as part of its hedge fund classification system. These category indexes follow the identical rules and methodology as the MHFI 1000, except that the pool of eligible assets for each index is all single-strategy funds within the given category. Thus, each category index represents the top 90% of eligible assets within the respective category.

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Calculating the Index Value

On the Cutoff Date, Morningstar calculates a final index value based on the Constituent Master Classes that have reported. The published version of the index value is calculated to two decimal places.

Each Master Class' monthly return is the simple average of that its component funds that report before the Cutoff Date, and the monthly return of the index is the simply average of each Master Class' returns.

Therefore, each month t, the index value is:

$$I_t = (1 + R_t) I_{t-1}$$

where

It = the month-end index value in month t
Rt = the monthly return of the index for month t in decimal form (i.e., 13% is 0.13)

Details of how returns are calculated are in the appendix.

- If a Constituent Master Class has not reported by the Cutoff Date for a given month, its return will not count toward the final index return for the month at issue.
- If m Constituent Master Classes are ineligible for the index due to delinquent reporting, the funds that remain in the index will have index weights of 1/(np-m), where np is the previous month's number of eligible funds.
- For Master Classes composed of more than one fund, we will calculate the simple average returns of the funds within that Master Class that report returns.
- If fewer than 50% of Constituent Master Classes have reported by the Cutoff Date for a given month, Morningstar reserves the right to extend that Cutoff Date at its discretion.
- If a Master Class is made obsolete in Morningstar's database (which may occur because the fund has ceased operations, completely stopped reporting returns, or for other reasons), it will be removed from the Index going forward.

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Publishing of Index Values and Return

Morningstar will report its index value daily beginning on the eighth business day of the month, until a final value is reached at month-end. Once the final index value is calculated and published, it will not change even if additional Constituent Funds report after the Cutoff Date.

Schedule for Rebalancing of Index

The index will be rebalanced monthly to its equally weighted status. The total list from which each Master Class' weight is calculated may change from month to month between reconstitution dates if funds are dropped from the index.

Schedule for Reconstitution of Index

The index will be reconstituted every six months, based on the procedures described above. This reconstitution will be performed one month prior to the actual live rollout of the reconstituted index. (For example, the reconstituted index as of July 1, 2008 will be determined on May 31, 2008.) Strategies that were previously removed from the index due to noncompliance will be eligible for the index if at the time of the reconstitution they have reported returns in 11 of the previous 12 months.

Survivorship and Backfill Bias

Survivorship bias and backfill bias are recognized obstacles in the construction of an index. Morningstar works to eliminate survivorship bias in its Index. Returns of funds that become obsolete or are otherwise dropped from the index will remain part of historical index returns that we publish. However, returns that include periods prior to March 2004 may contain incidences of survivorship bias, owing to Morningstar's purchase of the Altvest database and the data migration that took place at that time.

Morningstar also avoids practices that would lead to backfill bias. When a new hedge fund is added to the index, that fund's past returns will not be included in calculations of the index's historical performance. NAV values for a given month are final once published, and will not be adjusted later.

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Appendix--Calculations

Monthly return on a fund from change in NAV

$$R_{Cjit} = \frac{NAV_{Cjit}}{NAV_{Cjit-1}} - 1$$

where

RCjit = the monthly return on fund i of strategy j in currency C for month t

NAVCjit = the NAV per ownship unit of fund i of strategy j in currency C at the end of month t

Conversion of a fund's returns into U.S. Dollar-equivalent returns

$$R_{jit} = \left(1 + R_{Cjit}\right)\frac{S_{Ct}}{S_{Ct-1}} - 1$$

where

Rjit = the monthly return of fund i of strategy j for month t in U.S. Dollars

SCt = the spot exchange rate for U.S. Dollars per unit of currency C at the end of month t

Monthly return of a strategy

$$R_{jt} = \frac{1}{q_{jt}}\sum_{i=1}^{q_{jt}} R_{jit}$$

where

Rjt = the return of strategy j for month t in U.S. Dollars

qjt = the number of funds of strategy j that report their returns either monthly returns for month t or NAVs per ownership unit for month-ends t-1 and t

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Return of the index from return of the strategies in the index

$$R_t = \frac{1}{n_t} \sum_{j=1}^{n_t} R_{jt}$$

where

Rt = the return of the index for month tin U.S. Dollars

nt = the number of strategies in the index for month t

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