Fact Sheet: Morningstar® Hedge Fund Indexes

Investor Benefits

- Broadly representative hedge fund index serves as industry benchmark for performance measurement
- Category indexes allow for comparison and attribution among distinct hedge fund strategies
- Rules-based index construction and rigorous data vetting
- Equal weighting of constituents registers contribution of smaller hedge funds

Hedge funds, with an estimated $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 increasingly sought out by pensions and other institutional investment committees as a way to achieve diversification beyond the standard 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. By delving deeply into the quantitative and qualitative characteristics of the approximately 4,500 direct hedge funds in our database, our analysts have developed a category system that we believe captures many of the features needed to form relevant peer groups of hedge funds for comparison and performance measurement.

Morningstar Hedge Fund Index Family

Morningstar has been building its own hedge fund database since 2004, and acquired other hedge fund databases along the way. Although hedge funds present certain challenges because they are not subject to regulation, Morningstar has the necessary expertise in tracking and analyzing pooled investment vehicles.

In 2007, Morningstar introduced a new system for classifying hedge funds, which serves as the basis for our hedge fund indexes. Relying on a combination of cluster analysis techniques, returns regressions, and additional quantitative and qualitative research by our analysts, we came up with 17 hedge fund categories that we believe better identify what the funds actually do than traditional self-identified strategy classifications.

The Morningstar® 1000℠ Hedge Fund Index is a broad-based, equally weighted index that comprises 90% of the eligible single-strategy hedge fund assets in our database. For the purposes of the index, Morningstar counts funds with shared portfolios but different share classes as a single master class. The 17 Category Indexes use a similar methodology, including eligible strategies from each category that constitute 90% of category assets. The Morningstar hedge fund index family provides 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 (AUM) information to the Morningstar database. Closed funds are eligible for the index as long as they meet the other criteria. Master classes of funds that do not report an AUM within three months of an index reconstitution are ineligible. In addition, we have a two-strike rule in place with regard to returns reporting: any master class that fails to report returns twice within a 12-month period is ineligible for the index.

Morningstar 1000 Hedge Fund Index Construction Process

Morningstar Hedge Fund Database	→	Single-strategy hedge funds	→	Multiple share classes combined	→	Two-strike rule	→	Final constituents
		Hedge funds of funds are excluded from the index.		Identical portfolios with differing fee or fund structures are combined into master classes.		Funds that have failed to provide monthly returns twice within a 12-month period are excluded. Remaining funds form the eligible universe.		Funds are ranked by asset size until 90% of the assets of the eligible universe are reached. These are the constituent strategies of the index

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Returns Reporting

Hedge funds report performance to Morningstar in one of two ways: month-end net asset value (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 report are net of all fees, Morningstar assumes that all hedge fund performance is net of all fees.

Constituent Weighting

The Morningstar hedge fund indexes are equal-weighted. If there are n constituent funds of the same master class for which returns are available, the weight of each fund will be 1/n. The indexes are rebalanced monthly.

Rebalancing & Reconstitution

The indexes are rebalanced monthly to be equally weighted. 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. The index will be reconstituted every six months. Master classes that were previously removed from the index because of non-compliance will be eligible for the index if at the time of the reconstitution they have reported returns in 11 of the previous 12 months.

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. K

Learn More

For more information on Morningstar Hedge Fund Indexes:
Call +1 312 696-6391
Visit http://global.morningstar.com/HedgeFundServices

Morningstar 1000 Hedge Fund Index vs. Bmark Indexes

(November 2002–October 2007)

Index	Annualized Total Return%	Standard Deviation	Sharpe Ratio
MHFI 1000	13.4	4.7	2.2
S&P 500	13.9	9.1	1.2
MSCI World	16.3	9.4	1.4
LB Aggregate	0.4	3.6	0.39

The Morningstar 1000 Hedge Fund Index has produced equity-like returns with about half the volatility of benchmark equity indexes.

Morningstar Hedge Fund Indexes Family

Morningstar 1000 Hedge Fund Index

Category Indexes

Equity
Morningstar Developed Asia Equity Hedge Fund Index
Morningstar Emerging Market Equity Hedge Fund Index
Morningstar Europe Equity Hedge Fund Index
Morningstar Global Equity Hedge Fund Index
Morningstar Short Equity Hedge Fund Index
Morningstar U.S. Equity Hedge Fund Index
Morningstar U.S. Small Cap Equity Hedge Fund Index

Debt
Morningstar Global Debt Hedge Fund Index

Event
Morningstar Corporate Actions Hedge Fund Index
Morningstar Distressed Securities Hedge Fund Index

Arbitrage
Morningstar Convertible Arbitrage Hedge Fund Index
Morningstar Debt Arbitrage Hedge Fund Index
Morningstar Equity Arbitrage Hedge Fund Index

Global
Morningstar Global Non-Trend Hedge Fund Index
Morningstar Global Trend Hedge Fund Index

Multi-Strategy
Morningstar Multi-strategy Hedge Fund Index

Fund of Funds
Morningstar Hedge Fund of Funds Index

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