MSCI Risk Weighted Indices Methodology

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Section 1: Introduction

While standard MSCI market cap indices reflect the aggregate holdings of all investors and represent the market return (equity risk premium), many investors are now looking for access to other sources of systematic return (style and strategy risk premia) that can be captured through indices with alternative weighting schemes. For some time, MSCI has been pioneering alternatively weighted indices that provide exposure to systematic beta or that replicate simple investment strategies. In 2008, for example, MSCI introduced its Minimum Volatility indices which were designed to reflect the performance characteristics of a minimum variance strategy using optimization. More recently in 2010, the company introduced its Value Weighted indices emphasizing stocks with lower valuations.

The MSCI Risk Weighted Indices use a simple but effective and transparent process. Each MSCI Risk Weighted index reweights all the constituents of a cap weighted MSCI parent index so that stocks with lower historical return variance are given higher index weights. By emphasizing low volatility stocks in this way, the MSCI Risk Weighted Indices have historically produced lower realized volatility compared to their respective parent MSCI indices, while maintaining reasonable liquidity and capacity. The main potential benefits of the MSCI Risk Weighted Indices include:

- Simple and transparent methodology to achieve lower risk
- Includes the entire standard index universe, no stock selection bias
- Helps mitigate risk efficiently in a cost-effective, disciplined way
- Defensive characteristics, outperformance during recent crises
- Low concentration risk
- Moderate index turnover

The main potential applications for investors of the MSCI Risk Weighted Indices include:

- Strategic asset allocation: equity market exposure with lower risk
- Tactical asset allocation: downside protection in volatile periods
- Portfolio diversification: combine with other systematic betas
- Investment research: tools to study the characteristics of low risk strategies
- Performance analysis: performance benchmarks for actively managed low risk portfolios
Section 2: Index Construction Methodology

Section 2.1: Applicable Universe
The applicable universe includes all the existing constituents of MSCI ACWI Index. The MSCI ACWI Index is the MSCI Parent Index for determination of the risk weights as described in the following sections.

Section 2.2: Reweighting Index Constituents
All the existing constituents of the MSCI ACWI index are reweighted by their risk weights. The risk weights are derived from the respective security level price variance. The details of the re-weighting scheme are discussed in sections 2.3 and 2.4.

Section 2.3: Determination of Risk Weights
For a given rebalancing date, the security level price index data available until the last Friday preceding this date is used in the construction of the MSCI Risk Weighted indices.

The security level risk weight is computed as the ratio of the inverse of the security variance to the sum of the inverse of security variance of all constituent securities in the MSCI Parent Index.

\[ w_j = \frac{1}{\sigma_j^2} \times \frac{\sum_{i=1}^{n} 1/\sigma_i^2}{\sum_{i=1}^{n} 1/\sigma_i^2} \]

The security level variance \( \sigma_j^2 \), used in the above calculation, is the squared term of security level standard deviation \( \sigma_j \) computed using weekly returns over three years prior to the rebalancing date. In case the price data are not available for a three year period, the respective country-sector average of volatility is used for that security. In the event of country-sector average being unavailable, country average volatility is used. This aims to avoid estimating risk over different volatility regimes. Security standard deviation is capped at 80% on upside and 12% on downside. Only non-zero weekly returns are considered for computation of variance to deal with stale prices due to suspensions/ market disruptions etc.

The final security level inclusion factor (IF) is computed as the ratio of the final security level risk weight and security level pro forma market capitalization weight in the MSCI ACWI Index.

Section 2.4: Determination of Final Security Level Risk Weights in MSCI Country/Regional Indices
The final security level risk weights in the respective MSCI Country / Regional Indices is determined by applying the security level inclusion factor (IF) derived in section 2.3 on the corresponding market cap weights in the MSCI Country / Regional indices and renormalizing them accordingly.
Section 3: Maintaining MSCI Risk Weighted Indices

Section 3.1: Semi-Annual Index Reviews
The MSCI Risk Weighted Indices are rebalanced on a semi-annual basis, usually as of the close of the last business day of May and November, coinciding with the May and November Semi-Annual Index Review of the MSCI Standard Indices. The pro forma MSCI Risk Weighted Indices are in general announced nine business days before the effective date.

Section 3.2: Ongoing Event-Related Changes
In general, the MSCI Risk Weighted Indices follow the event maintenance of the MSCI Parent Index.

Section 3.2.1: IPOs and other early inclusions
IPOs and other newly listed securities will be added at the time of their inclusion in the MSCI Parent Index. Their inclusion factor will be computed as described in Section 2.3 using their respective country-sector or country average volatility at the time of the inclusion.

Section 3.2.2: Additions and Deletions due to corporate events
The general treatment of additions and deletions due to corporate events aims at minimizing turnover in the MSCI Risk Weighted Indices.

A constituent deleted from the MSCI Parent Index following a corporate event or during the Quarterly Index Review of the Parent Index will be simultaneously deleted from the MSCI Risk Weighted Index.

Please refer to Appendix I for more details on the treatment of corporate events.
Appendix I: Corporate Events Treatment

This appendix describes the treatment of the most common corporate events in the MSCI Indices. Details regarding the treatment of all other corporate events not covered in this appendix can be found in the MSCI Corporate Events Methodology book, available at http://www.mscibarra.com/products/indices/international_equity_indices/gimi/stdindex/methodology.html

<table>
<thead>
<tr>
<th>Event Type</th>
<th>Event details</th>
<th>Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquisition</td>
<td>Risk Weighted Index constituent acquires another Risk Weighted Index constituent</td>
<td>Maintain acquiring company and remove acquired company</td>
</tr>
<tr>
<td></td>
<td>Risk Weighted Index constituent acquires non Risk Weighted Index constituent</td>
<td>Maintain acquiring company</td>
</tr>
<tr>
<td></td>
<td>Non Risk Weighted Index constituent acquires Risk Weighted Index constituent</td>
<td>Remove acquired company without adding acquiring company</td>
</tr>
<tr>
<td>Merger</td>
<td>Risk Weighted Index constituent merges with Risk Weighted Index constituent</td>
<td>Add new company with a constraint factor that is the weighted average of the two constituents</td>
</tr>
<tr>
<td></td>
<td>Risk Weighted Index constituent merges with non Risk Weighted Index constituent</td>
<td>Add new company if MSCI links its price history to the Risk Weighted Index constituent. New company not added if price history is linked to the non Risk Weighted Index constituent</td>
</tr>
<tr>
<td>IPO</td>
<td>IPO added to Parent Index</td>
<td>IPO added to the Risk Weighted Index using country sector or country average as volatility estimator and determination of weight (please refer to section 2.3 for more details)</td>
</tr>
<tr>
<td>Spin-off</td>
<td>Risk Weighted Index constituent spins off security</td>
<td>Add spun-off security to the Risk Weighted index with the constraint factor of the spinning security, if it is included in the Parent Index</td>
</tr>
<tr>
<td>Conversion</td>
<td>Security A converted to B, A deleted from Parent Index, B added</td>
<td>B inherits constraint factors from A</td>
</tr>
<tr>
<td>Country Reclassification</td>
<td>Domicile of company reviewed: Security A deleted from country A, security B added to country B</td>
<td>B inherits constraint factors from A if it is added to the Parent Index</td>
</tr>
<tr>
<td>Stock exchange reclassification</td>
<td>Stock exchange (price source) of company reviewed: Security A deleted, security B added</td>
<td>B inherits constraint factors from A if it is added to the Parent Index</td>
</tr>
</tbody>
</table>
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