



MSCI Consultation on the Design of a High Dividend Yield Index

April 2006

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Introduction



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Introduction

- For over 30 years, MSCI has constructed global equity benchmark indices
- MSCI has recently extended its expertise to the domestic equity markets by building domestic benchmark indices for U.S, Japan and China
- As the next step in this evolution, MSCI is now responding to client interest for equity indices that can serve as
 - Benchmarks for different investment strategies
 - The basis for investment vehicles

High Dividend Yield Strategies

- High dividend yield strategies are well known strategies that have existed historically and seek to provide current income while preserving long-term growth of capital and/or income
- Investors have shown an increased interest in these strategies recently
 - Demographic changes around the world have resulted in an increase in the share of the older population, especially in the developed markets leading to an increased attraction for current income
 - Institutions such as endowments, which have specific cash flow disbursement needs, and insurance companies also find dividend based investment strategies a good alternative / complement to bonds
- The recent low return market environment and the defensive nature of high dividend yield strategies in the wake of bursting of the technology bubble have also contributed to the popularity of these strategies

Purpose of Consultation

- As a result, there has been an increasing demand by investors for indices that could act as benchmarks for high dividend yield strategies
- In this context MSCI is now conducting this consultation to evaluate investors interest in a family of high yield dividend indices constructed using a global and consistent methodology that can:
 - Serve as appropriate benchmarks
 - Enable passive indexation
- MSCI may or may not decide to launch a high dividend yield index series using the proposed design

Summary of the Proposal



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High Dividend Yield Indices - Methodology

MSCI proposes

- To build a high dividend yield index family using the MSCI Standard country indices as the starting point except in Europe ex-UK which would be treated as a region
- To exclude REITS from the eligible universe
- To apply screens based on payout and historical dividend growth that are designed to result in sustainable and persistent dividend payment
- To target a high level of dividend yield while providing a broad and diversified index by sector through the inclusion of:
 - Companies with a dividend yield greater than or equal to 1.3 times the dividend yield of the country/ regional MSCI Standard Index, and
 - Other highest dividend paying companies from each sector to achieve 20% coverage of market capitalization by each sector within the universe of dividend paying companies, ex-REITS

Investment Process and Index Design Considerations



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High Yield vs. Sustainability & Growth

- Dividend yield strategies, typically, target not only high dividend yield but also companies where that dividend is sustainable and/or growing
 - Focusing only on high dividend yield can lead to a 'value trap' and result in a portfolio with companies having deteriorating fundamentals
 - Sustainability screening is used in an effort to prevent the selection of such companies
 - However, including sustainability screening is likely to result in a decrease in the level of dividend yield achieved

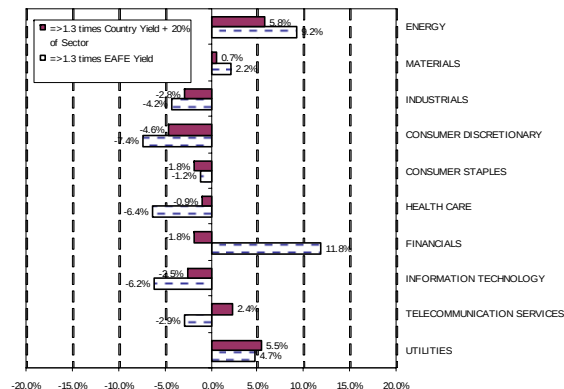
High Yield vs. Country/Sector Diversification

- Focusing on high and sustainable dividend yield companies only, without regard to diversification, could also result in portfolios that are highly concentrated in certain sectors or countries
 - For instance, a high dividend yield index built using the MSCI EAFE Index as the starting universe would result in a significant overweight of UK which has a higher yield than other countries, and a significant overweight in Financials
- While achieving high and sustainable dividend yield may be the primary consideration for high dividend yield strategies, broad diversification by country and sector is also a potentially important and desirable feature

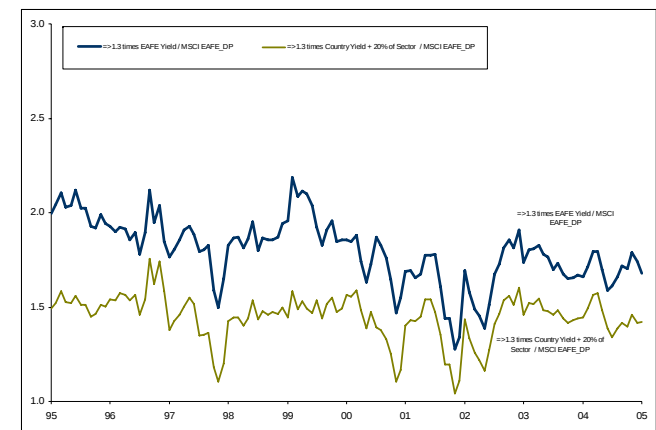
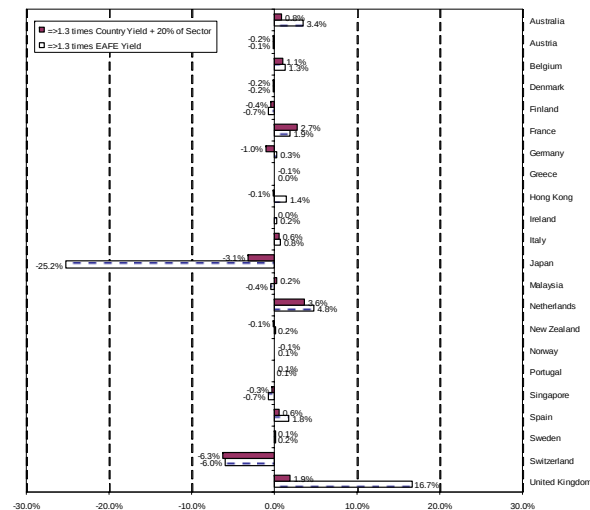
High Yield vs. Country/Sector Diversification (cont'd.)

- But achieving broad diversification by country and sector is likely to come at the cost of reducing the overall dividend yield
 - The graphs below depict the sector weight differences and relative yield of high dividend yield indices constructed from the MSCI EAFE Index by targeting:
 - All securities with dividend yield $\Rightarrow$ 1.3 times the EAFE dividend yield
 - All securities with dividend yield $\Rightarrow$ 1.3 times the country yield + 20% of sector market cap within each country

EAFE HDY - MSCI EAFE (Average Sector Weight Difference 1996 - 2005)



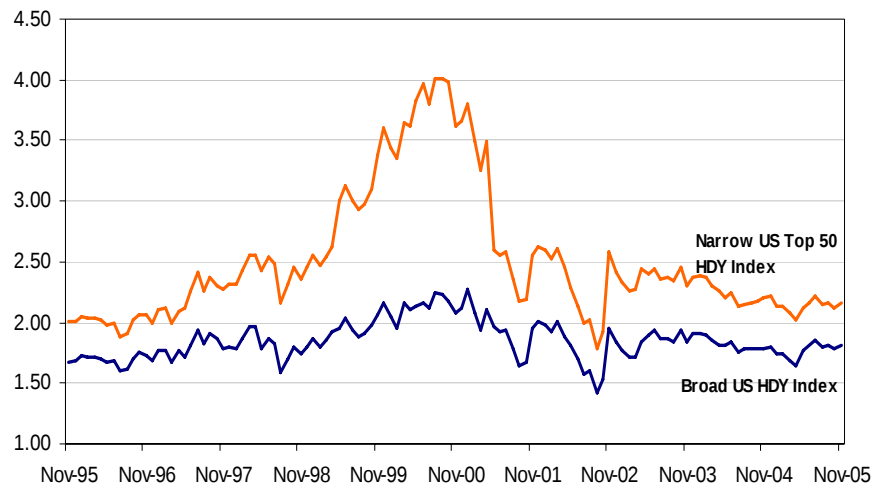
EAFE HDY- MSCI EAFE (Average Country Weight Difference 1996 - 2005)



High Yield vs. Index Breadth and Turnover

- Similarly, within a country, there exists a trade-off between the level of dividend yield and the breadth/diversification of the resulting portfolio
 - For instance, an index targeting the top 50 high yielding companies in the US results in a much higher dividend yield compared to that of a broader index.
 - However, such an index is highly concentrated and achieves a relatively low coverage of only 13% of the MSCI USA Index by free float-adjusted market capitalization
 - In addition, the resulting turnover is significantly higher when compared to the broader version

Relative Dividend Yield to the MSCI USA Standard



Turnover

Year	Broad US HDY Index: 1.3x Mkt Yield and then top 20% by sector	Narrow Index: Top 50 US Dividend Yielding Companies
1996	27.1	40.9
1997	31.1	60.2
1998	32.1	38.7
1999	51.1	84.2
2000	34.5	57.1
2001	27.1	66.6
2002	36.4	34.7
2003	39.4	54.8
2004	38.5	36.4
2005	33.2	39.8
Min	27.1	34.7
Max	51.1	84.2
Average	35.1	51.4



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Index Design

- The proposed index design tries to achieve a good balance among:
 - Targeting high dividend yield
 - Ensuring adequate persistency and sustainability of dividend payments
 - Providing broad country and sector diversification as well as adequate coverage
 - Reasonable index turnover

Proposed High Dividend Yield Index Design



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The Universe

- MSCI proposes to build the high dividend yield index family at the country/regional level using the MSCI Standard Index universe, ex REITS, as the starting point
 - The MSCI Standard country indices would be the starting universe for selecting securities for the high dividend yield index except in Europe ex-UK where the starting universe will be Europe ex-UK (treated as a region)
 - REITS are excluded due to their role as pass-through vehicles
 - For domestic high yield indices, the same methodology could be applied to the respective domestic index series, such as the MSCI U.S. Equity Indices, the MSCI KOKUNAI Japan Equity Indices, or the MSCI China A Share Index
- Regional and global composite high dividend yield indices would be created by combining the underlying country/region level high dividend yield indices

Dividend Sustainability & Growth

- To achieve inclusion of companies with persistent and sustainable high yield relative to the broad equity market two screens on payout and dividend growth are proposed
- Payout Screen
 - Companies that fall in the top five percent by trailing payout rank of the universe of positive payout and dividend paying companies in the appropriate MSCI Standard Index ex REITS, are excluded
 - The use of a percentile approach to exclude companies based on payout ensures that the companies at most relative risk of dividend cuts are excluded irrespective of the absolute level of the payout
- Dividend Growth Screen
 - Companies that have a negative 5-year long term historical dividend per share (DPS) growth trend are also excluded

Constituent Selection and Weighting

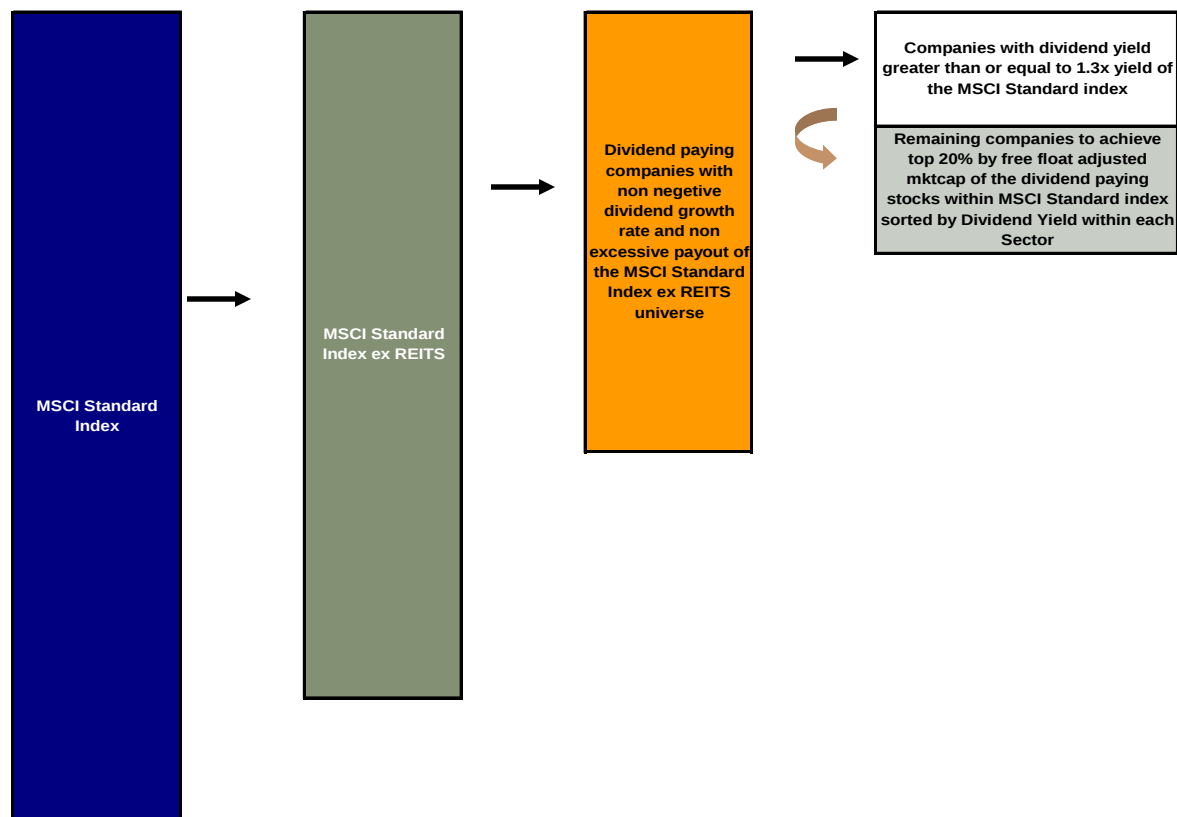
- Index constituents within countries would be selected using a two step selection methodology designed to achieve:
 - High dividend yield, and
 - Broad diversification by sector
 - Country diversification in multi-country composites results from the building block approach
- The index constituents would be capitalization-weighted with free float-adjustment

Constituent Selection Steps

- Step 1:
 - Companies from the screened universe would be sorted by decreasing order of dividend yield
 - All companies that have a dividend yield greater than or equal to 1.3 times the dividend yield of the country/ region MSCI Standard index, would be selected from the screened universe
- Step 2:
 - In order to achieve broad coverage and sector diversification, additionally, companies, ranked by decreasing order of dividend yield, from each sector would be selected to achieve 20% coverage of market capitalization by each sector, within the universe of dividend paying ex-REITs companies
- The proposed methodology seeks not only companies with high and sustainable dividend yield by including all high dividend yield companies, subject to the proposed screens, but also directly seeks to achieve sector diversification by targeting representation from each sector

The Scheme

- The high dividend yield indices would be built on a country-by-country basis (except Europe ex-UK which would be treated as a region).
- Regional and global composites would be formed by aggregating the underlying country/region indices



Maintenance

- Semi-annual rebalancing in May and November would be used to align with the regular MSCI rebalancing schedule and to keep the index current
- Corporate events and changes that impact the MSCI Standard index would flow through to the high dividend yield index
 - In addition provisions would be made for the inclusion of spinoffs/IPOs of well-established high dividend yield companies even without history for dividend growth (lack of history would be treated differently from negative dividend growth trends) provided they are constituents of the MSCI Standard index
- Buffer rules both at the screening level (payout, growth) and at the coverage (sector ranking, dividend yield required relative to the market) level would be applied for entry/exit to further reduce and manage index turnover

Resulting Attributes

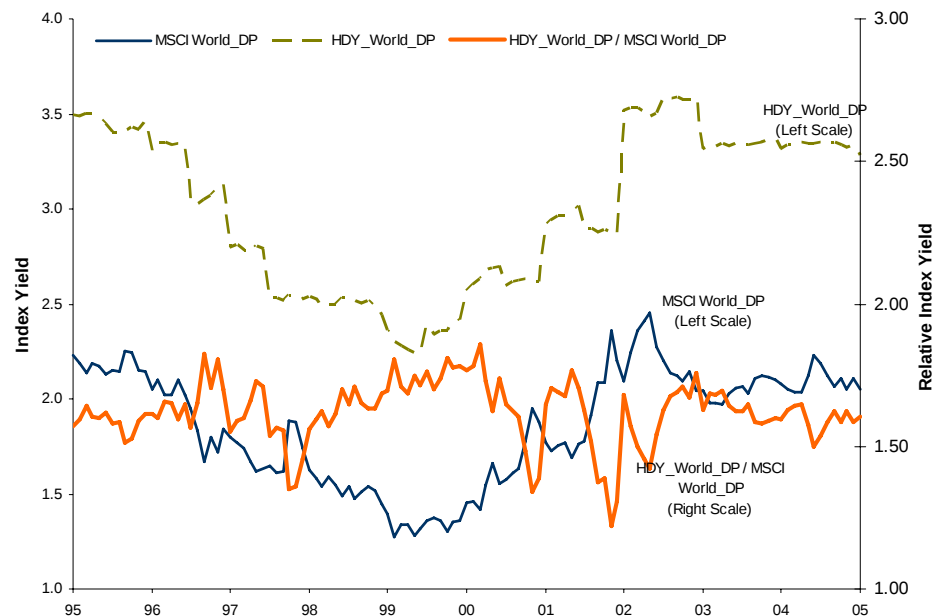
- The proposed high dividend yield index would:
 - Be rules-based with objective construction methodology
 - Contain constituents domiciled in the relevant country for country high dividend yield indices
 - Provide broad diversification by sector and country
 - Target persistent, high dividend yield relative to broad measures of the stock market
 - Be free float-adjusted capitalization-weighted and designed to experience only reasonable turnover

Features of the Proposed High Dividend Yield Index (Based on Simulations without Buffers)

Relative Yield, Coverage, and Turnover

World *

- On average, the proposed high dividend yield index had 1.6 times the dividend yield of the MSCI Standard index during the period from 1995-2005
- On average, the proposed World high dividend yield index had 444 companies and an annual one-way turnover of 63% (without buffers)



World HDY Index

Year	Nb. Of Securities	HDY Dividend Yield	MSCI World Dividend Yield	Relative Yield	Turnover (%)	Coverage
1996	442	3.4	2.1	1.6	45.4	28.6%
1997	501	2.9	1.9	1.6	49.6	30.6%
1998	522	2.5	1.6	1.5	53.2	31.2%
1999	521	2.5	1.5	1.7	60.8	29.7%
2000	508	2.5	1.4	1.8	74.5	30.4%
2001	404	2.8	1.7	1.6	72.1	30.0%
2002	389	3.2	1.9	1.7	82.7	29.4%
2003	374	3.4	2.1	1.6	59.8	30.8%
2004	384	3.3	2.1	1.6	46.3	29.6%
2005	394	3.3	2.1	1.6	80.6	29.6%
Min	374	2.5	1.4	1.5	45.4	28.6%
Max	522	3.4	2.1	1.8	82.7	31.2%
Average	444	3.0	1.8	1.6	62.5	30.0%



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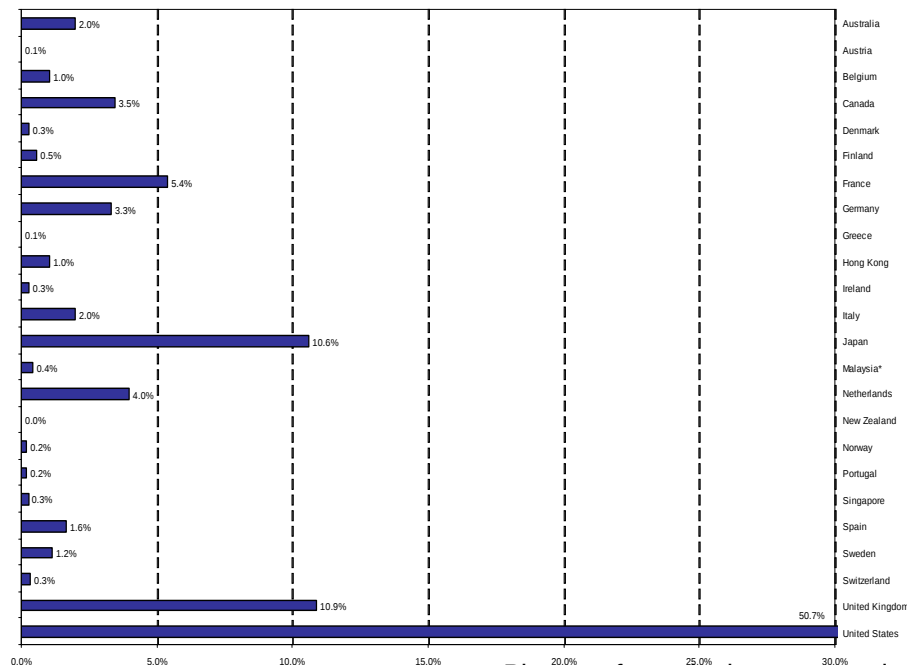
* Similar analysis for other select countries/regions available on request

Country Weight Comparison

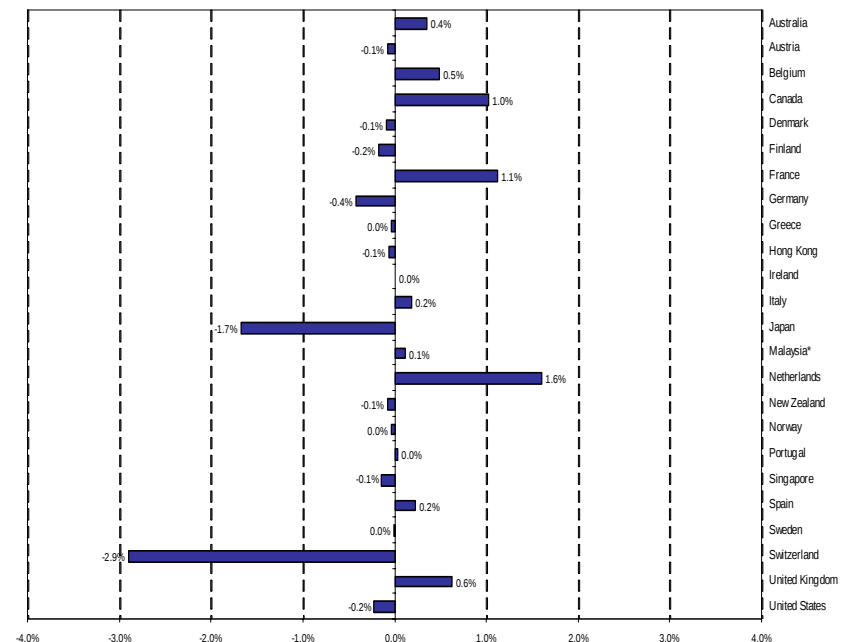
World

- On average**, from 1995-2005, relative to the MSCI World Standard index, the proposed high dividend yield index had an overweight in Netherlands and France (1.6%, 1.1%) and underweight in Switzerland and Japan (-2.9%, -1.7%)

World HDY(Average Country Weight 1996 - 2005)



World HDY- MSCI World (Average Country Weight Difference 1996 - 2005)



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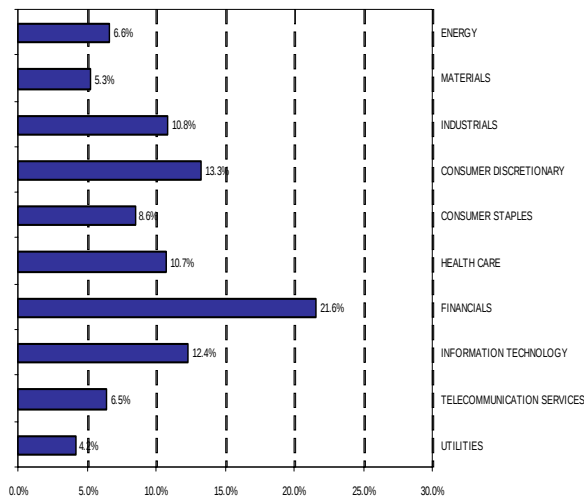
** See appendix for November 2005 comparison

Sector Weight Comparison

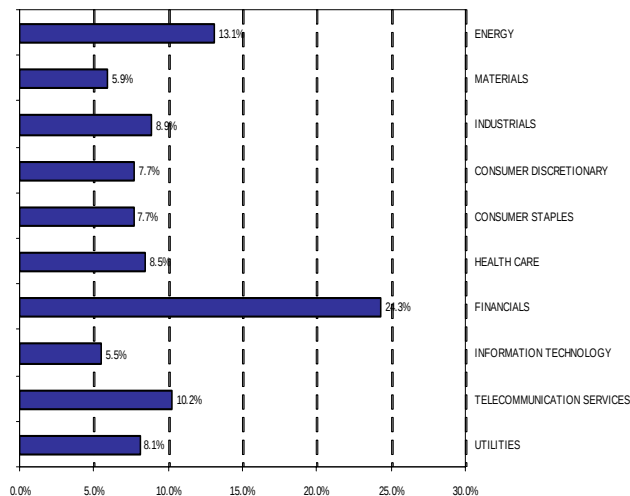
World

- On average**, from 1995-2005, the proposed methodology achieved reasonable sector diversification even though there was some sector weight deviation from the MSCI World Standard index

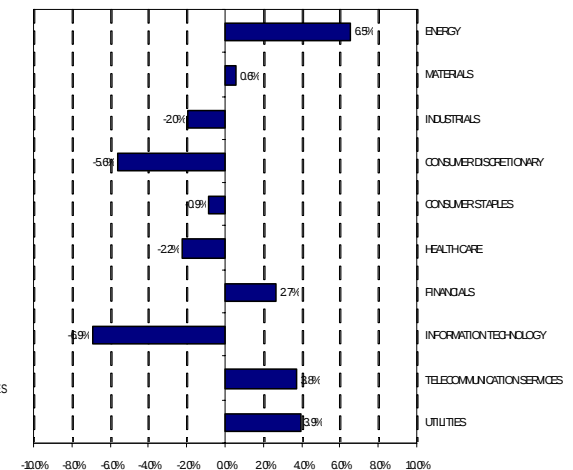
WORLD (Average Sector Weight 1996 - 2005)



WORLD HDY (Average Sector Weight 1996 - 2005)



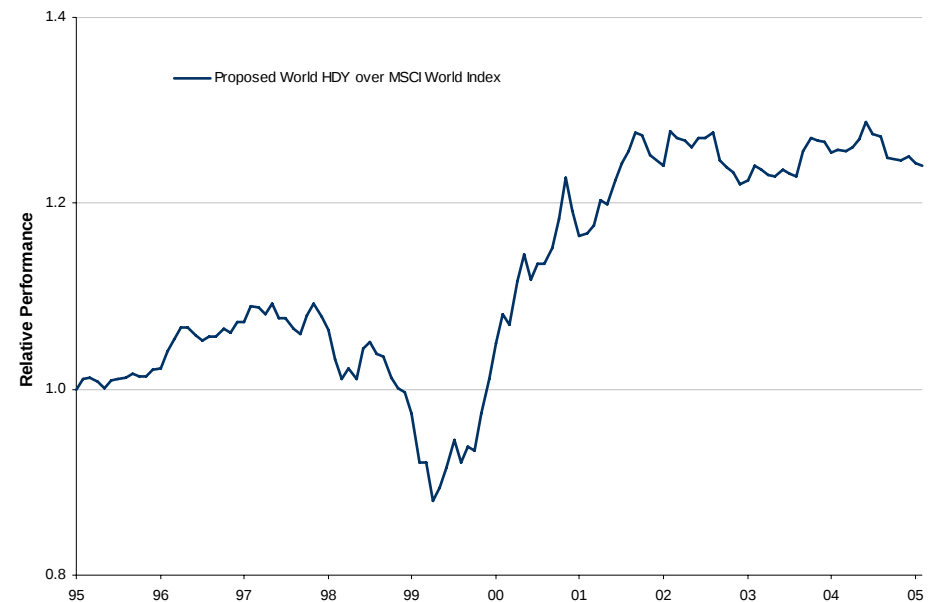
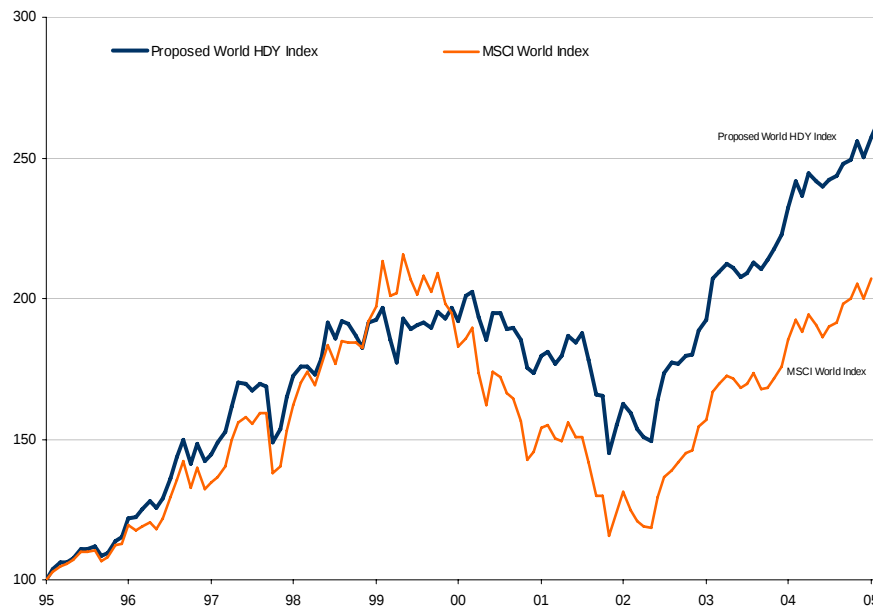
WORLD HDY - MSCI WORLD (Average Difference 1996 - 2005)



Performance: Nov 1995- May 2005

World

- Between Nov 1995 and May 2005, the proposed World high dividend yield index outperformed the MSCI World Standard index
 - During the period from late 1998 to early 2000, the World Standard index outperformed the proposed high dividend yield index



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Consultation Discussion

Discussion – Investment Process

- How important are sustainability and growth of dividends for high dividend yield strategies?
 - Are the proposed criteria to assess sustainability appropriate?
 - Should there be additional alternate criteria?
- How important is broad diversification by country and sector ?
 - Is the proposed approach, which directly targets sector representation, appropriate?
- Is there a need for a global high dividend yield index?
 - Or is the need only for select countries/regions?
 - In markets where domestic MSCI indices exist, such as the U.S and Japan, is there any interest in additional high dividend yield indices based on these indices?
 - Is there any interest for a high dividend yield index based on the International Small Cap Index?

Discussion – Proposed Index Design

- The proposal excludes REITS from the selection universe
 - Should REITS be included for select countries?
- Does the proposed approach strike a good balance between achieving a high dividend yield while providing broad country and sector diversification?
 - Is the 1.3x market dividend yield threshold, which provides high dividend yield but a somewhat narrower index, too high, too low?
 - Is the 20% coverage by sector, which results in the addition of companies with lower yield while providing better sector representation, too large?
- Is the level of coverage which, for the proposed World high yield index, is approximately 30% of the MSCI World Standard Index market capitalization with 444 companies appropriate?
 - Would broader coverage, which could lower yield and turnover be acceptable?
 - Would narrower coverage, which could raise yield, be preferred?

Discussion – Proposed Index Design (*cont'd.*)

- The proposal uses a country approach except for Europe ex-UK where a regional approach is used
 - Would a country approach for Europe ex-UK be attractive?
 - Would a more global approach, such as World or EAFE taken as a whole, be preferable?
 - Should a regional approach be used for Asia ex-Japan?
 - Should an approach that combines UK into Europe be considered?
- The proposal includes all securities that pass the selection criteria
 - Would an index using a fixed number of securities, which could provide higher index yield at the cost of higher turnover, be preferred?

Discussion – Proposed Index Design (*cont'd.*)

- The proposal uses float-adjusted capitalization weighting for a high dividend yield index
 - Would the use of other weighting schemes, such as dividend-weighting, be acceptable from an investment process perspective?
- The proposal uses gross yield in its screening process as tax considerations do not seem to play a significant role in high dividend yield strategies
 - Are there any reasons to consider net yield rather than gross yield?
- If MSCI decides to build a family of high dividend yield indices, how much history would be desired?

Appendix

Buffer Rules

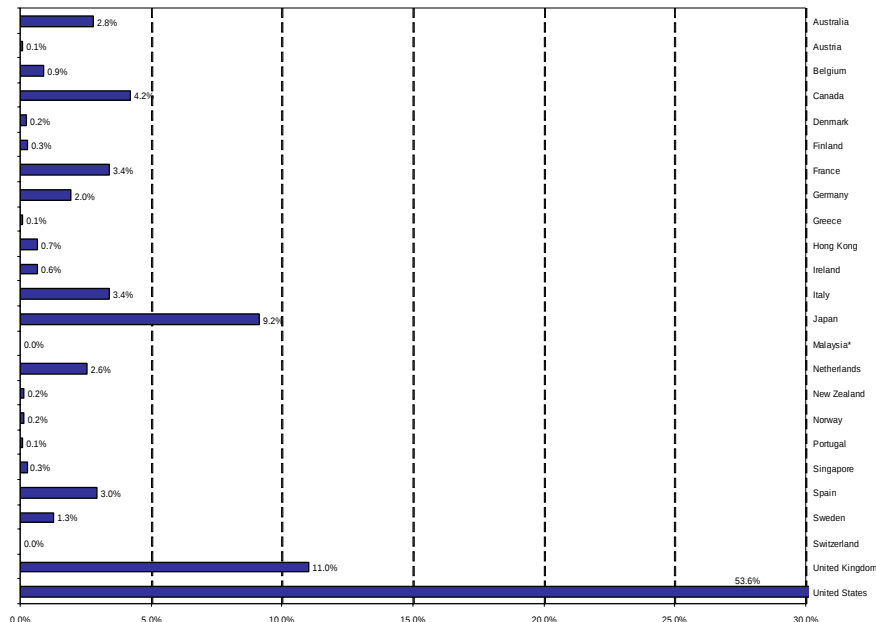
- Buffer rules would be fine-tuned to achieve the best balance of low turnover and the achievement of other index objectives
- Examples of buffer rules that could be applied at the different steps are:
 - At the screening level (payout), a constituent could be allowed to remain in the index even if the average payout rank rises up to the top three percentiles or if the company earnings turn negative resulting in a negative payout ratio
 - At the screening level (dividend growth trend), a constituent could be allowed to remain in the index even if the dividend growth trend becomes negative – persistency rule for negative dividend growth
 - In terms of the relative dividend yield requirement, an existing constituent could be allowed to remain in the index as long as its dividend yield relative to the MSCI Standard index is more than 1.1x the MSCI Standard Index's dividend yield
 - In terms of the coverage at the sector level, an existing constituent could be allowed to remain in the index as long as its dividend yield rank remains within the top 25% by market capitalization

Country Weight Comparison: November 2005

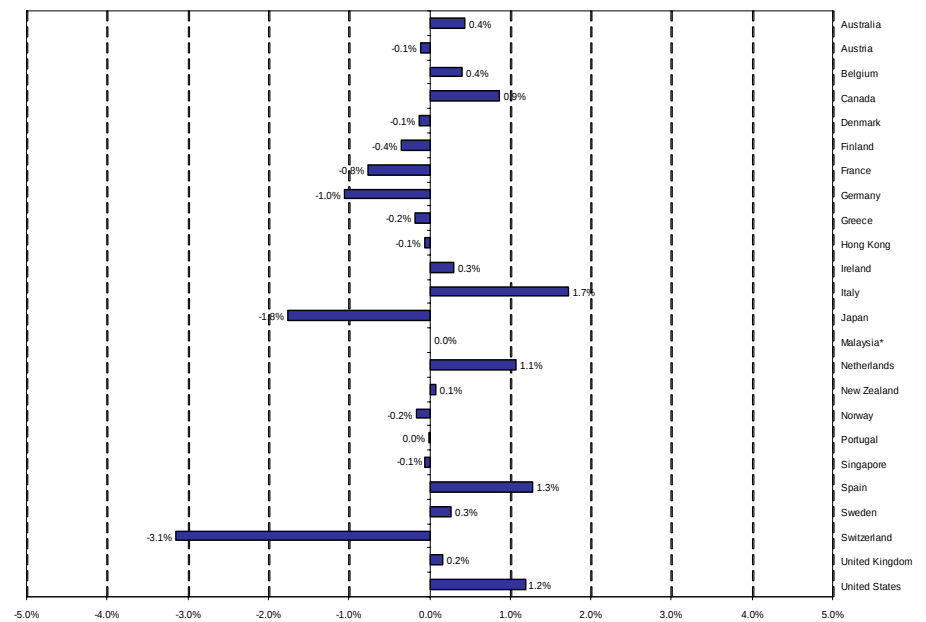
World

- In November 2005, relative to the MSCI World Standard Index, the proposed high dividend yield index had an overweight in Italy and Spain (1.7%, 1.3%) and an underweight in Switzerland and Japan (-3.1%, -1.8%)

World HDY(Country Weight: November 2005)



World HDY- MSCI World (Country Weight Difference: November 2005)

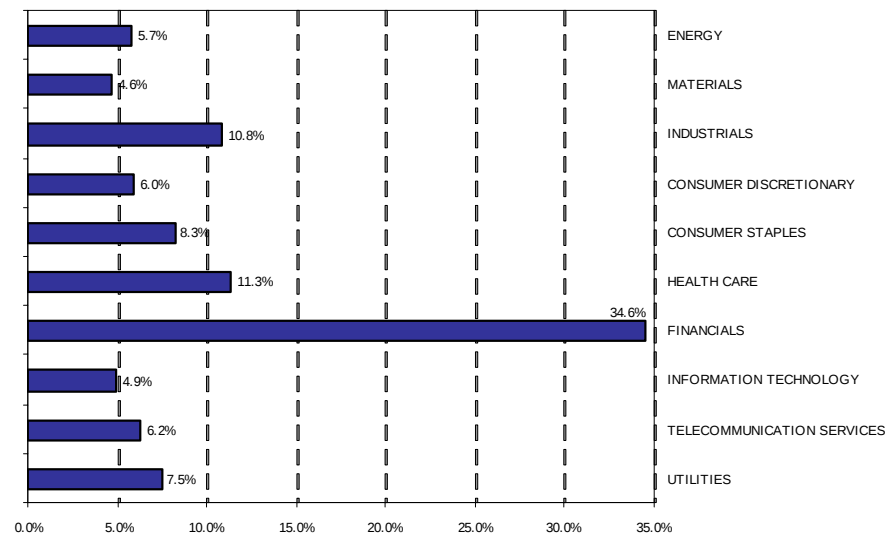


Sector Weight Comparison: November 2005

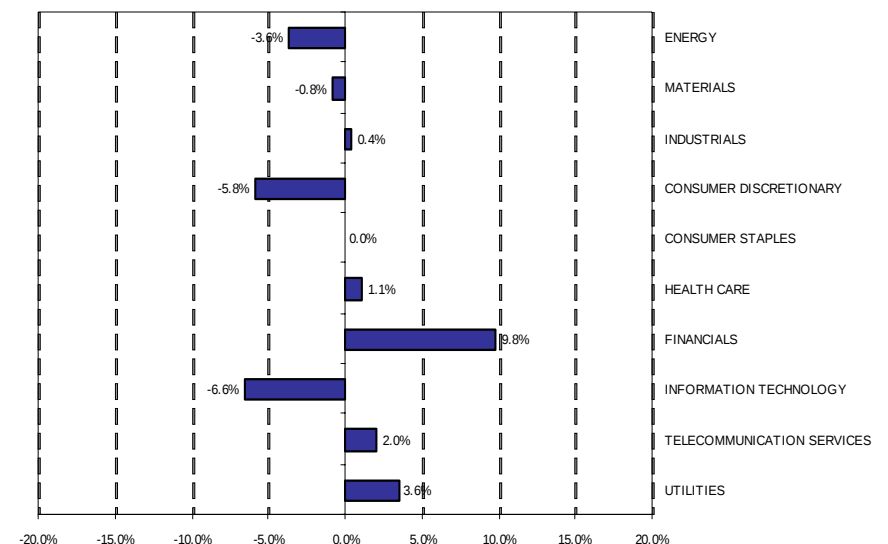
World

- In November 2005, relative to the MSCI World Standard Index, the proposed high dividend yield index overweighted Financials (9.8%) and underweighted Information Technology (-6.6%)

WORLD HDY (Sector Weight: November 2005)



WORLD HDY - MSCI HDY (Difference: November 2005)



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