

MSCI Consultation

MSCI Consultation Paper on Proposed Enhancements to the Morgan Stanley REIT Index (RMS)

I. INTRODUCTION

As announced on November 23rd 2004, MSCI, the leading provider of global indices and benchmark related product and services has taken over the day to day management and ownership of the Morgan Stanley REIT Index (RMS) from Morgan Stanley.

Following this transfer, MSCI is soliciting feedback on certain possible enhancements to the current RMS Index methodology. This paper provides details of the proposal and sets forth a series of questions for investors to provide MSCI with additional information and feedback. MSCI will announce its final decisions regarding this proposal at least 30 days prior to implementation of any changes. Importantly, please note that this consultation may or may not result in any changes to the current RMS Index methodology.

II. SUMMARY OF PROPOSALS

The main proposals set out in this paper are:

1. REIT Universe Definition:

- MSCI proposes not to change the type of REIT securities used for construction of the RMS Index.
- MSCI proposes to include only REIT securities from the investable market segment of the MSCI US equity universe in the RMS Index.

2. Proposed Index Enhancements:

- MSCI proposes to free float adjust the RMS Index constituents using the MSCI free float methodology in order to reflect the availability of shares from the perspective of US domestic investors.
- MSCI proposes to apply to the RMS Index the same investibility screens that are used in the construction and maintenance of the MSCI US Equity Indices.
- MSCI proposes to apply to the RMS Index the same periodicity of index reviews as are applied to the MSCI US Equity Indices.
- MSCI proposes to apply to the RMS Index the same corporate event maintenance methodology as is applied to the MSCI US Equity Indices.
- MSCI proposes to change the RMS Index calculation methodology to Laspeyres' principle of a weighted arithmetic average together with the concept of chain-linking.
- MSCI proposes to calculate a real time price return variant (without dividend reinvested) of the RMS Index, in addition to an end of day total return variant (with dividend reinvested) of the RMS Index.

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III. DEFINING THE REIT UNIVERSE

1. Real Estate Investment Trusts

A Real Estate Investment Trust, or REIT, is a company that owns, and in most cases, operates income producing real estate assets. Some REITs provide loans to the owners and operators of real estate. To qualify as a REIT under the Internal Revenue Code, a REIT is required to distribute at least 90% of its taxable income to shareholders annually and receive at least 75% of that income from rents, mortgages, and sales of property.

There are approximately 193 publicly traded REITs in the U.S. today, with a total market capitalization of USD 274 Billion (Table 1).

Table 1: MSCI US REIT Universe

Type	Count	Company Full Market Cap	Security Full Market Cap	Largest Company	Smallest Company	% of REIT Universe (Nb of Securities)	% of REIT Universe (Mcap)
Equity	153	246,237	245,414	11,160	4	79.3%	89.9%
Mortgage	31	21,479	20,986	3,213	7	16.1%	7.8%
Hybrid	9	6,183	6,152	4,536	11	4.7%	2.3%
Total	193	273,898	272,552	11,160	4	100.0%	100.0%

Source: MSCI. Data as of Sept 30, 2004. All market caps are in USD million.

REITs are classified into the following categories:

- An Equity REIT owns and operates real estate directly. Equity REITs generate income from rental and lease payments, and they offer the potential for growth from property appreciation as well as occasional capital gains from the sale of property.
- A Mortgage REIT provides loans to owners and operators of real estate assets or holds or trades mortgage backed securities. Mortgage REITs earn interest income and are subject to credit risk (that is, the chance that a loan will not be repaid).
- A Hybrid REIT holds both properties and provides mortgage loans to real estate owners and operators.

2. Defining the MSCI US REIT Universe

MSCI proposes not to change the REIT universe used for construction of the current RMS Index. We have outlined below two other alternatives to determine REIT securities that will be eligible for inclusion in the RMS Index. Please note that, in all alternatives, eligible securities are classified under the Global Industry Classification Standard (GICS) "REIT Sub-Industry" in the MSCI US Equity universe. Companies classified under the GICS Real Estate Management & Development Sub-Industry will not be considered for inclusion.

MSCI's Proposal: Current RMS Index Universe

All equity REIT securities, except certain specialty Equity REIT securities that do not generate a majority of their revenue and income from real estate rental and leasing operations, in the MSCI US REIT universe will be eligible for inclusion in the RMS Index provided they meet the index eligibility rules and guidelines outlined in this document.

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Our initial analysis of the MSCI US REIT universe indicate that there are only three specialty Equity REIT securities representing 4% of the Equity REIT universe by market capitalization, that do not generate a majority of their revenue and income from real estate rental and leasing operations.

Alternative II: Pure Equity REIT Universe

All Equity REIT securities, including certain specialty equity REIT securities that do not generate a majority of its revenue and income from real estate rental and leasing operations, in the MSCI US REIT universe will be eligible for inclusion in the RMS Index provided they meet the index eligibility rules and guidelines outlined in this document.

Alternative III: All REIT Universe

All REITS (Equity, Mortgage and Hybrid) in the MSCI US REIT universe will be eligible for index inclusion provided they meet the index eligibility rules and guidelines outlined in this document.

3. Defining the Depth of Coverage of the REIT Universe

A close analysis of the Equity REIT universe in the MSCI US equity universe highlights the fact that most of the REIT securities are either small or mid cap securities (Table 2). A relatively large number of REIT securities are also in the micro cap range (24% of Equity REIT universe securities have a market capitalization below USD 250 million). Therefore, in order to ensure that the performance of the Equity REIT universe can be replicated in actual institutional and retail portfolios of different sizes, MSCI proposes to include only REIT securities that are of reasonable size, in terms of full and free float-adjusted market capitalization.

Table 2: Equity REIT Security Full Market Cap Distribution

Market Cap Distribution (Full Security Mcap)	REIT Universe	Security Full Mcap	Largest Security	Smallest Security	% of Equity REIT Universe (Nb of Securities)	% of Equity REIT Universe Mcap
Greater than 5 Billion	12	89,333	11,159	5,697	7.8%	36.4%
USD 1 Billion to 5 Billion	59	124,309	4,867	1,037	38.6%	50.7%
USD 250 Million to USD 1 Billion	46	27,702	999	278	30.1%	11.3%
USD 100 Million to USD 250 Million	22	3,674	243	103	14.4%	1.5%
Less than 100 Million	14	396	97	4	9.2%	0.2%
Total	153	245,414	11,159	4	100.0%	100.0%

Source: MSCI. Data as of Sept 30, 2004. All market caps are in USD million.

MSCI's Proposal: Investable REIT Universe (Excludes Micro Cap REIT securities)

MSCI proposes that Equity REIT securities, excluding certain specialty Equity REIT securities that do not generate a majority of their revenue and income from real estate rental and leasing operations, that are included in the investable market segment of the MSCI US equity universe will be eligible for inclusion in the RMS Index at the time of the semi-annual index review, provided they meet other index inclusion criteria. The current RMS constituents will remain included in the index until they migrate outside of the investable market segment or fail an investability screen at the time of semi-annual index review.

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As seen in Table 3, there are 113 Equity REIT securities in the investable market segment of the MSCI US equity universe. The largest Equity REIT security in the investable market segment has a market capitalization of USD 12,936 Million and the smallest Equity REIT security has a market capitalization of USD 110 Million.

Table 3: Equity REIT Index Comparison: Security Full Market Cap Distribution

Market Cap Distribution (Full Security Mcap)			IMI Equity REIT		BMI REIT	
	IMI (Equity)	BMI(Equity)	Largest Security	Smallest Security	Largest Security	Smallest Security
Greater than 5 Billion	13	13	12,936	5,052	12,936	5,052
USD 1 Billion to 5 Billion	60	60	4,849	1,004	4,849	1,004
USD 250 Million to USD 1 Billion	38	42	997	300	997	250
USD 100 Million to USD 250 Million	2	20	179	110	223	101
Less than 100 Million	0	1	-	-	64	-
Total	113	136	12,936	110	12,936	64

Source: MSCI. Data as of Oct 29, 2004. All market caps are in USD million.

Alternative II: Broader REIT Universe (Includes Micro Cap REIT Securities)

An alternative would be to include equity REIT securities, excluding certain specialty equity REIT securities that do not generate a majority of their revenue and income from real estate rental and leasing operations, that are included in the broad market segment that represents the top 99.5% of the MSCI US equity universe at the time of the semi-annual index review provided that their market capitalization is greater than USD 20 Million. Current constituents will remain in the index until their market cap falls below USD 10 Million.

As seen in Table 3, there are 136 Equity REIT securities in the broad market segment of the MSCI US equity universe. The largest Equity REIT security in the broad market segment has a market capitalization of USD 12,936 million and the smallest Equity REIT security has a market capitalization of USD 64 Million.

IV. PROPOSED INDEX ENHANCEMENTS

1. Free Float-Adjusting Constituent Weights in the RMS Index

MSCI proposes to free float-adjust the market capitalization of constituents in the RMS Index in order to reflect the availability of shares from the perspective of US domestic investors.

MSCI defines the domestic free float of a security as the proportion of shares outstanding that are deemed to be available for purchase in the public equity markets by domestic investors. Therefore, domestic free float excludes strategic investments in a company, such as stakes held by governments, controlling shareholders and their families, the company's management or another company.

2. Redefining the Investability Screens for Index Inclusion

MSCI proposes to apply the investability screens that are used in the construction and maintenance of the MSCI US Equity Indices to the RMS Index. A summary of the investability screens that are currently applied to the MSCI US Equity Indices are outlined in Table 3.

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MSCI Consultation (continued)

Table 4: MSCI US Equity Indices Investibility Screens

MSCI US Equity Indices Investibility Screens	
Maximum Trading Price	Securities trading above USD 5000 are excluded from the universe
Minimum Trading Price	None
Liquidity Requirement	In the Investable Market Segment, securities that belong to the top 99.5% of the cumulative security full market capitalization of the US equity universe in descending order of ATVR, after excluding those securities trading above USD 5,000, are eligible for index inclusion
Length of Trading	A seasoning period of at least three calendar months is required for all new issues of small companies at the time of the eligible US equity universe creation. IPOs and newly listed securities with a company full market capitalization rank equal to or above 750 in the Investable Market Index do not need to satisfy this condition.
Company and Security Free Float	Securities of companies with an overall and/ or security free float of less than 15% are generally not eligible for inclusion.
Relative Security Free Float-Adjusted Market Capitalization	Securities should have free float-adjusted security market capitalization representing at least 10% of the company full market capitalization

Source: MSCI

3. Index Reviews and Maintenance

The proposed maintenance process for the RMS Index places special emphasis on continuity and on minimizing unnecessary index turnover. In this regard, we propose the Index to be fully reviewed on a semi-annual basis, at the end of May and November, and partially reviewed at the end of February and August. In addition, consistent with the index methodology employed in maintaining existing MSCI equity indices, MSCI will reflect corporate events in the RMS Index as they occur.

Table 5: Proposed Index Reviews and Maintenance Policy

	Current	Proposed
Intra-quarter	Only deletions and share changes above 5%	As per current corporate event methodology
Additions	At each quarter, minimum 6 months of trading history	At each semi-annual rebalancing, minimum 3 months of trading history
Frequency	4 quarterly index rebalancings (comprehensive)	2 semi-annual rebalancings (comprehensive), 2 quarterly index reviews (partial)
Timing	Effective date of quarter rebalancing is the business day immediately following the 3rd Friday after each calendar quarter end	Effective dates of semi-annual rebalancings will be the first business day of June and December. Effective date for quarterly index reviews will be the first business day of March and September.

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4. Index Calculation Methodology

The current RMS Index is calculated using the Paasche index calculation methodology, which effects corporate event adjustments to the index’s previous day basis. In order to be consistent with MSCI index calculation methodology, MSCI proposes to calculate the RMS Index using the Laspeyres’ principle of a weighted arithmetic average together with the concept of chain linking, which effects corporate event adjustments to the index’s current market capitalization.

In addition to calculating an end of day total return variant (with dividend reinvested) of the RMS Index, MSCI proposes to calculate a real time price return variant (without dividend reinvested) of the RMS Index.

5. Announcement Policy

MSCI proposes to apply to the RMS Index the same announcement policy that MSCI applies to the MSCI US Equity Indices.

A summary of the current and proposed announcement policy for the RMS Index is given in Table 5.

Table 6: Proposed Announcement Policy

	Current	Proposed
Index Review and Rebalancings	All changes are announced by AMEX four business days prior to the effective date	All changes will be announced at least two weeks prior to the effective date
Intra-quarter	All changes are announced by AMEX at least one full business day prior to the event	Through the ACE file, events will typically be announced with an expected status ten days prior to the event and with a confirmed status three days prior to the event; intra-day announcements will be posted on the web for last minute events.

V. INVESTOR FEEDBACK

MSCI now invites our clients and investors to comment on the proposals presented in this consultation paper. Below we present some questions to facilitate your feedback. Please feel free, however, to comment on any other aspect of the proposals. To participate in this consultation please write to us at consultation@msci.com or contact us at (212) 762-5790.

REIT Universe Definition

1. Does the current RMS Index adequately represent the REIT investment opportunity set? If not, should the index universe definition be enhanced to include other REIT securities, like the Mortgage and Hybrid REITS.
2. Should Real Estate Operating Companies and publicly traded REIT preferred securities be included in the RMS Index?

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3. Should the RMS Index include specialty Equity REIT securities that do not generate a majority of their revenue and income from real estate rental and leasing operations?
4. Does the current RMS Index sufficiently capture the depth of the Equity REIT universe? If not, should smaller REIT securities be eligible for index inclusion?

Free Float Weighting the Index

5. Should the RMS Index be free float adjusted? If yes, then what is the best way to implement the proposed change to ensure a smooth transition?

Investibility Screens

6. Will applying the same investibility screens as are applied to the MSCI US Equity Indices to the RMS Index create any issues in the RMS Index construction and maintenance processes?

Index Calculation

7. How are you using the RMS real time index in your investment process? How important is it for you for the index to be available on real time basis?
8. What is the benefit of having a real time daily total return index vis-à-vis a real time price index for managing Exchange Traded Funds based on REIT indices?
9. How much history will be required for the proposed price return (without dividend reinvested) variant of the RMS Index?

Index Maintenance and Announcement

10. Should index reviews for the RMS Index be modified from four quarterly rebalancing to two semi-annual index rebalancings and two quarterly index reviews?

Thank you for your participation in this Consultation Paper. Again, MSCI will announce its final decisions regarding this proposal at least 30 days prior to implementation of any changes. Importantly, this consultation may or may not result in any changes for the current RMS Index methodology.

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