MSCI consultations regarding the MSCI/AREF UK Quarterly Property Fund Index on:

- **The implementation of the time-weighted return methodology**
- **Changes to the inclusion criteria**

Attendees

There were 24 attendees representing 11 fund management houses, 4 investors in property funds, MSCI and AREF. 22 funds in the MSCI/AREF UK Quarterly Property Fund Index were represented.

Introduction

Everyone was welcomed by Ray Adderley, Head of Performance & Investment Process, Nuveen Real Estate and member of AREF Research & Information Committee.

The event was held under Chatham House Rules and was only recorded to enable AREF to prepare notes of the roundtable. The recording would not be shared outside of AREF.

The aim of the roundtable was for AREF Members to be able to question, and share observations with, MSCI about their proposals. This would help firms to formulate their own responses to the consultation by 21st May.

The MSCI/AREF UK Quarterly Property Fund Index (Index) was over 20 years old and was an established, trusted and well used index. To ensure this continued it was important to that contributors and users of the Index responded to the consultation.

Proposal for implementation of the time-weighted return methodology

Bert Teuben, Vice President, Index Management Research, MSCI gave an overview of the proposed changes to the Index calculation methodology.

After the consultation, held just over a year ago, it was agreed to change indices in Australia, Canada and Continental Europe to the time-weighted return methodology. In the UK, MSCI agreed to collect 3 years of data and produce parallel results to compare the proposed time-weighted return methodology to the current unitised methodology. This latest consultation provided the results of the parallel run and proposed moving to the time-weighted return methodology, in the UK, in Q1 2022. The consultation would close on 21st May and MSCI would feedback the results by the end of June.

The following changes to the Index methodology have been proposed:

- Returns would be calculated using Time-Weighted Return Methodology (reflecting daily-weighted external cash flows at fund level) instead of the current Unitized Methodology.

- Fund-level index returns would be made available both on a net and gross fee basis.

- Income return calculations to be based on the net investment income.

- Consistent interpolation would be applied when Net Asset Value and the Net Investment Income are not available on a monthly basis and the external cash flows are not available on a day-dated basis.

- Cross-holdings adjustment would be discontinued.

MSCI's rationale for moving from an unitised methodology to a time-weighted return methodology with adjustment for daily-weighted external cash flows were:

- Better alignment with Global Investment Performance Standards (GIPS) by considering day-dated external cash flows.

- Global standardisation would benefit funds having international investors or international fund raising.

- Income return was more comparable amongst funds which were not (or were partly) distributing their income

- A fund level return calculation would consider the overall fund level returns while the unitised return calculation considered individual investors returns. It would therefore be more accurate for funds with different share-classes and bid-offer spreads.

- It allowed for the timing of external cash-flows resulting in a more accurate capital employed calculation both for individual funds, but also for weighting in the indexes.

In the simulated results, approximately 72% of the Index (based on NAV) was used. The main reason for the other 28% of the Index not providing data was that those funds did not have the resources to do so at the time.

The simulated results showed differences between the methodologies of:

- About 5bp in most quarters for Aggregated Net Total Return (this was lower in Q2 and Q3 2020 as there was quite a few funds that had suspended dealing then.)
- 15-20bp each quarter for Income Return

The drivers of the return difference between the methodologies were:

Current unitized methodology	Proposed time-weighted methodology
Return based on individual investors returns for individual units	Based on aggregated investors return including impact of bid-offer spread and aggregated for different share-classes
Timing of external cash-flows partially monthly but also quarterly	The external cash-flows are day-dated for the calculated of the weighted equity
Certain funds did provide quarterly while others did provide monthly NAVs	Consistent monthly NAV derivation for funds for which no monthly NAV is available
Income based on distributed income (for certain non-distributing funds this would be zero or even negative when charging fees)	Based on the net investment income

There were some differences in the timing between the net investment income and the distribution and therefore there could be difference in the return on a quarterly basis.

Other points mentioned by MSCI:

- There had been no major concerns with the discontinuation of the adjustment for cross-holdings in the consultation last year.
- If there was a change to the methodology historic data would not be reinstated.
- The consultation asked if there should be splicing of the Index or if there should be two separate time-series or a different approach.

Q&A with MSCI

MSCI gave the following responses to questions from attendees:

- For most funds the total returns deviation was zero; funds that had issued new units could have seen an impact of 5bp (Page 7 in the consultation).
- For income return, the Index reported on a gross yield. The denominator would be capital employed.
- Both income return and distribution yield would be reported.
- MSCI would allow for capitalised fees and accrued fees. They would improve the income definitions to ensure there was clarity on what should and shouldn't be included.
- The deviation between the methodology was lower where the impact of the bid-offer spread was lower and if very few units were issued. It could be affected by the timing of cash flows too.
- Distributions were deemed to be paid at an end of a period. MSCI agreed that the treatment of distributions across the funds needed to be the same regardless if funds were ex-div or cum-div.
- The definition of income yield was being adjusted to ensure funds reported on accrued income and not just income received.

Proposed changes to the inclusion criteria

Hariharan Ganesan and Girish Walvekar from MSCI presented on the proposed changes to the inclusion criteria for the Index.

The proposed changes to the Index rules were:

- **Rule 2** - The funds should have a minimum of 95% of their gross assets (excluding cash) invested in the UK instead of 85%. This reflected that the index was more UK centric and all current index constituents would currently meet this new rule.
- **Rule 3** - Investment performance of a funds direct property portfolio would be measured by MSCI at least quarterly rather than annually. This ensured that there would be consistency in valuation and performance measurement practices across all the funds in the index. Currently, about 4.5% of the Index NAV do not contribute to the quarterly property index.
- **Rule 5** – More clarity would be given on how a fund must be open to investment by new investors.
- **Rule 6** – This would be simplified to a fund having to have a NAV equal to or greater than £100m at each measurement period. All funds in the Index were currently over the proposed minimum size.
- **Rule 9** – The period of time to provide historic data for would change from a minimum of 5 years to 3 years.

The following changes to the sub-indices had been proposed in the consultation:

UK Long Income Property Fund Index – The definition for inclusion in this index would be changed to remove the requirement of diversified allocation and to clarify the low leverage criteria.

All Balanced Property Fund Index – The maximum exposure to sectors to be based on the Global Property Classification Sectors, i.e. Retail, Office, Industrial, Residential, Hotel And Other. Also, the requirement for funds to be open-ended would be removed from the inclusion criteria for this sub-index.

Low Geared Balanced Property Funds Index – This would be discontinued

Open-ended Property Funds Index – This would be introduced as a new sub-index to ensure a like-for-like comparability for the open-ended funds in the Index. 33 of the 45 funds in the Index were open-ended funds.

These additional changed were proposed in the consultation too:

Quarterly review and re-certification of inclusion criteria – Currently there was only a review of inclusion criteria when a fund joined the Index. Introducing a quarterly review would ensure the Index composition would be aligned with the inclusion criteria on an ongoing basis.

Introduction of an observation period – It has been proposed that if an Index fund was not adhering to Rules 2 and 6 and the sub-index criteria for 4 consecutive quarters it would qualify for exclusion.

Q&A with MSCI

- It was pointed out that MSCI needed to ensure there were no unintended consequences when making the proposed changes to the Index criteria.
- It was asked how the new Open-ended Property Funds Index would look different to the current All Balanced Property Funds Index since this sub-index is typically referenced as a benchmark for funds and investors. It was requested that MSCI provided firms with analysis on this.
- Also, it was mentioned by one of the attendees that closed-ended funds were often specialist in nature and were not seeking to raise money.

Roundtable discussion

MSCI representatives left the event prior to the roundtable discussion. 12 of the fund, investor and AREF representatives stayed to take part in the discussion.

Index calculation methodology change

- Alignment with GIPS

  It was agreed that there were benefits with being compliant with GIPS. However, there was a view amongst some that the current calculation methodology was GIPS compliant which negated one of the main benefits of the proposed changes.

- The UK market was based on unit pricing

  The proposed methodology would mean fund returns would be calculated rather than investor returns which may make the index less useful to investors. Funds may leave the Index if it wasn't relevant for their investors anymore.

- There needed to be consistency in reporting income return.

  There needed to be clear guidance on the data that should be reported for calculating income returns, for example, there could be disparity between settlement dates and XD dates and also, the reporting of rental income.

- Net vs Gross

  Providing fund-level index returns on both a net and gross fee basis could be quite sensitive and could differ from what funds were publishing themselves depending on their fee scales. Also, it should be clear which share class funds should use where more than one was present, or otherwise report on a blended basis

- Unintended consequences

  There was concern that MSCI did not have a detailed enough knowledge of the nuances of the funds and could be making some assumptions that could lead to unintended consequences if the changes went ahead. Also, data may not be easily available or understood by those supplying it or by MSCI which may cause issues & errors

- Transitional risk

  There would be transitional risk when moving from the existing to the new methodology

- Would proposed changes encourage funds to leave or join the Index?

  There was concern that some funds would decide to leave the Index if there was a methodology change leading to the Index becoming unviable. Funds coming to near to the end of their life may leave the Index early rather than change to new methodology. There was lots of uncertainty in the property market at the moment and adding this change as well could be one step too far for some funds. Also, funds would have to see there is a true benefit to them and their investors if they were to agree to take on the additional costs of providing the data requested. It was suggested that AREF and/or MSCI completed analysis on whether the changes would encourage more funds to join the index or discourage fund from joining?

- Would all funds be able to provide the data required?

  72% of funds (based on NAV) took part in the parallel run; were MSCI sure that the remaining 28% would be able to provide the data required and what would be the implications for the index if not? It was important that highest quality of data was provided without excluding funds from the Index.

- Fund's activity affects its performance

  There was concern that funds that had seen active net outflows would appear to be performing better than other funds.

- Implementation in Q1 2022

  It was believed that Q1 2022 was too soon to effect the change. Funds wanted a full understanding of the impact of the change on all participants before it went ahead.

- Splicing the Index

  It was appreciated that splicing had been done to other indices. There would need to be clear communication to investors, with MSCI's assistance, on splicing the Index series based on the current methodology and the proposed methodology to provide longer term index returns. Funds may continue to report unit level performance in their fund reporting to investors which will differ to the corresponding returns reported by MSCI in the Index.

  More detailed segmentation

  It was believed that MSCI could add more value to users by improving the segmentation available for analysis than changing the calculation methodology.

Changes to the inclusion criteria

- Do you agree with the proposed changes to some of the UK PFI inclusion rules?

  Attendees wanted to consider the proposals more closely to ensure there were no unintended consequences. They would feedback their thoughts to MSCI in their response to the consultation

- Closed-ended funds entering the All Balanced Property Fund Index

  Including closed-ended funds in the All Balanced Property Fund Index could reduce the relevance of the sub-index (particularly as this sub-index was typically a reference benchmark for funds and investors). Their closed ended nature could add fragmentation of investment time horizon within the index. It was asked if they would only be included during the fully funded stages.

- Rule 5 – Closed-ended funds

  It was asked if when the funds reach their wind down phase, or otherwise have no intention to raise capital / accept subscriptions, would they have to leave the Index?

- Observation period of four quarters

  It was asked if all the funds in the Index would be aware that a fund was under observation?

- Understanding the new rules and definitions

  MSCI should ensure funds understood the new rules and the interpretation of definitions were consistent.