



FTSE ActiveBeta Index Series Conceptual Framework

March 2010



PATENT PENDING



ACTIVEBETA CONCEPTUAL FRAMEWORK

Defining Active Betas

A significant portion of active equity management returns (traditionally referred to as alpha) appears to come from systematic sources of active returns, rather than managers' stock selection skill. These systematic sources of active equity returns arise from the *systematic* behavior of short-term and long-term earnings growth expectations and discount rates. We refer to these systematic sources of active returns as Active Betas.

The FTSE ActiveBeta family of indices, which utilize Westpeak Global Advisors' patent-pending index construction and maintenance methodology, provides an efficient, transparent, and cost-effective capture of these systematic sources of active equity returns in a country, regional, or global equity portfolio.

Systematic Behavior of Earnings Expectations and Discount Rates

The systematic sources of active equity returns arise from the systematic behavior of variables that drive stock prices, namely, earnings expectations and discount rates.

In open and competitive free-market economies, a fundamental influence drives the behavior of earnings growth and associated risks (discount rates), that is, that large groups of securities cannot sustain above-average earnings growth indefinitely. As a result, for large groups of stocks, changes in short-term expected earnings growth trend in the short run (up to one year). Meanwhile, changes in long-term expected earnings growth and discount rates mean revert in the long run (within three to five years).

Capturing the Systematic Behavior of Short-Term Earnings Expectation

Our research shows that changes in short-term earnings expectation contemporaneously drive returns (price momentum). The significant relationship between change in short-term earnings expectation and momentum implies that momentum offers an effective way of capturing the trending behavior of short-term earnings expectations in the short run. The systematic behavior of short-term earnings expectations leads high momentum stocks to have higher returns than low momentum stocks in the short run. As such, momentum is a short investment horizon strategy, and its horizon is consistent with the horizon over which short-term earnings trend.

Capturing the Systematic Behavior of Long-Term Growth Expectation

Our research also indicates that long-term earnings growth estimates have a significant contemporaneous relationship with value (e.g., the price-to-earnings ratio). The significant relationship between long-term earnings growth rate estimates and value implies that value offers an effective method of capturing the mean-reverting behavior of changes in long-term earnings expectation in the long run. The systematic behavior of changes in long-term earnings expectation leads value (i.e., low P/E and low expected growth) companies to have higher returns over time, as the mean reversion of long-term earnings growth expectation causes

valuations to expand. As such, value is a long investment horizon strategy, and its horizon is consistent with the horizon over which long-term earnings growth estimates mean revert.

Cyclical and Counter-Cyclical of Momentum and Value Active Returns

Momentum and value active returns are not earned linearly over time, but rather, exhibit pronounced cyclical behavior. In addition, momentum and value active returns exhibit counter-cyclical, or negative correlation, with each other. Changes in earnings predictability risk and risk tolerance of investors cause both the cyclical of, and counter-cyclical between, momentum and value active returns.

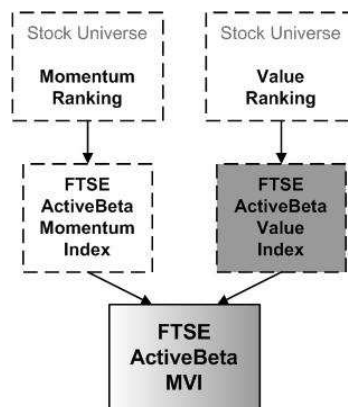
When the visibility of future earnings shortens, investors tend to focus on companies with high relative short-term earnings growth. This causes investors to favor short horizon (momentum) strategies over long horizon (value) strategies. When the visibility of future earnings lengthens, investors tend to focus on companies where reversion of long-term earnings growth will cause expansion in P/E multiples. This causes investors to favor long horizon strategies over short horizon strategies.

FTSE ActiveBeta Indices: Capturing Systematic Sources of Active Returns

The FTSE ActiveBeta Indices are designed to take advantage of two levels of diversification: 1) broadly-diversified momentum and value portfolios provide a higher probability of capturing the average systematic tendency of earnings expectations to trend and mean revert, respectively, and 2) a combined capture of momentum and value offers a more efficient, in a risk-adjusted sense, capture of the systematic sources of active equity returns, or Active Betas, as momentum and value independently have positive after-cost active returns, and these returns are negatively correlated (counter-cyclical). The negative correlation of these returns allows a combined capture to provide greater consistency and stability of active returns over time, compared to the independent capture of either momentum or value.

CONSTRUCTION METHODOLOGY OVERVIEW

The family of FTSE ActiveBeta Indices for any given universe comprises three indices: 1) a FTSE ActiveBeta Momentum Index, 2) a FTSE ActiveBeta Value Index, and 3) a combined FTSE ActiveBeta Momentum and Value Index (MVI). These indices are created using the 3-step process outlined below.



- 1) Specify a selection universe from which the FTSE ActiveBeta Indices will be created. The reference universes for the public indices will be the commonly-used FTSE market or regional indices. For example, an investor may choose FTSE ActiveBeta Indices based on the FTSE All-World Index Series.

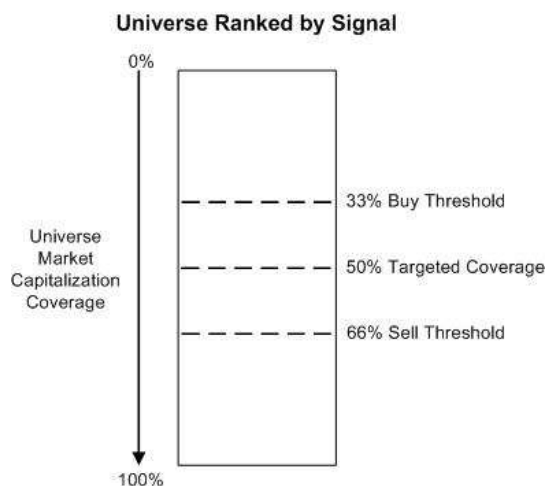
Rank each stock in the given selection universe, from high to low, on the momentum and value signals, independently.

- Momentum is defined as past 12-month total return.
- Value is defined as a composite signal consisting of price-to-book value, price-to-sales, and price-to-cash flow (or price-to-earnings, where appropriate). The composite signal is an equally-weighted average of the three valuation ratios.

- 2) Create independent FTSE ActiveBeta Momentum and FTSE ActiveBeta Value Indices.

These indices are created using buy and sell thresholds, which we refer to as buffer-based construction and maintenance. A universe is first ranked by the momentum and value signals, independently. A stock is included in a style index if its style rank places it within the top third of the universe market capitalization, and is excluded from the index when its style rank places it in the bottom third of the universe market capitalization. This buffer methodology limits turnover and results in about 50% market capitalization coverage of the underlying universe in each style index. The selected securities are then weighted according to their relative float-adjusted market capitalization. The use of trading buffers is shown below.

**Buffer-Based Construction and Maintenance
ActiveBeta Momentum or Value Index**



- 3) Combine the FTSE ActiveBeta Momentum Index and FTSE ActiveBeta Value Index, in equal proportions, to create the FTSE ActiveBeta MVI. In the creation of the FTSE ActiveBeta MVI, independent security-level positions from each style index are added with a 50% weight.

CUSTOMIZED INDICES

To better meet the specific investment needs of asset owners, FTSE ActiveBeta Indices can be customized in the following ways.

Universe Selection

The FTSE ActiveBeta Index Methodology can be applied to any universe of constituents specified by the investor, such as an Islamic index, a socially responsible index, or a custom index used by the investor in the asset allocation or portfolio structuring processes.

Targeted Coverage Custom Indices

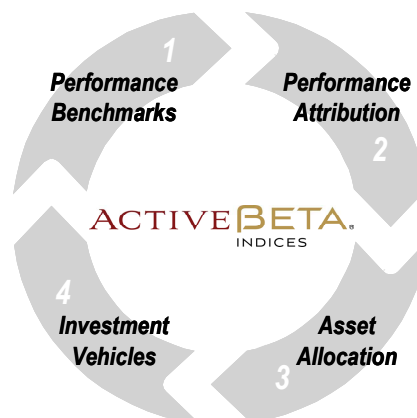
In the prevailing style index construction framework, a given methodology is applied to create a single set of value and growth indices. As a result, the coverage, active risk, and active return characteristics of the value and growth indices compared to the core, or reference, universe simply derive from the construction methodology. Investors currently do not have the option of capturing investment styles at various levels of coverage and active risk (or tracking error) for a given family of value and growth indices. Yet, this option may prove useful for many purposes, such as performance benchmarking, performance attribution, and asset allocation research and analysis.

Through customization, FTSE ActiveBeta Indices with varying parameters will deliver varying coverage of the core universe. Investors can consider high-coverage and low-coverage versions to quantify the trade-off between closely matching the market benchmark (through high coverage) and more effective style capture (through low coverage). The custom index construction methodology creates indices at various categories of coverage through variations in: 1) the pre-specified market capitalization percentage of the core universe held in a single-factor index and 2) the trading buffers.

Please contact FTSE or Westpeak Global Advisors for more information on FTSE ActiveBeta Index customization.

USES FOR FTSE ACTIVEBETA INDICES

The existence, and efficient capture, of Active Betas has several important implications within the equity investment process.



Performance Benchmarking

Active Betas offer a fresh perspective on style investing and suggest a new framework for performance benchmarking of active style managers. The ActiveBeta Framework argues that momentum and value better reflect the investment styles of active managers, compared to the current value and growth paradigm. As such, FTSE ActiveBeta Momentum Indices offer a better alternative to the poorly specified growth benchmarks. In addition, core managers have substantial momentum and value style tilts, thus making the FTSE ActiveBeta MVI a more suitable benchmark for these managers than the traditional, style neutral, core market benchmarks.

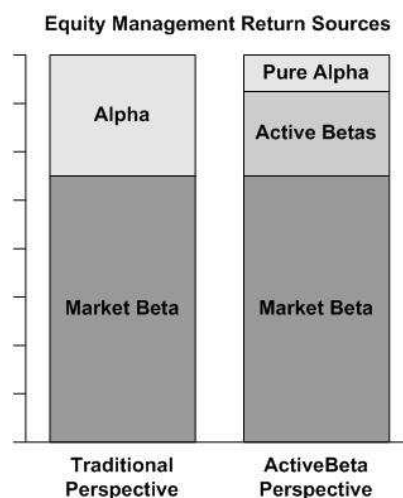
Performance Attribution

If value and growth do not appropriately or fully reflect the investment styles of active managers, then a performance attribution analysis based only on value and growth factors or indices could lead to misleading conclusions. Incorporating momentum, the missing systematic source, or style, into the analysis provides a better and more complete performance attribution analysis, allowing investors to decompose an active manager's return into a systematic source component (momentum and value tilts) and a pure alpha component.

Asset Allocation

With the insight provided by FTSE ActiveBeta Indices in assessing the true alpha of active managers, Active Betas offer a new perspective into structuring equity portfolios. Indeed, if alpha and market beta are the only two choices in decomposing portfolio returns, difficulties arise in distinguishing between systematic sources of active equity returns and a manager's true investment skill. In the alpha-beta return separation debate, therefore, there is a third source that should be considered explicitly – Active Betas. This implies that asset owners should structure their overall equity portfolios in terms of three components:

- Market beta, implemented through replication of market indices,
- Active Betas, implemented through FTSE ActiveBeta Index-like vehicles, and
- Pure alpha, implemented through skilled active managers.



Investment Vehicles

FTSE ActiveBeta Indices are based on investable and replicable market indices and, hence, are ideally suited for a variety of investment products.

On a risk-adjusted basis, the FTSE ActiveBeta Index active returns compare favorably with traditional active management returns. This performance not only validates the framework behind the FTSE ActiveBeta Indices, but also makes FTSE ActiveBeta Indices an efficient, transparent, and cost-effective alternative to traditional active management.

FOR FURTHER INFORMATION

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