MARKET NOTICE

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To: Market Participants
From: Indices Department
Date: 22 July 2014
Subject **Market Consultation: Proposed Changes to Dividend Plus Index**

FTSE/JSE has analysed feedback from its clients regarding concerns with the existing Dividend Plus Index (J259). The index is designed to measure the performance of the 30 instruments with the highest expected forward dividend yield. It is drawn from the universe of Top 40 and Mid Cap stocks (i.e. Top 100), excluding listed property companies. Constituents are selected and weighted based on a one-year forecast dividend yield. This yield is derived using consensus forecast data provided by INET BFA.

Some of the concerns raised that have been analysed include:

- **Forecast Quality**
  Instruments may be included in the index on a high forward yield based on a small number of contributing forecasters. Similarly, the variance of forecasts is a concern in that a particular forecast could be drawn from a pool of individual forecasts with a far larger range than normal, indicating a lower quality of consensus.
- **Treatment of Cancelled Dividends**
  It is possible, under the current methodology, for a company that cancels its dividends to remain in the index for up to six months.
- **Illiquid Instruments**
  Long-term index performance is potentially affected by the inclusion of relatively illiquid companies whose addition or deletion results in a liquidity squeeze at semi-annual rebalancing.
- **Churn**
  The current index has displayed high levels of reweighting churn historically.

FTSE/JSE proposes to keep the current philosophy of the index unchanged by continuing to utilise a single risk factor, namely forward dividend yield, for both constituent selection and weighting. Practically, the inherent volatility of this metric leads naturally to relatively high constituent turnover; however internal analysis indicates that modifying the weighting methodology generally decreases the differentiation of the J259 from other indices in the Series.

As such, certain construction rules remain unchanged. The index will remain a single-factor index based on forward dividend yield. In addition the eligible universe will remain unchanged as the Top 40 and Mid Cap, as well as an unchanged limit of 5 constituent changes per review. Reviews will continue to take place on a semi-annual basis at March and September.

After the merger between McGregor BFA and INET into INET BFA, the new combined forecast contains materially more contributors than previous forecasts. This increased number of contributors is expected to increase the statistical quality of the consensus forecast used.

PROPOSAL

Once a forward dividend yield is calculated for each of the companies in the eligible universe the following set of criteria is proposed in order to remove, re-rank or down weight companies causing the concerns listed above. Thus, the new proposed criteria are applied before both selection and weighting of constituents.

- **Forecast Quality**
  - All consensus forecasts with fewer than five contributors will have their forward dividend yields multiplied by 0.8
  - Volatility of forecast is measured using the standard deviation of individual forecasts on cut date. Applying an approximate 95th percentile the companies with the 5 highest volatilities are excluded.
- **Treatment of Cancelled Dividends**

  Constituents that experience a negative dividend event can be removed at the June or December reviews. A negative dividend event is deemed to have taken place if both of the below have taken place since the previous review:
  - A dividend declaration resulting in a one-day fall in historical dividend yield exceeding 2.5%, or to 0%.
  - A drop in forward dividend yield from the previous J259 review exceeding 2.5%, or to 0%.
- **Illiquid Instruments**

  Liquidity is screened based on a one-year median daily value traded for eligible instruments. Applying a 95th and 90th percentile approach, the five eligible instruments with the lowest liquidity are excluded. The next five eligible instruments will have their forward dividend yields multiplied by 0.8. This replaces the current R50 million liquidity screen.

Having applied the above tests, the eligible universe should now reflect a subset of the original universe with lower weights held by those companies with poor or volatile forecasts, low liquidity and dividend cuts.

SUMMARY

This proposal endeavours to keep core index principles unchanged, but makes adjustments in response to practical concerns identified. These changes are proposed to be effective from the September 2014 review.

All existing and potential index users are invited to review the proposal and submit any comments or suggestions to the JSE by email (indices@jse.co.za). All comments should be submitted by close of business on 12 August 2014. Should you wish to discuss the detail of the new methodology or arrange a meeting before submitting final comments, please contact indices@jse.co.za or Mark Randall on 011 520 7137.

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