

Viewpoint

Russell Research

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Part 3 of a 4-part series on global equities

Finding the fertile hunting ground: What type of global equity managers succeed, and why multi-manager makes sense in global equities

*“People will
doubt what you
say, but will
always believe
what you do.”
- Anonymous*

Russell has been researching U.S. managers for more than 30 years, and international managers for more than 25. Markets and portfolio management have evolved greatly in this time, and in part 2 of this four-part series,¹ we discussed the evolution of global equity portfolio management over the past two decades. There has been tremendous product growth; managers have moved from region-focused to fully global products; their processes have become more systematic and defined, and the landscape continues to grow increasingly competitive as new strategies enter the marketplace. Throughout this evolution, Russell has continued to change as well, honing our views on global equities and global equity managers.

Our research method has progressed over the years, and importantly for this discussion, our views on the types of managers most likely to succeed in the long run have advanced as well. Throughout our 30-year research history, we have continually sharpened our views about what type of manager succeeds, on average; what type of manager has a structural advantage; what type of manager is best suited for multi-manager versus single-manager mandates, and so on. While there is no set formula for success, and while eclectic managers can and do succeed, we have found that managers cut from a certain mold have a head start.

In this paper we will talk primarily about the benefits of global equity, but it must be said at the outset that we are not endorsing clients' disposal of their current regional building blocks. Instead we argue that global strategies provide a strong *complement* to the other, more regionally based equity strategies clients currently employ in their pension plans. In asset classes such as emerging markets and small cap, local-market knowledge is important in the quest for excess returns; regional products and emerging

¹ “The new face of global equity asset management.” Russell Research, September 2010.

markets products lean towards a small cap bent more than their global counterparts do. By combining global products, which emphasize the characteristics discussed below, and regional products, which emphasize local-market strengths, clients are arguably better served and provided with a higher probability of achieving excess returns. That caveat aside, in this paper we will focus solely on the global equity space, what we believe works in global equities, and why we think multi-manager structures are even more compelling in global equities than in other asset classes.

Why use global equity managers?

In parts one and two of this series we have discussed globalization and the evolution of global equity mandates, but the most important question underlying each of these white papers is “Why should I use a global equity manager?” As is the case for any investment, it’s all about risk and return. Global equity strategies offer opportunities for high excess returns relative to benchmarks, while at the same time offering diversification against other regional equity strategies. The proof statement for this claim can be seen in the exhibit below; over the past 20 years, global equity managers have outperformed the index by an average 1.3%. The other important point shown in this exhibit, beyond the fact that global equity managers have on average produced strong excess returns, is that all styles have produced excess returns over the long period, though to varying degrees. This points to the idea that it is possible to win in a number of ways in the global equity arena.

Exhibit 1 / Global Equity Universe Annualized Excess Returns

	Growth %	Core %	Value %	Total
5 Years	2.5	2.2	1.7	2.1
10 Years	0.3	1.8	5.8	2.5
Since 1990	1.3	0.8	2.6	1.3

Past performance is not indicative of future results.

Data as of 6/30/2010. Excess returns vs. MSCI World Index.

First, let’s delve into the premise that global equities offer higher potential for long-term returns than regional products do, both from a theoretical perspective and in practice. Richard Grinold and Ronald Kahn introduced “the fundamental law of active management” in 2001, stating that investors’ information ratios (“IR”) are equal to their information coefficient multiplied by the square root of breadth (number of active decisions).²

$$IR = IC \sqrt{N}$$

That is, risk-adjusted returns are largely determined by the extent of investors’ knowledge and the dimensions of the nets they can cast. As measured by the Russell Global Index, there are more than 12,000 available securities from which global equity managers can choose. By contrast, within the U.S. – the largest equity market in the world – only a quarter of that number is available (Russell 3000® Index); and for the majority of investors, who use a large cap benchmark such as the Russell 1000® Index, only one-twelfth. Assuming global managers have the same level of knowledge about a given security as regional managers do, global equity managers have a mathematical advantage – they have a higher “n,” greater “bottom-up breadth,” and as a result a higher IR.

² Due to portfolio constraints, some advocate that a transfer coefficient (TC) needs to be included in the formula, accounting for the implementation ease of the portfolio.

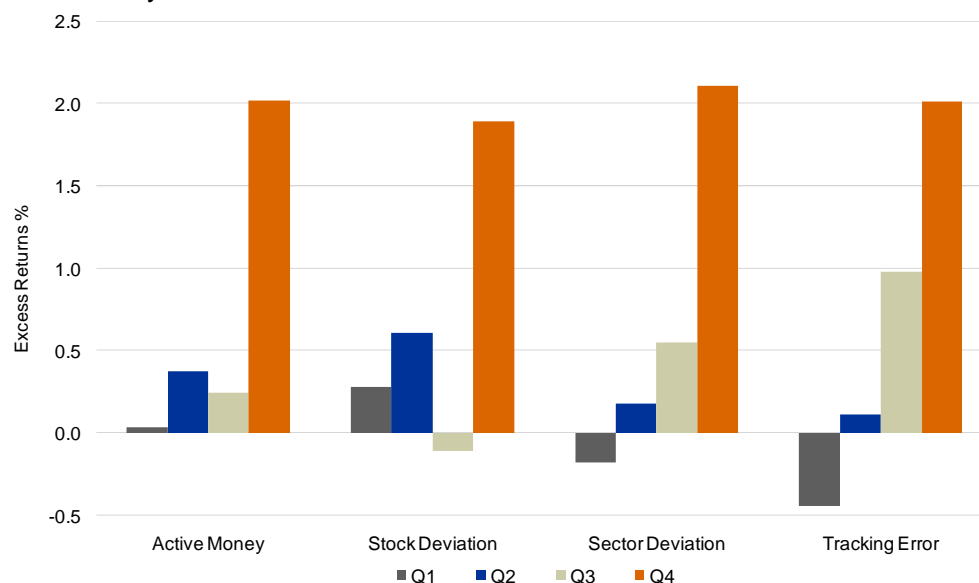
In practice, managers exploit this mathematical advantage by selecting the best ideas from the broadest opportunity sets. Take, for instance, a portfolio with six regional managers – one in the U.S., one in the U.K., one in emerging markets, one in Europe ex-U.K., one in Asia ex-Japan and one in Japan. All of the managers select the best energy sector ideas in their respective regions. For the U.S. manager, this could be Exxon; for the U.K. manager, it could be Shell; for the emerging markets manager, it could be Petrobras. The global equity manager can choose the optimal security from among the three, to avoid doubling up on exposure to a single sector or country.

Somewhat complementary to this is the idea of holding securities for risk mitigation. Currently, HSBC makes up 7.7% of the U.K. equity market as measured by the Russell U.K. Index. If a U.K. equity manager decides not to hold HSBC, that manager is making a sizable bet against one security and thereby creating a great deal of single-name portfolio risk. Consequently, U.K. managers tend to hold the security, but at an underweight position if they have a negative view. This practice – which is relatively common among regional managers, given the concentrated nature of many regional or single country benchmarks – has the effect of tying up, for risk-management purposes, capital that might be put to better use seeking alpha. By contrast, the global manager does not face the same level of benchmark concentration (HSBC makes up less than 1% of the Russell Global Index) and is thus free to deploy more active money in the pursuit of alpha.

As discussed in part two of our series, the concept of “active money” is one way to explain the trade-off between risk mitigation and the pursuit of alpha. Russell monitors the percentage of market value in the top 10 stocks; tracking error, both ex ante and ex post; and sector/country deviation compared to the benchmark. But one of our favorite indicators is the level of “active money” in a portfolio. Active money, sometimes labeled “active share” in the marketplace, measures the level of bets a portfolio takes compared to a benchmark by summing the absolute value of all security bets (over- and underweights) in the portfolio and dividing by 2. For instance, imagine a portfolio with two securities, A and B, at 50% weights. The benchmark consists solely of 100% of Security A. The active-money statistic would be calculated as follows: 50 (from a 50% underweight to Security A) + 50 (from a 50% overweight to Security B) ÷ by 2 = 50.

Furthering upon the comparative levels of risk-taking and portfolio concentration, we looked at the performance of strategies with varying levels of risk. This study quartiled managers by tracking error, active money, stock deviation and sector deviation versus the Russell Global Developed Large Cap Index. In each case there was a near-linear progression, with the greatest concentration and deviation from the benchmark garnering the highest level of returns. As you can see in the exhibit below, tracking error had the clearest progression, but each category fits the mold.

Exhibit 2 / Russell's Global Equity Universe Annualized Excess Returns Quartiled by Various Risk Measures



Quarterly average excess returns to active money quartiles for manager universe (2001-2009)

Past performance is not indicative of future results.

Excess returns vs. Russell Global LC Developed

The next question to ask is how this compares to other asset classes; is it unique to global? The answer varies by asset class, but the important thing to note is that the phenomenon is most pronounced within global equities. In fact, global equity managers with the highest levels of active money outperformed managers with the lowest levels of active money by nearly 2%. That is more than double the average spread of other asset classes (see exhibit below). For global equity managers who are already on average more active, concentrated and conviction-led than other products, global “best ideas” products have tended to outperform, and they have done so in a more pronounced fashion than other asset classes have. Global equity managers have tended to have higher active money, which, combined with strong selection (something we will get to later), has led to a larger performance spread.

	Q1	Q2	Q3	Q4	Q4 minus Q1
Europe	-1.59%	-1.35%	-1.46%	-0.52%	1.07%
EAFE	0.85%	0.39%	0.30%	1.79%	0.94%
Global	0.02%	0.36%	0.23%	2.01%	1.99%
Japan	1.96%	1.70%	1.92%	2.58%	0.63%
US MO	0.31%	0.36%	0.57%	1.08%	0.77%
US Growth	-0.33%	0.61%	0.44%	1.54%	1.87%
US Value	0.49%	1.36%	0.92%	0.63%	0.14%

The indexes are the Russell Global Developed Europe, Russell Global LC Developed ex NA, Russell Global LC Developed, Russell Global Japan, Russell 1000, Russell 1000 Growth, Russell 1000 Value in descending order.

Past performance is not indicative of future results.

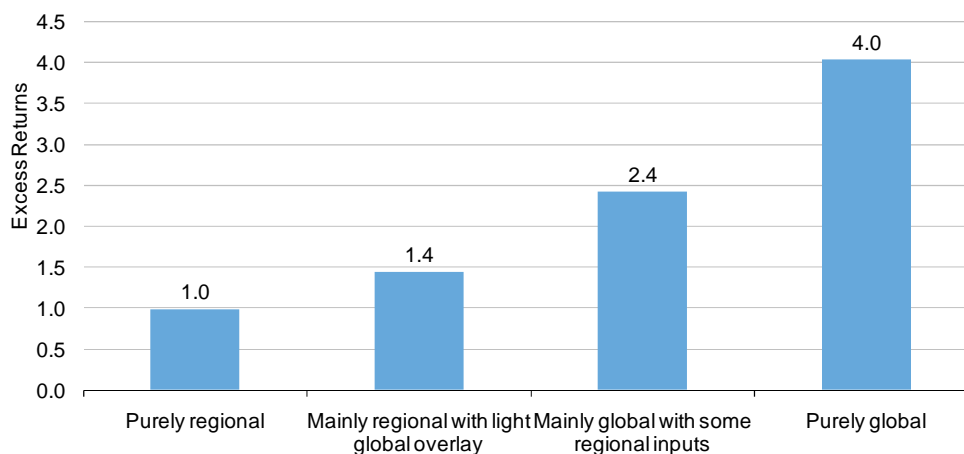
What type of manager wins in global?

As discussed above, we highly recommended adding global equities to a pension plan's portfolio allocation. Just adding global equities can help to increase diversification in a plan and potentially increase returns, but also specifying the type of management style to deploy greatly potentially increases the ability to add value. In decades of manager research, Russell has formed qualitative views of which managers tend consistently to do best in global equities. Combining this experience and perspective with our deep quantitative research, we have identified a rich pool from which to select global equity managers. Their approaches, detailed further below, include taking a fully global perspective; choosing young firms, with low assets under management; utilizing a concentrated, best-ideas strategy; maintaining high flexibility in coverage; and implementing with high process consistency.

Fully global

Within the universe of global equity managers, a gradual change over the past 20 years has been the transformation of processes from regional to fully global in nature. Improved technology and information flows and better accounting standards have greatly increased managers' ability to operate fully global platforms. We have tracked this progression and monitored the performance of managers whose practices take a variety of approaches along the regional to global spectrum. Russell's own research (see the exhibit below) shows that both over the long term and in recent years, managers offering "purely" or "predominantly" global products have tended to outperform those offering "purely" or "mostly" regional mandates. As we discussed in earlier papers, this has led to a transformation of the universe as a whole. Managers have recognized the benefits of a fully global approach, and new products launched have tended to be fully global in nature.

Exhibit 3/ Annualized Excess Returns by Global versus Regional from 1991 to 2010 (Average)



Past performance is not indicative of future results.

Excess returns vs. MSCI World Index.

The universe used is INTWORLD, the Russell Global Equity Universe.

While much of this outperformance has come from stock selection (see the exhibit below), global managers have also better exploited opportunities such as those

associated with the underperformance of U.S. equities and the outperformance of emerging markets. As discussed earlier in this paper, there are a number of advantages to the fully global approach, ranging from breadth of opportunities to the ability to play global themes.

Exhibit 4 / Excess Annualized Return Contribution from Stock Selection within Country

	Growth %	Core %	Value %	Total%
5 Years	0.8	1.1	0.3	0.7
10 Years	-0.7	1.1	4.5	1.5
Since 1990	0.8	0.7	2.0	1.0

As of 6/30/2010.

Past performance is not indicative of future results.

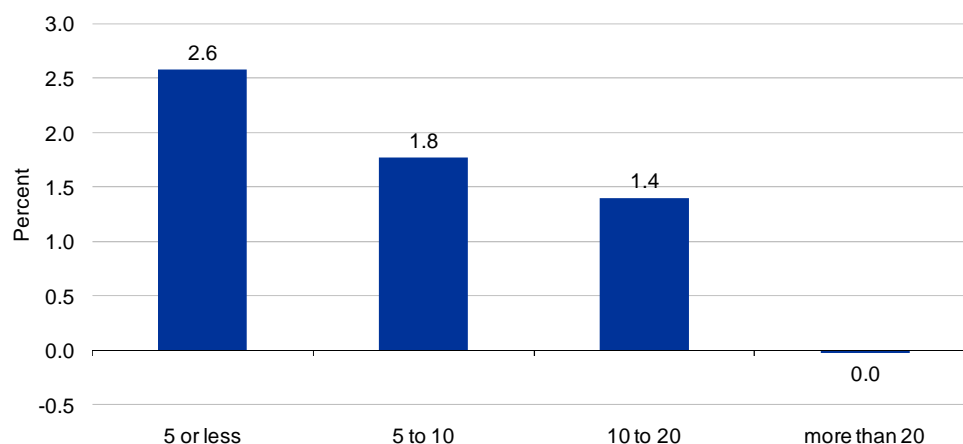
Excess returns vs. MSCI World Index.

The universe used is INTWORLD, the Russell Global Equity Universe.

Small is beautiful

Russell has espoused the view that across asset classes, young firms with smaller asset bases tend to outperform their more established, greater asset – wielding brethren. Russell and others have published quantitative studies to support this claim. The results are no different in global, showing that as assets increase beyond a critical mass, firm performance suffers. Research undertaken by Russell confirms a link between the size of a firm’s investment team and its assets under management with performance. In the first exhibit below, you can see that excess returns over the five-year period from 2006 through 2010 decline monotonically as investment team size rises. Teams with fewer than five investment professionals have added about 2.6% above the index over the past five years. Compare that with teams of more than 20 people, which have lagged the benchmark slightly.

Exhibit 5 / Annualized Excess Returns Relative to Russell Global Large Cap Developed Index by Size of Team from 2006 to 2010

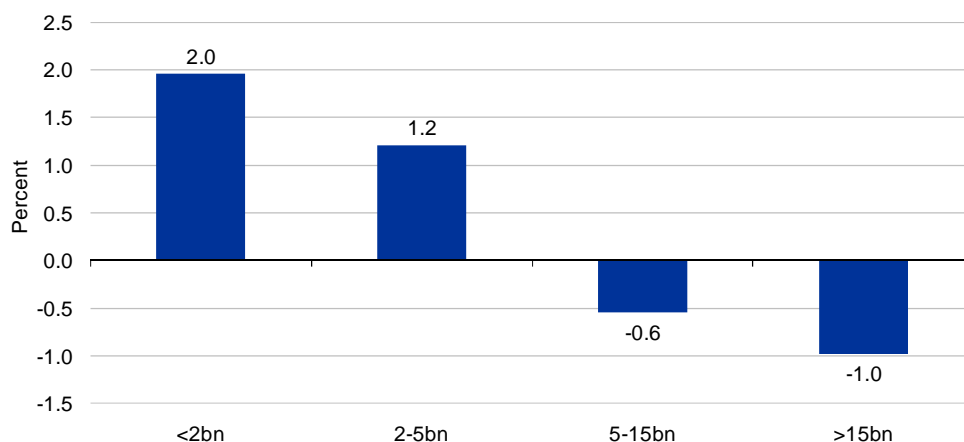


Past performance is not indicative of future results.

Based on the Russell Global Equity Universe (Intworld) and is categorized within the universe.

The spread for firms with relatively higher levels of assets is even more evident. While the asset levels set below are somewhat arbitrary, we can again see a consistent pattern. Those managers with assets above \$15 billion have, on average, underperformed by nearly 1% versus their benchmarks. Compare that with firms earlier in the asset growth cycle – firms with less than \$2 billion in assets, for example – and you can see that in the five-year period, managers with greater numbers of assets under management significantly underperformed their smaller counterparts.

Exhibit 6 / Annualized Excess Returns Relative to Russell Global Large Cap Developed Index by Assets Under Management from 2006 to 2010



Past performance is not indicative of future results.

Based on the Russell Global Equity Universe (Intworld) and is categorized within the universe.

This critical mass varies widely by firm depending on trading capabilities and investment strategy. However, the return premium for smaller investment firms is evident. Why is this?

One obvious reason is that as assets under management within a strategy rise, investment flexibility decreases. Investment flexibility is affected in two ways. First, the more assets a team is managing, the greater the market impact it suffers as it enters and exits positions in the portfolio. Second, as assets under management increase, there will be fewer opportunities for the team to invest in small companies, which often comprise a fertile hunting ground for active managers – reducing both the portfolio’s opportunity set and its alpha potential. In addition to retaining more investment flexibility, smaller teams tend to work and communicate more efficiently than larger teams. Most crucially, the lead investor(s) is more directly involved with all investment decisions when the team is small.

Related to this is the observation that there is, arguably, a greater alignment of interest between small firms and their clients than exists for larger firms. When a firm is small, and especially if it is newly founded, its survival is almost entirely dependent on its investment performance. Couple this with the fact that many start-ups and boutique asset management firms are heavily staff-owned, and it is easy to understand why such firms tend to produce better results than their larger peers: everyone has a stake in the firm’s success and is pulling in the same direction. A recent study³ confirms these views

³“Extra Gravy When Funds Eat Their Own Cooking.” Joe Morris (June 9, 2010). Ignites/Morningstar. Available at http://www.ignites.com/c/114427/10963/extra_gravy_when_funds_eat_their_own_cooking.

quantitatively. The study finds that funds whose managers have invested at least \$1 million of their own assets score 12 percentage points higher in their categories than funds whose managers invest less than \$10,000 over a five-year span. Those managers with “more skin in the game” generated five-year returns in the 42nd percentile, on average, compared with the 54th percentile for managers investing less than \$10,000.

Global equity, as an asset class, is relatively new and product growth has been remarkable in recent years as the marketplace has shifted from regional to global. With many of the new entrants in the asset class being boutique firms and start-ups, clients have found it advantageous to move early and get access to some of these future stars while they are still small and relatively undiscovered.

“Passivity invites mediocrity; aggressiveness makes its own breaks.”

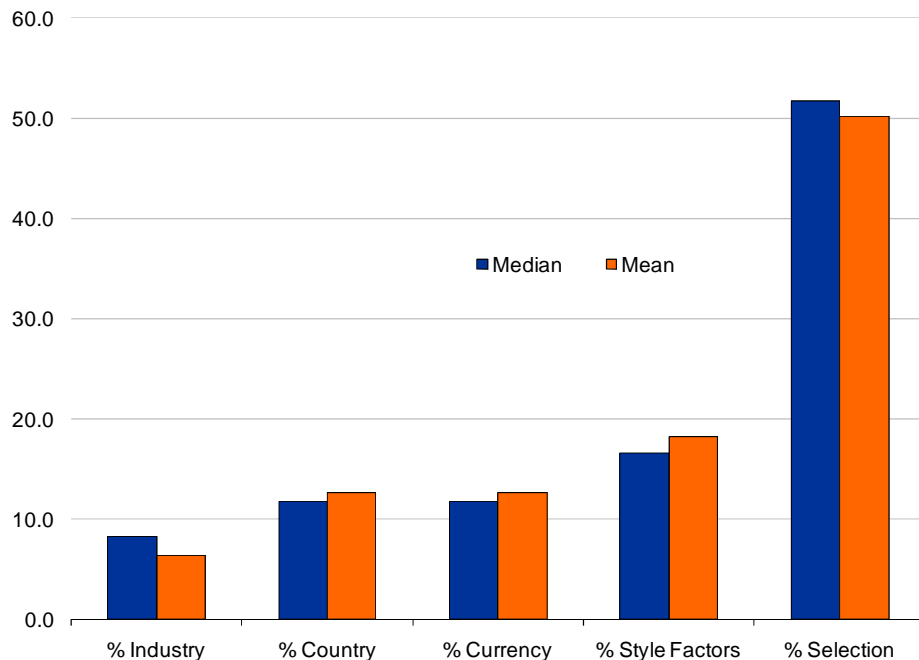
George Raveling, former USC head basketball coach, wasn’t talking about global equity investing when he encouraged aggressiveness in the quote above, but his sentiment is pertinent to global equity investing. Managers can claim they run active strategies but, in reality, outside observers may dub a process a “closet indexer” – meaning the managers do not take risk sufficient to generating substantial excess returns. These days, clients are looking to make their money work harder within active management. This has led to an increase in the proportion of managers who are allowed to run mandates that are less sensitive to benchmarks, to take more risk and to invest more in non-index companies. In recent years this approach has been successful as, in general, managers have been rewarded for taking more risk, and as unconstrained global equity managers have significantly outperformed their more conservative peers. See exhibit 2. Managers’ ability to change opportunistically – to dynamically refresh their portfolios on the basis of current investment outlook – is of utmost importance. This flexibility can manifest itself in a number of ways.

CONCENTRATION

Within global equities portfolios, the average manager holds 117 securities, versus the typical 138 security portfolio in the international equity manager universe⁴. Looking at the data from another angle, 70 global equity managers hold fewer than 50 securities. Only 28 international managers can claim the same trait. The effect of this, on global managers’ portfolios, is that stock selection becomes a key component of risk. To illustrate this, we looked at over 30 managers on the Russell buy list, breaking down the portfolios with a third party risk system, Axioma, looking at percent contribution to active risk (see below). These 30 managers had, on average, more than half of their risk coming from stock selection, the largest contributor to risk, according to Barra risk analytics.

⁴ Here we define international from a U.S. perspective (i.e. managers which invest only in securities outside of the U.S.) Global managers are, again, managers which can invest in any stock around the world. Information based on Russell’s manager research database.

Exhibit 7 / Global Equity Buy List Managers Percent Contribution to Risk



Data as of 12/31/2010 vs. Russell Global LC Developed.
Data is historical and not indicative of future results.

In the exhibit below, we look at stock selection within countries in the global equity universe. You can see that over each period, managers have added value from stock selection, as we showed prior. We want to point out, again, that the large-bet managers have made better selections than managers in the small-bet bucket (by portfolio concentration). Over the period since 1990, the large-bet managers have generated nearly five times more excess return from stock selection. Greater concentration has magnified the excess return opportunity available from stock selection.

Exhibit 8 / Annualized Excess return % contribution from stock selection within country

	5 Years	10 Years	Since 1990
Large Bet	1.2	3.1	2.7
Med Bet	0.3	0.2	.01
Small Bet	0.3	1.2	0.6
Total	0.7	1.5	1.0

Data as of 6/30/2010.
Based on the Russell Global Equity Universe (Intworld).
Past performance is not indicative of future results.
Excess returns vs. MSCI World Index.

SECTOR AND COUNTRY ROTATION

Another factor contributing to global equity managers' achieving higher returns is their ability to play global themes and dynamically over- and underweight sectors, countries and regions. We like to call this "top-down breadth." A manager in the U.S. has a good deal of top-down breadth. Managers can choose from homebuilders to semiconductors to capital markets institutions. In all, there are 68 industry baskets to choose from. By contrast, global equity managers also have more than 47 *countries* to choose from,

which means there are theoretically more than 3,200 country industry top-down baskets to choose from. (In reality, the present number of baskets is around 2,500, or 36 times the number of top-down basket opportunities.)

Although markets are increasingly driven by global-sector themes, opportunities to exploit country mispricings still exist, and global managers have more freedom to take advantage of such opportunities than do regional managers. See, for instance, the graphic⁵ below, in which we show sector returns by region in developed markets by use of the Russell Global Developed Index. In 2009, a Japanese manager would have had the opportunity to return more than 30% by overweighting the Japanese consumer discretionary sector, but was unable to access the many superior investment opportunities available in other markets. The global manager, on the other hand, had the freedom to invest anywhere the returns were likely to be highest, and could choose to avoid low-returning areas such as Japan, as many global managers in fact did last year.

Exhibit 9 / 2009 Russell Global Developed Index basket returns %

	Cons Disc	ConsStap	Energy	Financials	Health Care	Industrials	Tech	Materials	Telecoms	Utilities	Total
Asia ex Japan	84.3	70.3	7.18	81.4	41.7	64.0	140.0	99.5	29.1	27.9	76.3
Europe ex UK	34.5	36.4	38.3	43.0	21.8	45.0	28.8	57.1	21.3	11.4	35.0
Japan	30.7	-8.7	-8.0	-15.0	-4.6	11.9	21.0	20.5	-16.1	-21.3	5.4
North America	51.2	15.11	25.6	21.3	21.5	22.6	62.0	56.4	11.5	12.2	30.9
United Kingdom	70.1	38.5	35.8	46.1	25.1	46.5	77.9	129.0	23.6	20.4	45.9
Total	45.9	22.2	29.6	31.3	20.7	28.7	54.2	64.4	14.2	8.6	32.4

Past performance is not indicative of future results.

Data for the year 2009 was chosen to illustrate the large dispersion that can exist among regions.

Many important investment themes are global in nature, and the best investments may exist in, say, emerging rather than developed markets. Global managers enjoy much greater freedom than regional managers do in roaming across markets to seek out these opportunities. Portfolios can tap into different macro and business-cycle dynamics across the globe. For example, housing in Brazil is at quite a different stage than it is in the U.S. or Ireland. Defense spending cycles differ widely from country to country. Sovereign debt risk is apparent in Europe but not in Singapore, which has a current account surplus. The ability to find the best macro and business cycle dynamics is a key driver of higher global equity returns.

Our research shows that historically, global managers have taken advantage of such opportunities and added value from taking country and sector bets. One way to view this is by breaking out manager returns attributable to stock selection versus returns derived from country allocation. In Table 3, we look at Russell's Global Equity Universe average over the past 5, 10, and 20 years to see how well managers have allocated to countries. In total, managers since 1990 have added 81 basis points from their country allocations, with value managers driving the success more so than the growth managers.

⁵ Source: Russell Investments, as of 12/31/2009.

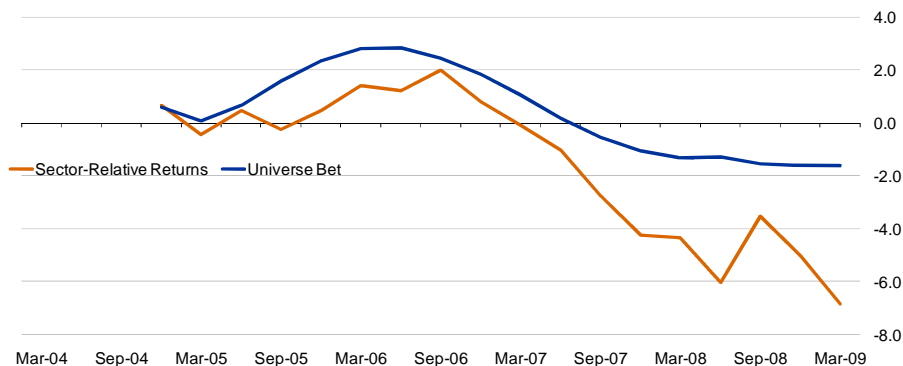
Exhibit 10 / Russell Global Equity Universe Annualized Excess Return Contributors from Country Allocation

	Growth %	Core %	Value %	Total%
5 Years	1.6	1.1	1.5	1.4
10 Years	0.9	0.7	1.4	0.9
Since 1990	0.0	0.8	1.6	0.8

Past performance is not indicative of future results.
Data as of 6/30/2010. Excess returns vs. MSCI World Index.

Anecdotally this can be seen through the 6% average underweight to the U.S. by global equity managers (Russell Global Universe) in the 2000s. During the last decade, the U.S. underperformed global equity markets (Russell Global Index) by 14.4%. From a sector allocation standpoint, managers have also been reasonably successful. To illustrate this, we can look no further than to the cause of the latest crisis, the financials sector. In the graph below, we look at the relative performance of the global financials sector and the global equity universe bet versus the index in the financials sector. What you will notice is that managers in general did a good job of overweighting the sector (blue line) in the run-up to 2007, when banks were making sizable profits and outperforming the market (orange line). During the first quarter of 2007, managers moved underweight the sector, on average, benefiting when sector performance rolled over. Though managers are first and foremost stock selectors rather than sector or country allocators, the global equity mandate requires enough flexibility such that portfolio managers can take advantage of disequilibria in a country or sector. Over time, this is another lever global equity managers have successfully employed to boost excess returns.

Exhibit 11 / Russell Global Equity Universe Four-Quarter Moving Average Bet to Financials and Financials Four-Quarter Sector-Relative Returns %



Data as of 06/30/2010.
Past performance is not indicative of future results.

FLEXIBILITY IN EMERGING MARKETS

We will talk more about this in part four of this series, but the ability to access opportunities in emerging markets is a key benefit for global managers. Research coverage and the ability to rotate in response to opportunities is an important part of manager processes. In the exhibit below, you can see global equity managers' emerging markets coverage compared to that of the emerging markets index. The circles represent all of the stocks in the emerging markets index and a representative global equity fund, with the size of the bubble being the weight of the stocks in the index or the fund, respectively. The axis shows the Axioma value score on one axis and the size (market cap) score of the stocks on the other. That is, a large bubble in the bottom left-hand quadrant will be a big fund weight in a small cap growth stock. One way to judge flexibility within emerging markets is to look at the breadth of coverage. There should be coverage across the style spectrum (left to right on the graph) and at various points along the capitalization spectrum (top to bottom on the graph) within emerging markets, traits that are apparent among Russell's selected global equity managers in the exhibit below.

Exhibit 12 / Emerging Markets Holdings for a Representative Global Fund



Graphic is shown for illustrative purposes only and is not intended to represent an actual investment.

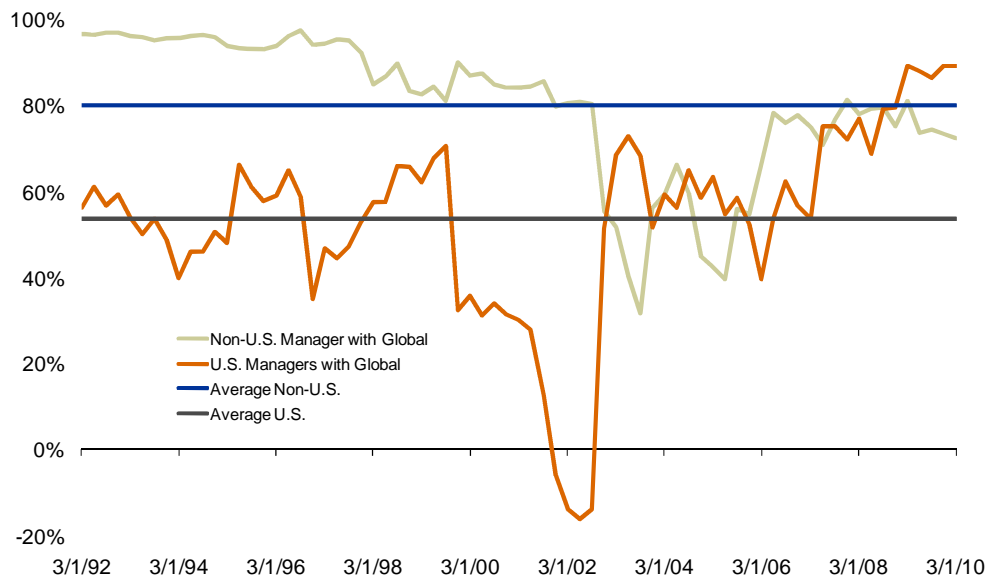
ABILITY TO MOVE ALONG THE CAPITALIZATION SPECTRUM

As mentioned, small cap companies can be an area where active managers can add tremendous value. Calendar year 2009 is a good example of a market environment in which global managers owning small cap stocks were rewarded. However, as we saw in 2008, smaller cap companies can also have periods where the risks of smaller cap companies outweigh the return potential due to bankruptcy fears, risk aversion, and funding concerns. The ability to take advantage of the opportunities, when present, in small caps coupled with the ability to overweight larger cap companies when prudent adds another lever for managers and increases their likelihood of success.

Diversification: The only free lunch in finance

Beyond the potential returns, there is another key benefit to adding global equity managers to portfolios: diversification. Global strategies can complement existing regional strategies, providing a diversified set of returns within clients' plans. In times of stress, correlations increase and diversification appears to be nonexistent, but global equities offer superior diversification over the long term. This is true not just within global equity portfolios (i.e., uncorrelated securities in portfolios mitigating risk), but also at the broad plan level. Equity correlations have risen over the years, but from a diversification perspective there still remains a sizable benefit to adding global equity. In the following exhibit,⁶ we show excess return correlations for U.S., international⁷, and global active equity managers. The excess return correlation between U.S. managers and global equity managers has varied from -0.2 to about 0.9, but, on average, the correlations are less than 0.5. While international and global managers perform similarly (due to the propensity of both asset classes to include an out-of-index bet in emerging markets), there are still diversification benefits to be had with a correlation of less than 0.8. For clients currently employing a regional structure consisting of six components including the U.K., Europe ex-U.K., Japan, Asia ex-Japan, the U.S. and emerging markets, the diversification benefits are arguably even higher, as the correlations of said strategies are lower than between a non-U.S./U.S. and a global construct. However, by adding global to existing portfolios, clients may be able to get access to a diversified set of returns and lower volatility.

Exhibit 13 / Median Manager 3-Year Rolling Annualized Excess Return Correlations versus Global Managers



Past performance is not indicative of future results.

Data as of 3/31/2010. Excess returns vs. MSCI World, MSCI EAFE and Russell 1000 Indexes.

⁶ Source: Russell Investments as of 3/31/2010. Depiction is of Russell U.S., EAFE, and global manager universes.

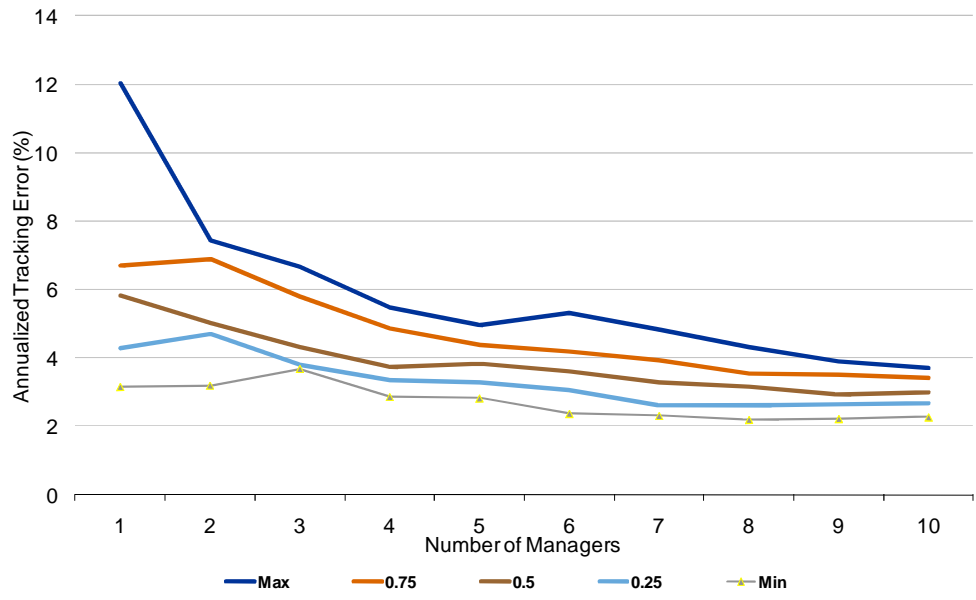
⁷ Again, international as defined by a U.S. investors

Applying the multi-manager framework to global investing: the best of both worlds

As we have espoused in other asset classes, our experience shows that a multi-manager approach makes sense in global equities. Judging by the criteria already discussed, multi-manager funds are even more compelling in global equities than in other asset classes. We have talked much about global equity managers' traits – high-alpha, large-bet managers who take sizable risks in a concentrated fashion. While the return premium has proven to be large over the past decade, the question clients typically ask themselves is: "Can I stomach the risk of these strategies, so that I don't sell at exactly the wrong time (after a period of a given stock's or sector's underperformance)?" As stand-alone approaches, these strategies might be too volatile for most clients, but in a smartly constructed portfolio, much of the risk can be dampened by combining diversified return patterns.

To further illustrate the diversification benefits of global equities, we performed a simulation using the quarterly performance figures of the Russell Global Equity Universe. Using the 76 global equity managers and 10 years of history, we ran 1,000 random simulations of multi-manager structures with anywhere from one to 10 managers in each. In the next exhibit, we show the results of the 10-year tracking-error distribution for the 1,000 randomly constructed simulated portfolios. One can see that in a single-manager fund, for instance, the maximum tracking error was just over 12% for the 10-year period (blue line), and the minimum tracking error within the global equity universe we follow was just over 3% (yellow line). Even using random manager combinations, diversification causes a substantial reduction in tracking error. By going from one randomly selected manager to six randomly selected managers, the median 10-year tracking error for a simulated global composite falls from nearly 6% to less than 3.6% (green line), a near-40% reduction. Through this naïve simulation, one can see a substantial benefit to using multiple managers within the global equity universe. Beyond naïve diversification, however, there is even greater potential opportunity via intelligent combination of managers.

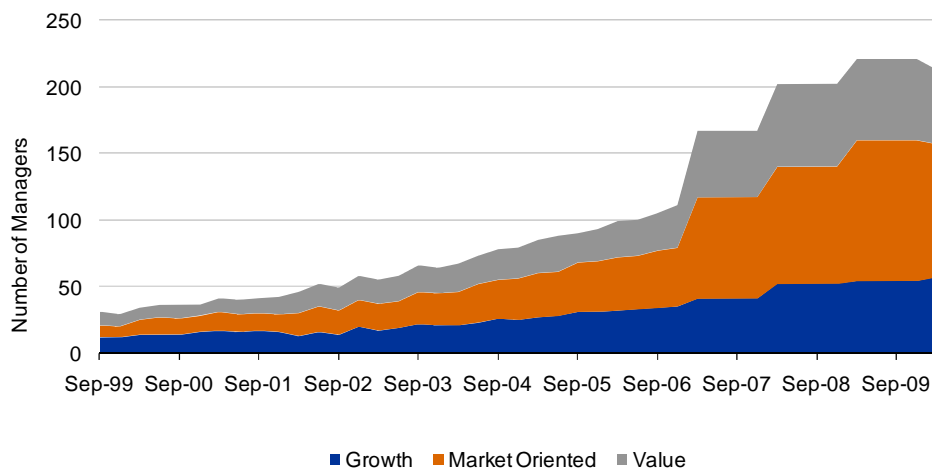
Exhibit 14 / Tracking Error for Simulated Multi-Manager Composite (All Styles) 10 Years Ending June 30, 2010



Past performance is not indicative of future results

We mentioned earlier that the second-highest contribution to risk for global equity managers is in style risk factors, just behind stock-selection risk factors. Changing dynamics in the global equity space over the past 15 years have made this truer than it was previously. With the explosive growth in global equity products, there has also been greater style delineation (see below), so much so that we have created sub-styles within global equity universes to better represent close peers. This style proliferation has meant that there is an adequate pool within each style and sub-style to enable multi-manager products to select from among best-of-breed managers, rather than from among the best of a more restricted and thus potentially sub-par lot.

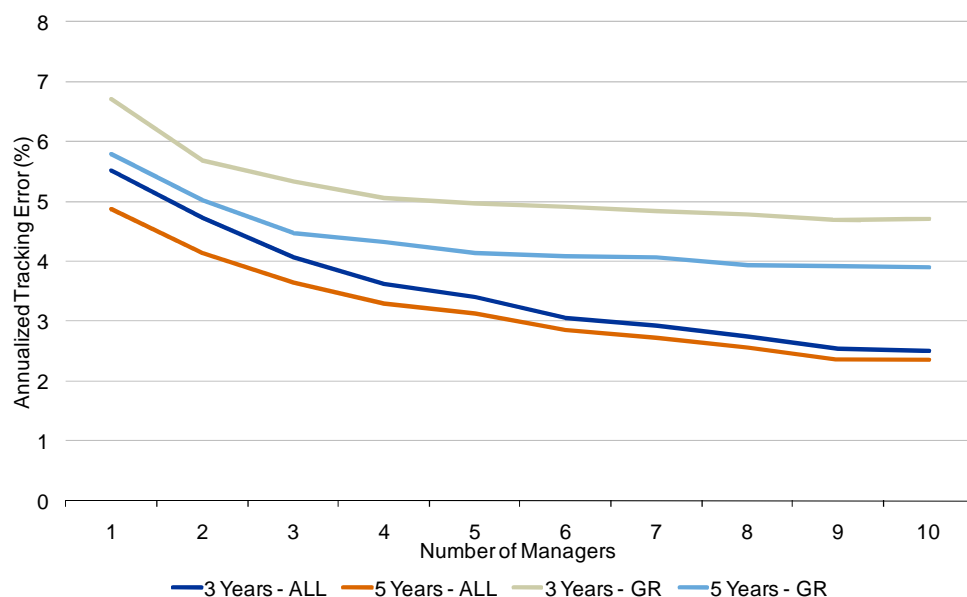
Exhibit 15 / Russell Global Equity Manager Universe Growth By Style



As of 6/30/2010. Data is historical and is not indicative of future results.

To show the benefits of style diversification, we again performed the 1,000 simulations described above, this time on a three- and five-year basis using two universes – the entirety of the global equity universe, including all styles; and a subset, the global equity growth universe. In the exhibit below, instead of showing the distribution as seen in the exhibit above, we show the three- and five-year average tracking error for various numbers of managers. Again, the results point to reducing tracking error by adding managers, both in the global equity universe and the global equity growth universe.

Exhibit 16 / Average Tracking Error for Simulated Multi-Manager Composite Ending June 30, 2010



Past performance is not indicative of future results.

The more important results from this, however, are the differences between the growth universe and the all-styles universe. By going from one randomly selected growth manager to six randomly selected growth managers, the three- and five-year tracking errors are reduced by 27% and 30%, respectively. By going from one randomly selected manager (all styles) to six randomly selected managers, the three- and five-year tracking errors are reduced by 45% and 42%, respectively. The style diversification adds another level of tracking error reduction, allowing the multi-manager composites to reduce risk further than would a single-style approach. The last point to make regarding these simulations is that they are just that: *random* simulations and, therefore, lacking the benefit of any special skills or insights into the selection and combination of managers. Were such skills applied, the results are expected to be significantly improved upon.

Walking the talk

Much of the preceding discussion has looked at the various attractions of global equity and how it lends itself to an active approach, more so than other equity asset classes. A logical conclusion is that global equity is particularly well suited to a multi-manager approach. Applying our insights about active management, which we have discussed

earlier in this paper, we believe global equity multi-manager funds should be designed with the following features:

- Small teams and boutique managers – teams characterized as boutique managers or small teams are focused around a narrow set of products with global equities at the core. By emphasizing small teams, it can be argued, managers stay aligned with clients' primary interest – maximizing excess returns – by maintaining the flexibility to rotate in response to opportunities. “Key-person risk” is often a feature of such teams, but understanding incentive structures and endorsing appropriate mechanisms for long-term retention, so that key individuals are tied in for a specified duration of time, helps mitigate said risk.
- Fully global, high-alpha managers – by using only fully global equity managers running aggressive, high-conviction strategies, clients are selecting from a subset of managers that our research has shown are expected to achieve the highest returns.
- Differentiated by style – in selecting managers, clients should aim as nearly as is possible to make sure that manager styles and excess return patterns are uncorrelated. This reduces the level of risk associated with individual styles, which may go in and out of favor over time, and leads to a more smooth and consistent pattern of performance.
- Concentrated fund structures – while diversification is essential, it needs to be commensurate with the amount of excess return managers are expected to deliver for clients. Our research suggests that the majority of the benefits from diversification are achieved with four to six managers in global equity.

While there is no guarantee that such strong results for global equity will continue into the future, our research argues strongly in favor of active management in this arena. Moreover, our experience shows that by combining boutique, style-diversified, high-alpha managers within a multi-manager structure, the potential from active management can best be realized. Beyond providing the potential for excess returns, global strategies provide a strong complement to the other regional equity strategies currently employed in many clients' plans. The ability to make global tradeoffs needed to run global equity products provides a strong complement to the local-market knowledge that is important for achieving excess returns in regional structures. Through a combination of global products, which emphasize the characteristics discussed above, and regional products, which emphasize local-market strengths, clients are arguably better served and provided a higher probability of achieving excess returns.

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