Russell Indexes Quarterly Commentary

Market Review

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The structure of global equity markets at Russell index reconstitution June 2010

The annual reconstitution of the Russell Indexes took effect after market close on June 25, 2010. In this commentary we again take an opportunity to examine the structure and characteristics of global equity markets at Russell Reconstitution, putting the BRIC countries—Brazil, Russia, India and China—in the spotlight.[1] Our focus on these four countries highlights how the Russell Global Indexes, which are constituted on a global-relative rather than country-first basis, illuminate the structure of the world equity markets in terms of emerging vs. developed countries; regional distribution; sector and style.[2]

A partial recovery in global market values

During the twelve months from July 1, 2009 and June 30, 2010—Recon Year 2010[3]—global markets experienced partial recovery from the massive decline in valuations that occurred during the prior 12-month period. Markets actually hit bottom in March 2009, three months prior to Reconstitution, and as of the date of this writing have not again reached or broken through that low. The early months of Recon Year 2010 saw increasing confidence that the worst was over, leading the IMF to declare in August that the global recession had ended. The U.S. National Bureau of Economic Research, however, did not follow suit and call the recession at an end in the U.S. This disparity in official recession dating reflects investors' and observers' continuing uncertainty about

[1] The author thanks Oanh Hoang for her invaluable contribution to this research.

[2] For prior analysis on Russell Index methodology and BRIC countries, see M. Fjelstad, "BRIC Countries after Russell Index 2009 Reconstitution: a Snapshot in Time," Russell Research, July 2009, and K. Haughton, X. Yan, G. Cano and P. Velvadapu, "It's all a matter of perspective," Russell Indexes, March 2008.

[3] For purposes of this paper, we employ the term "Recon" to designate the last day of June in each year when Russell Reconstitution impacts the month-end reporting of index returns, weights and characteristics. For example, Recon 2009 refers to the last business day of June 2009; similarly, Recon 2010 refers to the last business day of June 2010. We further define the twelve-month period from one Reconstitution to the next as a "Recon Year," e.g., for Recon Year 2010, returns are calculated for the 12-month period beginning July 1, 2009 and ending June 30, 2010. See the Appendix for a full mapping of terminology to exact dates.

the state of the global economy, uncertainty which became increasingly evident during the first half of 2010.

Figure 1 shows that from July 2009 to June 2010, global equity markets as measured by the Russell Global Index increased 14% in value, reaching a total valuation level of $27.146 trillion. It also clearly shows that valuations have not yet returned to the levels seen in 2006–2008. Equity markets reflect continuing concerns regarding the strength of the global recovery: the management of stimulus programs by key countries; the ability of China to manage continued growth; and above all, European sovereign debt levels and the viability of the Euro.

Figure 1

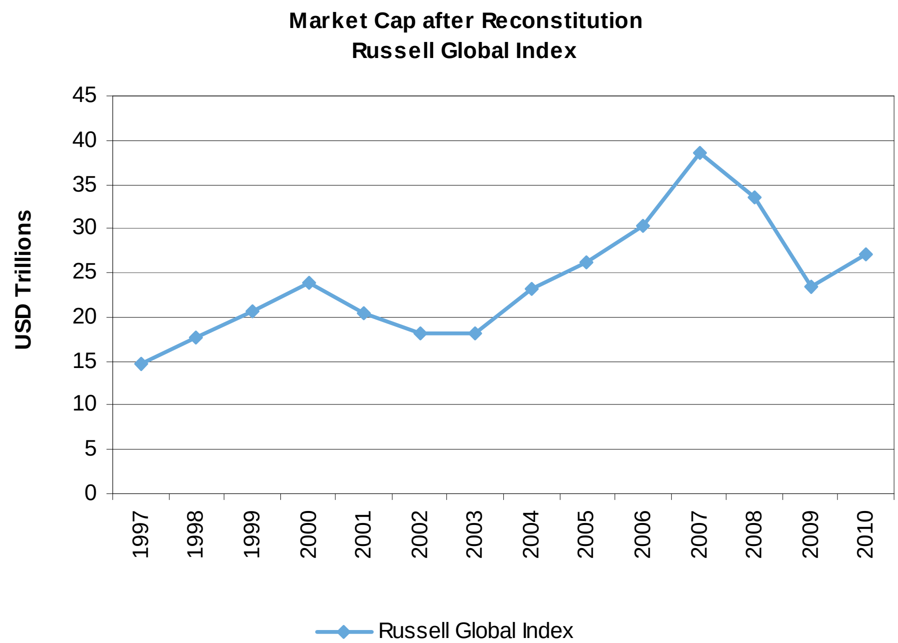
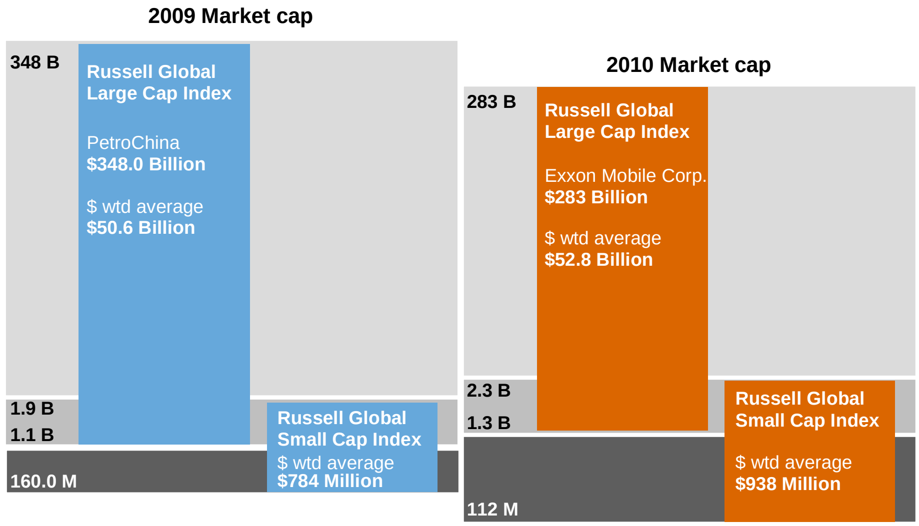


Figure 2 highlights the mixed impact the recovery has had on the capital structure of the Russell Global Index: the market cap of the largest and smallest companies has declined over the period, even though aggregate global market cap has increased, as shown in Figure 1.

Figure 2 / Global capitalization rank comparison



Data as of May 29, 2010

Our snapshot of global equity markets as of the Recon Year ending June 2010 reveals some notable changes, many of which are continuations of long-term trends:

- Emerging Markets gained again in importance within the Russell Global Index at the expense of Developed, continuing a long-term trend.
- The North America region—Canada and the U.S.—gained the most ground within the Russell Global Index. Latin America and the Asia-Pacific region also increased in index weight, and Europe suffered a reduction in weight of 2% relative to its position as of June 2009.
- Global sector structure remains stable, although returns during the year were mixed across defensive and aggressive sectors, in line with the general uncertainty regarding the state of the recovery. Energy and Utilities dramatically underperformed the Russell Global Index; Health Care and Financial Services also fell short. Best sector performance relative to the other sectors was achieved in the Consumer Discretionary, Producer Durables, Materials and Processing, Consumer Staples and Technology sectors.
- The better performing sectors were those more heavily weighted toward growth, either as of the beginning of our period under review—July 2009—or moving toward a growth bias by the end. Growth outperformed value globally over the year, and small cap stocks trounced large cap: the small cap premium over the 12 months under review was 7.2%.
- Certain sectors experienced significant style shifts: Energy and Utilities became more heavily weighted toward value; Heath Care, formerly strongly growth, is now balanced; Materials and Processing, Consumer Discretionary and Producer Durables are now more solidly growth sectors.

The BRIC countries are often cited as examples of life imitating art. The BRIC concept was first introduced in 2001 by Goldman Sachs to highlight opportunities in emerging market countries, and the world eagerly embraced it. Brazil, Russia, India and China have significantly increased their economic ties since 2001. China has become the biggest trading partner for both India and Brazil. There are important synergies among these countries in the exchange of raw materials, manufacturing and consumption.

It may be that these four countries would have naturally increased their economic interactions even without the help of the clever BRIC acronym. It seems, however, that the concept may have contributed to increased awareness of how advantageous such cooperation could be. The countries now hold annual BRIC economic conferences, the second of which took place in April 2010 in Brasilia. (A separate BRIC meeting that was to have been held during the recent G20 Summit was cancelled at the last minute when flooding in Brazil meant President Luiz Inácio Lula da Silva would not be attending.) Our spotlight on the BRIC countries reveals that during Recon Year 2010:

- All four countries increased their weights in the Russell Global Index. The greatest gain was by India; in absolute terms (simple difference in index weight), India had the biggest gain, followed by Brazil and China, and Russia last. When we look at percentage change in index weights from the year before, China experienced the smallest increase. Of the four, India and China contributed the most new constituents (net) to the Russell Global Index.
- Brazil, Russia and India all outperformed the Russell Global Index over the 12 months, but China was flat versus the global return; Russia and India strongly outperformed within their respective regions.
- Notable sector shifts are: Russia's exposure to Energy decreased, and its exposure to Financial Services and Materials and Processing increased; Brazil experienced a similar reduction in Energy exposure, with increases in Financial Services and Consumer Staples; China's exposure to Financial Services and Utilities is now decreased, tipping more toward Consumer Discretionary and Technology. India's sector structure remains the most consistent of the four countries over this period.
- In terms of cap structure, we see only minor changes, with China and Russia tipping marginally more toward small cap. India is still the most entrepreneurial of the four countries (more heavily exposed to small cap), and Russia and Brazil continue to be biased toward larger companies.

Emerging markets in the global economy

At Recon 2009 we noted a minor increase in the weight of emerging markets in the Russell Global Index, a reflection of the fact that the global economic crisis had a greater impact on the developed world. We see a continuation of this trend as of Recon 2010. The Russell Global Index as of June 2010 reflects an additional and indeed greater shift in the relative importance of emerging markets in the world economy. Key measures of the positions of developed and emerging markets within the Russell Global Index are shown in Table 1.

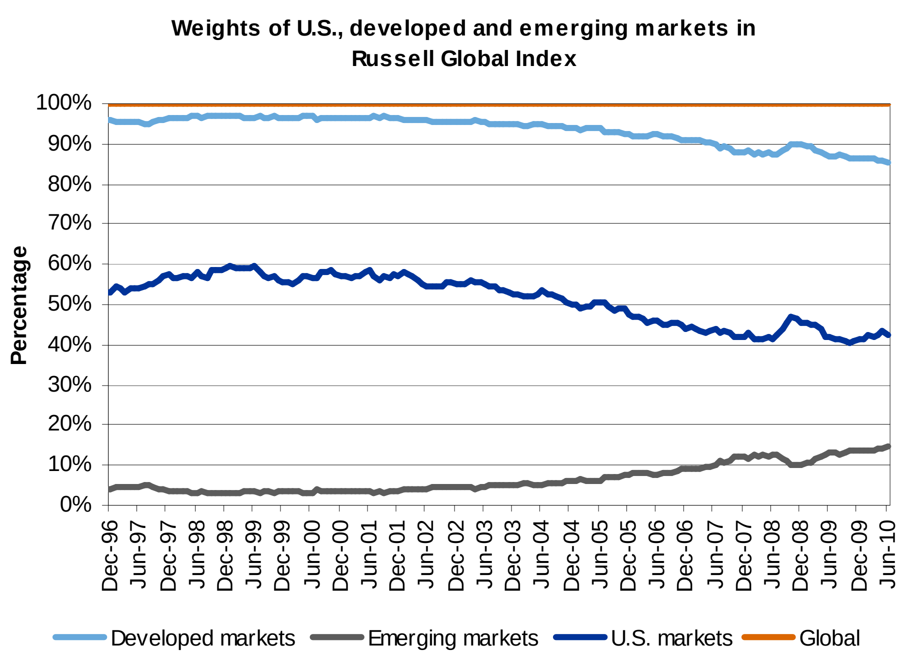
Table 1 / Key statistics for developed and emerging equity markets, Recon 2009 and Recon 2010[4]

	2010		2009		Change from 2009	
Developed		**% of Global**		**% of Global**	**Difference**	**% Change**
# of securities	7,471	70.8%	7,548	72.3%	-77	-1.6%
# of countries	26	42.6%	26	40.0%	0	2.6%
Market cap (US$ B)	23,184	85.4%	20,345	87.0%	2839	14.0%
Change in index weight					-1.5%	
Emerging						
# of securities	3,100	29.3%	2,890	27.7%	210	1.6%
# of countries	35	57.4%	39	60.0%	-4	-2.6%
Market cap (US$ B)	3,962	14.6%	3,060	13.1%	902	29.5%
Change in index weight					1.5%	

As of Recon 2010, there are four fewer countries represented in the Russell Global index, and all four— Argentina, Bulgaria, Lithuania and Sri Lanka—are emerging markets countries. Nevertheless, despite this elimination, the Russell Global index has an increased proportion of securities from the emerging world markets: developed markets lost in aggregate 77 companies, and emerging gained 210. In terms of market weight, emerging markets gained 1.5% at the expense of developed and presently constitute 14.6% of global equity market cap.

Figure 3, below, gives more perspective on the history of emerging markets in the global economy. Here we see the changing proportions of emerging markets versus developed (U.S. and ex-U.S.) markets since 1996. This chart demonstrates a slow but (except during the brief period of intense risk-aversion during the global crisis) steady increase in emerging markets' weight in the global economy over these 15 years.

Figure 3



[4] Market cap values are float-adjusted.

Investor preference for emerging markets is also reflected in equity market performance over the 12 months July 2009 through June 2010, as Figure 4 shows. In this period, emerging markets returned nearly 25%, outperforming developed markets by 12.4%.

Figure 4

Index performance shown here and in subsequent charts is not indicative of the performance of any specific investment. Indexes are not managed and can not be invested in directly.

Within the emerging markets world, the four BRIC countries are by many measures the largest; as of Recon 2010, all four carry larger weights in the Russell Global Index than they did a year earlier, as we see in Table 2.

Table 2 / BRIC countries in the Russell Global Index: 2009 and 2010 at Reconstitution[5]

	2010		2009		Change from 2009	
		% of Global		% of Global	Difference	% Change
Brazil						
# of securities	198	1.9%	191	1.8%	7	3.7%
Market cap (US$ B)	547	2.0%	420	1.8%	127	30.2%
Change in index weight					0.2%	12.3%
Russia						
# of securities	120	1.1%	89	0.9%	31	34.8%
Market cap (US$ B)	260	1.0%	196	0.8%	64	32.7%
Change in index weight					0.1%	14.4%
India						
# of securities	480	4.5%	404	3.9%	76	18.8%
Market cap (US$ B)	393	1.5%	281	1.2%	112	39.9%
Change in index weight					0.3%	20.6%
China						
# of securities	417	3.9%	314	3.0%	103	32.8%
Market cap (US$ B)	671	2.5%	533	2.3%	138	25.8%
Change in index weight					0.2%	8.5%

[5] Market cap values are float adjusted

Looking at absolute differences in market cap, China leads the pack (+$138B); Brazil follows (+$127B); then comes India (+$76B), and finally Russia (+$64B). China and India account for the greatest number of new companies in the Russell Global Index, adding 103 and 76 names, respectively. India had the greatest percentage increase in weight in the Russell Global Index, followed by Russia and Brazil; however. China had the smallest improvement in position as measured by percentage increase in weight within the Russell Global Index of these four countries.

The importance of regions: Europe continues to struggle

North and Latin America, as well as the Asia-Pacific region, grew in importance within the Russell Global Index at the expense of Europe over the 12 months from July 2009 through June 2010. Growing alarm over sovereign debt levels, doubts about the viability of the Euro and uncertainty regarding the impact of austerity measures within Europe were important factors contributing to this change. The greatest increase in regional weights in the Russell Global Index was in North America (U.S. and Canada), but Latin America and the Asia-Pacific, home to three of the four BRIC countries, also had positive change. Despite Russia's increased weight, noted above, Europe as a whole now constitutes 2% less of global markets than it did at Recon 2009.

Table 3[6] / Key statistics for major world regions in the Russell Global Index, Reconstitution 2009 and Reconstitution 2010[7]

	2010		2009		Change from 2009	
		% of Global		% of Global	Difference	% Change
North America						
# of securities	3,468	32.8%	3,395	32.5%	73	0.3%
# of countries	2	3.3%	2	3.1%	0	0.2%
Market cap (US$ B)	12,770	47.0%	10,753	45.9%	2017	18.8%
Change in index weight					1.1%	
Europe						
# of securities	2,170	20.5%	2,246	21.5%	-76	-1.0%
# of countries	29	47.5%	31	47.7%	-2	-0.2%
Market cap (US$ B)	6,992	25.8%	6,507	27.8%	485	7.5%
Change in index weight					-2.0%	
Latin America						
# of securities	358	3.4%	367	3.5%	-9	-0.1%
# of countries	5	8.2%	6	9.2%	-1	-1.0%
Market cap (US$ B)	832	3.1%	643	2.8%	189	29.4%
Change in index weight					0.3%	0.3%
Asia Pacific						
# of securities	4,107	38.9%	3,822	36.6%	285	2.2%
# of countries	13	21.3%	14	21.5%	-1	-0.2%
Market cap (US$ B)	6,043	22.2%	5,056	21.6%	987	19.5%
Change in index weight					0.7%	

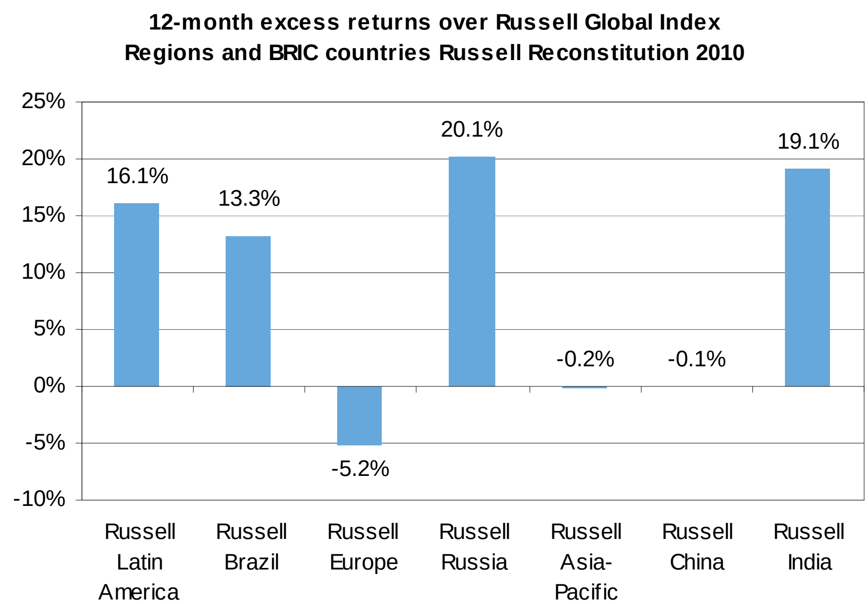
In terms of numbers of constituents, Europe lost by far the greatest number of securities net— 76; Latin America lost 9. Asia-Pacific added an impressive 285 constituents net, and North America added 73 companies net.

[6] Market caps are float-adjusted.

[7] Market caps are float-adjusted.

The fortunes of the BRIC countries afford an interesting comparison to their regions. In terms of net changes within the Russell Global Index, Brazil lines up with Latin America; China and India line up with the Asia-Pacific region; and all experienced increasing importance and representation in the Russell Global Index. This pattern is broken within Europe, however; Russia has experienced positive changes, while Europe as a whole has been reduced. When we compare 12-month performance in excess of the Russell Global Index, as in Figure 5, we also see a mixed pattern: Latin America and Brazil, both positive, are strongly aligned; Russia's return is also strongly positive, in stark contrast to Europe, which underperformed as compared to the overall performance of the Russell Global Index; and within Asia, we see a notable contrast between China, India and the Asia-Pacific region—China and Asia-Pacific were essentially flat to the Russell Global Index, whereas India strongly outperformed.

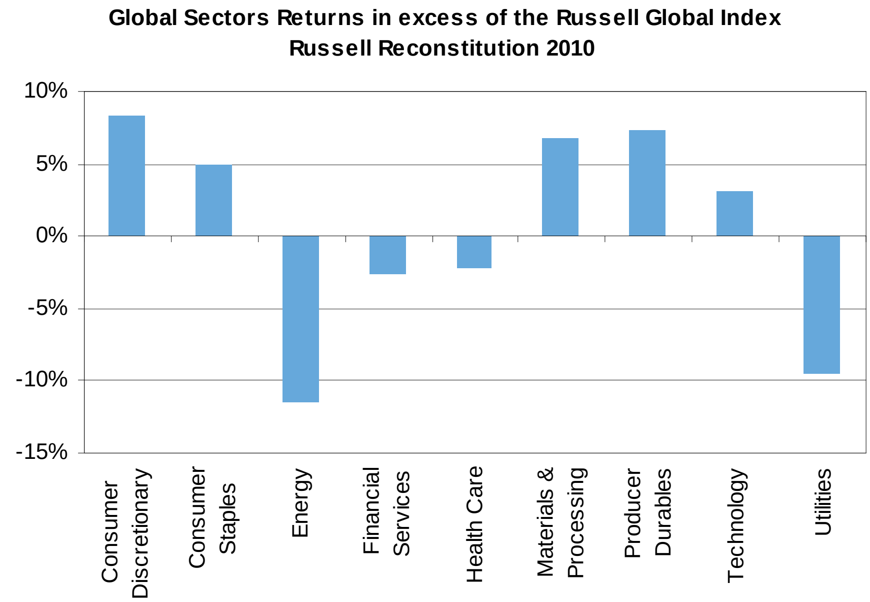
Figure 5



What about sectors?

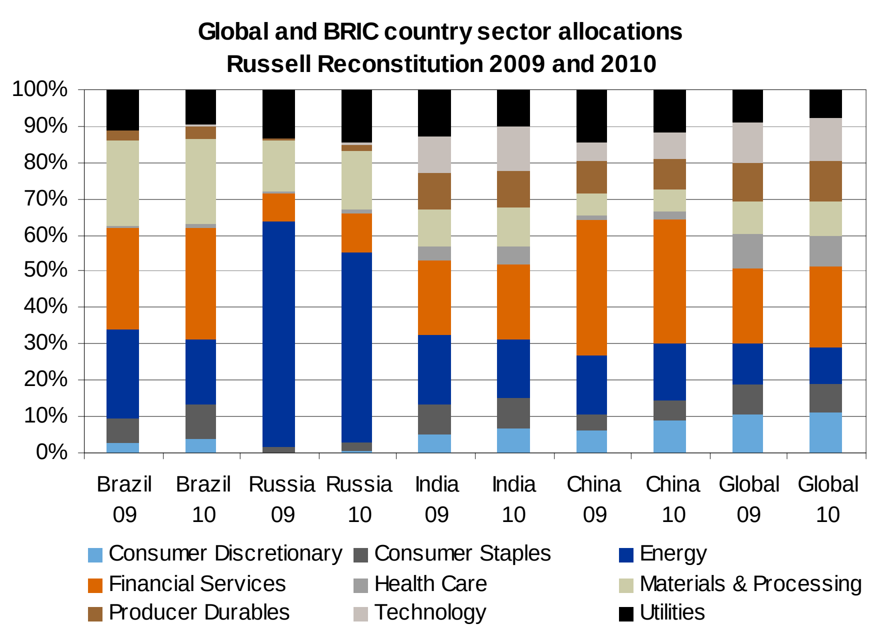
During the 12-month period July 2009 through June 2010, global sectors diverged remarkably in terms of returns, as Figure 6, which reports sector returns in excess of the Russell Global Index, clearly demonstrates. Hardest hit were the Energy and Utility sectors, although Financial Services and Health Care also underperformed. Manufacturing sectors did well: Consumer Discretionary, Consumer Staples, Materials and Processing, Producer Durables and Technology all turned in positive excess performance.

Figure 6



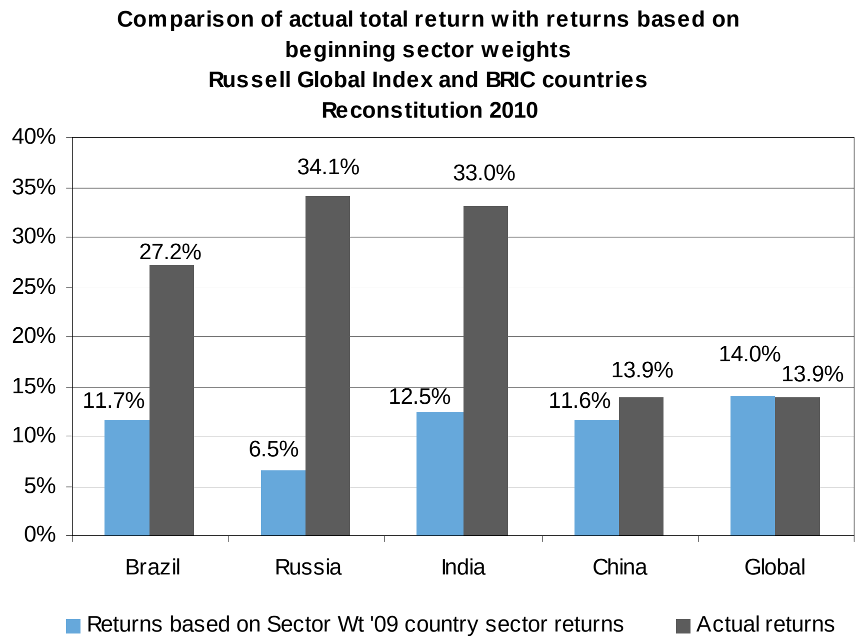
Despite the strong differences in sector performance during Recon Year 2010, we observe only minor changes in the sector structure of the Russell Global Index, although three of the four BRIC countries exhibit larger shifts. Figure 7 shows the sector allocations at Recon 2009 and Recon 2010 for all four BRIC countries, as well as for the Russell Global Index. Sector structure for the Russell Global Index (the two columns to the far right) shows very little change. Only three sectors experienced a shift in allocation greater than 1%: Financial Services increased 1.1%, despite the sector's underperformance; Energy and Utilities decreased 1.3% and 1%, respectively. Among BRIC countries, the most dramatic shift is a declining exposure to Energy, most notably in Russia and Brazil, indicating progress toward more diversified economies in those two countries. China and India also are less exposed to Energy in 2010, but their shifts away from the sector are minor in comparison to Russia's and Brazil's.

Figure 7



A very simple analysis indicates that while sector structure and performance align very well on the global level, for individual BRIC countries, global sector performance does not explain BRIC country returns. Computing the sum-product of Recon 2009 sector weights and global sector returns for the 12 months July 2009 through June 2010, we see first (Figure 8, below) that there is close alignment with the weighted sector returns (14.03%) and actual returns (13.94%) for the Russell Global Index. This is not surprising, given the stability of global sector weights from 2009 to 2010. In contrast, the match-up for the BRIC countries is close only for China—11.6% vs. 13.9%—although even in China's case, actual performance exceeds performance based on global sector returns by 2.3%. For Brazil, Russia and India, actual country performance far exceeds performance based on global sector returns.

Figure 8



BRIC country sector returns diverged significantly from global sector returns during Recon Year 2010, as we see in Table 4. For Brazil, Russia and India, 9 of 10 sectors outperformed global sectors, with Health Care turning in three-digit excess returns in Brazil and Russia. China's performance relative to global sectors was more mixed, however.

Table 4 / BRIC sector returns in excess of global sector returns, Recon Year 2010 (July 2009 through June 2010)

	Brazil	Russia	India	China
Consumer Discretionary	42.9%	9.2%	45.9%	19.5%
Consumer Staples	35.1%	61.7%	26.0%	36.3%
Energy	-4.8%	12.3%	17.0%	12.9%
Financial Services	16.9%	86.8%	20.5%	-3.5%
Health Care	101.6%	103.8%	59.0%	25.2%
Materials & Processing	15.9%	37.6%	21.7%	-19.7%
Producer Durables	30.1%	40.2%	5.0%	-11.6%
Technology	93.1%	-13.5%	47.7%	21.4%
Utilities	27.1%	47.1%	-10.8%	-2.5%

The impact of cap size and style

During Recon Year 2009, we noted that in global equity markets there was very little differentiation between returns of large and small cap sectors, and between growth and value styles. Systemic factors dominated during that period. For Recon Year 2010, we see that investors have once again begun to differentiate between cap and valuation segments in the global market, as reported in Table 5. The biggest premium has been to small cap stocks: the small cap premium (the excess return of small cap stocks over large cap stocks) for 2009–2010 was 7.3% for the 12 months July through June. Value underperformed growth over the same period—down –2.4%, a much smaller year-to-year difference than that seen with cap size; nevertheless, there was greater differentiation in style returns over Recon Year 2010 than over Recon Year 2009.

Table 5 / 12-month returns to global cap and valuation styles (July–June), 2002–2010

	Russell Global Growth Index	Russell Global Value Index	Value premium (value-growth)	Russell Global Large Cap Index	Russell Global Small Cap Index	Small cap premium (small cap - large cap)
2002–2003	-0.1	-0.9	-0.9	-0.8	2.6	3.4
2003–2004	23.1	29.4	6.4	24.9	39.8	14.9
2004–2005	8.1	17.3	9.2	12.2	17.6	5.4
2005–2006	17.4	20.4	3.0	18.4	23.0	4.7
2006–2007	26.2	26.4	0.2	26.0	29.1	3.2
2007–2008	-4.7	-14.2	-9.5	-8.9	-14.4	-5.6
2008–2009	-28.8	-29.1	-0.2	-29.0	-28.2	0.9
2009–2010	15.1	12.7	-2.4	13.2	20.5	7.3

The BRIC countries differ markedly in their exposures to cap size and style. Russell's global-relative definitions of style allow us to recognize and evaluate style differences across countries, rather than forcing all countries and regions to fit the same mold. The world clearly recognizes that countries differ in their sector weights; but countries differ in cap and style exposure as well. In Figure 9 we see that BRIC countries are not equally exposed to large and small cap companies. The most interesting contrast is between Russia, with its notable tilt to large cap, and India, which among the four countries is the most heavily weighted toward small cap. Note that as of Recon 2010, Russia has become slightly less large cap–oriented; a similar shift is seen in China. Brazil's cap structure remained stable over this period, with a bias toward large cap.

Figure 9

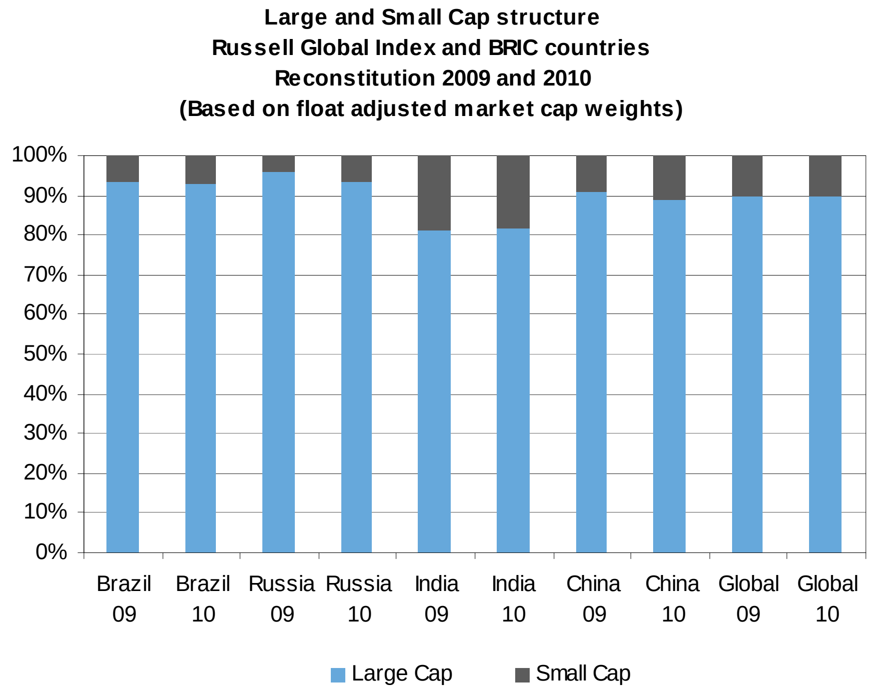
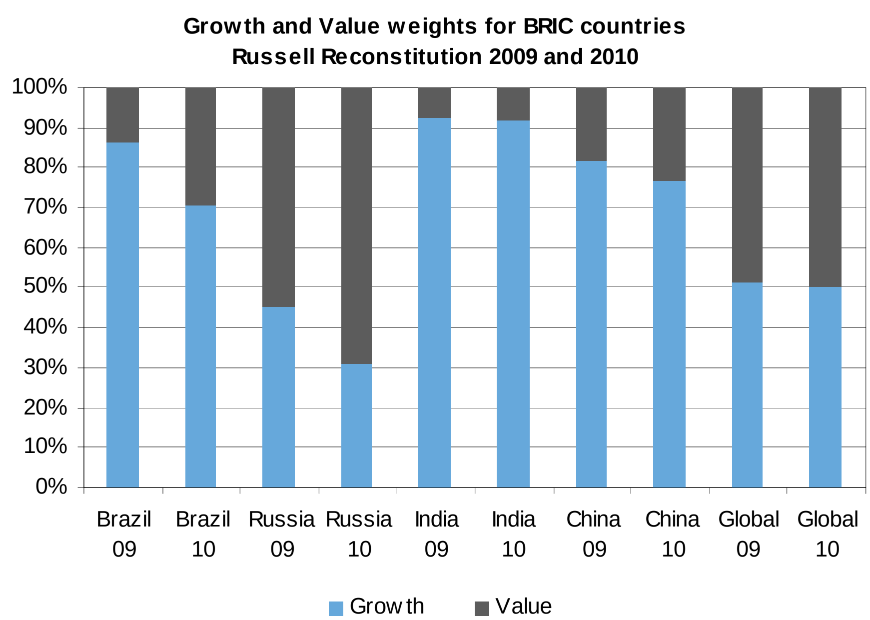


Figure 10 shows allocations to growth and value for the BRIC countries at Recon 2009 and Recon 2010. Differences in BRIC style exposures demonstrate the insights Russell's global relative index methodology affords regarding essential differences among these four countries. Russia's tilt toward value, which was recorded at Recon 2009, has increased such that Russia is now 70% value. India remains heavily weighted in growth securities. Brazil and China remain growth-oriented, although both, most notably Brazil, have increased exposure to value.

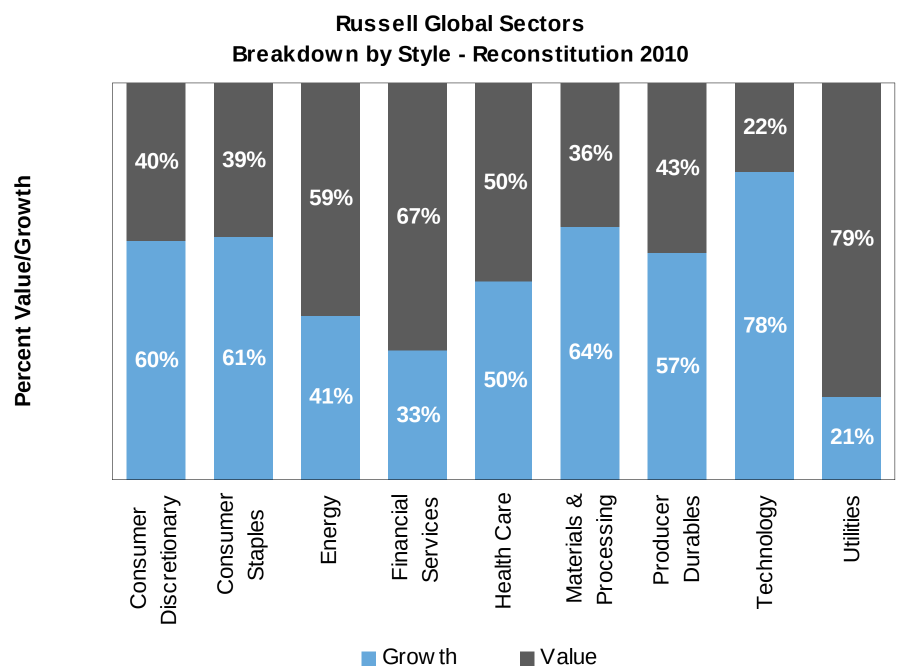
Figure 10

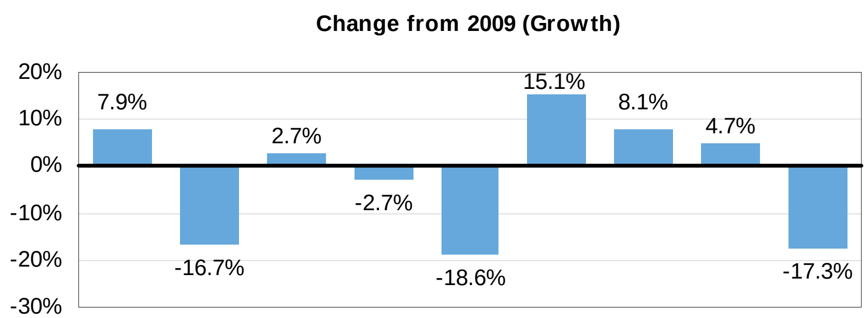


Where style and sector intersect

From 2009 to 2010 we observe interesting changes in the style biases of global sectors; these are displayed in Figure 11.[8] The biggest changes are in Consumer Staples, Health Care and Utilities, with double-digit percentage shifts (17%, 19% and 17%) toward value and away from growth, and in Materials and Processing, which has become a solid growth sector. Consumer Discretionary and Producer Durables both saw an 8% shift toward growth. Technology similarly moved more heavily into growth, with a 5% shift. Financial Services shifted another 3% into value space, and Health Care experienced a similar shift (3%), but away from value and toward growth. Utilities, Energy and Financial Services are the three sectors now dominated by value in global markets.

Figure 11 / Style weights in Russell global sectors; change from 2009





[8] The author thanks Johann Schneider for this chart design.

Summary

Our snapshot of global equity markets and BRIC countries as of Recon 2010 illuminates a number of important trends:

- Emerging markets have once again increased in importance and weight within global markets relative to developed countries; this trend is observable over a number of years.
- Europe has again suffered a reduction in weight relative to the rest of the world, while the other major regions—North and Latin America, Asia-Pacific—have grown. Europe has been hard hit by the crisis and the recession, and continues to be an epicenter of uncertainty and concern. Here the foci are heavy debt levels, both sovereign and private. Of special concern is the Eurozone, as investors anxiously watch the 16 member states of the relatively youthful monetary union work through stimulus spending/reduction decisions and deficit management while at the same time sustaining the private economy and, perhaps most vitally, political harmony.
- In contrast to what we reported last year, when systemic factors dominated markets and we saw little difference in returns based on cap and style, during Recon Year 2010 investors did differentially reward value versus growth, large cap versus small cap. The small cap premium for the 12 months was 7.26%, and value underperformed growth by 2.37%.
- All four BRIC countries increased their weight in the Russell Global Index by all measures, in line with the relative health of emerging markets in general. India and Russia strongly outperformed their respective regions.
- Markets also differentiated between global and country sectors. China excepted, almost all BRIC countries' sectors strongly outperformed their global sector counterparts over this period.
- Market performance suggests that investors have uncertainty regarding China. The flat returns to China relative to the Russell Global Index stand in stark contrast to the outperformance of the other three countries. China plays a vital role in the world economy and has been a source of growth during the period of the recession. The world is watching to see whether China can manage sustained but real growth.

Appendix

Definition of terms

Recon: The Annual Reconstitution of all Russell Indexes occurs on the last Friday of the month of June each year. The Reconstitution of the Russell Indexes impacts month-end values, returns and characteristics for the indexes as of the last day of June each year. Accordingly, we employ the term “Recon” to designate the last day of each June when reconstitution is incorporated in month-end numbers, i.e.,

Recon 2009: the last day of June, 2009

Recon 2010: the last day of June, 2010

Recon Year: We define a “Recon Year” primarily for the purpose of returns calculation to designate the twelve month period from one Recon to the next, i.e.,

Recon Year 2009: the twelve month period from July 1, 2008 to June 30, 2009

Recon Year 2010: the twelve month period from July 1, 2009 to June 30, 2010

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Disclosures

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