



# Introducing the Russell Multi-Factor Equity Portfolios

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A robust and flexible framework  
to combine equity factors within  
your strategic asset allocation

## Executive Summary

Smart beta strategies are increasingly seen by investors as a flexible tool to help them achieve their investment objectives in a variety of ways. In using smart beta to manage risk factor exposures more intentionally and construct portfolios more cost-effectively, investors can improve the efficiency of their strategic asset allocation through reducing risk and/or exploiting additional sources of return.

In practice however, investors face a myriad of challenges in selecting the strategies or factor exposures most relevant to them. One particular challenge for investors is how to combine them effectively in a way that addresses the cyclical underperformance in any given strategy and reflects their investment beliefs, preferences, risk tolerances, and objectives.

In this paper, we introduce a framework to combine four of the most common equity risk factors at the strategic level, helping you avoid common pitfalls in factor investing and allowing you to tailor your factor allocation to your preferences.



# Introduction

Early adopters of smart beta used alternative-weighting strategies to exploit perceived inefficiencies of the cap-weighted market (e.g. Fundamentally-weighted, Equal Weight, Minimum Variance, Maximum Diversification)<sup>1</sup>. However, the behaviour of these strategies (i.e. what made them 'work') was largely driven by their exposure, indirectly, to various factors such as Value, Size, and Low Volatility. We believe that by using strategies more explicitly targeting desired factors rather than these alternative-weighting strategies is a more precise way to attain the factor exposures investors' desire and a more reliable way to improve strategic asset allocation efficiency.

There is growing interest in factor exposures and an increased number of publications are advocating the combination of different factor exposures in a single multi-strategy portfolio. The publications have included strategies ranging from as simple as equal-weighted allocations<sup>2</sup> to maximum diversification strategies and even combinations of different weighting schemes<sup>3</sup>. While these publications have gone a long way in informing investors of the vast array of portfolio construction techniques available, Russell sees a need for greater clarity as to which approach should be used and when for a particular investor. Russell has long believed that it is important to focus on multiple sources of return and risk when building a well-diversified equity portfolio and has been the cornerstone of our investment process for over 40 years.

Combining multiple return sources in a strategic equity portfolio may help provide more consistent performance through time. When one factor is underperforming, another factor may be outperforming. A multi-factor portfolio acts to smooth out different factor cycles and to reduce volatility associated with individual return sources. However, when combining multiple factors careful consideration needs to be given to the design and specification of the individual factors to ensure they have common features that allow them to be combined without one dominating the others.

The two strategic multi-factor equity portfolios we introduce in this paper utilise a transparent framework for multi-factor portfolio construction that efficiently captures the factors robustly through time, is well-diversified, and aligns the factor characteristics to investor objectives.

<sup>1</sup> See Clare, Andrew and Motson, Nick and Thomas, Steve, An Evaluation of Alternative Equity Indices - Part 1: Heuristic and Optimised Weighting Schemes (March 30, 2013). Available at SSRN: <http://ssrn.com/abstract=2242028> or <http://dx.doi.org/10.2139/ssrn.2242028> and 'Smart Beta: A deeper look at asset owner perceptions', Russell Indexes, April 2014.

<sup>2</sup> See Bender J., Brandhorst E. and Wang T., "The Latest Wave in Advanced Beta: Combining Value, Low Volatility and Quality", The Journal of Index Investing 5, No.1 (2014)

<sup>3</sup> See Amenc N., Goltz F., Lodh. A. and Martellini L. "Towards Smart Equity Factor Indices: Harvesting Risk Premia without Taking Unrewarded Risks", The Journal of Portfolio Management 40, No. 4 (2014)



## Factor Identification: Which equity factors should you consider?

Five well-documented risk factor exposures that Russell believes are persistent sources of equity return are **Value, Quality, Momentum, Low Volatility** and **Size**.

### 1 VALUE

A value investment strategy involves identifying those stocks that are trading at a discount to fair value or the broader market. Behavioural research suggests that investors mistakenly expect the high growth rate of growth firms and the low growth rate of value firms to persist in the future and that they price stocks accordingly. When growth rates mean revert and earnings expectations are not met, growth firms are penalised more severely than are value firms. The value effect is at least partly present because most investors lack the patience to wait for mean reversion.

### 2 MOMENTUM

Momentum-based investment strategies focus on identifying those stocks with strong performance over the past 12 months (absolute or relative), with the expectation that their recent strong performance will continue. Momentum may occur due to investors under-reacting to new information and information being slowly incorporated into prices. Alternatively, momentum can arise from investors overreacting to private information and causing prices to be pushed away from fundamentals.

### 3 QUALITY

Quality-based investment strategies focus on identifying companies that have a greater ability to deliver sustainable returns to shareholders. These companies are typically characterised by high profitability, low leverage and low earnings volatility. Investors tend to favour more volatile (high leverage) stocks with more explosive potential upside in the short term. This preference can lead to higher quality companies being mispriced in the shorter term, resulting in attractive longer-term returns.

### 4 LOW VOLATILITY

Low volatility-based investment strategies focus on identifying companies that have more stable return patterns than the broader market. Low volatility strategies tend to outperform cap-weighted benchmarks in bear markets. Although we don't believe that the Low Volatility factor is a strong excess return driver, it can be used for absolute portfolio volatility reduction or portfolio beta control.

### 5 SIZE

Russell's preferred long-term strategic positioning is to be overweight smaller capitalisation stocks. However, it is important to be aware of the source of the Size exposure as the Size premium does not necessarily exist uniformly across the other factors.

## Factor Capture: Building single factor exposure portfolios

We believe that Value, Momentum and Quality will outperform in the long run, and Low Volatility is an effective tool to help you control total volatility levels and risk-adjusted returns<sup>4</sup>. These beliefs are based on both economic intuition and longer historical perspective<sup>5</sup>. We construct the Russell Multi-Factor Equity Portfolios by considering explicit allocations to each of these four factors. We do not consider explicit allocations to small cap in the construction process as exposure to the other factors provides indirect exposure to Size due to the nature of the factors. For example, Value and Momentum typically have a bias to smaller companies.

To proxy for the individual factor returns, we use the Russell Factor Exposure series. This series has many of the desired characteristics that we would look for in a factor portfolio, for example the non-linear weighting algorithm ensures that a higher factor score results in a higher exposure to a stock within the factor index, but only marginally so at the extremes of the distribution.

In Exhibit 1, we provide summary statistics for the Russell Factor Exposure series.

Although each of the factors have outperformed the Russell Global LC Index (the 'benchmark') over the period from July 1996 to May 2015, the performance patterns vary widely between factors. As expected, absolute volatility and semi-deviation of Low Volatility are lower than those of the benchmark. The maximum absolute drawdown over the studied period is the worst for Value. Low Volatility has the highest historical tracking error and maximum active drawdown, while Quality has the lowest historical tracking error and active drawdown. (These results are highlighted in the table below.)

**Exhibit 1: Russell Global LC Factor Exposure Portfolios Summary Statistics (Jul 1996 – May 2015, in USD)**

	Value	Low Volatility	Momentum	Quality	Russell Global LC
Annualized Return (CAGR*)	9.6%	9.0%	9.3%	9.0%	7.5%
Annualized Volatility	16.9%	12.5%	17.1%	16.3%	16.1%
Sharpe Ratio	0.49	0.57	0.47	0.47	0.38
Semi-Deviation	12.5%	9.7%	13.3%	12.5%	12.4%
Sortino Ratio	0.66	0.73	0.60	0.61	0.50
Maximum Drawdown	-57.7%	-46.6%	-55.0%	-51.1%	-54.9%
Historical Beta	0.99	0.72	1.00	0.99	1.00
Excess Return (CAGR*)	2.2%	1.6%	1.8%	1.5%	N/A
Tracking Error	5.3%	6.2%	5.3%	2.9%	N/A
T-stat of Excess Return	1.74	0.64	1.53	2.17	N/A
Information Ratio	0.40	0.15	0.35	0.50	N/A
Active Semi-Deviation	3.4%	4.3%	4.0%	1.9%	N/A
Active Sortino Ratio	0.62	0.21	0.47	0.73	N/A
Maximum Active Drawdown	-27.1%	-30.3%	-17.1%	-7.3%	N/A
Turnover	35.0%	25.0%	67.0%	29.0%	3.0%

\*Compound Annual Growth Rate

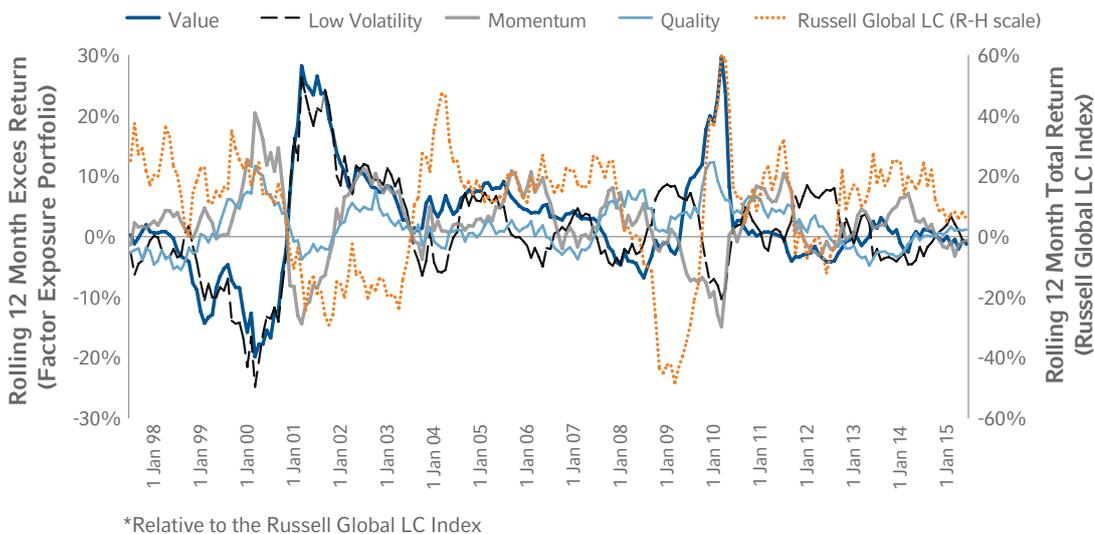
<sup>4</sup> We believe that Low Volatility is an effective tool to control total volatility levels and to improve Sharpe ratio.

<sup>5</sup> See "The continued evolution of Russell's investment beliefs", Jeff Hussey, US Russell Communique (2nd Quarter 2014).

## Why combine multiple factors?

Although the factor premia are expected to be positive in the long run, they are not consistently positive over shorter time horizons and changing market regimes. Further, the correlation of the individual excess returns has been low or negative as each factor exhibits cycles of performance which do not coincide, as illustrated in Exhibit 2. Negative correlations are key criteria to consider when building a well-diversified portfolio from a combination of factors.

**Exhibit 2: Russell Global LC Factor Exposure Portfolios' 1-Year Rolling Excess Return\* and Russell Global LC Index Returns (Jul 1997 – May 2015)**



At market bottoms, Value tends to start performing well due to a wide dispersion of valuation ratios across stocks and thus larger profit opportunities. At the same time, Momentum tends to start performing poorly because after a market crash it is overweight low beta stocks and underweight high beta stocks. At market tops, the opposite holds, as Value tends to start performing poorly while Momentum tends to start performing well.

The Quality factor is the most stable in terms of returns, but still performs better than the broad market during recessions when investors “fly to quality”. The Low Volatility factor demonstrates the strongest counter-cyclical pattern.

This distinction in the sensitivities of the factors to different regimes suggests that combining exposures to these four factors will lead to more consistent performance over time.

We include further details of the correlation of each of these factors in both nominal and excess returns in the Appendix.

## WATCHPOINT

When combining multiple factor portfolios you also need to ensure that the individual factor portfolio construction techniques have common features that allow them to be combined without one factor unintentionally dominating the others. For example, when the average active stock position (over or underweight relative to the benchmark) in the Momentum portfolio is the same as the average active stock position in the Value portfolio and the factor exposures are of a similar magnitude, this results in highly complementary exposures with both factors contributing equally to the outcome of the total combined portfolio. This is achieved through using a consistent portfolio construction process across each of the factors.

This approach contrasts to early adoptions of smart beta by investors who might have combined a fundamentally-weighted strategy with a minimum variance approach. In such an example, the differences in portfolio construction would result in the low volatility factor from the minimum variance portfolio having a greater impact on the combined portfolio because the value factor exposure in the fundamentally-weighted strategy was of a much smaller magnitude.



## The Russell Multi-Factor Equity Portfolios: Introducing a robust allocation framework

The goal of the Russell Multi-Factor Equity portfolios is to provide well-diversified exposure to the desired factors. They are built for the time horizon of five-plus years and cater to two different investment objectives<sup>6</sup>:

1. **'Sharpe ratio'** investors are those who seek a core equity exposure focused on absolute risk-adjusted returns. These investors may be looking to re-allocate some of their market-cap passive equity exposure to a multi-factor portfolio to improve their strategic allocation efficiency, targeting market-like returns with lower absolute volatility.
2. **'Information ratio'** investors are those who seek a core equity exposure focused on benchmark-relative risk-adjusted returns. These investors may be looking to replace some of their active equity exposures to a multi-factor portfolio to achieve desired factor exposures more cost-effectively within their existing risk budget.

In determining the strategic weights allocated to the four underlying factors for these two multi-factor portfolios, we have created a robust and intuitive framework that utilises all the key elements of modern portfolio theory (MPT) – risk, return, and diversification – while controlling for the well-documented issues found in optimised solutions<sup>7</sup>, such as being overly sensitive to the estimation error inherent in optimised approaches.

### Ranking

We prefer the use of a ranking (non-parametric) approach to determine the individual factor weights as it mitigates the estimation risk inherent in optimised approaches which rely upon historical estimates of excess return expectations and the variance-covariance matrix. A small error in the estimation of expected return can lead to a significant change in the optimal portfolio. We also rank factors across several regions (US, Developed ex US, and EM) to improve robustness and to prevent a particular region alone from driving the factor allocation decision.

In all the considered regions, we first rank the four return sources based on the historical returns, and then calculate the average rank across the regions for each factor. We then rank factors the same way based on semi-deviation. Finally, in order to rank the return sources by correlations, we calculate correlation of each factor with the three other factors in the region, the lowest average correlation having the highest rank. We summarise all the ranks in Exhibit 3 (absolute risk/return) and Exhibit 4 (relative risk/return).

<sup>6</sup> An investor with a greater focus on generating excess return relative to a benchmark could target a higher Information Ratio. Alternatively, a higher Sharpe or Sortino Ratio could be targeted if an investor had a greater emphasis on managing absolute volatility

<sup>7</sup> Michaud, R.O. (1989) "The Markowitz optimization enigma: Is 'Optimized' optimal?" Financial Analysts Journal 45 No.1, January-February, 31-42

## Rebalancing

The multi-factor portfolio is then rebalanced back to the strategic weights on a semi-annual basis. We tested multiple rebalance frequencies and found the semi-annual rebalancing frequency provided the best trade-off between exposure to the factor and manageable turnover levels.

We believe this approach is consistent with how investors strategically allocate to other return sources, allows for clearer performance attribution and provides greater transparency as to the main drivers of return (the weighted average of the underlying factor exposures).

## Central Management

Centrally managing the factor exposures in an integrated multi-factor portfolio offers investors the benefit from the netting of trades of overlapping securities between single-factor portfolios. This improves the efficiency of implementation by reducing total portfolio turnover and transaction costs.

## Added flexibility

We can exploit the flexibility of our approach even further by incorporating additional factors<sup>8</sup> and by enhancing the ranking process (i.e. by adding additional characteristics that the investors might care about). One example would be making a portfolio more tax friendly by adding another characteristic to the ranking process: tax exposure that comes from capital gains or dividend income for each factor portfolio.

<sup>8</sup> More than 330+ return sources were identified by academics since 1970 (see Greene et al. [2013]). Most of these return sources can be captured by systematic approaches to security selection and packaged as factor indexes. In the end, though, only several equity factors likely matter the most and an investor needs to have the beliefs about which factors are important for her risk/return objectives and investment horizon.

## The Sharpe Ratio (SR) Portfolio

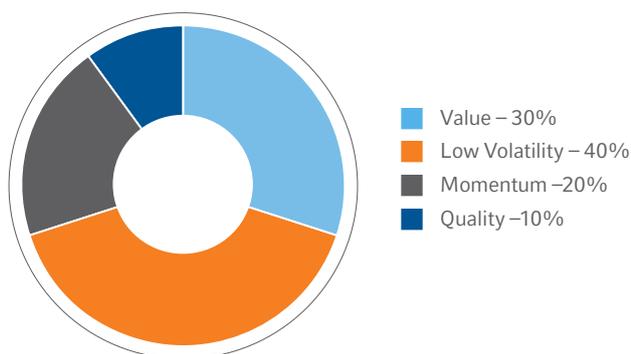
The SR Portfolio is focused on the trade-offs of absolute risk and return. This portfolio allocates a greater weight to those factors that rank best historically in terms of higher absolute returns, greater diversification properties (measured by correlation of absolute returns) and smaller drawdowns (absolute semi-deviation). These ranks are summarised in Exhibit 3. For example, Value has the highest rank (1) in terms of absolute returns and Quality the lowest (4), but Volatility ranks highest in terms of smaller drawdowns and low correlations to the other factors.

When taking all three of these absolute risk and return trade-offs into consideration, Low Volatility has the highest overall rank, followed by Value, Momentum, and Quality. This translates into the following strategic weights for the SR multi-factor portfolio: 40% Low Volatility/30% Value/20% Momentum/10% Quality.

**Exhibit 3: Return sources average ranks\* across regions and final ranks for SR Portfolio<sup>9</sup>**

	Value	Low Volatility	Momentum	Quality
Absolute Return	1	3	3	4
Absolute Semi-deviation	3	1	4	2
Correlation of Absolute Returns	3	1	2	4
<b>Total</b>	<b>2</b>	<b>1</b>	<b>3</b>	<b>4</b>

\*1 = most favourable; 4 = least favourable



For illustrative purposes only

<sup>9</sup>To clarify, in each line, for Excess Return, Active Semi-deviation, and Correlation of Excess Returns, we show average rank across regions. E.g., for Excess Return, both Low Volatility and Momentum have an average rank of 3.

## The Information Ratio (IR) Portfolio

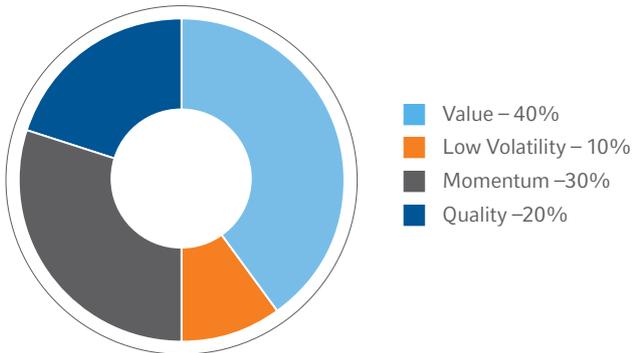
The IR Portfolio is focused on the trade-offs of risk and return relative to the (market-cap) benchmark. This portfolio allocates a greater weight to those factors that rank best historically in terms of higher excess returns, greater diversification properties (measured by correlation of excess returns) and lowest risk of underperforming the benchmark (active semi-deviation). These ranks are summarised in Exhibit 4. For example, Value ranks highest and Quality lowest again in terms of excess returns, but Quality ranks highest (1) in terms of low downside risk while Low Volatility has a greater chance of underperforming the benchmark (particularly in periods of strong market performance) and ranks lowest (4).

When taking all three of these relative risk and return trade-offs into consideration, Value has the highest overall rank, followed by Momentum, Quality, and Low Volatility. This translates into the following strategic weights for the IR multi-factor portfolio: 40% Value/30% Momentum/20% Quality/10% Low Volatility.

**Exhibit 4: Return sources average ranks\* across regions and final ranks for IR Portfolio<sup>9</sup>**

	Value	Low Volatility	Momentum	Quality
Excess Return	1	3	3	4
Active Semi-deviation	2	4	3	1
Correlation of Excess Returns	2	4	1	3
<b>Total</b>	<b>1</b>	<b>4</b>	<b>2</b>	<b>3</b>

\*1 = most favourable; 4 = least favourable



For illustrative purposes only

## Benefits of strategic multi-factor equity portfolios

In Exhibit 5, we compare the characteristics of the two strategic Russell Multi-Factor Equity Portfolios with those of the Russell Global LC Index and a portfolio constructed by a simpler equal-weighting of the four underlying factor portfolios.

### Return Enhancement

An appealing rationale for combining the four factors in the multi-factor portfolio is that the active returns to those factors are negatively or lowly correlated while expected to be positive in the long run. By combining them in one multi-factor portfolio, we try to achieve more consistent returns in excess of the benchmark, as illustrated in Exhibit 6.

Also, the excess returns relative to the benchmark have been statistically significant historically. Therefore, the portfolios built from combining the four single factor portfolios increased the Sharpe Ratio relative to the benchmark over the full historical period by 42% (IR Portfolio) and 50% (SR Portfolio). We would expect these multi-factor portfolios to continue to produce superior risk-adjusted returns relative to the broad market over the long term given our beliefs of the underlying factors.

### Risk Reduction

At 14.6% over the period, the standard deviation (absolute volatility) of the SR Portfolio is significantly lower than that of most single factors, the benchmark and the other factor combinations.

The results also confirm that significant diversification benefits can be obtained by combining different return sources into one portfolio. For example, the tracking errors of the IR Portfolio (2.3%) and the Equal-weighted portfolio (2.4%) are significantly lower than the levels we observed in Exhibit 1 for the various return sources in isolation (3-7%). This demonstrates that combining the factors into one portfolio reduces the risk associated with any one factor underperforming the market at a given time.

The IR Portfolio has a significantly greater Information Ratio than each of the four factors individually and the other four-factor combinations considered. It is also more attractive when examining active semi-deviations, active Sortino ratios and maximum active drawdowns.

Therefore, the IR Portfolio was historically the best in delivering consistent excess returns over the studied period. On the other hand, the SR Portfolio was better with respect to the absolute risk-return trade-off.

Interestingly, the simple Equal-weight Portfolio was able to capture most of the improvements in performance characteristics shown by the two Strategic Portfolios but is inferior to both, depending on the investor's preference for a better absolute or relative risk/return trade-off.



### Exhibit 5: Global LC Equity Strategic Portfolios Summary Statistics (Jul 1996 – May 2015, in USD)<sup>10</sup>

	Strategic IR	Strategic SR	Equal-weight	Russell Global LC
Annualized Return (CAGR)	9.5%	9.4%	9.4%	7.5%
Annualized Volatility	15.8%	14.6%	15.2%	16.1%
Sharpe Ratio	0.50	0.53	0.51	0.38
Semi-Deviation	12.1%	11.2%	11.6%	12.4%
Sortino Ratio	0.66	0.69	0.67	0.50
Maximum Drawdown	-54.5%	-52.1%	-52.7%	-54.9%
Historical Beta	0.97	0.89	0.93	1.00
Excess Return (CAGR)	2.0%	1.9%	1.9%	N/A
Tracking Error	2.3%	3.2%	2.4%	N/A
T-stat of Excess Return	3.38	2.07	2.94	N/A
Information Ratio	0.78	0.48	0.68	N/A
Active Semi-Deviation	1.5%	2.2%	1.6%	N/A
Active Sortino Ratio	1.19	0.70	1.00	N/A
Maximum Active Drawdown	-7.2%	-16.2%	-8.9%	N/A
Turnover (of aggregate holdings)	40.0%	36.0%	36.0%	3.0%

### Exhibit 6: Global LC Strategic Portfolios 1-Year Rolling Excess Return\* (Jul 1997 – May 2015)



\*Return relative to the Russell Global LC Index

## Alternative combinations

We have researched more than 20 alternative methods of portfolio construction using the same set of equity factors (including minimum variance, maximum Sharpe ratio, maximum diversification, minimum correlation, risk parity and equal contribution to risk). However, such structures did not produce a portfolio with meaningfully better return characteristics than the two Russell Strategic Equity Portfolios that we have outlined above.

<sup>10</sup> Portfolios in this exhibit utilise fixed weights discussed earlier.

## Conclusion

With the rise in popularity of smart beta and factor investing, investors face a myriad of challenges in selecting the strategies or factor exposures most relevant to them. One particular challenge is how investors should incorporate these exposures into their portfolios effectively in a way that addresses the cyclical underperformance in any given strategy and reflects their investment beliefs, preferences, risk tolerances, and objectives.

In this paper, we introduce a framework to combine four of the most common equity risk factors – Value, Momentum, Quality, and Low Volatility – at the strategic level. Specifically, we present two strategic equity portfolios that meet two distinct objectives: to align with an absolute (Sharpe ratio) or a relative (Information ratio) risk-return objective.

Combining several equity factor return sources in one portfolio provides diversification to deliver more consistent outcomes. We are also mindful of the sensitivity of highly optimised approaches to estimation errors and out of sample results. Therefore, our robust and flexible framework moves away from single point estimates sensitive to estimation error and captures the high-level relationships of return sources through a ranking approach aligned with investor's objectives. These high level relationships have shown to hold through time and allow for consistent exposures over the long term.

This multi-factor approach of incorporating equity risk factors into a portfolio is consistent with how investors strategically allocate to other return sources, it can be used to help investors improve the efficiency of their strategic asset allocation and helps to provide more cost-effective access to the drivers of equity returns they desire.



## Appendix

### Correlation of factor returns

Exhibit A shows the correlation matrix of absolute (total) returns. It is not a surprise that long-only factors are highly correlated as they are all exposed to equity market beta, but with diversification potential. Low Volatility and Momentum returns are the least correlated series historically.

Exhibit B shows that factors' excess returns (relative to the market-cap benchmark) are not highly correlated with each other and this presents an exploitable opportunity to minimise active risk. The cross-correlations vary by return sources, but the average cross-correlation across the four factors excess returns is close to zero.

#### Exhibit A: Correlation of Russell Global LC Factor Exposure Portfolios Absolute Monthly Returns (Jul 1996 - May 2015, in USD)

	Value	Low Volatility	Momentum	Quality
Value	1.00			
Low Volatility	0.95	1.00		
Momentum	0.86	0.87	1.00	
Quality	0.92	0.90	0.96	1.00

#### Exhibit B: Correlation of Russell Global LC Factor Exposure Portfolios Excess Monthly Returns (Jul 1996 - May 2015, in USD)

	Value	Low Volatility	Momentum	Quality
Value	1.00			
Low Volatility	0.42	1.00		
Momentum	-0.44	-0.17	1.00	
Quality	-0.29	-0.24	0.46	1.00

### Performance attribute definitions

**Information Ratio (IR):** excess return per unit of risk (tracking error) relative to the benchmark.

**Sharpe Ratio:** excess return per unit of absolute risk (volatility as measured by standard deviation) relative to a risk-free asset.

**Sortino Ratio:** a modification of the Sharpe ratio that differentiates harmful volatility from general volatility by taking into account the standard deviation of negative asset returns, called downside deviation.

**Active Sortino Ratio:** a modification of the information ratio that differentiates harmful tracking error from general tracking error by taking into account the standard deviation of negative excess returns, called active semi-deviation.

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