Russell

TITLE

Russell's Core Investment Beliefs

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SYNOPSIS

Russell's business spans many countries and we serve many different types of clients. We offer a wide variety of products and services. There is however a core set of beliefs that guide the investment strategies we design, recommend and implement. These beliefs are founded on decades of experience and thorough research and evaluation.

This note attempts to articulate the key foundational beliefs underlying Russell's investment approach. Each belief is summarised as an observation with a brief exposition attached. The relevant research substantiation is placed against each belief in reverse chronological order. Key documents in each belief set are highlighted in yellow.

Russell Research

Introduction

Investment markets are inherently noisy places. Ideas jostle for attention, driven by vested interests and spurred by competition. To be successful, an investor must distinguish between short-lived fads and genuine insights. Summarised below are fifteen beliefs that have been distilled from Russell's rich research heritage. Each belief is stated in rather general terms and risks being labelled in certain quarters "motherhood". However within each belief there resides a set of powerful, practical insights that transcend current fashions and market valuations. No great significance should be placed on the fact that there are fifteen, nor should they all be assumed to carry the same importance.

These beliefs are not set in stone. Russell is continuously monitoring the evidence supporting or challenging each of the beliefs. This happens both directly as a result of deliberate research and indirectly through the accumulation of experience with our clients. Open minded evolution is good both for our clients and for Russell. Respecting the wisdom of the lessons we have learned whilst maintaining an open mind about new ideas and approaches is critical for our continuing relevance to clients and success as a business.

BELIEF #1	**POOR DECISION MAKING STRUCTURES CAN ERODE SUBSTANTIAL VALUE.**

Clear governance structures that promote decisiveness, efficiency and accountability are more likely to be effective in ensuring that fund objectives are met. In an increasingly complex world, decision makers should engage relevant expertise where appropriate. They may also employ experts to implement strategies, but should not abdicate responsibility for the strategic decisions affecting their portfolio.

- **The challenge of new ideas – avoid carelessness, not risk** by John Gillies (Nov 2004)
- **Roadmap for Fiduciary Risk Management – The Importance of an Effective Investment Management Program** by Janine Baldridge (Oct 1999)
- **Excellence in Pension Fund Management: A Perspective on Current Practices** by Don Ezra (Aug 1999)
- **Prudence is Process, Not Performance** by John Ilkiw (Nov 1996)

BELIEF #2 CLEAR OBJECTIVES ARE ESSENTIAL.

The liabilities for which an investment portfolio exists are an important starting point in designing an investment strategy. However perfect matching of liabilities by an investment strategy is practically impossible for most dynamic long term investment portfolios. In the absence of precise matching of assets to liabilities, investors need to consider their attitude to the financial risks arising from the mismatch between their objectives and their strategy.

- **Liability Driven Investment** by Sorca Kelly-Scholte (Mar 2006)
- **Defined Benefit Pension Plans: Should You and Can You, Match Assets To Liabilities?** by Don Ezra (Nov 2005)
- **What is New in Immunization Theory and Practice** by Mary Fjelstad (Jul 2004)
- **What Is Risk Budgeting and What Is Russell's Advice to Clients on Adopting It?** by Robin Penfold (Nov 2003)
- **Is the Minimum Risk Portfolio a Good Choice for Most DB Pension Plans?** by Robin Penfold (Dec 2002)
- **Handbook on Asset-Liability Management: A Guide for US Fiduciaries** by John Ilkiw (Dec 1998)
- **Asset Allocation by Surplus Optimization** by Don Ezra (Feb 1990)

BELIEF #3 THE STRATEGIC ASSET ALLOCATION IS THE KEY INVESTMENT DECISION.

The size and complexity of investment markets makes it imperative to organise the decision process into manageable steps. Bonds, equities and cash are clearly distinct asset classes and can serve as basic building blocks in an investment strategy. Their performance characteristics can be optimised relative to objectives with a reasonable degree of confidence to form the Strategic Asset Allocation. This analysis should be reviewed on a periodic basis to ensure the Strategic Asset Allocation remains relevant.

Sub asset classes do exhibit different return profiles but these are less distinctive. Diversification across asset classes and sub-asset classes is important but asset allocation to sub-asset classes is not suitable for mathematical optimisation and needs to be determined in a more judgmental way.

- **On the Sensitivity of Portfolio Weights to Underlying Parameters** by Steven Fox, Leola Ross (Dec 2004)
- **How to Make Prudent and Profitable Decisions** by Craig Ansley (Nov 2004)
- **Capital Market Forecasts for Asset Allocation: Russell's Philosophy and Techniques** by Steve Fox, Grant Gardner, Ralph Jackson (May 2000)
- **Asset Allocation? How About the Importance of Common Sense?** by Ernest Ankrim, Chris Hensel (Jun 1999)
- **Making Superior Asset Allocation Decisions: Implications of Recent Research Commentaries** by Chris Hensel, Andrew Turner (Dec 1992)
- **The Value of Asset Allocation Decisions** by Chris Hensel, Don Ezra, John Ilkiw (Mar 1990)

BELIEF #4 MARKETS ARE CONTINUALLY EVOLVING AND ASSETS ARE BEING ENGINEERED INTO DIFFERENT FORMS.

Competitive markets breed innovation in industry structure, security design and investment strategy. Each innovation needs to be judged on its individual merits. Techniques that separate market (beta) and security selection (alpha) components of return can be employed as enhancements to overall portfolio strategy.

- **Potential Risks and Returns of Collateralized Debt Obligations (CDOs)** by Clive Smith (Feb 2005)
- **Policy Portfolios and Portable Alpha** by Grant Gardner (Jul 2004)
- **Threading a Rope Through a Needle: How Does a Large Scale Investor Approach Hedge Funds?** by Leola Ross (Jul 2003)
- **Risk Exposure and Hedge Funds** by Leola Ross (Nov 2002)
- **Exchange-Traded Real Assets: Commodities in Asset Allocation** by Ernest Ankrim, Chris Hensel (Apr 1992)

BELIEF #5 EQUITIES OUTPERFORM BONDS OVER THE LONG TERM.

Over the long term, the equity risk premium in world equity markets has been observed to be positive. It is variable on a shorter term basis. In a world of free flowing capital, there is no reason why one specific market should outperform others on a systematic basis. Therefore equity market exposures should be diversified in order to maximise the chance of capturing the equity risk premium and to help smooth shorter term variability in the equity risk premium. Systematic long term strategic biases to specific markets should not be based on differential return expectations.

- **How Often Should One Expect Stocks to Out-perform Bonds?** by Robin Penfold (Nov 2003)
- **Rationale and Implications of Russell's Recommendation that Clients Use a 3% Equity Premium for Asset Allocation Studies** by Grant Gardner, Michael Hall, George Oberhofer (May 2002)
- **Were the Returns from Stocks and Bonds of Different Countries Really Different in the 1980's?** by Andrew Turner, Chris Hensel (May 1991)

BELIEF #6 MARKETS ARE NOT SYNCHRONISED AND TURNING POINTS IN MARKET CYCLES CANNOT BE FORECAST PRECISELY.

Tactical asset allocation which attempts to time entry into or out of markets on the basis of their near term direction is intuitively appealing but hazardous in practice. Temporary departures from SAA may have a purpose of reducing risk or adding value but each decision should be associated with a clear purpose and a catalyst for reversal. A more certain way to take advantage of market volatility and provide consistent long-term returns is to conduct a disciplined rebalancing strategy. Absent any ex ante information about the short term performance prospects for markets, it is rational to rebalance portfolios back to the Strategic Asset Allocation. Newer global macro hedge fund style TAA products, which apply a broader set of decisions than simple TAA and apply similar insights to other forms of active management, may be useful as part of a hedge fund strategy providing that suitable managers can be identified.

- **Tactical Asset Allocation** by Yvonne Ooi (Apr 2004)
- **Implementing a Rebalancing Policy** by Bob Collie (Nov 2002)
- **How Should We Respond to Economic and Market Forecasts?** by Steve Murray, George Oberhofer (Oct 2001)

BELIEF #7 INTERNATIONAL ASSETS OFFER BROADER DIVERSIFICATION.

Australia has a relatively small population, a narrow industrial base and concentrated securities markets. International markets offer exposure to a wider range of economic activity and to individual companies and issuers not available in Australia. International markets are also likely to reflect local business cycles that are less than perfectly correlated with Australia's.

- **International Equity Investment: Why, How Much & Where** by Yvonne Ooi (Jul 2004)

BELIEF #8 CURRENCY EXCHANGE RATES CAN BE VOLATILE OVER THE SHORT TERM, BUT OVER THE LONG TERM TEND TOWARDS PURCHASING POWER PARITY.

Currency volatility does not impact materially on overall portfolio risk for Australian investors until overseas allocations approach 25%. At higher levels of exposure, currency volatility makes estimating an optimal hedge ratio using standard statistical techniques impossible. Therefore, subject to peer group considerations, and the tolerance for risk, we typically set a benchmark hedge ratio of 50% in order to minimise regret for portfolios with significant overseas allocations. Active management of currency exposures can add value if it is not dominated by one currency pair.

- **Strategic Currency Hedge Ratios for Australian Investors** by Craig Ansley (Aug 2003)
- **Statistical Estimates of the Normal Currency Hedge Ratio: Best Practice or Best Guess?** by Grant Gardner, Douglas Stone (Nov 1995)
- **The Regret Syndrome in Currency Risk Management: A Closer Look** by Grant Gardner, Thierry Wuilloud (Aug 1994)

BELIEF #9 MARKETS ARE IMPERFECTLY EFFICIENT.

Investment markets are highly competitive but securities are not priced efficiently all of the time and active managers will have an opportunity to outperform. However that opportunity is unlikely to be uniformly distributed through time or across asset classes. The alpha of the few investment managers with genuinely superior skills will therefore fluctuate over time. Over the long term, investment strategies that are successful will be emulated or anticipated, which will lead to corrosion of their competitive advantage. Managers with superior skill will tend to be specialists focused on a specific market, strategy or sector.

- **Cross-Sectional Volatility and Active Manager Return Dispersion** by Ernest Ankrim, Zhuanxin Ding (Jun 2001)
- **Capturing Alpha through Active Currency Overlay** by Janine Baldridge, Brian Meath, Heather Myers (May 2000)
- **Performance Evaluation Using Conditional Alphas and Betas** by Jon Christopherson, Wayne Ferson, Andrew Turner (Jun 1999)
- **Volatility and Predictability of Manager Alpha** by Jon Christopherson, Andrew Turner (Oct 1991)

BELIEF #10 ACTIVE MANAGEMENT IS WORTH THE RISK.

Passive management is a logically consistent approach to investing. However the net alpha from successful active management can make a material contribution to portfolio returns. Diversified exposure to active managers across the portfolio can reduce the total level of active risk to the point where active multi-manager investing becomes a compelling proposition.

- **Risk Averse Versus Risk Seeking Capital Markets Study Summary: Global Fixed Income** by Mary Fjelstad, Steve Fox (Apr 2006)
- **Performance of Active Currency Managers** by Yvonne Ooi (Sep 2004)
- **Active or Passive Management? A Logical Decision Model** by George Oberhofer (Apr 2001)
- **Calculating Each Manager's Contribution to the Expected Total Return and Volatility of a Multi-Manager Structure** by George Oberhofer (Oct 2000)
- **The Four Golden Rules – Common Sense Principles for Winning the Active Management Game** by Don Ezra (Feb 1999)

BELIEF #11 PAST PERFORMANCE IS NOT A GOOD GUIDE TO FUTURE PERFORMANCE.

Random variation in active returns combined with changes in markets, investment process and personnel mean raw performance data is not predictive of the future performance of active investment managers. Analysis of portfolios and qualitative analysis of the people and processes behind the performance provide valuable information about the likelihood of superior future performance.

- **When Should You Terminate a Manager?** by Scott Donald (Jun 2000)
- **The Evolution of Investment Processes** by Paul Greenwood (Jun 1999)
- **Pursuing Performance Persistence: Is Consistency the Answer?** by Thomas Goodwin, Leola Ross (Mar 1999)
- **Our Commitment to Qualitative Manager Research** by George Oberhofer (Apr 1998)
- **Peer-Relative Active Portfolio Performance: It's Even Worse Than We Thought** by Ernest Ankrim (Feb 1998)
- **Volatility and Predictability of Manager Alpha** by Jon Christopherson, Andrew Turner (Oct 1991)
- **How to Select and Evaluate Investment Managers** by Duncan Smith (Dec 1988)

BELIEF #12 STYLE BIAS INTRODUCES UNREWARDED VOLATILITY.

Most skilled investment managers follow a disciplined process that causes persistent and discernible patterns in portfolio holdings and performance over time. In some markets (notably the US equity market) this phenomenon is called "style" and has resulted in subdivision of the stock and manager universes into sub-categories on the basis of style. In most other markets, the process differentiation is less marked but still important. It is possible to use these persistent characteristics to guide manager diversification when building multi-manager portfolios. "Style neutrality" can be achieved only approximately and, if pursued without reference to the alpha available, is not always desirable.

- **How Many Managers Make a Good Multi-Manager Portfolio?** by Steve Wiltshire, Steve Fox (Jun 2001)
- **How Well Do Style Indexes Describe Manager Behavior?** by Brad Lawson (Mar 2000)
- **Australian Equity Style Indices: Tools for Performance Evaluation and Plan Management in the Australian Market** by Jon Christopherson, John Douglas, Peter Gunning (Jan 1996)

BELIEF #13	**ILLIQUID SECURITIES AND MARKETS CAN BE WORTH THE EFFORT.**

Private markets can offer enhanced returns but require more attention to information discovery in the research process, as well as attention to liquidity and diversification issues.

- **Whither Real Estate?** by Adam Babson (Jun 2006)
- **Property Investment Options and Successful Implementation** by Ed Schuck, Juliana Howard (Nov 2004)
- **Establishing Higher Confidence Policy Exposures to Private Real Estate, Private Equity and Hedge Funds Using Two-Stage Asset Allocation** by John Ilkiw, Steven Murray (Jul 2002)
- **An Introduction to Private Equity** by Adam Goff (Aug 1999)

BELIEF #14	**DERIVATIVE IS NOT A DIRTY WORD.**

Derivatives contracts such as futures, swaps and options offer a cheaper, alternative way of achieving certain types of economic exposures but also require specific risk management and governance processes.

- **Do Swaps Have a Role For Institutional Investors?** by Sorca Kelly (Feb 2006)
- **The Role of CDS in Investment Portfolios** by Mary Fjelstad, Eugene Philalithis, Clive Smith, Martijn Vijver (Dec 2005)
- **Investing in Collateralised Commodity Futures** by Juliana Howard (Apr 2005)
- **Doubtful About Derivatives** by Don Ezra (Apr 2002)

BELIEF #15	**IMPLEMENTATION MATTERS.**

Fees, costs and delays in implementation can all cause unnecessarily large leakage of returns. This is especially true in portfolio transitions (when a manager or strategy change necessitates moving assets), in making allocations to certain alternative investments and in cashflow management (to equitise residual cash and to invest frictional cash). Investors can appoint agents to assist in managing these leakages or develop internal processes that address the key problems.

- **Do Not Drop The Baton When Managing Your Portfolio's Structure** by John Moore (Aug 2006)
- **The New Trustee's Guide to: Trading Costs** by Bob Collie (Dec 2002)
- **Slouching Trader, Hidden Drag on Performance** by Robert Werner (Oct 2001)
- **Transition Management and Long-Term Performance** by John McDonough, Bob Werner (Jun 1999)

No.1

Global manager of managers

$235 billion

Russell's strength lies in multi-manager investing, with global assets under management of $235 billion

$3.0 trillion

Russell advises clients on the investment of $3 trillion worth of assets worldwide

2000

Russell provides investment solutions for 2000 institutional clients in 44 countries

40,000,000

individual investors use Russell's services

44

operating in 44 countries around the globe