Income dividend distributions and distribution yields

Why do they vary from period to period and fund to fund?

Investors often rely on income dividend distributions from mutual funds to satisfy their income needs. Market trends may significantly affect the level of income delivered by funds–whether they are fixed income or equity funds. For example, in a low interest rate environment, it is more likely for fixed income funds to have lower income dividend distributions. This article aims to provide investors with the rationale behind the factors that impact income dividend distributions.

Factors impacting dividend distributions

While a mutual fund's strategy generally provides insight into the magnitude of potential dividend distributions (e.g., fixed income funds generally seek to deliver greater income distributions than equity funds), several factors make dividend distributions variable from period to period and fund to fund. Those factors are not guaranteed to stay constant for any fund. Further, funds have no ability to estimate cumulative effects of these factors on the rate of future income distributions in any period. The main factors impacting dividend distributions include:

- **A requirement for a mutual fund to distribute 98% of income** received from underlying securities in order to avoid an excise tax in a given period.
- **Changing portfolio holdings** that have different income distribution rates and policies over time.
- **Difference in frequency of income distributions** between the underlying portfolio holdings and income distributions by the fund.
- **Currency exchange rates**, which can significantly impact the actual dividends paid for funds with non-U.S. exposure. Any gains or losses as a result of currency exposure are treated as income, rather than capital gains. In addition, aside from any realized gains or losses from currency for non-U.S. securities, the funds are required to mark-to-market currency in the portfolio at the end of each year, meaning the funds realize any currency gains or losses at the end of the fiscal year.

In other words, if a fund has a dividend from a non-U.S. security, that dividend can be completely wiped out by the settlement of another transaction that has a negative currency impact. Simply bringing that cash dividend payment back into U.S. dollars could negate the actual dividend itself due to the fluctuations in exchange rates.

Or conversely, there may have been no dividends paid by any of the underlying securities all year, but a dividend will be declared at the end of the fiscal year through the process of marking to market any currency holding or currency exposure through portfolio holdings in the fund. Therefore, it is not possible to make accurate income distribution estimates because of the nature of currency fluctuations.

- **Tax adjustments**, which are not made in the funds until the final 1099-DIV or 1099-INT statements are produced. Therefore, shareholders should not base their tax planning on the Dividend Announcement or the Capital Gain Estimates. Rather, they should refer to form 1099-DIV or 1099-INT.
- **December income distributions.** Unlike other period income distributions that are based on actual income distributions received during the period, the last income distribution of the year in mid-December includes tax adjustments, as well as an estimate of how much income would be received by the fund in the remainder of the

month. It also incorporates any adjustments made during the audit of the fund financials. Therefore, it is unpredictable and may vary significantly.

- **Income distributions for the first period of the calendar year**. Because the mid-December income distributions are based on estimates, any deviation of the estimates from the actual income distributions received by the fund in December after the fund made its last income distribution can be accounted for in the fund's income distribution for the first period of the following calendar year. Therefore, the first income distribution of the year is likely to be more variable than others.
- **Share class differences**. When a fund calculates the amount of income distribution in each period, the income received from underlying securities during that period and allocated pro rata to all classes is reduced by the amount of class-level expenses accrued during that period. Therefore, the share classes with higher expense ratios (e.g., Class C Shares) pay lower income distributions than the classes with lower expense ratios (e.g., Class S Shares). In periods when a share class with lower expense ratios has a relatively small distribution, the share class with higher expense ratios may not have any distribution if expenses paid exceed income received by the fund.

What to expect relative to Russell Investment Company (RIC) Funds

When looking to RIC Funds as a source of income, advisors should remember that none of the RIC Funds aim to deliver a constant level of income dividend distributions. The Funds have various investment objectives that they often seek to achieve through both income and capital appreciation. This can result in income dividend distributions that can be uneven and vary period to period.

Below are some details about how the factors that impact dividend distributions, which are discussed above, apply to RIC Funds and LifePoints® Funds.

RIC Equity, Alternative and Specialty Funds

- **Variability due to changing portfolio holdings**. Over time, portfolio holdings change, and equity securities do not pay consistent income dividends.
- **The last distribution of the year in mid-December may vary from other quarterly distributions more significantly, and some equity funds only pay income dividend distributions annually**. For the funds with quarterly distributions, mid-December distributions reflect actual income received by a fund for the first 2½ months of the quarter plus an estimate for the remainder of the month of December. Also included in these distributions are tax adjustments and adjustments required as a result of the audit of financial statements, reflecting the full year of operations of a fund. Therefore, these adjustments may significantly increase or decrease the mid-December distributions relative to other quarterly distributions.

RIC Fixed Income Funds

- **Variability due to changing portfolio holdings**. Over time, portfolio holdings change, and a fund may hold securities with different income payout rates.
- **The last distribution of the year in mid-December may vary from other monthly distributions more significantly.** This distribution reflects actual income received by the fund for part of the month of December plus an estimate for the remainder of the month of December. Also included in these distributions are tax adjustments and adjustments required as a result of the audit of financial statements, reflecting the full year of operations of a fund. Therefore, these adjustments may significantly increase or decrease the mid-December distributions relative to other monthly distributions.
- **The distributions at the beginning of February may vary from other monthly distributions more significantly.** Since this is the first distribution of the calendar year, it includes any adjustments necessary to account for the difference between the estimated and actual income distributions received by the fund in the last part of December, after the mid-December distribution was paid. These adjustments contribute to variability of this period's distribution.

- **Asset-backed securities may experience a "paydown."** Asset-backed securities are ones whose value and income payments are derived from or backed by a specific pool of underlying assets. These pools of assets can include payments from different types of loans such as mortgages, auto loans, or other types of loans. Paydowns occur when borrowers pay down the principal and interest on their debt early and are recognized and distributed as dividend income. Changes in interest rates can affect the rate of prepayments, and this, in turn, affects income distributions to shareholders.

LifePoints® Funds, Target Portfolio Series

- **Variability due to changing portfolio holdings.** The income dividend distributions of the underlying funds are the source of income dividend distributions received by the LifePoints Funds. The LifePoints Funds receive distributions from the underlying funds based on the number of underlying fund shares held by the LifePoints Funds. Therefore, underlying fund allocation changes may result in a change in income distribution rates.
- **Last distribution of the year in mid-December may vary from other quarter distributions more significantly.** LifePoints Funds are scheduled to pay any income distributions quarterly. For the funds with quarterly distributions. The mid-December distributions reflect actual income received by a fund for the first 2½ months of the quarter plus an estimate for the remainder of the month of December. Also included in these distributions are tax adjustments and adjustments required as a result of the audit of financial statements, reflecting the full year of operations of a fund. Therefore, these adjustments may significantly increase or decrease the mid-December distributions relative to other quarterly distributions.
- **The distributions at the beginning of April may vary from other quarter distributions more significantly.** Since this is the first distribution of the calendar year, it includes any adjustments necessary to account for the difference between the estimated and actual income distributions received by the fund in the last part of December, after the mid-December distribution was paid. These adjustments contribute to variability of this period's distribution.

Factors impacting dividend yields

The distribution yield of a fund is the sum of the trailing 12 months of income distributions divided by its current net asset value (NAV), adjusted upward for any capital gains distributed over the same time period. To the extent income dividend distributions for a fund vary from period to period due to factors described above, so will its dividend yield. Additionally, because NAV and capital gains are used in the calculation, their variability impacts the yield. For example, in rising markets the same income distributions produce a lower distribution yield, due to an increased NAV, and vice versa.

Dividend yield is a different metric than SEC yield. Dividend yield is calculated based on income distributed in the past that reflects both income received by the fund and adjustments described above (e.g. currency gains/losses, tax adjustments). Due to its historical nature, dividend yield is not reflective of the current portfolio. SEC yield is calculated based on income received by the funds from current underlying holdings and does not account for currency gain/loss or tax adjustments.

As noted above, changes in the underlying fund allocations impact the LifePoints Funds' income dividend distributions, and therefore their dividend yield as well. Similarly, changes in underlying fund allocation have an impact on the weighted-average dividend yield calculation for the Model Strategies. In particular, fund additions/removals may make changes to yield from period to period more significant, as they generally affect a larger portion of a portfolio relative to a reallocation of existing funds.

LifePoints Funds, Target Portfolio Series and Model Strategy yield differences

There are a number of factors that make the dividend yields of a LifePoints Fund, Target Portfolio Series and a weighted-average dividend yield of a corresponding Model Strategy not comparable.

- **Differences in the underlying funds and their allocations.** These differences have increased over time further reducing comparability of the LifePoints Funds and Model Strategies.

- **LifePoints Funds have higher expense ratios relative to the weighted average expense ratio of the Model Strategies for the same class of shares (e.g. Class S).** Expenses incurred by the funds reduce the amount of income distributed and therefore impact the yields.
- **Dividend yield calculation differences**.
  - Taking class S as an example, LifePoints Funds Class S dividend yield is a function of the income received from the Y classes of the underlying funds and the LifePoints Funds Class S expenses. Model Strategy Class S weighted-average dividend yield is a weighted average of the dividend yields of the Class S underlying funds.
  - The LifePoints Funds dividend yield calculation is impacted by LifePoints Funds NAV and their capital gain distributions. Model Strategy weighted average dividend yield is impacted by the NAVs of all of the underlying funds and their capital gain distributions.
  - Due to quarterly distribution frequency for the LifePoints Funds, dividend yield calculations in certain periods will capture a different set of distributions for the underlying funds than the Model Strategy weighted average dividend yield.

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Fund objectives, risks, charges and expenses should be carefully considered before investing. A summary prospectus, if available, or a prospectus containing this and other important information can be obtained by calling (800) 787-7354 of visiting www.russellinvestments.com. Please read a prospectus carefully before investing.

Important Risk Disclosures:

Mutual fund investing involves risk. Principal loss is possible.

Please remember that all investments carry some level of risk, including the potential of principal invested. They do not typically grow at an even rate of return and may experience negative growth.

Model Strategies are exposed to the specific risks of the funds directly proportionate to their fund allocation. The funds comprising the strategies and allocations to those funds have changed over time and may change in the future.

Investments that are allocated across multiple types of securities may be exposed to a variety of risks based on the asset classes, investment styles, market sectors, and size of companies preferred by the investment managers. Investors should consider how the combined risks impact their total investment portfolio and understand that different risks can lead to varying financial consequences, including loss of principal.

Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes, tax laws and interest rates all present potential risks to real estate investments. Fund investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a fun's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

Use of currency trading strategies may adversely impact a Fund's ability to meet its investment objective of seeking to provide current income.

The LifePoints® Funds are a series of fund of funds which expose an investor to the risks of the underlying funds proportionate to their allocation. Investment in LifePoints Funds involves direct expenses of each fund and indirect expenses of the underlying funds, which together can be higher than those incurred when investing directly in an underlying fund.

Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Model strategies represent target allocations of Russell Investment Company funds; these models are not managed and cannot be invested in directly.

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