Myth-busting the 'closet indexer' misconception about multi-manager / multi-style investing

Russell Investments

Executive Summary

For decades, Russell Investments has advocated a multi-manager, multi-style approach to equity investing based on three core beliefs:

1) Skilled manager selection requires a forward-looking assessment to identify drivers of durable excess returns.

2) No single manager can consistently outperform across all market environments.

3) Effective manager diversification can improve investor outcomes. By combining specialized managers with differentiated approaches, we believe investors can build portfolios that preserve excess return potential while improving the consistency of outcomes over time.

Myth: Multi-manager portfolios are simply "closet indexers."

A persistent myth in the investment community is that multi-manager portfolios are simply "closet indexers." The argument is that since these portfolios often exhibit lower Active Share and Tracking Error[1], they must deliver little true differentiation from the benchmark, raising questions about paying active fees for what appears to be benchmark-hugging behavior.

The reality is that lower Active Share does not necessarily indicate less active management. In a multi-manager portfolio, it is often evidence that multiple independent active managers have been combined into a more efficient portfolio.

When multiple active managers are combined, Active Share and Tracking Error naturally decline because individual active bets partially offset one another. This does not mean active management has disappeared. Rather, it reflects the same diversification principles investors already accept when building portfolios of stocks.

Reality: A well-constructed multi-manager portfolio can diversify manager-specific risk while preserving active return potential, improving the efficiency and consistency of active outcomes.

In this paper, we will walk through Russell Investments' core beliefs around the benefits of multi-manager, multi-style portfolio construction, tackle the myth of closet indexing, and test the approach using a real-world example from historical U.S. small-cap manager data.

[1] See Appendix 1 for list of key terms and definitions

Why consider multi-manager, multi-style portfolio construction in active management?

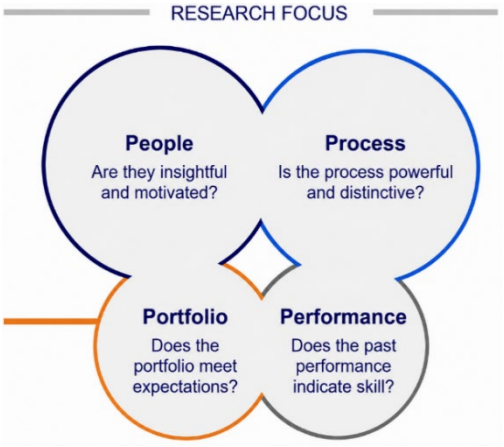
Russell Investments is a leading advocate of multi-manager, multi-style portfolio design. Our framework is rooted in three long-standing beliefs about active management:

1. Managers have cycles and require skilled evaluation

Academic and practitioner research shows that active managers experience performance cycles driven by opportunity sets, factor exposures, competitive conditions, and organizational dynamics. Evaluating whether a manager's skill is repeatable requires a robust, forward-looking framework; one that can distinguish sustainable excess returns from luck or temporary factor rotation.

This forward-looking perspective is core to our process. This is why past performance is only one element of our manager research process and must be evaluated alongside the people, process, and portfolio underlying the results.

Figure 1: Focusing on drivers of future performance



2. No single manager wins all the time

The second principle is equally fundamental: no single manager can outperform in all environments. Decades of market history demonstrate that styles such as value, growth, momentum, quality, low volatility, and small cap leadership rotate frequently. (Figure 2)

Figure 2: Investment styles and strategies rotate frequently

2021	2022	2023	2024	2025
U.S. Growth 32.0%	U.S. Value -5.2%	U.S. Growth 30.0%	U.S. Growth 36.1%	Non-U.S. Val 42.3%
U.S. Value 24.9%	Non-U.S. Val -5.6%	U.S. Value 22.2%	Global Eq 17.5%	EM Growth 34.3%
Global Eq 18.5%	EM Value -15.8%	Global Eq 22.2%	U.S. Value 12.3%	EM Value 32.7%
Non-U.S. Gr 11.3%	Global Eq -18.4%	Non-U.S. Val 19.0%	EM Growth 10.3%	Global Eq 22.3%
Non-U.S. Val 10.9%	Non-U.S. Gr -23.0%	Non-U.S. Gr 17.6%	Non-U.S. Val 5.7%	U.S. Growth 22.2%
EM Value 4.0%	EM Growth -24.0%	EM Value 14.2%	EM Value 4.5%	Non-U.S. Gr 20.8%
EM Growth -8.4%	U.S. Growth -29.4%	EM Growth 5.8%	Non-U.S. Gr 2.1%	U.S. Value 13.2%

Sources: U.S. Growth and Value: S&P 500 Growth Index, S&P 500 Value Index, Non-US Growth and Value: MSCI World x-US Growth Index and MSCI World x-US Value Index, Emerging Markets Growth and Value: MSCI Emerging Markets Growth Index and MSCI Emerging Markets Value Index, Global Equity: MSCI All Country World Index; MSCI Country returns and value stock classifications

3. The diversification benefits of a multi-manager portfolio can improve investment outcomes

A combination of well-researched, specialized managers, each expressing distinct stock selection capabilities and exhibiting relatively low correlations to one another, can offer more consistent long-term outcomes than relying on a single generalist. When multiple differentiated active managers are combined, diversification can reduce manager-specific volatility without necessarily sacrificing expected return. All else equal, that lower volatility can improve compounding, increase terminal wealth and create a smoother investor experience.[2]

When constructed properly, multi-manager portfolios can result in:

- Preserved excess return potential,
- Reduced volatility of excess returns (Tracking Error),
- Improved risk-adjusted results (Information Ratio), and most importantly,
- Improved ending wealth.

This is the essence of skilled multi-manager, multi-style manager research and portfolio construction.

Active Share, Tracking Error, and the Myth of Closet Indexing

The myth that multi-manager portfolios are closet indexers began to gain traction after the influential work of Cremers and Petajisto (2009), who introduced Active Share as a measure of how different a manager's holdings are from the benchmark. Specifically, Active Share is expressed as the percentage of the portfolio that does not overlap with the index.

Their research showed that single-manager portfolios with high Active Share were associated with stronger subsequent performance. This led many investors to draw a flawed conclusion: Any strategy with lower Active Share or lower Tracking Error must be closet indexing and therefore not worth the fee. But this logic only holds when evaluating single managers.

What exactly is a closet indexer?

A closet indexer is not simply a portfolio with low Tracking Error or lower Active Share. A closet indexer is a strategy that charges active management fees while providing little genuine active decision-making or opportunity to outperform its benchmark.

[2] For a full, theoretical demonstration that isolates the diversification benefits of multi-manager, see Appendix 3

Active Share measures difference; it does not measure value.

Active Share tells us how different a portfolio is from its benchmark. It does not tell us whether that difference is likely to be rewarded. Many investors, whether retail, advisory, or institutional, combine managers. This is part of basic Modern Portfolio Theory: diversify risk, not return.

As such, a diversified portfolio of managers will naturally have:

- Lower Active Share
- Lower Tracking Error

…because the active bets of the individual managers are often complementary to one another.

Multi-Manager Myths vs Reality

Myth	Reality
Lower Active Share means less active management	Lower Active Share may simply reflect diversification across active managers
Lower Tracking Error means benchmark hugging	Lower Tracking Error can result from offsetting active bets
More managers dilute active management	Diversification can make active risk more efficient, not less active
Single managers are more active	Single managers are more concentrated; concentration and activeness are not the same thing

This does not necessarily mean the portfolio has less expected excess return.

A multi-manager portfolio may exhibit lower Active Share and Tracking Error than its underlying managers, not because active management has disappeared, but because multiple independent active strategies have been combined into an effectively diversified portfolio.

Empirical analysis: Single manager vs. multi-manager outcomes

To test whether the principles of an effective multi-manager, multi-style approach can be demonstrated in a realistic investment setting, we used historical manager data from the Russell Investments U.S. small-cap active manager universe to simulate single-manager and multi-manager outcomes.

The analysis assumes no skill in identifying which managers will outperform in the future. It does, however, incorporate intentional portfolio construction by combining managers from different styles. This allows us to evaluate whether manager diversification can improve the distribution of benchmark-relative outcomes without assuming an ability to select future winners.

We simulated 10 years of investing in a single manager vs. a multi-manager, multi-style approach. Specifically, a Monte Carlo simulation applies a controlled manager selection and rebalancing process to historical manager data.[3]

The results highlight an important distinction between manager selection and portfolio construction. In this simulation, randomly relying on a single manager produced a median outcome close to the market. With no assumed manager selection skill, that result is intuitive. **Of particular note in the single manager test is the wide dispersion of outcomes, including a pronounced downside tail.**

In contrast, *despite no assumed manager selection skill*, combining managers across styles produced meaningful improvements in return efficiency and outcome consistency, with further improvements when moving from 3 managers to 6 managers. Versus the single manager simulations, we observed:

- **Positive median excess returns and greatly improved Information Ratios.**
- **A much tighter distribution of outcomes, with a higher probability of positive 10-year excess returns.**
- **Meaningfully lower Tracking Error and Active Share.**

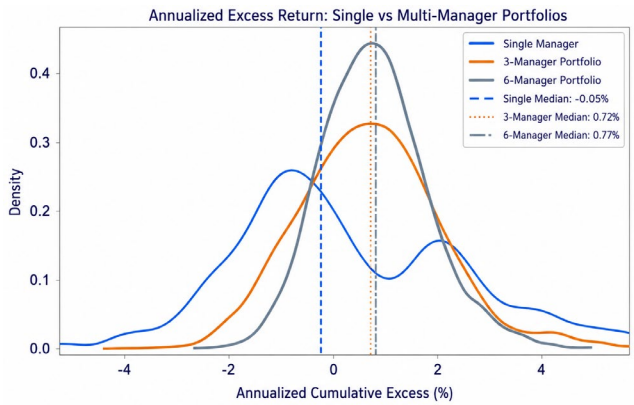
[3] See Appendix 2 for more detail on setup and testing

Table 2. U.S. Small Cap Monte Carlo Median Results: Single Manager vs. Multi-Manager

Scenario	Annualized Arithmetic Excess Return	Annualized Compounded Excess Return	Cumulative 10-Year Excess Return	% of Simulations with Positive 10-Year Excess Return	Tracking Error	Information Ratio	Average Quarterly Active Share
1-Manager	-0.05 %	-0.05%	-1.20%	48.18%	7.23%	-0.01	93.37%
3-Manager	0.41%	0.72%	17.23%	72.44%	4.58%	0.16	82.75%
6-Manager	0.44%	0.77%	18.46%	81.24%	4.01%	0.19	71.21%

Source: Russell Investments. Historical-data Monte Carlo simulation; results are hypothetical. Results shown are median outcomes unless otherwise stated. All returns are gross of manager fees. Actual investor returns would be reduced by applicable fees, expenses, and implementation costs. Each statistic is calculated independently for every simulation path, after which the median result is reported. Consequently, the median Information Ratio may not equal the median excess return divided by the median Tracking Error.

Chart 2. U.S. Small Cap Monte Carlo Median Results: Single Manager vs. Multi-Manager



Source: Russell Investments. Historical-data Monte Carlo simulation; results are hypothetical. Note: The single-manager distribution reflects 5,000 random draws from 128 managers. Repeated sampling from this limited set contributes to its more irregular shape.

How can the multi-manager results produce such a better chance for a successful outcome with lower Active Share and Tracking Error? The reason is straightforward. Active Share measures how different a portfolio looks from its benchmark, while Tracking Error measures the variability of its benchmark-relative returns. Neither tells us how efficiently the portfolio's active risks have been assembled.

Under a traditional interpretation, lower Tracking Error and Active Share might suggest the portfolios were becoming less active. Yet the opposite occurred: the active return profile became more efficient, with higher median excess returns, lower Tracking Error, stronger Information Ratios and a higher likelihood of producing positive cumulative excess returns over the 10-year period.

Thoughtful portfolio construction seeks to combine differentiated sources of active return so that manager-specific risks offset one another without eliminating the portfolio's opportunity to outperform. In this simulation, that resulted in a smoother and more efficient active return profile.

Conclusion

The myth of the multi-manager “closet indexer” persists because many investors focus on the wrong metrics.

Lower Active Share and lower Tracking Error do not necessarily indicate weaker active management. In many cases, they simply reflect the benefits of diversification across multiple active managers.

Just as investors diversify across stocks to reduce company-specific risk, multi-manager portfolios diversify across active managers to reduce manager-specific risk. The result can be a more efficient active portfolio; one that diversifies manager-specific risk while retaining multiple independent sources of potential excess return.

Ultimately, the objective of active management should not be to maximize Active Share or Tracking Error. It should be to use active risk efficiently.

Thoughtfully constructed multi-manager portfolios seek to do exactly that: combine differentiated sources of return while diversifying the manager-specific risks investors do not need to take. Since volatility matters to compounding, reducing unnecessary active risk can also improve the efficiency with which returns translate into long-term wealth.

Appendix 1: Key Terms and Definitions

- **Active Share:** A holdings-based measure calculated as one-half the sum of the absolute differences between portfolio and benchmark weights.
- **Tracking Error:** Annualized standard deviation of monthly arithmetic excess returns.
- **Information Ratio:** Annualized compounded excess return divided by Tracking Error.
- **Arithmetic Return:** The simple average of periodic returns, without accounting for compounding.
- **Compounded Return:** The compounded return experienced over time.
- **Excess Return:** Portfolio return minus the return of the reference benchmark.
- **Annualized Arithmetic Excess Return:** Portfolio arithmetic annualized return minus benchmark annualized arithmetic return.
- **Annualized Compounded Excess Return:** Portfolio compounded annualized return minus benchmark compounded annualized return.
- **Cumulative 10-Year Excess Return:** Total 10-year portfolio compounded return minus total 10-year benchmark compounded return.
- **Percent of Simulations with positive 10-Year Excess Returns**: Share of simulations where the compounded portfolio return beat the compounded benchmark return over the full 10 years (in other words, share of simulations where cumulative 10-year excess is greater than 0).
- **Average Quarterly Active Share:** One-half the sum of the absolute differences between portfolio and benchmark security weights, then averaged across quarters.

Appendix 2: Empirical analysis setup

We compare multi-manager vs. single manager using the following approach:

1. Setup:
    a. Universe: Russell Investments US Small Cap active manager universe.
        i. Eligible managers: 128 managers with complete return histories over the 10-year analysis period, comprising 64 outperformers and 64 underperformers. Managers launched or terminated during the period are purposely excluded.
        ii. Managers were classified ex-post according to whether they generated positive or negative excess returns over the full analysis period relative to their style-specific benchmark. Equal representation from the two groups was used to neutralize any assumed ability to identify future outperformers.
    b. Start Date: April 1, 2016
    c. End Date: March 31, 2026

d. Quarterly Active Share: Calculated at each quarter-end as one-half of the sum of the absolute differences between the normalized portfolio and benchmark security weights

    i. Active Share only used for simulations with 6 years or more of holdings (507 1-Manager, 1,323 3-Manager, and 2,447 6-Manager simulations excluded from overall Active Share calculations)

2. Randomly select a 1-manager strategy.

    a. Assume a 50% probability of picking a manager with positive/negative excess returns for the holding period so there is no assumed skill in manager selection.

3. Randomly select a 3-manager strategy.

    a. Use a multi-style approach randomly picking one manager from each of the Russell Investments' value, growth, and market-oriented style universes.

    b. Assume a 50% probability of picking a manager with positive/negative excess returns for the holding period so there is no assumed skill in manager selection.

4. Randomly select a 6-manager strategy.

    a. Use a multi-style approach randomly picking two managers from each of the Russell Investments' value, growth, and market-oriented style universes.

    b. Assume a 50% probability of picking a manager with positive/negative excess returns for the holding period so there is no assumed skill in manager selection.

5. Assume a 10-year holding period. For multi-manager simulations: equal weighting and annual rebalancing throughout the full holding period.

6. Generate returns analytics based on the weighted returns of the selected manager(s) relative to the Russell 2000 Index.

7. Repeat the steps above for 5,000 simulation paths to produce a distribution of results.

The analysis is presented gross of manager fees to isolate the effects of manager diversification and portfolio construction. Actual investor outcomes will also reflect manager fees, vehicle expenses, implementation costs, and other applicable charges.

Running the test in this way allows us to test the math around single vs. multi-manager approaches by reflecting the dynamics of portfolio construction.

Appendix 3: Why Diversification Can Improve Outcomes

A Hypothetical 2-Asset Example

The empirical analysis above illustrates the effects of multi-manager portfolio construction in a historical manager universe. The simplified example below isolates one specific mechanism underlying diversification: the effect of lower volatility on compounding when expected returns are held constant.

To prove the math behind the theory, we present a simplified example with two hypothetical assets. Each asset has the same expected return and standard deviation. The correlation between the two is set to zero.

The purpose of this example is not to suggest that returns are perfectly predictable or that correlations are always zero. Rather, it is to isolate the effect of diversification. If two assets have the same expected return and volatility, but their return patterns are not perfectly correlated, combining them can preserve expected return while reducing overall volatility.

The simulation is based on the following assumptions:

- Annualized arithmetic return: 10%
- Asset 1 volatility: 30%
- Asset 2 volatility: 30%
- Correlation between assets: 0.0
- Portfolio weights: 50% / 50%
- Simulation paths: 5,000
- Time horizon: 240 months, or 20 years

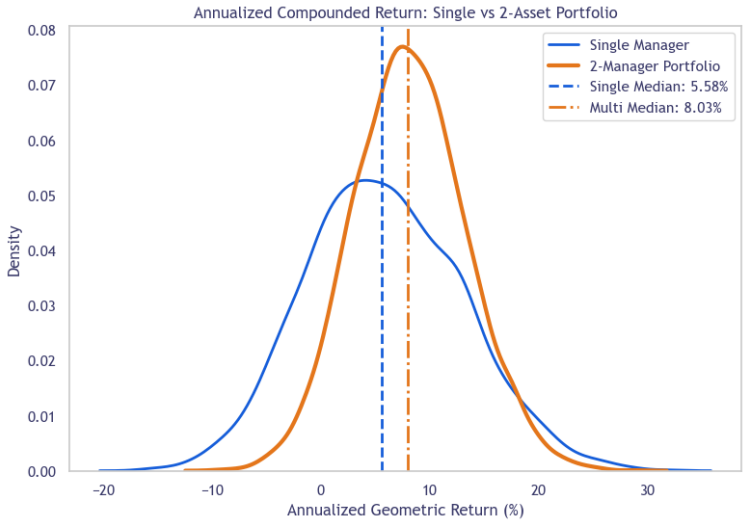
The simulation uses monthly return paths and compounds returns over the full 20-year period. The single-asset portfolio is based on one return stream. The two-asset portfolio combines two independent return streams at equal weights and rebalances monthly.

Table 1. Monte Carlo Median Results: Single Asset vs. Two-Asset

Scenario	Annualized Arithmetic Return	Annualized Compounded Return	Volatility	Terminal Wealth	Max Drawdown
Single Asset	9.92%	5.58%	30.26%	2.96x	-66.40%
Two-Asset	10.02%	8.03%	21.41%	4.68x	-46.13%

Source: Russell Investments. Hypothetical Monte Carlo simulation. Results shown are median outcomes unless otherwise stated.

Chart 1. Monte Carlo Median Results: Single Asset vs. Two-Asset



Source: Russell Investments. Hypothetical Monte Carlo simulation.

Why Geometric (Compounded) Returns Matter More Than Arithmetic Returns

Academic research and analysis often focus on average annual returns, also known as arithmetic returns. However, long-term wealth creation is driven by geometric returns—the compounded return investors actually experience over time. The key point is that volatility creates a drag on compounding.

For example, an initial portfolio of $100 that gains 50% in one year and loses 50% in the next has an arithmetic return of 0% per year. Yet $100 becomes only $75, resulting in a negative geometric return.

This is why reducing volatility can improve long-term outcomes even when average returns remain unchanged.

When multiple active managers are combined, arithmetic return expectations may remain similar, but lower volatility can lead to higher compounded returns, greater terminal wealth,

Although the portfolios generated nearly identical arithmetic returns, the two-asset portfolio produced an annualized compounded (geometric) return nearly 250 basis points higher. The difference was driven primarily by lower volatility, which reduced volatility drag and improved compounding.

When volatility is reduced, more of the portfolio's return is retained through compounding. The result is a higher geometric return, greater terminal wealth, and a smoother investment journey.

In other words, diversification is not simply reducing risk. It is improving the efficiency with which returns are converted into long-term wealth.

Disclaimer:

The information, analyses and opinions set forth herein are intended to serve as general information only and should not be relied upon by any individual or entity as advice or recommendations specific to that individual entity. Anyone using this material should consult with their own attorney, accountant, financial or tax adviser or consultants on whom they rely for investment advice specific to their own circumstances.

Products and services described on this website are intended for United States residents only. Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained on this website should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional. Persons outside the United States may find more information about products and services available within their jurisdictions by going to Russell Investments' Worldwide site.

Russell Investments is committed to ensuring digital accessibility for people with disabilities. We are continually improving the user experience for everyone, and applying the relevant accessibility standards.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates Management, L.P., with a significant minority stake held by funds managed by Reverence Capital Partners, L.P. Certain of Russell Investments' employees and Hamilton Lane Advisors, LLC also hold minority, non-controlling, ownership stakes.

On July 2, 2026, Russell Investments Group, Ltd. (“Russell Investments”) entered into a definitive agreement and plan of merger (the “Transaction”) pursuant to which Russell Investments will be acquired by a consortium led by B Capital Group Management, L.P. that includes California Public Employees Retirement System. The Transaction is expected to close by the end of Q1 2027, subject to the receipt of regulatory approvals and other customary closing conditions.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

CORP-13164