

Perspective

July 2010

Governance

Considering the bigger picture



Capital markets
Do low dividends
indicate low returns?

The gold rush
Are there opportunities
in commodities?

FX trading
Who's looking after
your interests?

Investment services

Our global network of investment professionals helps investors around the world develop, implement and maintain efficient and effective investment programmes. Our clients range from small and mid-sized organisations to many of the world's largest and most sophisticated investors, responsible for hundreds of billions of pounds.

Our flexible range of services includes the following:

1. Fiduciary management
2. Consulting and advisory services
3. Third-party manager solutions
4. Implementation services
5. Russell Indexes

Fund snapshot

Emerging Markets Equity Fund

"Russell's multi-manager approach helps investors avoid the large pitfalls without sacrificing returns. For example, in 2009 the dispersion between the best and worst manager return was over 100%; picking the wrong manager cost investors dearly. In this environment, Russell's Emerging Markets Equity Fund outperformed the benchmark by over 9% gross of fees.

Our process also helped our Emerging Market funds to win the 2010 Lipper Fund Awards for Emerging Markets over five and ten years in different regions."

Scott Crawshaw, CFA
Portfolio Manager



Industry recognition



Manager of managers of the year
2010



Multi-Manager of the year
2010



Consistent, risk-adjusted
outperformance relative to peers



Top marks in Transition
Management 2010



Most thorough due diligence
process in the consulting industry

Russell in-house lunch on 21st September

CAN FIDUCIARY MANAGEMENT REDUCE COST AND ENHANCE TRUSTEES' CONTROL OF PENSION FUNDS?

Every month we invite key members of the pensions community to discuss current investment topics. Each session includes a presentation by senior associates at Russell, managers we research or key figures in the industry.

At the next session, we are excited to host a Question and Answer session with a pensions manager, Tom Gallagher, Pensions Director at Smurfit Kappa, who recently implemented a Fiduciary Management Pension Solution for their pension scheme.

To reserve your place or to find out more, please contact Dawn Cuthbert on 020 7024 6363.

Welcome



Since the accident on BP's Deepwater Horizon oil rig in April, the cost is mounting for all stakeholders, from BP's shareholders who have seen the value of their investment plummet to local residents and businesses, wildlife and the environment. There are many questions that need answering. "Who was to blame?" "Will the company survive?" "Could it have been prevented?" "What can be done to minimise the risk of this type of event occurring in the future?" Trustees are facing almost identical questions as they look at their pension fund deficits.

Just as any permanent worldwide ban on deep-water drilling is unlikely to be sustainable, trustees can't eliminate risk altogether. However, Trustees and sponsors can better monitor and manage these risks in real time. But this calls for a radical transformation of the modus operandi of most trustees who spend a significant proportion of their time thinking of investment returns and not enough time on risk.

We argue in our feature article that the root cause of the "unexpected" deterioration in funding of most pension funds is attributable to a failure in risk management. We propose that inadequacies of the current governance structure need to be addressed if we are to avoid making the same mistakes again. In a subsequent article we propose that fiduciary management may provide a possible answer.

Trustees may not be able to eliminate the risk of their own pipe leak in the future. But with a proper governance structure, a focus on risk management and the right decisions being made by the right people, they may be able to minimise the chance of any such episode and in any event contain the fallout.

Regards,

A handwritten signature in black ink, appearing to read 'Shamindra Perera'. The signature is stylized and cursive.

Shamindra Perera
Managing Director, Fiduciary Management

RUSSELL INVESTMENTS

Russell Investments provides asset management and investment services to institutional and individual investors globally. We serve clients in Europe, Middle East and Africa from offices in London, Paris, Amsterdam, Johannesburg and Geneva, as well as our head office in Tacoma, Washington.

A pioneer in multi-manager investing and the creator of the Russell Indexes, Russell manages approximately £94 billion in assets. Founded in 1936, Russell is a subsidiary of Northwestern Mutual. More information about our investment products and services is available at www.russell.com

Data as at 30 June 2010



Will current low dividends reduce future long-term equity performance?

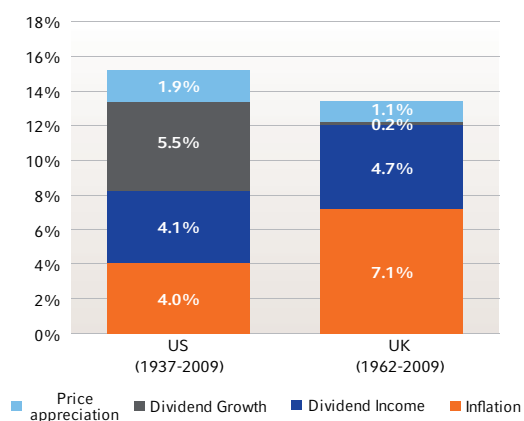
John Velis, Head of Capital Markets, EMEA argues that current low dividend yields are a short-term blip in the long-term trend and will be countered by higher future dividend growth.

The vast majority of after-inflation returns from equities come from income. In other words, dividends and dividend growth drive the performance of stock markets over the long term, not capital gains. This is intuitive: profits are primarily returned to shareholders in the form of dividend income; prices only increase if the market thinks that future dividend payouts will increase.

An illustration

This point is illustrated in Figure 1. Looking at the US equity market data (for which we have the longest history) between 1937 and 2009, on average equities returned nearly 16 percent per annum over a ten-year holding period. In real terms, this translates to 11.5% per annum.

Figure 1 – Average long-term equity market returns



How much of that rate of return is accounted for by real price appreciation? Not much, as it turns out: just 1.9%, or less than one-eighth of the total real return. The vast majority of equity returns is in fact accounted for by income paid to shareholders in the form of dividends (4.1% per year) and the average annual growth rate in those payments, an additional 5.5% per year.

Data for the UK (from 1962 through 2009) shows a similar pattern. Of the 13.1% annualised return over that period, 7.1% is due to inflation and just 1.1% to price appreciation. The remaining 4.9% of FTSE-All Share returns is a combination of dividend income and dividend growth.

Low dividends are a short-term interruption of the longer-term trend

Given the events of the Credit Crunch of 2007-08, many firms – especially banks – were forced to cut or even suspend dividend payments, opting instead to channel cash into paying off debt or shoring up balance sheets that had been negatively impacted by weakened assets. As a result the last few years were particularly poor for dividend investing.

However, we have seen this in the past and, despite periods with low dividend payouts historically, equities have on average produced high long-term real returns. These were driven by high dividends or high dividend growth. Given that dividend payments are now at a historically low level, we view the prospects for growth in dividends as quite promising over the next several years. We believe that it is likely that one of the great – but often overlooked – truisms of investing, that investors own stocks to share in the profits of firms via dividend income, will be confirmed yet again over time.

NOTES: US: S&P500 (in USD), UK: FTSE All-Share (£). Bar charts represent average of rolling 10Yr annualised periods
SOURCE: Russell Calculations, Shiller database, FTSE, Bloomberg

The gold rush

Mark Paris, Senior Research Analyst, discusses the opportunity for growth in commodities

Commodities enjoyed a very strong run prior to the global financial crisis of late 2008 but the market subsequently fell by over 50% before rallying to post a return of almost 20% for 2009¹. Some investors question the future prospects of commodities, but we believe that the market will continue to grow strongly for the reasons outlined below.

China's ascent:

China has focused its attention on making significant inroads into Latin America's resource rich economies. In particular, they have sought out companies involved in the production of iron ore and copper so that they have the materials to build the infrastructure required for the next commodities boom.

Asian expansion:

As Asia's "tiger" economies continue to develop, their demands for infrastructure – and the raw materials necessary to meet this demand – will increase markedly.

The "petrodollar":

In Russia natural resource revenues flowing from the country's deep oil and natural gas resources look set to be funnelled into diverse infrastructure projects, such as improving access to the Black Sea resort of Sochi in time for the 2014 Winter Olympics.

Demographic change:

The expansion of the middle classes in developing markets like China and India has seen growing consumption of meats (particularly pork) and processed foods in the former, while the latter's 'fats and oils' consumption has increased.

Climate change:

Strong economic growth over the past few years has granted resource-rich governments significant capital to dedicate towards infrastructure investment. These economies generate disproportionate demand, needing hard commodities such as steel, nickel, tin and copper.

Of course, factors such as the environment, geopolitics, currency, demographics and technology could negatively affect market prices in the short term. However, we believe that the medium-long term remains positive for commodities.

The strategic reason for holding commodities

- **Attractive long-term return prospects:** Over the long term we expect continued and increased demand for commodities from rapidly emerging economies like China and India.
- **Diversification:** As with other real assets, higher commodities prices translate into higher costs for corporations just as they represent higher costs for households. As such, when commodity prices rise financial markets suffer, and vice versa.
- **Help portfolios to outpace inflation over the long term:** Commodities and other real assets form a material portion of the cost basis of production and household expenses, so it is reasonable to assume that they can offer an element of inflation protection.

Figure 1 - Commodities cover a wide range of real assets

Energy	Industrial Metals	Precious Metals	Agriculture & Livestock	
Crude Oil	Aluminium	Gold	Wheat	Sugar
Natural Gas	Copper	Silver	Cotton	Coffee
Gasoline	Zinc		Corn	Lean Hogs
Heating Oil	Nickel		Soybeans	Live Cattle

¹Source: Dow-UBS Commodity Index in USD

Governance: Considering the bigger picture

Lloyd Raynor, Senior Consultant, explains how pension funds could improve their fund governance by acting less like investment clubs and more like insurance companies, applying a greater focus on liabilities.

What caused the large deficits facing many pension funds today? It's easy to blame the credit crunch: sharply falling asset prices, simultaneously rising liability values, increased correlation between return seeking assets and the drying up of liquidity. However, the real reason is that some of the risks inherent in most pension funds were not properly understood, let alone measured and managed, repeating the so-called "1-in-200" event of the "tech wreck" a decade ago.

So, how should pension funds avoid repeating past mistakes?

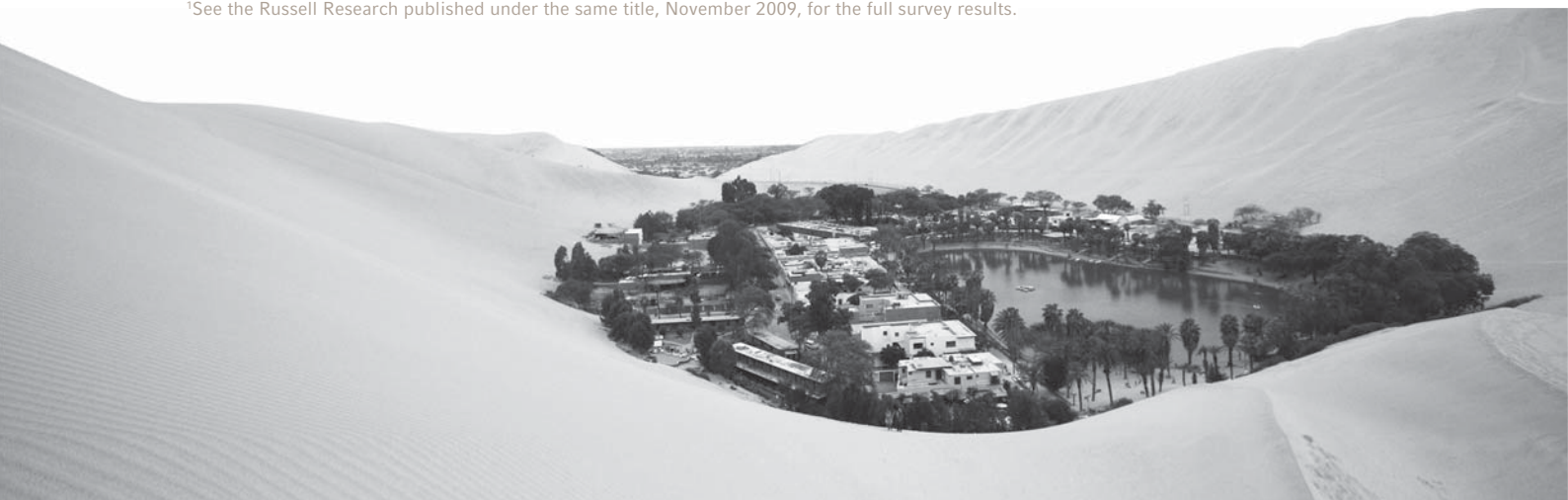
GOVERNANCE LIES AT THE HEART OF THE REAL PROBLEM

The majority of trustees believe that their present structures are effective as they have Investment Committees, in-house staff or advisers to help them make investment decisions. However, some funds still continue to assign too much importance and time to discussing the relative merits of different investment ideas, strategies and managers, applying insufficient focus on their liabilities. They can improve how their funds are run by learning from the strong focus on liabilities by insurance companies. In addition, they can learn from the day-to-day professionalism that insurance companies apply to the management of their assets. In particular, funds should:

- 1. Focus on total fund risk.** It is critical to understand and define the nature and level of risks that are appropriate for your particular fund, given inter alia, the strength of the sponsor covenant, affordability of contributions and funding objective. Rather than treating investments as a series of discrete decisions, the focus should be on the sum of these decisions in the context of the overall fund risk.
- 2. Consider dynamic investment and risk management.** Real-time management is required for maintaining the optimal investments and risk levels in the face of fast-changing markets and their impact on the funding level. Given the calendar-time meeting schedules of trustees and investment committees, it is unrealistic to expect the continuous monitoring and management of overall fund level investments and risks within the current governance structure of many funds.
- 3. Employ experts and invest in systems and processes.** Insurance companies employ full-time professionals, supported by systems and processes which are subject to constant enhancements, to manage their investments and risks. Most pension funds don't have the scale to build the infrastructure needed to manage their pension fund in-house.

If the pension fund was an insurance subsidiary of the sponsor, it is very unlikely that it would be run as it currently is.

¹See the Russell Research published under the same title, November 2009, for the full survey results.



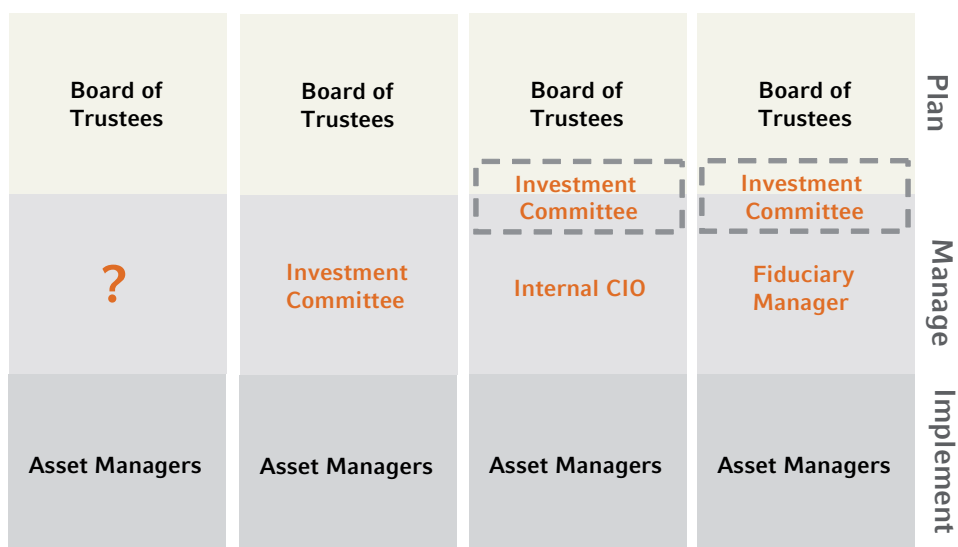
WHAT SHOULD TRUSTEES DO DIFFERENTLY?

There are a number of different governance models available to pension funds that satisfy best practice; the most appropriate depends on the fund's investment complexity and access to in-house resource and experience (figure 1 shows some of these structures). For some, the answer lies in changing their governance model. For others, those unwilling or unable to change their model, modifying some of their practices will help to make significant improvements, for example:

- 1. Revisit the trustee agenda.** Trustees need to refocus on their objectives, risk budget and overall investment strategy. Often, trustees get distracted from their priorities by getting involved in decisions which should be delegated to those responsible for implementation. For example, does your Trustee Board or Investment Committee get involved in manager beauty parades or manager presentations? The answer should arguably be 'no' given the need to maintain a large line-up of managers if pursuing alpha, but it rarely is.
- 2. Delegate to expertise and resource.** This sounds obvious, but do all the members of your Investment Committee have an investment background? Many funds have Member Nominated Trustees on their Investment Committees, which suggest delegation to representation, not expertise. Also, most funds don't even have one full-time employee solely dedicated to investments, an inadequate resource to implement complex, real-time strategies.
- 3. Streamline over-elaborate oversight reports.** Oversight reports often comprise of excessive amounts of data as opposed to the higher-level data that decision-makers in a governing (as opposed to managing) capacity should be receiving. A trustee should not have to notice the tenth number on the seventh page to find out that something is wrong. Rather, this information should be emphasised far more effectively in a shorter report. Good oversight reports should be brief, focus on the big picture, set out exceptions and provide an evaluation of whether the delegated task is being done well (e.g. a traffic light report).

Today, one of the biggest challenges to effective pension fund management is a lack of introspection on the part of trustees with respect to how their fund is run. A large number of trustees think their fund is well run simply because they have developed beyond the simple trustee/balanced manager model prevalent a decade ago. But if this is the case, one might query why so many funds have larger deficits now than they would ever have expected. In many cases, trustees owe it to their members to revisit their governance structures to consider whether it is possible to institute greater professionalism with regard to the management of their fund's assets. To this end, the insurance industry, while certainly not perfect, provides a useful case study for how many funds could change their governance practices.

Figure 1 – Possible decision-making structures





Clearer accountability

Defining the three levels of fiduciary responsibility

Fiduciary management can bring greater accountability in the decision-making process. Shamindra Perera, Managing Director, Fiduciary Management, looks at the different roles in a pension fund and how a fiduciary manager fits in.

A ‘fiduciary’ is a person or body that stands in a position of trust to another person (the beneficiary). The fiduciary has scope to exercise some discretion and its actions will affect the beneficiary’s legal or practical interest. Identifying the roles of different types of fiduciary helps to ensure clearer accountability; we set out the three main fiduciary roles below, illustrating pension fund governance in the context of corporate governance principles.

Governing Fiduciary: The board of trustees is the governing fiduciary of a pension fund in the same sense that the **board of directors** is the governing fiduciary of a company. At a minimum, the governing fiduciary has responsibility for setting the objectives of the fund and formulating the investment strategy for achieving those objectives. In the context of fiduciary management, the trustees remain the governing fiduciary of the pension fund. *This is an often misunderstood point - there is a perception that fiduciary management entails a handing over control of the pension fund, which is not the case.*

Managing Fiduciary: The role of the managing fiduciary is to implement the investment strategy within the guidelines set by the governing fiduciary. Traditionally, this function is performed by in-house pension staff and/or an investment committee. In the context of a company, its **management team** performs the function of

the managing fiduciary and is entrusted with executing the strategy adopted by the board of directors. In the absence of adequate in-house expertise or resources, it makes sense to outsource the managing fiduciary responsibility that cannot be implemented efficiently in house to an external fiduciary manager (its primary function).

Operating Fiduciary: The operating fiduciary in a pension fund is responsible for buying and selling securities. Apart from some of the very largest pension funds, it is common practice to outsource the operating fiduciary responsibilities to external fund managers. To complete the corporate analogy, the operating fiduciaries of a company are its **employees**. The operating fiduciary is accountable to the managing fiduciary and will be monitored in line with metrics agreed between them. Among other things, the managing fiduciary requires the expertise, systems and resources to adequately understand and monitor the activities of the operating fiduciary.

In short, fiduciary management refers to the outsourcing of the managing fiduciary function to an expert, who has the appropriate skills, resources, systems and scale to perform the required responsibilities efficiently. The governance structure of this solution can be illustrated in the governance matrix below.

Role	Function	Accountability		
		Corporate Equivalent	Traditional Pension Fund Structure	Enhanced Pension Fund Structure
Governing Fiduciary	<ul style="list-style-type: none"> Set vision and objectives Control strategy Oversee the managing fiduciary 	Board of Directors	Trustee	Trustee & Sponsor
Managing Fiduciary	<ul style="list-style-type: none"> Advise governing fiduciary Manage the operating fiduciary Accountability for implementing strategy 	Management	Not always clear	Fiduciary Manager
Operating Fiduciary	<ul style="list-style-type: none"> Discrete tasks to execute strategy 	Employees	Investment Managers	Investment Managers

Are your FX fees too high?

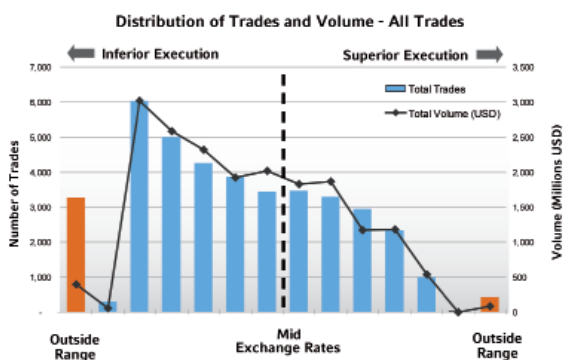
By Shashank Kothare, Director, Investment Communications

In October 2009 a lawsuit filed against custodian State Street on behalf of two of the world's largest pension funds¹ alleged that these funds had been overcharged for foreign exchange ("FX") trading by over US\$56m over an eight year period. Regardless of the specifics of this particular case, many commentators have noted the lack of transparency in the FX market – a feature which is costing pension schemes through inefficient execution according to our studies.

The cost – empirical evidence

Over 2008/2009, we analysed almost 40,000 FX trades conducted on institutional assets totaling approximately US\$19 billion. Illustrated in the chart below, which plots the exchange rate achieved on each trade relative to the mid price of the day, there is a bias towards inferior trade execution (greater frequency of observations to the left of the dotted line). We estimate that the average cost incurred by the clients whose trades were measured was approximately 9 basis points ("bps"). This figure greatly exceeds most cost estimates in the FX market, which has typically been in the range of 1-3 bps for the most traded developed market currencies.

In addition, we found the FX execution costs for many individual clients to be much higher, with one investor suffering average FX execution costs in excess of 40 bps. It is clear that trading is not, as is often thought, a friction-free process.



Causes

There are four potential causes for this observation:

- › FX trading is not a core competency of many investment managers.
- › The bundling of FX trading with custody services to lower explicit costs.
- › Lack of market structure.
- › Potential conflict of interest.

What can investors do?

One of the most obvious courses of action to ensure FX is executed efficiently is to state publicly that you will be reviewing the costs associated with its execution. Alternatively, investors or managers may want to consider appointing a third-party agent to manage all or some of their FX trades.

In short, Russell's research suggests that investors cannot simply rely on their managers or custodian to execute FX trades efficiently. Too often FX receives a lack of attention resulting in a material impact on costs for investors. This issue is discussed in detail in our paper "Are your FX fees too high? - Ways to close the responsibility gap".

¹ See article in Global Investor, 21 October 2009, for further details. Source: Russell Investments

Q&A with our head of Transition Management.



Chris Adolph is Russell's Head of Transition Management in EMEA. Shashank Kothare talks to him about his move to Russell last year and what he sees as the main factors affecting the transition management industry.

Chris, you have worked with firms such as First Quadrant, State Street and UBS. How is Russell different to these organisations?

A question often asked is how will you adapt to a smaller company? What people often don't realise is that the larger the company sometimes the more siloed the separate business units. In one of my previous roles the Transition Management (TM) team was housed in a small office where the door had to be kept closed at all times. If not closed properly a security guard would actually appear!

It was very refreshing to find that at Russell not only does the TM team sit along side such integral units as overlay services, but that inter-departmental coordination is positively encouraged. It certainly demonstrates the seamless nature of the process that is so often talked about in TM, but rarely actually evidenced in practice.

You have been in the financial services industry for over 20 years. How has transition management changed over the last two decades?

In the 1990s, the number of transition managers in the UK ballooned from a mere handful to dozens as investors moved away from balanced mandates and transitioned to more specialist ones. More recently the squeeze

on internal resources, brought on in large part due to the impact of the "credit crunch", has seen the number of providers probably halve. At the same time the range of investment services investors need from Transition Managers has significantly expanded, encompassing areas such as overlay services, and LDI.

What do you think investors will want from transition managers in the future?

I believe that investors will continue to demand more of their transition managers while at the same time insisting on greater transparency, but this will not be limited to transparency of cost but extend to transparency of process. With greater attention by finance directors on the impact of pension schemes on their corporate bottom lines, trustees will want to apply a greater focus on the governance structure and risk management procedures.

Outside of work, what keeps you busy?

I love sport, but not just watching. As a qualified rugby referee, when I'm not blowing a whistle at the Sutton and Epsom rugby ground every Sunday, I manage a local cricket team. Even when on holiday, I'm happiest when I'm skiing or scuba diving, and I can't wait to do another solo sky dive.

What is Transition Management?

When moving assets from A to B, such as switching from one manager to another, you can simply 'sell out' of one manager and 'buy' the other. However, this can introduce unnecessary dealing costs as some investments may be sold and then re-bought. However, implementing changes efficiently is only part of the story: investors often ignore the risks associated with a transition.

During the transition period, often no-one takes responsibility for performance and a portfolio can often be exposed to large unintended exposures. A simple example illustrates this: if during a transition period 50% of the portfolio is held in cash and the market goes up by 10% during this period, the investor has lost 5% without noticing it.

A Transition Manager takes accountability during a transition, helping investors to minimise cost, minimise risk and ensure an efficient and timely completion of the overall project.

Contacts

London // Rex House, 10 Regent Street, London SW1Y 4PE



Shamindra Perera
Managing Director,
Fiduciary Management
Tel: +44 (0)20 7024 6198
Email: sperera@russell.com



Roger Whittaker
Director, UK Sales
Tel: +44 (0)20 7024 6400
Email: rwhittaker@russell.com



Justin McKie
Head of Large Market, EMEA
Tel: +44 (0)20 7024 6334
Email: jmckie@russell.com



Loretta Leberknight
Director, UK Sales
Tel: +44 (0)20 7024 6287
Email: lleberknight@russell.com



Mirko Butti
Director, Southern Europe, Middle East
and North Africa
Tel: +44 (0)20 7024 6709
Email: mbutti@russell.com

Amsterdam // World Trade Centre, Strawinskyiaan 321, 1077 XW Amsterdam, The Netherlands



Gerben Borkent
Associate Director, Sales, Netherlands
Tel: +31 20 567 4316
Email: gborkent@russell.com

Paris // 6, rue Christophe Colomb, 75008, Paris, France



Dominique Dorlipo
Managing Director, France
Tel: +33 153 57 40 25
Email: ddorlipo@russell.com



Lionel Tangy-Malca
Manager, Sales and Client Service, France
Tel: +33 153 57 40 28
Email: ltangy-malca@russell.com

Johannesburg // 63 Wierda Road East, Wierda Valley, Sandton 2196, South Africa



Mark van der Walt
Manager, South Africa
Tel: +27 11 505 6004
Email: mwalt@russell.com

This material is not intended for distribution to retail clients. This material does not constitute an offer or invitation to anyone in any jurisdiction to invest in any Russell product or use any Russell services where such offer or invitation is not lawful, or in which the person making such offer or invitation is not qualified to do so, nor has it been prepared in connection with any such offer or invitation.

Unless otherwise specified, Russell Investments is the source of all data. All information contained in this material is current at the time of issue and, to the best of our knowledge, accurate. Any opinion expressed is that of Russell Investments, is not a statement of fact, is subject to change and, unless it relates to a specified investment, does not constitute the regulated activity of "advising on investments" for the purposes of the Financial Services and Markets Act 2000.

The value of investments and the income from them can fall as well as rise and is not guaranteed. You may not get back the amount originally invested.

Any forecast, projection or target is indicative only and not guaranteed in any way. Any past performance figures are not necessarily a guide to future performance. Any reference to returns linked to currencies may increase or decrease as a result of currency fluctuations. Any references to tax treatments depend on the circumstances of the individual client and may be subject to change in the future.

Copyright © 2007 – 2010 Russell Investments Limited

Issued by Russell Investments Limited. Company No. 02086230. Registered in England and Wales with registered office at: Rex House, 10 Regent Street, London SW1Y 4PE. Telephone 020 7024 6000. Authorised and regulated by the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.