

Russell Update

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Market Update on Recent Financial Volatility

Ernie Ankrim, Russell's Chief Investment Strategist, addresses events that have developed in the financial markets over the past few days.

The Situation

Recent extreme market volatility has resulted in heightened anxiety and concern by investors. While we believe that risks do remain in what might ultimately go down as one of the most significant crises in financial markets history, monetary authorities appear to be making calculated responses to each complex situation as they unfold.

Just recently, central banks around the world announced a plan to inject more than US\$180-billion into global money markets in a co-ordinated attempt to lubricate seized-up lending caused by the collapse of major financial institutions on Wall Street.

The U.S. Federal Reserve's interaction with several of Wall Street's largest institutions illustrates the complexities that are involved in this new financial market environment. In the case of Bear Stearns, the Fed faced a choice as to whether or not to intervene. The Fed judged that it was in the market's interest for this institution to survive, albeit via a takeover by JP Morgan.

Counter Party Risk

The issue here seemed to be counterparty risk. In the simplest terms, counterparty risk is the chance that the person on the other side of a deal - the counterparty - won't be there when it's time to pay up.

In financial markets, traders and banks are constantly thinking about counterparty risk. When they make a deal to buy or sell, they often look at the credit rating of the party on the other side of the transaction. If the credit rating is high, they will go ahead with the deal. If the credit rating is low, they might ask for additional guarantees or collateral. Or maybe they won't do business with the counterparty at all, which is what happened to Bear Stearns.

The case of Fannie Mae and Freddie Mac illustrates a similar, if somewhat different point. In this case, given the implicit promise of U.S. government backing for these two entities, the Federal Reserve judged that it would have been untenable to let them fail.

Similarly, the Fed put together an emergency loan package in exchange for the government assuming an 80% ownership position in AIG. The view is that had these entities failed, it could have had dramatic consequences on an already fragile financial system.

In the case of Lehman Brothers, it appears that the Fed wanted to send another message to the marketplace. That is, the U.S. government will not support all institutions impacted negatively by this financial crisis. In their minds, to do so over the long term could result in

investors taking on more imprudent risk, not less. Here the Fed allowed capitalism to function more or less unconstrained, resulting in a negative outcome for Lehman and its investors.

On the upside, the announcement that Barclays PLC will purchase Lehman's North American banking operations (as well as its New York and New Jersey facilities) may indicate that we're closer to the end of this crisis than we are to the beginning.

Historically, private institutions have stepped up in cases like this when 1) they've felt reasonably certain about what federal authorities are going to do relative to the entity in question and 2) they're confident in the potential value of the company (or parts of the company) they're buying.

Outlook

Looking ahead, it may be the case that the current credit crisis causes business conditions to tighten, which may result in a drag on gross domestic product. It remains uncertain, however, whether the market will look past this period and anticipate improving conditions in 2009. In our view, this seems somewhat likely. As always, the market is a forward-looking mechanism. Once investors believe the worst has passed, they may be inclined to take on risk in equities (including financials) again.

Broadly speaking, we believe the recent crisis highlights the importance of several of Russell's investment tenants. First, recent market action has obviously spoken to the danger of insufficient diversification. From our perspective, the meltdown in the financial sector illustrates the necessity of broad diversification not just among securities, but among managers and investment styles.

Lastly and most importantly, we believe this period of crisis highlights the need for a long-term investment perspective. While the last year has been difficult and Monday's sell-off was substantial, there have been worse days in the market. For those patient investors with a long-term perspective, this too shall pass. Broadly speaking, our advice to clients is to stay diversified, stay invested, and to match their level of risk with their long-term investment objectives. We believe this is a rational strategy for consistently building wealth over time.

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