

Market Review

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BRIC countries after Russell Index 2009 Reconstitution: a snapshot in time

Reconstitution of the Russell U.S. indexes—the Russell 3000[®] (broad market) Index, the Russell 2000[®] (small cap) and Russell 1000[®] (large cap) indexes, and their value and growth sub-indexes—has long been a major event in U.S. equity markets. In 2007, Russell launched the Russell Global Index, the reconstitution of which takes place annually on the same day as that of the U.S. Index. Russell's reconstitution (Recon) day is now an event of global significance.

The most recent reconstitution of Russell indexes took place on June 26, 2009. In this commentary, we use the moment of Recon 2009 to examine how the positions and roles of the BRIC countries—Brazil, Russia, India and China—have changed since Recon 2008 (which set index membership for the period June 2008 to May 2009).¹ We focus on these four countries to underscore how the Russell Global Index, which is constituted on a global-relative rather than country-first basis, illuminates the structure of the world equity markets in terms of emerging vs. developed countries, regional distribution, and sector and style.²

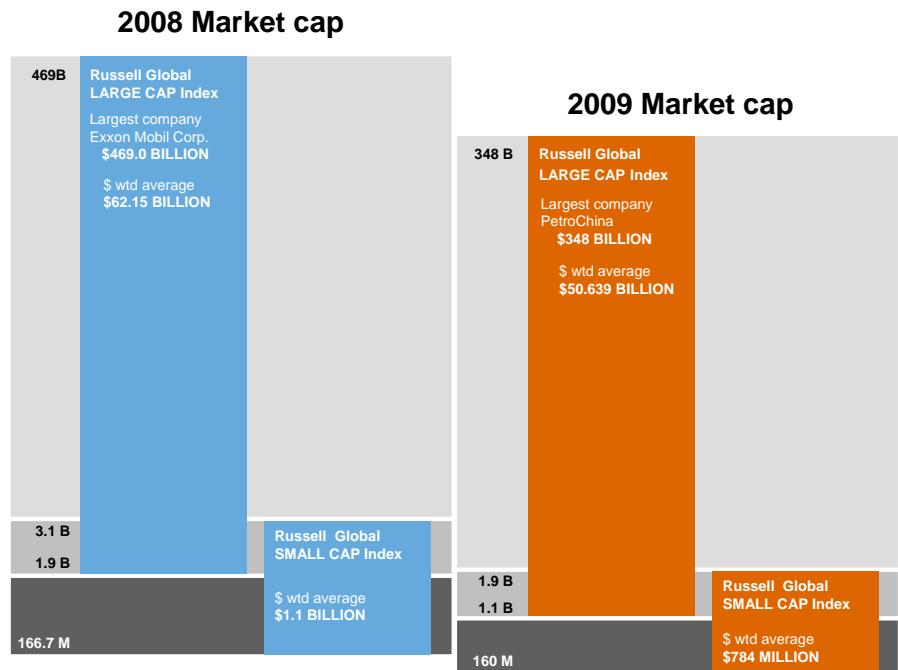
The massive loss in global market value

Beginning in mid-2007 and extending through 2008 into 2009, global markets experienced significant upheaval and notable declines in valuations. From June 2008 to May 2009, global equity markets as measured by the Russell Global Index lost 35% in value. Figure 1 highlights the impact of the loss in valuation on the capital structure of the Global Index—the sharp decline of the largest and smallest companies in the index, as well as the breakpoint between the large cap and small cap market segments.

¹ Although Russell Reconstitution impacts the published indexes at the end of June each year, the constituents of all indexes—global, developed, emerging, frontier, large and small cap, value and growth—are determined as of the end of May. For that reason, we use the Reconstitution indexes as of end of May in 2008 and 2009 to mark changes and the 12 months from June 2008 to May 2009 to calculate returns.

² For prior analysis on Russell Index methodology and BRIC countries, see K. Haughton, X. Yan, G. Cano and P. Velvadapu, "It's all a matter of perspective." *Russell Indexes*, March 2008.

Figure 1 / Global capitalization rank comparison

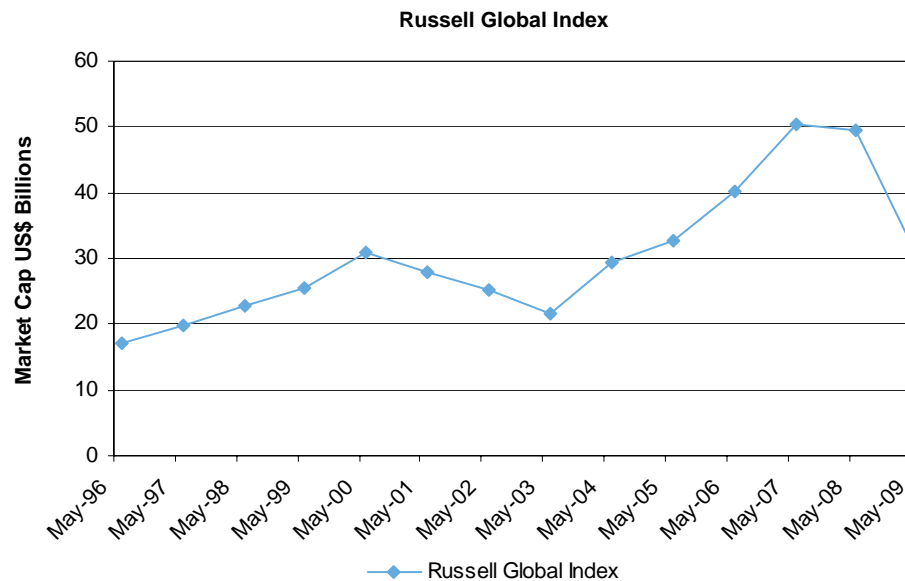


Data as of May 29, 2009. Values shown in U.S. dollars.

This reduction in global equity market valuations from May 2008 to May 2009 continued the trend of losses begun in 2007. Figure 2, below, charts the changes in total market cap of the Russell Global Index since 1996³; in 2009 the global market as a whole declined to 2005 levels of cap value.

³ The history of the Russell Global Index begins in July 1996

Figure 2 / Total market cap at reconstitution



The steep fall in valuations impacted all regions, styles and sectors, and we see surprisingly little alteration in global equity market structure from Recon 2008 to Recon 2009. This stability in market structure underscores the global systemic nature of the crisis. The changes we do observe are gradual but nonetheless worth noting. In the reconstituted Russell Global Index, we find that:

- The allocation to developed vs. emerging markets shifted slightly in favor of emerging.
- Allocations to North and Latin America saw very little change, but Europe lost ground to the Asia-Pacific region.
- Sector returns from June 2008 to May 2009 differed markedly, but the overall sector structure of global equity markets remained stable.
- Markets did not differentiate between large cap and small cap or between value and growth; returns to all these styles during the 12 months from June 2008 to May 2009 were very similar.
- Some sectors experienced unusual shifts in style, most notably energy moving into value and financial services shifting toward growth.

Our spotlight on the BRIC countries reveals that:

- China and India increased their weights in the Global Index, while Brazil and Russia experienced reductions; this pattern is in line with regional restructuring in Asia-Pacific and Europe.
- The changes in index weights and constituent numbers align with returns over the last 12 months, although China's weight increased disproportionately relative to its returns.
- India and China experienced notable shifts in sector exposures, while Brazil was fairly stable, and Russia saw virtually no change in sector allocations.
- India shifted slightly toward large cap, and Russia shifted more heavily toward value.

Emerging markets in the global economy

The reconstituted Russell Global Index as of May 2009 reflects only a minor shift in the relative importance of emerging markets in the world economy. Key positions of developed and emerging markets within the Russell Global Index are shown in Table 1.

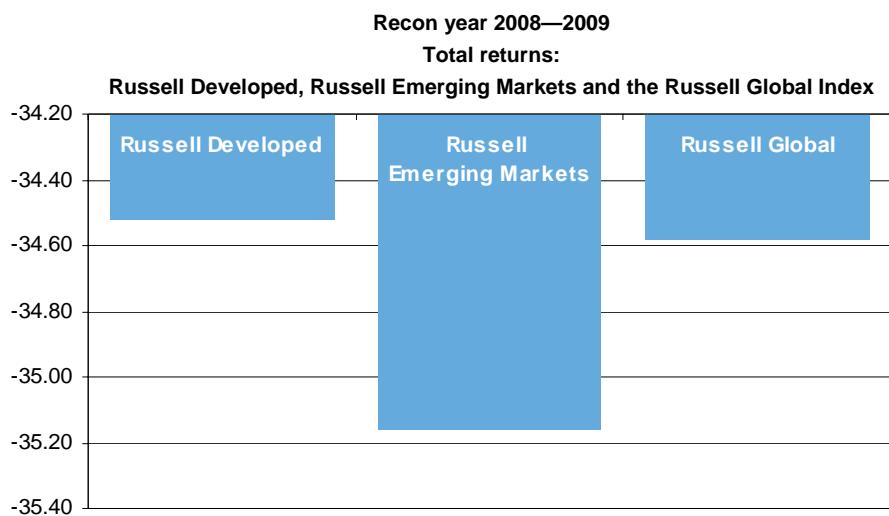
Table 1 / Key Statistics for Russell Developed and Emerging Equity Market Indexes at Recon 2008 and Recon 2009⁴

	2009		2008		Change from 2008	
		% of Global		% of Global	Difference	% of Global
Developed						
# of Securities	7,459	72.10%	7,863	73.39%	-404	-1.29%
# of Countries	26	40.00%	26	37.14%	0	2.86%
Market Cap (US\$ B)	20,385.16	86.78%	31,931.52	87.19%	-11,546.36	-36.16%
Change in Index Weight						-0.41%
Emerging						
# of Securities	2,887	27.90%	2,851	26.61%	36	1.29%
# of Countries	39	60.00%	44	62.86%	-5	-2.86%
Market Cap (US\$ B)	3,104.14	13.22%	4,690.61	12.81%	-1,586.47	-33.82%
Change in Index Weight						0.41%

As of Recon 2009, there are five fewer countries in the Russell Global Index, and all five—Vietnam, Ukraine, Pakistan, Latvia and Slovakia—are classified as emerging-markets countries. Despite this elimination, the proportion of emerging-markets securities has increased in the Russell Global Index: the Developed Markets category lost, in aggregate, 404 companies, while Emerging Markets gained 36. In terms of market weight, however, relative to a year ago, developed- and emerging-market countries constitute roughly the same proportion of equity markets as of Recon 2009: Emerging increased its weight by 0.41%; Developed experienced the offsetting reduction. Emerging Markets achieved this slight increase in weight despite suffering greater losses over the 12 months from June 2008 to May 2009, as Figure 3 shows.

⁴ Market cap values are float-adjusted.

Figure 3



The proportion of world equity markets that are classified as emerging did not change from 2008 to 2009, but the relative weights of the four BRIC countries—all classified as emerging markets—changed in very different ways, as we see in Table 2.

Table 2 / BRIC Countries in the Russell Global Index at Recon 2008 and Recon 2009⁵

Country	2009			2008		
	Market Cap US\$ B	Securities	Index weight	Market Cap US\$ B	Securities	Index weight
Brazil	44	191	1.8531	73	203	1.9897
China	51	313	2.1647	61	285	1.6593
India	29	405	1.2287	38	391	1.0454
Russian Federation	23	89	0.9672	49	91	1.3335

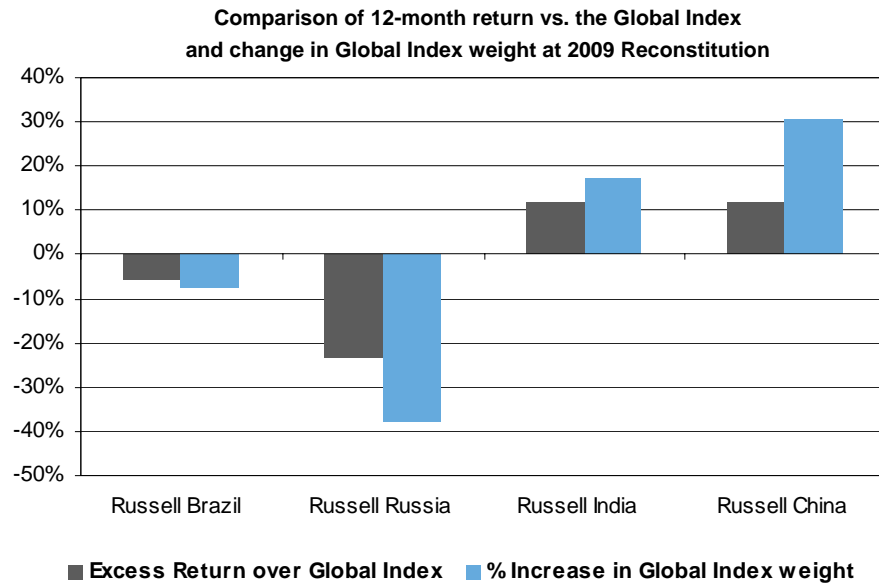
Country	% Change 2008–2009		
	Market Cap US\$ B	Securities	Index weight
Brazil	-40.30%	-5.91%	-6.87%
China	-16.44%	9.82%	30.46%
India	-24.64%	3.58%	17.53%
Russian Federation	-53.39%	-2.20%	-27.47%

Only two BRIC countries, China and India, increased their weights in the Global Index. The weights of Brazil and Russia declined, and Russia's declined significantly. Changes in market cap and security constituents accord with this pattern: China and India lost value, but less than the other two countries (and less than the overall Global Index) and consequently have greater weights in the new 2009 Global Index. Brazil and Russia lost more than the Global Index and thus have reduced weights in 2009.

⁵ Market cap values are float-adjusted.

The fortunes of the BRIC countries fall in line with their June 2008 to May 2009 returns relative to the Global Index, as Figure 4 shows. India and China outperformed the Russell Global Index, and their weights increased in the index. Brazil and Russia underperformed, and their weights have declined. We note that China's weight increased far more than its outperformance would suggest.

Figure 4



The importance of regions

The two BRIC countries that experienced positive excess returns vs. the Global Index and increased weights in the Global Index at Recon 2009—China and India—are in the Asia-Pacific region. Russia is a part of Europe, and Brazil is the largest country in South America. Globally, these regions experienced quite different structural changes at Recon 2009 vs. Recon 2008, as we see in Table 3. At Recon 2009, the Asia-Pacific region as a whole gained ground in the Global Index, primarily at the expense of Europe in terms of weight: Europe's weight has been reduced by 2.45%, and Asia-Pacific's weight is up 2.25%.

Table 3⁶

	2009		2008		Difference	Change in % of Global
	# of Securities	% of Global	# of Securities	% of Global		
North America						
# of Securities	3,395	32.81%	3,477	32.45%	-82	0.36%
# of Countries	2	3.08%	2	2.86%	0	0.22%
Market Cap (US\$ B)	10,815.52	46.04%	16,795.77	45.86%	-5,980.26	-35.61%
Change in Index Wt						0.18%
Europe						
# of Securities	2,246	21.71%	2,495	23.29%	-249	-1.58%
# of Countries	31	47.69%	34	48.57%	-3	-0.88%
Market Cap (US\$ B)	6,605.54	28.12%	11,196.27	30.57%	-4,590.73	-41.00%
Change in Index Wt						-2.45%
Latin America						
# of Securities	367	3.55%	373	3.48%	-6	0.07%
# of Countries	6	9.23%	6	8.57%	0	0.66%
Market Cap (US\$ B)	653.76	2.78%	1,029.51	2.81%	-375.75	-36.50%
Change in Index Wt						-0.03%
Asia-Pacific						
# of Securities	3,821	36.93%	3,916	36.55%	-95	0.38%
# of Countries	14	21.54%	16	22.86%	-2	-1.32%
Market Cap (US\$ B)	4,978.91	21.20%	6,937.43	18.94%	-1,958.51	-28.23%
Change in Index Wt						2.25%

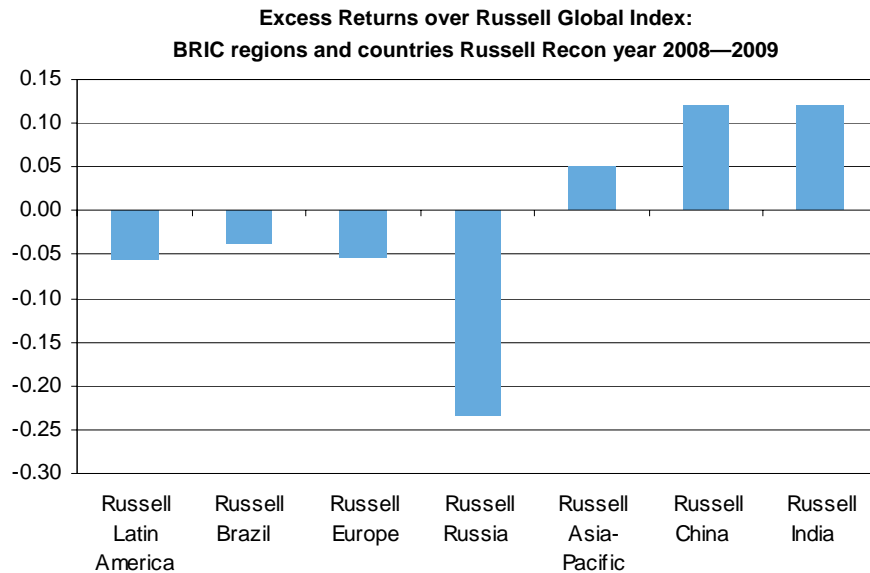
For a list of countries included in the Russell Global Index visit
www.russell.com/Indexes/membership/default.asp

In terms of numbers of constituents, Europe lost by far the greatest numbers of securities, net 249; Asia-Pacific and the U.S. lost 95 and 82, respectively, and Latin America lost only six.

Changes in the BRIC countries' positions in the Global Index are roughly in alignment with those of their respective regions. Russia and Europe as a whole lost ground; China and India improved their positions, as did the Asia-Pacific region in aggregate; Brazil and Latin America suffered only a slight reduction in representation. Figure 5, below, charts the excess returns over the Russell Global Index for the year June 2008 to May 2009 for BRIC regions and countries. Brazil's returns are in line with those of Latin America as a whole; Russia, however, markedly underperformed Europe, while China and India did better than the overall Asia-Pacific region.

⁶ Market caps are float-adjusted.

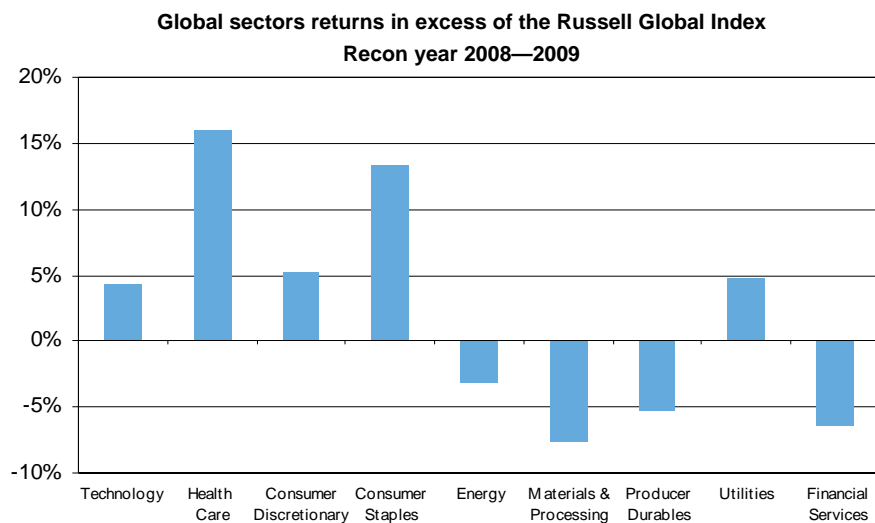
Figure 5



What about sectors?

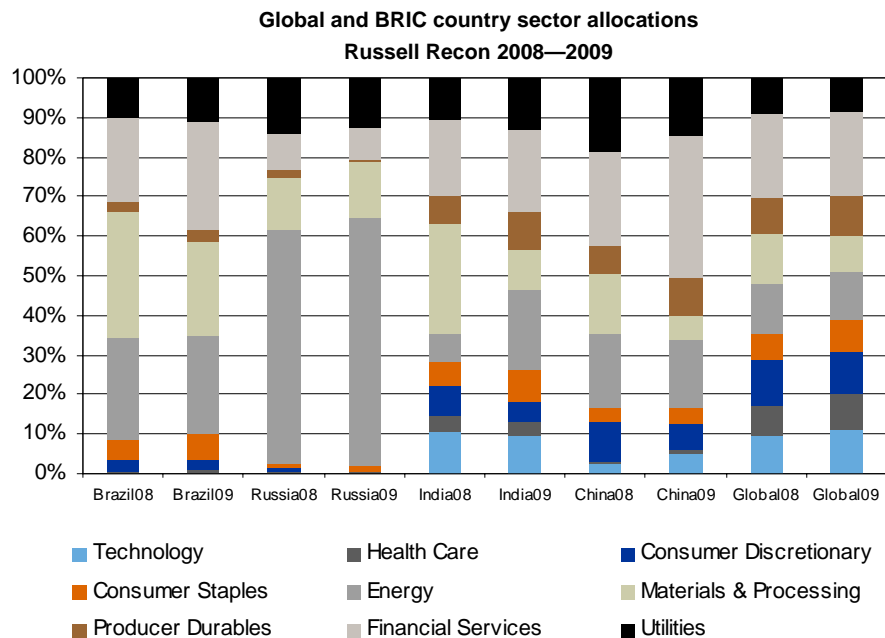
During the period June 2008 to May 2009, global sectors diverged remarkably in terms of returns, as Figure 6 clearly demonstrates. Health Care, Consumer Staples, Consumer Discretionary, Utilities and Technology sectors all outperformed the global market, while Energy, Producer Durables, Financials and Materials and Processing lost relative value.

Figure 6



Despite the strong differences in sector performance over the period June 2008 to May 2009, we observe only minor changes in the sector structure of the Global Index, although three of the four BRIC countries exhibit larger shifts. Figure 7 shows the sector allocations at Recon 2008 and Recon 2009 for all four BRIC countries, as well as for the Global Index. Sector structure for the Global Index (the two columns at the right) shows very little change from 2008 to 2009; most notable are the decline in Materials and Processing and the increase in Health Care. Among BRIC countries, Russia exhibits the greatest stability in sector structure, which continues to be dominated by Energy; its other major sectors, Materials and Processing and Utilities, show little change. Brazil experienced a shift out of Materials and Processing toward Financial Services, but the rest of its structure remains relatively stable. China also moved out of Materials and Processing toward Financial Services. India, too, shifts away from Materials and Processing, but there the major increase is in Energy.

Figure 7



A very simple analysis indicates that while sector structure and performance align very well on the global level, for individual BRIC countries, sectors do not explain all of the divergence in BRIC country returns. Computing the sum-product of Recon 2008 sector weights and sector returns for the 12 months from June 2008 to May 2009, we see first (in Figure 8 below) that the weighted sector returns (–34%) and the actual returns (–35%) are closely aligned to the Global Index. This is not surprising, given the stability of global sector weights from 2008 to 2009. The matchup for the BRIC countries is close only for Brazil (–38% vs. –40%). Russia’s actual returns are much worse than those projected at beginning-of-period sector allocation, and India and China’s are much better.

Given the divergence in sector allocations among the BRIC countries depicted in Figure 7, above, it is remarkable how little difference there is in the 12-month returns based on sector exposures, as we see in Figure 8. Brazil’s sector losses were the greatest,

computed at -38%; Russia's were computed at -37% and both India's and China's at -36%. But these are minor compared to the divergences in actual returns. The sector allocations are very different among these countries, and sector returns diverged over these 12 months, but all countries' sector mixes at the beginning of the period, had they been held over these 12 months, would have brought in almost identical returns.

Figure 8

**Comparison of Actual Total Return with Returns based on Beginning Sector Weights
Russell Global Index and BRIC countries
Recon year 2008—2009**



Returns based on 2008 Sectors weights calculated as the sumproduct of Recon 2008 Sector Weights in the Russell Global Index and sector returns over the twelve months from June 2008 to May 2009.

The impact of cap size and style

Over the 12 months from June 2008 to May 2009, global equity markets made very little distinction between large and small cap sectors of the market, and between the styles of growth and value. This is very unusual, as we demonstrate in Table 4. The small cap premium (the excess return of small cap stocks over large cap stocks) for 2008—2009 is -0.53%. This is smallest calendar year gap between the returns to global large cap and small cap stocks since 1997; 2008's small cap premium was almost -10.00%. The small cap premium has ranged as high as 15.2% and as low as -18.6%. The value premium (the excess return of value stocks over growth stocks) is even smaller than the small cap premium this year, only -0.17%. Since 2002, just one year—2006—has seen a smaller differential in the returns of value vs. growth. Since 1997, the value premium has ranged from a high of 9% to last year's low of -9.97%.

2008 to 2009 was also very unusual in that there was virtually no difference among the global returns to large and small cap compared to value and growth. It is remarkable how little difference there is among the four total returns: the low is -34.85%; the high is

–34.32%. The systemic, broad-based nature of the global market crisis is apparent in this set of returns.

Table 4 / 12-Month Returns to Global Styles (June–May) 1997–2009

	Russell Global Growth Index	Russell Global Value Index	Value Premium (Value – Growth)	Russell Global Large Cap Index	Russell Global Small Cap Index	Small Cap Premium (Small Cap – Large Cap)
1997–1998				23.24	4.65	–18.59
1998–1999				13.29	–2.28	–15.57
1999–2000				14.54	11.66	–2.88
2000–2001				–13.36	–5.26	8.1
2001–2002				–11.82	1.36	13.18
2002–2003	–9.04	–7.82	1.22	–8.67	–5.57	3.1
2003–2004	23.54	28.78	5.24	24.82	40.01	15.19
2004–2005	9.12	18.11	8.99	13.19	18.18	4.99
2005–2006	18.65	22.4	3.75	19.53	29.07	9.54
2006–2007	25.44	27.55	2.11	26.51	26.5	–0.01
2007–2008	3.31	–6.43	–9.74	–1.01	–6.37	–5.36
2008–2009	–34.32	–34.85	–0.53	–34.56	–34.73	–0.17

BRIC countries differ markedly in their exposures to cap size and style. Russell's global-relative definitions of style allow us to recognize and evaluate stylistic differences across countries, rather than forcing all countries and regions to fit the same mold. The world clearly recognizes that countries differ in their sector weights; they differ in cap and style exposure as well. In Figure 9 we see that BRIC countries are not equally exposed to large cap and small cap stocks. Brazil is more heavily weighted to large cap than the global average, and Russia is more large cap–tilted than Brazil. China and India, in contrast, tip more toward small cap, with India having the greater exposure to small cap stocks. We also see that Russia's small/large cap distribution is essentially unchanged from 2008; Brazil, China and India all experienced shifts away from small cap to large cap, and India's change in that direction is the most notable.

Figure 9

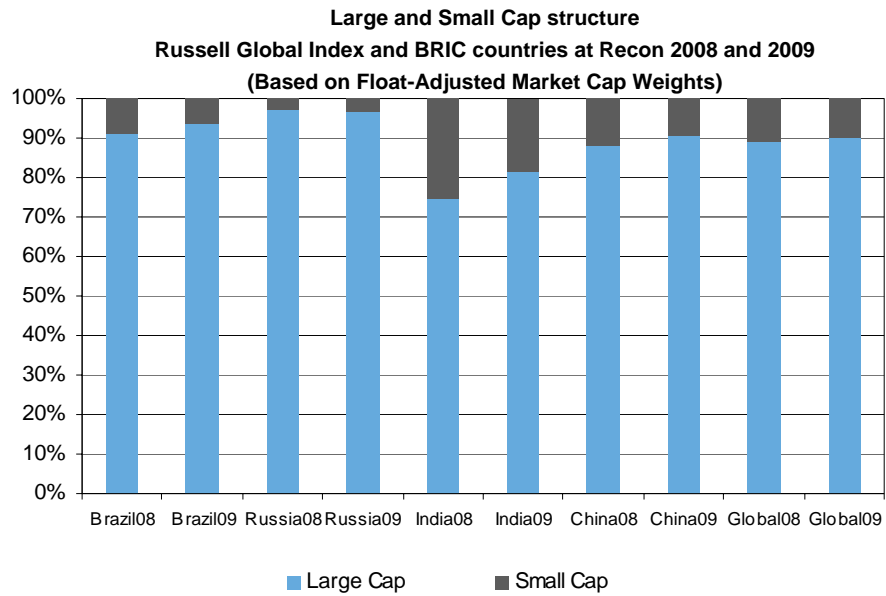
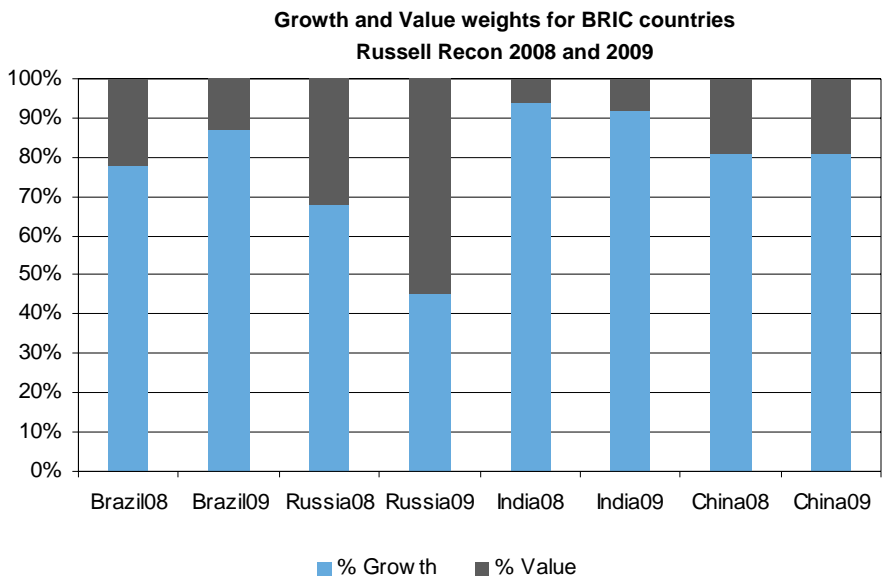


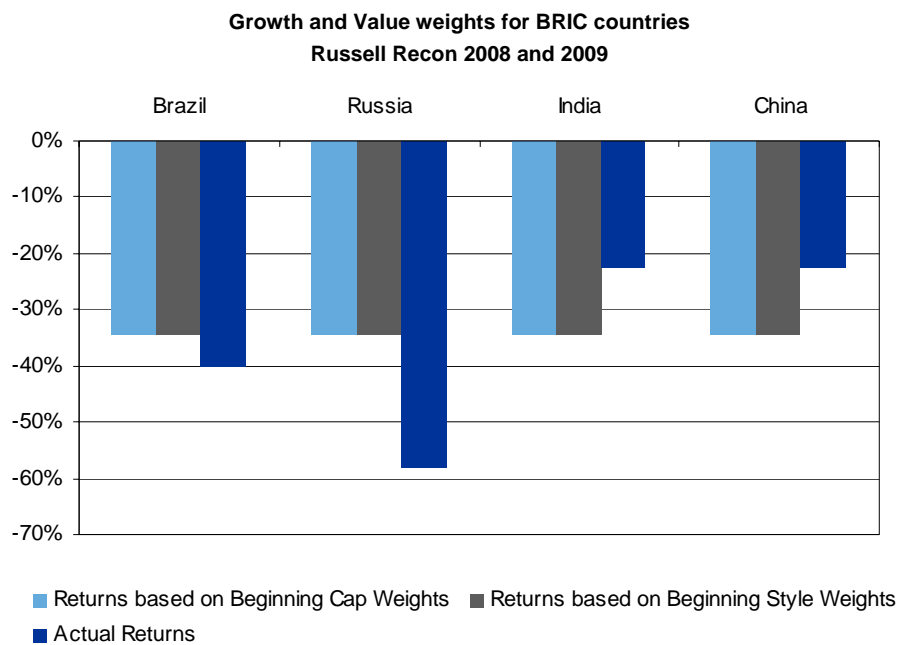
Figure 10, below, shows the allocations to growth and value for the BRIC countries at Recon 2008 and Recon 2009. At Recon 2008, all four countries were tipped toward growth, China, India and Brazil quite heavily (India's growth weight exceeded 90%). The biggest change at Recon 2009 is Russia's shift from growth toward value: Russia is now predominantly a value country. China's style weights are unchanged, and India's are very close to 2008's structure. Brazil shifted slightly toward growth.

Figure 10



The Russell global-relative index methodology allows us to differentiate among countries along the large/small cap continuum, and along the style continuum from growth to value. During most periods, these structural differences in style noticeably impact performance, but for the year June 2008 to May 2009, different weights to small cap and large cap and to value and growth had little effect on returns to the BRIC country equity markets, as is clear in Figure 11. The simple exercise of computing returns on the basis of beginning exposures to large and small cap and to value and growth not surprisingly produces almost identical returns to all four BRIC countries for the 12-month period between reconstitutions.

Figure 11



Returns based on Beginning Cap weights calculated as the sumproduct of Recon 2008 Large and Small Cap Index Weights in the Russell Global Index and returns to the Russell Global Large and Small Cap Indexes over the twelve months from June 2008 to May 2009.

Returns based on Beginning Style weights calculated as the sumproduct of Recon 2008 Growth and Value Index Weights in the Russell Global Index and returns to the Russell Global Growth and Value Indexes over the twelve months from June 2008 to May 2009.

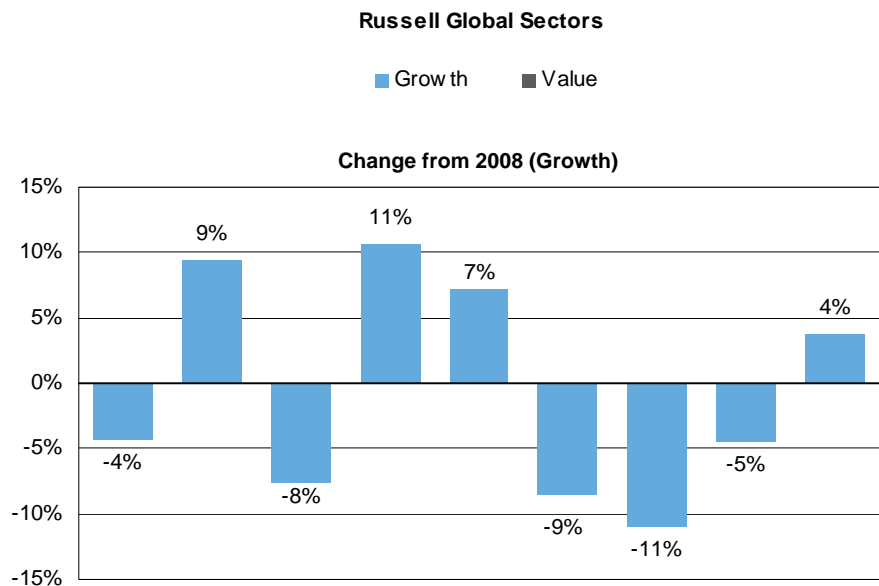
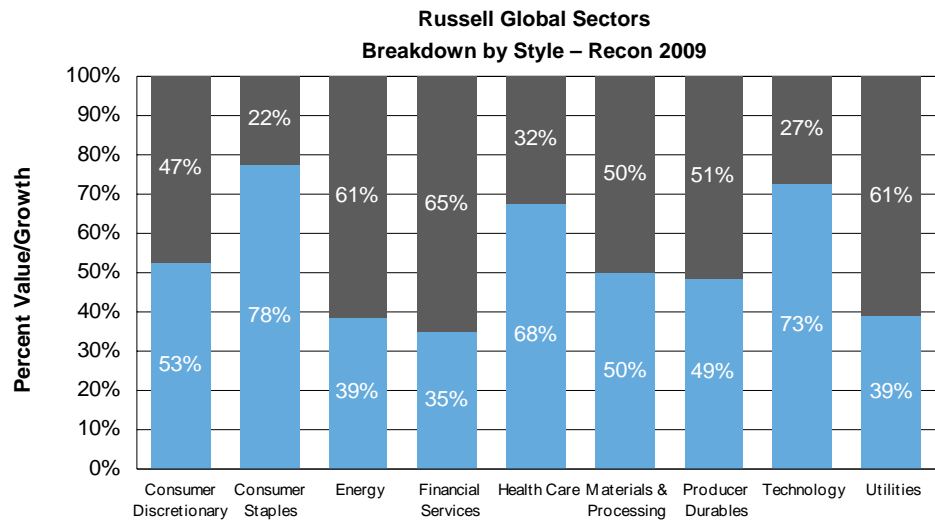
Where style and sector intersect

We observe interesting changes from 2008 to 2009 in the style biases of global sectors; these are displayed in Figure 12.⁷ The biggest changes are the shift of Financial

⁷ The author thanks Johann Schneider for this chart design.

Services toward growth and of Producer Durables toward value; each shift is 11%. In aggregate, Financial Services remains a predominantly value sector, but such a large shift toward growth is noteworthy. Energy and Materials and Processing both experienced shifts away from growth toward value (8% and 9%, respectively), and Energy is now a solidly value sector. Consumer Staples has increased its tilt to growth by 9%.

Figure 12 / Style Weights in Russell Global Sectors—Change from 2009



The shift in style emphasis of global sectors sheds light on the major change we noted in country-level style: Russia's increased value exposure (see Figure 10, above). Russia is heavily exposed to Energy, and the marked shift of that sector from growth to value contributed to Russia's movement into value.

Summary

At first glance, the major story from May 2008 to May 2009 in global markets appears to be the substantial loss of value and the economic upheaval that affected all styles, sectors and countries. But the real story is our finding that the disruptions have resulted in very little change in the structure of global equity markets. The crisis was systemic in nature: this ebb tide lowered all boats. Despite the massive devaluations and disruption in global equity markets over the 12 months from Recon 2008 to Recon 2009, the changes in the structure of the global equity market as measured by the Russell Global Index are relatively minor: a very slight shift in favor of emerging markets; a slightly bigger shift toward Asia-Pacific at the expense of Europe; virtually no difference in market returns to style or cap size. Rewards to sectors were quite different, but the overall global sector structure saw little change. Most notable are the style changes on the sector level, for example, Energy becoming a value sector and Financial Services demonstrating more growth characteristics.

For the BRIC countries, the advantages go to China and India in the Asia-Pacific region. The greatest reduction in weight is Russia, positioned in Europe and heavily exposed to the Energy sector. The Russell global-relative approach to indexing allows us to see the significant differences among BRIC countries in style and cap exposures in addition to differences in sector. However, none of these had much impact on the difference among country returns over the period from June 2008 to May 2009, as the market did not differentiate returns to style and cap, and country aggregate sector return differences were minimal. For global markets in aggregate and for the BRIC countries in particular, we mark changes at Recon 2009 that are evolutionary rather than revolutionary in nature.

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Russell 1000 Growth Index – Measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index – Measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

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Russell 2000 Growth Index – Measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values.

Russell 2000 Value Index – Measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 3000 Index – Measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

Russell 3000 Growth Index – Measures the performance of the broad growth segment of the U.S. equity universe. It includes those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 3000 Value Index – Measures the performance of the broad value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell Global Index – Measures the performance of the global equity market based on all investable equity securities. The index includes approximately 10,000 securities in 70 countries and covers 98% of the investable global market. All securities in the Russell Global Index are classified according to size, region, country, and sector; as a result the Index can be segmented into more than 300 distinct benchmarks.

Russell Developed Index – Measures the performance of the largest investable securities in developed countries globally, based on market capitalization. The Russell Developed index is constructed to provide a comprehensive and unbiased barometer for this market segment and is completely reconstituted annually to accurately reflect the changes in the market over time.

Russell Emerging Markets Index – Measures the performance of the largest investable securities in emerging countries globally, based on market capitalization. The Russell Emerging Markets index is constructed to provide a comprehensive and unbiased barometer for this market segment and is completely reconstituted annually to accurately reflect the changes in the market over time.

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