

JUNE 2007

Capitalization Banding: Russell Indexes

WRITTEN BY

Rolf Agather and Sarah McCarthy
Russell Investments

JUNE 2007

Capitalization Banding: Russell Indexes

By Rolf Agather and Sarah McCarthy

Russell's new capitalization banding methodology implemented with its 2007 Index Reconstitution significantly reduces turnover in its indexes without sacrificing their ability to represent the market.

For over twenty years, Russell has been constructing indexes that represent the market; are objective and transparent in their construction; and, offer replicable vehicles for passive investment portfolios and active benchmarks. Throughout the years, we have introduced methodology enhancements that further serve our ability to construct indexes that fulfill these objectives. Examples of these include development of provisional and legacy indexes, adoption of the NASDAQ closing cross and incorporating IPO's on a quarterly basis.

In 2007, we are pleased to introduce capitalization banding to our indexes. It has always been Russell's goal to maintain the representative nature of our indexes while reducing the potential costs of turnover caused by the reconstitution process. The introduction of our Global Index presented us with the opportunity to further refine our index construction methodology and incorporate a new approach to establishing the market-capitalization breakpoints for our large-, mid-, and small-cap indexes.

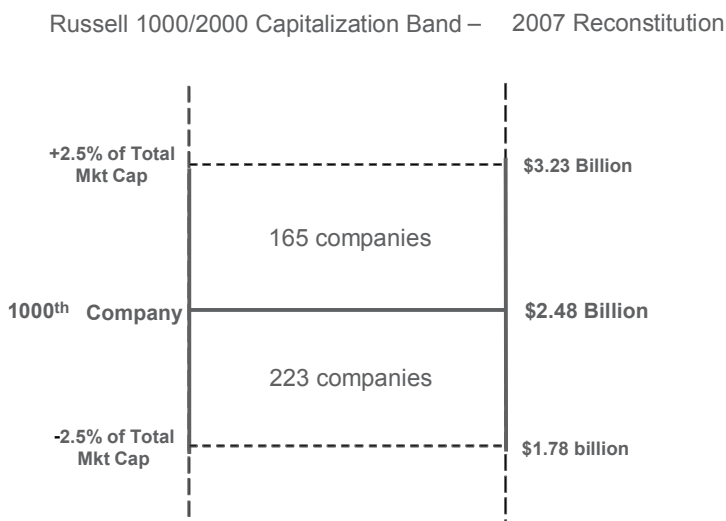
What is capitalization banding?

The motivation for creating large and small capitalization indexes is based on the premise that large stocks and small stocks behave differently and thus require specific benchmarks to capture their behavior. Russell identified the distinction between large- and small-cap investment managers over twenty years ago in the U.S., and more recently it has been demonstrated in global markets as well. Much academic research has been focused on determining the appropriate dividing line between large and small stocks, but Russell's research in this area shows that there is no precise line separating large and small cap, especially when looking across multiple regions; instead the division between large and small stocks is best established using a range or capitalization "band" around which representative large- and small-cap indexes can be created.

Based on a comprehensive historical analysis of the Russell U.S. and Global Indexes, Russell has determined that using a 5% band (+/-2.5%) around the traditional market-capitalization breakpoints (in the U.S., the 1000th largest company by total market capitalization) results in a dramatic reduction in turnover without adversely affecting the characteristics or performance of the resulting capitalization indexes. Beginning with the 2007 reconstitution in the U.S., stocks are ranked in descending order by total market capitalization, and companies that are within +/- 2.5% (of total index capitalization) of the largest 1000th company retain their capitalization assignment in the new indexes. So at reconstitution, existing Russell 2000® companies in the upper part of the band (above the 1000th company) will remain in the Russell 2000, and existing Russell 1000® companies in the lower part of the band (below the 1000th company) will remain in the Russell 1000.

The Russell Global Indexes will follow a similar methodology, but using percentile ranges instead of a fixed number of securities.¹

The following diagram illustrates the characteristics of the capitalization band which was used to determine membership in the Russell 1000 and Russell 2000 at the 2007 reconstitution.



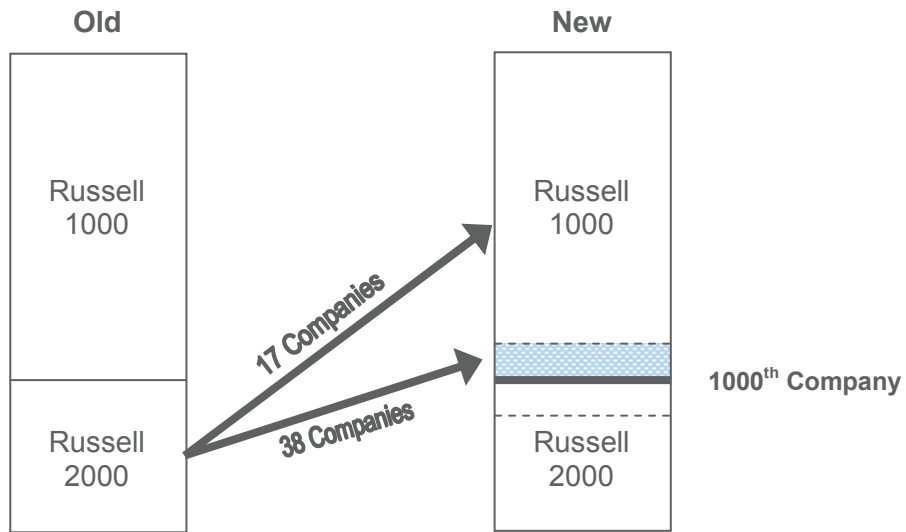
The market capitalization of the 1000th company was \$2.48 billion, and the market capitalization of the band ranged from \$3.23 billion (+2.5% of total index capitalization) to \$1.78 billion (-2.5% of total index capitalization). There were 165 companies in the upper part of the band (above the 1000th company) and 223 companies in the lower part of the band (below the 1000th company). It is important to note that not all companies in the upper/lower portion of the band will be existing Russell 2000 or Russell 1000 members; only those stocks who were in the Russell 2000 or Russell 1000 prior to reconstitution and fall within the band will retain their small-/large- cap classification. In 2007, less than 25% of companies in the upper portion of the band were classified as small-cap, and less than 30% of companies in the lower portion of the band were classified as large-cap.

Affect On Turnover

Russell's research on capitalization banding demonstrated substantial reduction in turnover between the Russell 1000 and Russell 2000 historically; and the results of the 2007 reconstitution confirm that capitalization banding dramatically lowers turnover. The following diagrams illustrate how capitalization banding affected the movement of companies moving between the Russell 1000 and Russell 2000 in 2007:

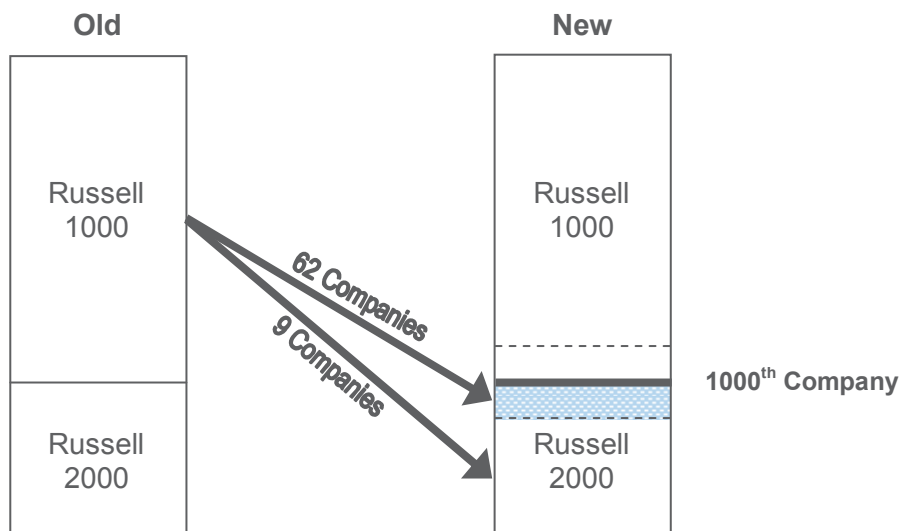
¹ For more information on the rules used for the Russell Global Indexes, please see the Russell Global Index Construction and Methodology document.

Russell 2000 to Russell 1000 Turnover – 2007



If capitalization banding had not been implemented in 2007, 55 companies would have moved from the Russell 2000 to the Russell 1000. With capitalization banding, 38 companies remained in the Russell 2000, and only 17 companies migrated to the Russell 1000.

Russell 1000 to Russell 2000 Turnover – 2007



If capitalization banding had not been implemented in 2007, 71 companies would have moved from the Russell 1000 to the Russell 2000. With capitalization banding, 62 companies remained in the Russell 1000, and only 9 companies migrated to the Russell 2000.

The reduction in turnover measured as a percentage of the index is dramatic. The following table summarizes the reduction in turnover that resulted by applying capitalization banding to the Russell 1000 and Russell 2000 in 2007:

Table 1: Capitalization Banding Impact on Turnover

	Number of Stocks	Market Value (\$billion)	Russell 1000 Impact	Russell 2000 Impact
R2000 to R1000	17	53.7	Adds (%)	Deletes (%)
R2000 to Band	38	89.4	0.3	3.6
	55	143.1	0.6	6.0
			0.9	9.6
	Number of Stocks	Market Value (\$ billion)	Deletes (%)	Adds (%)
R1000 to Band	62	124.5	0.8	8.3
R1000 to R2000	9	10.3	0.1	0.7
	71	134.8	0.9	9.0

Without banding, 55 companies would have moved from the Russell 2000 to the Russell 1000 resulting in \$143.1 billion moving from the Russell 2000 to the Russell 1000, representing 0.9% of the Russell 1000 (Adds) and 9.6% of the Russell 2000 (Deletes). Implementing banding reduced this turnover by \$89.4 billion, lessening the absolute impact on the Russell 1000 by 0.6% and the Russell 2000 by 6.0%.

Similarly, without banding 71 companies would have moved from the Russell 1000 to the Russell 2000 resulting in \$134.8 billion moving from the Russell 1000 to the Russell 2000, representing 0.9% of the Russell 1000 (Deletes) and 9.0% of the Russell 2000 (Adds). Implementing banding reduced this turnover by \$124.5 billion, lessening the absolute impact on the Russell 1000 by 0.8% and the Russell 2000 by 8.3%.

Combined, the reduction in turnover due to banding (in absolute terms) was 1.4% (0.6 + 0.8) for the Russell 1000 and 14.3% (6.0 + 8.3) for the Russell 2000.

Summary

The use of capitalization banding in the Russell Indexes dramatically reduces turnover at reconstitution. Russell's research shows that a 5% band provides an optimal balance between representing asset class return behavior and reducing turnover, which ultimately benefits investors using the Indexes as passive vehicles or active portfolio benchmarks.

The introduction of the capitalization banding methodology and the market environment leading up to the 2007 reconstitution have made the annual Russell Index re-balancing a “non-event”, especially for the Russell 2000 with record low turnover results. Additionally, capitalization banding has offset much of the one-time impact of adding BDI companies to the Russell Indexes, and is expected to dramatically reduce turnover in future re-balancings. Since the first public Russell index reconstitution in 1985, the goal of reconstitution is to ensure our indexes remain representative and reflect the market. It is not the purpose of our index to be a market event.

For more information on our index construction, please refer to the Index Construction and Methodology document or contact your client account representative.

For more information please visit our website at www.russell.com/indexes.

Copyright © Russell Investments 2007. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an “as is” basis without warranty.

Russell Investments is a Washington, USA Corporation, which operates through subsidiaries worldwide and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell Logo is a trademark and service mark of Russell Investments.

Russell Investments is the owner of the trademarks, service marks and copyrights related to its respective indexes. Indexes are unmanaged and cannot be invested in directly.

First use: June 2007. Revised July 2008.

RC4697