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Market Index Change: Why it creates better measures

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“The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers, goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.”

“The opening up of new markets, foreign or domestic... illustrate(s) the same process... that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism.”

Joseph Schumpeter, [Capitalism, Socialism and Democracy](#), 1942, pages 82-85.

Schumpeter's Creative Destruction requires measures of market systems be designed to handle constant change. Market indexes may have many purposes, but measuring the market is the primary one for Russell indexes. What gets lost or misunderstood in the literature is how a market index continues to do its job of measuring the market as it changes. Since indexes are intended to measure capital markets, index design must take into consideration the ever changing nature of markets. In particular, it is expected that new companies will come into being, existing companies will either grow or shrink and companies will change product lines, operations centers, revenue centers, stock exchanges and physical locations.

Market indexes should anticipate and recognize the changes happening over time, which means as countries and companies become available for global investment they should be reflected in market indexes. Russell's unique index reconstitution process efficiently funnels capitalism's Creative Destruction into a measure of publicly traded equities, by routinely capturing all significant market changes while also managing turnover costs.

Companies Lead the Way

Unlike other market indexes, which include a sampling of stocks from a constrained list of countries, Russell's index reconstitution brings individual companies into the index as they become ready for consideration by institutional investors. Russell examines the size and liquidity of the security, the constraints on foreign ownership, the institutional framework, and the economic and political stability where the security trades in determining investability.

An emphasis on the investability of the security itself, as opposed to an entire country's securities or industries/sectors, simultaneously gives a market index a broader perspective and more ability to adapt to change. One example of this is the impact on new industries joining an index. Since Russell's index process is market driven and does not constrain membership by requiring particular industry coverage, all sizable and liquid companies from new industries are added to the Russell Indexes as they become accessible. This process, combined with Russell's complete reconstitution process, tends to represent new industries earlier

than other index providers. Case in point, Russell was the first to include financial exchanges—NYSE and Chicago Mercantile Exchange—in its index family.

In addition to better representing expanded industry/sector exposures, Russell's index process also tends to include more companies within each industry. Because many index providers constrain the number of companies in their indexes, they are forced to select stocks from certain industries in order to simulate a market-relative industry exposure. This means that important companies, from all industries, can be excluded from market indexes that take a sector-, rather than a company-based, approach to index construction. A few notable examples of companies historically excluded from popular sector-based indexes include Google, BMW, and Microsoft.

Country vs. Company

With an expectation that market indexes should measure the market, the globalization of the world's economies means national barriers become less relevant for investment decisions. Global market indexes, if they are to measure the market, should reflect this new environment. Some index providers constrain country membership and make large macro decisions on when to add a country to an index or when to move a country from one index to another. If the index provider decides to add a country, they will add, say, 85% of the market capitalization of the new country. This is done regardless of whether or not all 85% of the country's equity market is accessible, or in other words, is of global institutional investment size and liquidity. Frequently, this decision rule results in some companies which are not yet investible being added to the index before they are institutionally accessible and, conversely, many companies which become investible being left out of an index for a period of time.

What about Emerging Markets?

The term "emerging markets" is a rather dated term coined in the 1950s to differentiate nations based on their degree of industrialization and per capita income. The global investing landscape is significantly different today, but the term and the indexes based upon them have persisted. Investors continue to allocate significant assets to emerging markets in the elusive search for alpha, but the concept of an emerging market has changed.

If a country was once designated "emerging" by a popular index provider, then all of the stocks associated with that country are considered "emerging markets" stocks. Moving countries to "developed" status within an index family means that all of the country's stocks are deleted from the emerging market index (plus all associated index funds) and added to the developed market index. Not only does this type of broad classification potentially misrepresent some of the stocks within a particular country, but it also limits an index's ability to accurately represent the actual investibility of a country's market as a whole. Popular indexes are also, understandably, reluctant to make a change of this magnitude due to associated turnover costs, further distorting the ability of that index to accurately measure the market. This problem will continue to persist unless a different perspective is taken.

One way for indexes to approach the emerging market problem is to look at companies instead of countries—like real investors do. In local markets, investors have long considered stocks based upon their fundamentals, prices, size, style and industry/sector exposure. Why shouldn't global investors (and indexes) follow suit? In fact, global investors have been following suit and choosing stocks based on industry exposure and company fundamentals regardless of their home country. Samsung is one of the largest 70 companies in the world and one of the ten largest companies in global technology. It does business in over 100 countries. But since

Samsung is based in Korea, it is considered an emerging market stock by many index providers. This is despite its global business and large size; despite the fact that it shows up in portfolios benchmarked against large cap developed market indexes.

Ignoring the problems inherent in many global market indexes, investment managers are increasingly investing on a global or non-U.S. basis rather than on a developed or emerging markets basis. Some managers are specializing in large cap or small cap within the global or non-U.S. category. Most manager portfolios benchmarked against MSCI EAFE look more like the Russell Non-U.S. Large Cap index because this particular Russell index reflects large companies around the world, period; even those companies, such as Samsung, in “emerging” countries.

Using a Russell global benchmark, which is organized by size rather than country, means there will not be a disruptive decision made about when to transition Korea into the developed market index. Moving entire countries from one index to another causes disruptions to investment portfolios; in particular, index funds. Index philosophy that captures the investible universe gradually as market conditions change and as companies grow over time better represents the market both now and as it evolves. Microsoft was a member of Russell’s U.S. indexes for more than eight years before it was added to the most well-known U.S. broad market index. If a company as significant as Microsoft isn’t reflected in market indexes for long durations, imagine how many growing companies around the world are being missed.

As country capital markets grow, they are typically driven by relatively few industries. Limiting membership in global market indexes to only those countries with broad equity markets doesn’t reflect how managers behave. Worse, it doesn’t allow for the constant change occurring in capital markets. If a company from a country not previously represented in the index becomes investible, then the country should come into the index. It represents an investment opportunity in that country. The number of companies from the country will grow as the publicly traded companies in those countries grow and thrive. Conversely, as the market capitalization of industries and countries shrink their proportion of the world market pie shrinks.

In the chart below, we see the number of companies in the Russell Global Index from China, India and Russia has grown over the last few years, while the number of companies from Brazil, Hungary and Mexico has remained relatively constant. This reflects the investment reality in these countries and the world.

	7/1/2001	7/1/2002	7/1/2003	7/1/2004	7/1/2005	7/3/2006
China	132	88	91	113	115	173
India	92	96	120	169	238	278
Russia	7	11	20	20	26	28
Brazil	91	85	79	78	102	88
Hungary	7	9	11	9	11	8
Mexico	51	50	41	43	44	49

Russell's global approach ensures companies get added to market indexes when they become investible by global investors, not when some other arbitrary rule comes into effect. We do not, for example, determine first if enough companies from a particular country qualify for inclusion to justify putting the entire country into the index or whether Korea is now a developed country.

In order to measure markets and provide the necessary context needed to evaluate the skill of investment managers, Russell builds indexes to reflect the investible universe of global equity securities. The force of Creative Destruction makes this universe a moving target. To stay on target, it is critical to have a process which both reflects and can accommodate for the changes inherent to global capital markets. Using a market-driven approach, Russell's reconstitution process, its underlying methodology and overall approach to index construction efficiently reflect these inevitable changes and create reliable market indexes that actually measure the market. By doing so, the process produces reliable barometers for evaluating manager skill and accurate tools as the basis for index funds.

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

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