

Viewpoint

Russell Research

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Part 2 of a 4-part series on global equities

The new face of global equity asset management

The 20-year evolution of the global equity manager universe

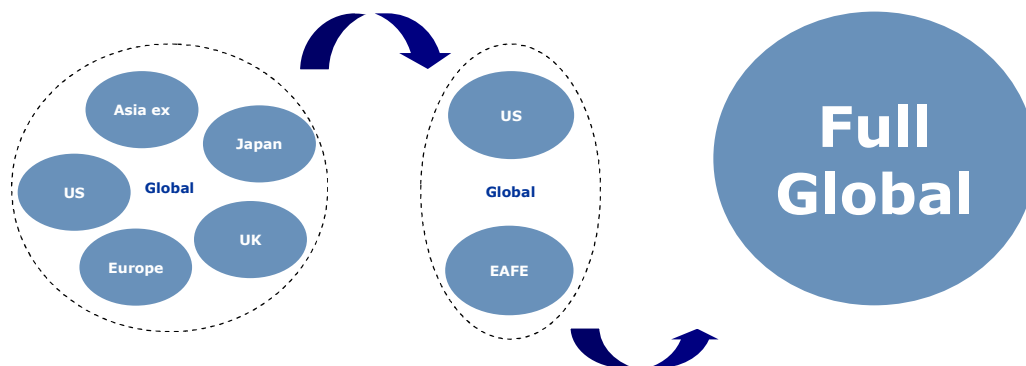
In part one of this series, we considered the impact of globalization on country economies and equity markets and flagged the potentially detrimental effects of home-country bias (i.e., lower return with greater risk). In this installment, we look at the evolution of global equity strategies within the Russell global equity universe and what it has meant for clients. The overall number of available global products has clearly expanded, but more importantly, the types and quality of global equity product offerings have evolved a great deal as well. Accordingly, we'll discuss three major changes within the global equity manager universe: product and style proliferation, the sophistication and nature of processes and, finally, the ages and sizes of firms that comprise the asset class.

“When you’ve finished changing, you’re finished.”
- Benjamin Franklin

Global vs. regional vs. international equities – how are they different?

Before launching into a discussion of the evolution of the global equity space, it is important that we delineate the product offerings that are often discussed within the marketplace by articulating our definitions. For nearly 30 years, Russell has offered clients equity exposure across the world through a number of venues. For clients in the U.S., this has meant “international or global excluding U.S.” offerings. For clients outside the U.S., we have offered “regional” products to gain exposure to large markets, such as the U.S., the UK, Europe, Japan and Australia. More recently (in the past decade), Russell has launched fully “global” products that offer investors exposure to world equity markets in what we believe is a more comprehensive and optimal fashion.

Naturally, regional products were the first to be offered – often, initially, as just single-country mandates. For example, London-based investors specialized only in UK equities, whereas U.S.-based money managers sought just the best U.S. stocks, and so on. These country/regional strategies have become more expansive, and today the main “regional” products are distinct offerings that typically span broader sets of markets, such as “Europe ex-UK” or “Asia ex-Japan.” Pension plans would set a static strategic allocation to each region, and then work with specialists to pick stocks in just that locale. International strategies were the next derivation, wherein pension plans began to use singular allocations to markets outside of their home countries. In the U.S., this practice was usually dubbed an “EAFE (Europe, Australia, Far East)” or “global ex-U.S.” strategy, followed in attempts to add value by selecting from among stocks within the entirety of non-U.S. markets. Static allocations now comprised weightings to just the U.S. (or the home market) and non-U.S. (or home market ex-rest of world) equity components. Finally, adopting a global strategy – an unconstrained approach wherein decisions are based on identifying the best stocks around the world, and portfolios are constructed more on a bottom-up basis than by reference to country or regional benchmark weightings – were the logical final conclusion in long-only equities.



Each of these strategies – regional, international and global – has distinct advantages. The three are also complementary, and in our view they warrant separate allocations within your plan. With this background information, let’s understand the evolution in “global” equity products.

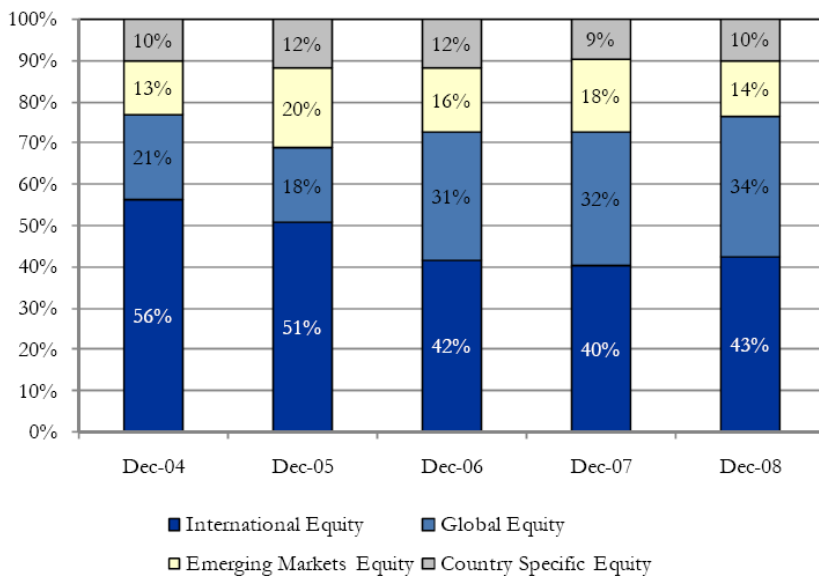
Ch- ch- ch- changes: a move toward truly global

As we’ve noted previously, corporations conducted business largely in their country of domicile 25 years ago and competed against local peers. Securities markets were less open in those days, and many nations still protected their industries by means of such constraints as import duties and tariffs so as to limit foreign competition. Aside from the early multinationals, which were better able to navigate these complexities, few companies gave more than tentative consideration to branching out into global markets, continuing instead to focus on their local markets. Investors tended to follow this line of thought as well, and compared stocks against local peers and benchmarks. While some asset managers did understand companies from a global perspective, they were few and far between. Similarly, pension funds had yet to really diversify their assets outside their domestic markets; hence, the demand for global ex-home country equity exposure was limited. Not surprisingly, the universe of global products was small twenty years ago, and the

global products that did exist were often naïve constructs of regional products simply bolted together at market capitalization weights.

The most important development in global equities over the past 20 years has therefore been the move from regionally constructed global equity products to those which approach the investment equation from a singular, fully global perspective. Many portfolio managers today have spent their careers watching the impact of globalization on equity markets and have gained the ability to look across borders and make effective stock comparisons between corporations based in Japan or the U.S. or India or Germany. With the acquisition of this skill set, the demand for fully global products (see Exhibit 1) has naturally increased tremendously. And this has fostered a virtuous circle, in that more asset managers are devoting greater resourcing towards staffing global equity products,¹ which in turn means that pension plans will have increasingly robust product choices. The figure, a sample provided by Casey Quirk & Associates, shows survey responses from US institutional investors representing over \$1 trillion of assets. Over four years' time, the percentages of assets allocated to global equity by these institutions grew from 21% in 2004 to over 34% at the end of 2008, a 62% increase.

Exhibit 1 – Institutional allocations to non U.S. equity by product type



Russell has been closely tracking the shift toward fully global products through our own universe. In Exhibit 2² we illustrate the breakdown of the Russell global equity universe by different categories, from the original regional constructs through to purely global. As of 1996, 71% of the global equity universe was primarily regional as represented by firms such as Fidelity or Capital International, among the leading players in international investment at the time. Teams were situated in Europe, Asia

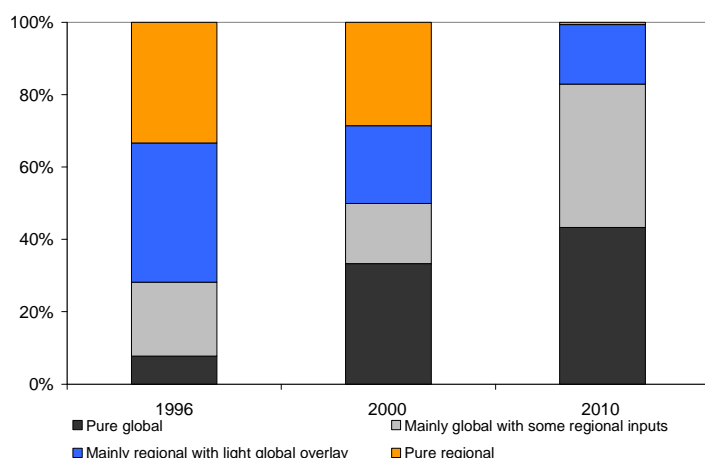
¹ Source: Casey Quirk. March 31, 2009.

² Source: Russell Investments. Analyst assessment is qualitative in nature and aggregated for this analysis. Research analysts were surveyed, then categorized into four buckets on the basis of how global in nature their processes were.

and the U.S.; they each ran regional slices weighted by market capitalization, then summed up to a global product. By contrast, only 8% of the universe was purely global in nature – run by single teams picking stocks on a global basis – and many of these firms were smaller boutiques. By 2010, the number of purely global products has risen to 42%, and those that were mainly global, together with the former category, represented the vast majority, at 81% – a complete reversal.³

Let’s contrast the limitations of a regional approach vs. the opportunities inherent in a global one. Using a global approach provides greater flexibility for tactically exploiting a) significant near-term market anomalies and b) significant structural changes within the markets. A fixed-weight regional construct by definition limits this flexibility. A nice example to illustrate tactical flexibility is the overvaluation of Japan in the 1990s and early 2000s. Managers within the Russell global equity universe had the opportunity to underweight Japan, which many did, and this significantly added to the returns they achieved.

Exhibit 2 – Distribution of Russell Global Equity Universe by process



Portfolios with regional constructs tied to Russell Global Index weights had difficulty avoiding the negative consequences that followed these periods of Japanese equity overvaluation. The other example is the persistent structural tailwind to emerging markets over the past decade, which is likely to continue for many years, coupled with the ability of global managers to participate in this trend more fully than in the regional option.

To further explore the inherent flexibility of purely global investment management, we can look to managers’ average exposures over time, as well as to how they have adapted to the changing makeup of the global equity market. Just 10 years ago, emerging markets made up only 2.8% of the total global market cap as measured by the Russell Global Index. As of March 2010, emerging markets make up over 13.8% of the Index. Managers have adapted to this change and added exposures that are more in line with market capitalization (see Exhibit 3⁴). An evolution has also occurred within the capitalization spectrum surrounding managers’ ability to buy shares of smaller-cap companies. Due to improved

³ Source: Russell Investments. Analyst assessment is qualitative in nature and aggregated for this analysis.

⁴ Source: MFS, eVestment Alliance. 2009.

screening techniques and better accounting standards, managers have extended their coverage to companies within small capitalization sectors (see below for more on these topics). In 2000, the median global equity manager had a modest 0.2% overweight to the smallest-cap quintile within the benchmark. Today that bet is about 4%. The same trend is true in emerging markets, as discussed above, where the average weighting has more than doubled from under 4% in 2000 to over 9% today (see Exhibit 4)⁵. It is important to note that the weighting to EM is effectively a non-benchmark bet, as these markets are not captured within the standard global benchmarks (the Russell Global Index and Russell Global Developed Large Cap indexes).

Exhibit 3 - Global Managers' Coverage of Equity Markets as of 2009

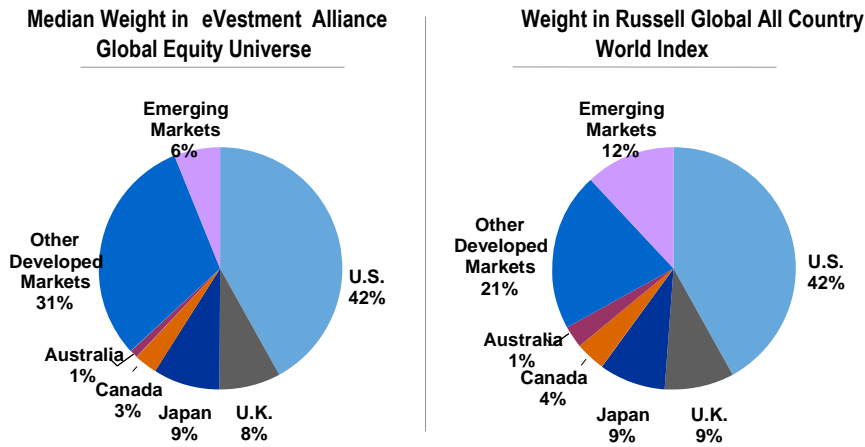
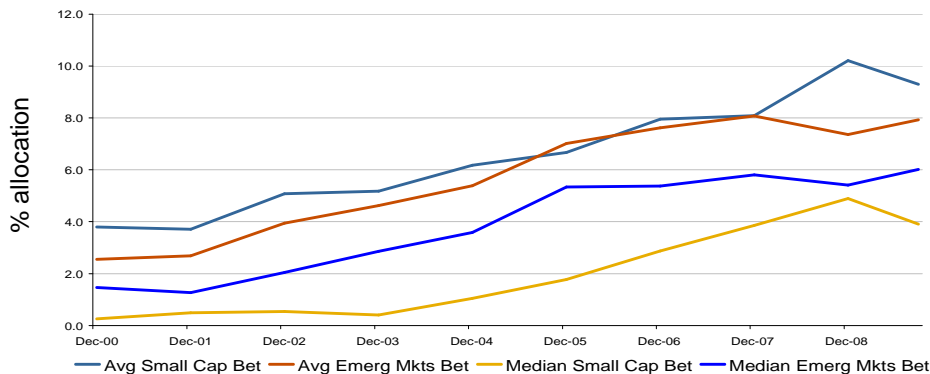


Exhibit 4- Russell Global Equity Universe bets vs. Russell Global Index to small cap and emerging markets as of 12/31/2009



Explosive growth in numbers of products/broad style proliferation

Among the most striking changes regarding the rise of global equity investing have been broad style proliferation and the sheer growth in numbers of products, both of which factors have in recent years favored the multi-manager approach. In Exhibits

⁵ Source: Russell Investments database. 2010. To form capitalization quintiles, the benchmark is divided into 5 equal sections. Manager portfolio weights within each section are summed to form their weight to the quintile. Then the benchmark weight is subtracted from managers' portfolios to find the "bet" to each quintile.

5 and 6, below, you can see the massive extent of growth in global equity mandates.

Exhibit 5 - Number of Fully Global Products (Russell Global Equity Universe)

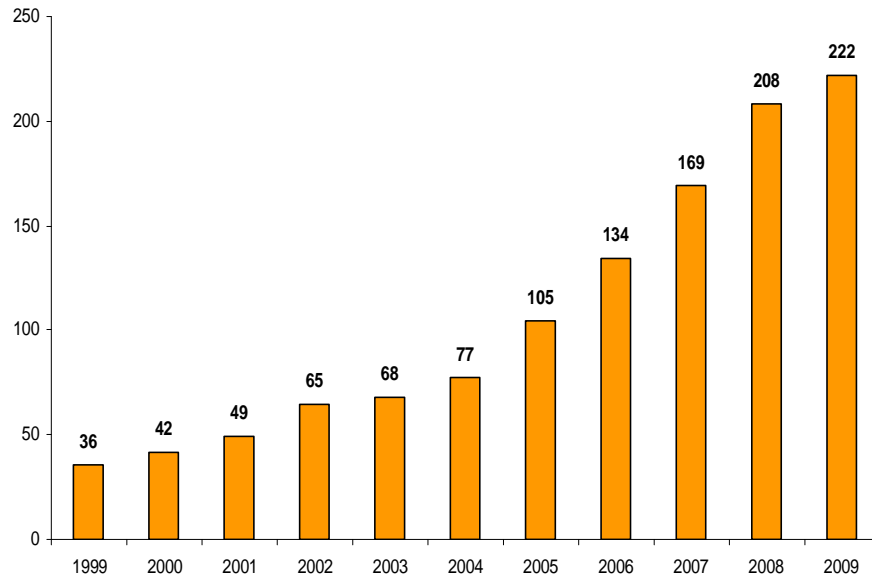
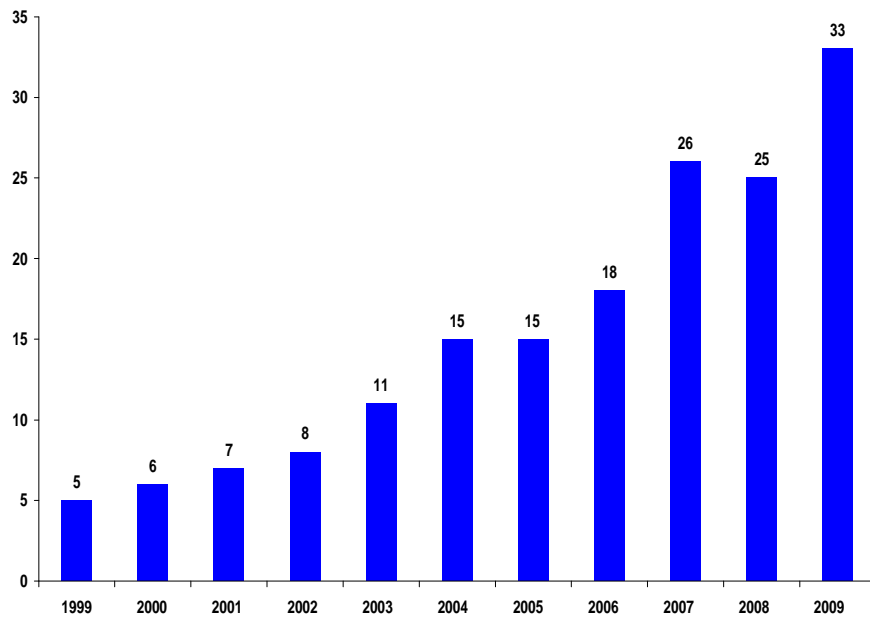


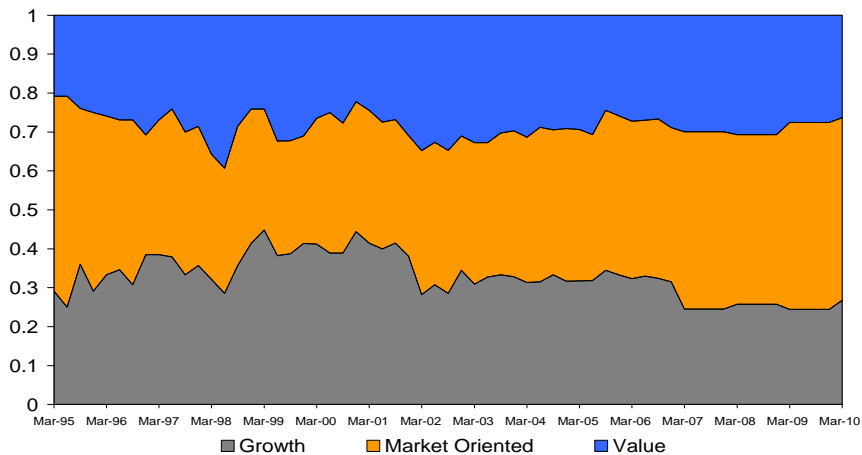
Exhibit 6 - Growth of Russell Global Buy List



As recently as 10 years ago there were only 42 products in the Russell global equity universe, and only six on the Russell global “buy” list. Today those figures have increased exponentially – more than 400% each.⁶

Looking a bit deeper within this product growth, we’ve observed a broadening in available styles as well. However, as the time series graph (Exhibit 7⁷) below demonstrates, styles have not seen identical growth; over various periods, one style has grown more quickly than others. Throughout the late 1990s, when growth managers performed tremendously well due to forays into technology, their style outpaced those of market-oriented and value managers. During the first quarter of 2000, growth managers actually made up 41% of the Russell global equity universe. With the subsequent popping of the tech bubble, the number of growth managers declined. Given the success of value-biased managers throughout the mid-2000s, the number of firms operating in the value space increased. However, the more dramatic effect could be seen in the increase in numbers of market-oriented managers. At their style’s peak in 2007, market-oriented managers made up 47% of the active global equity universe. Looking back to the period from 2003 through early 2007, the market environment was one of stability and low volatility. The CBOE Market Volatility Index (VIX) was in the low teens for an extended period, a far cry from the 70s of 2008 and the mid-30s of today. Within this low-volatility environment, markets were smooth and trending for much of the period. Beyond low volatility, valuation factors also paid handsomely. This was a ripe environment for market-oriented quantitative investing. The number of quantitative managers within the market-oriented universe grew steadily throughout the decade.

Exhibit 7 – Percent of each style in the Russell Global Equity Universe



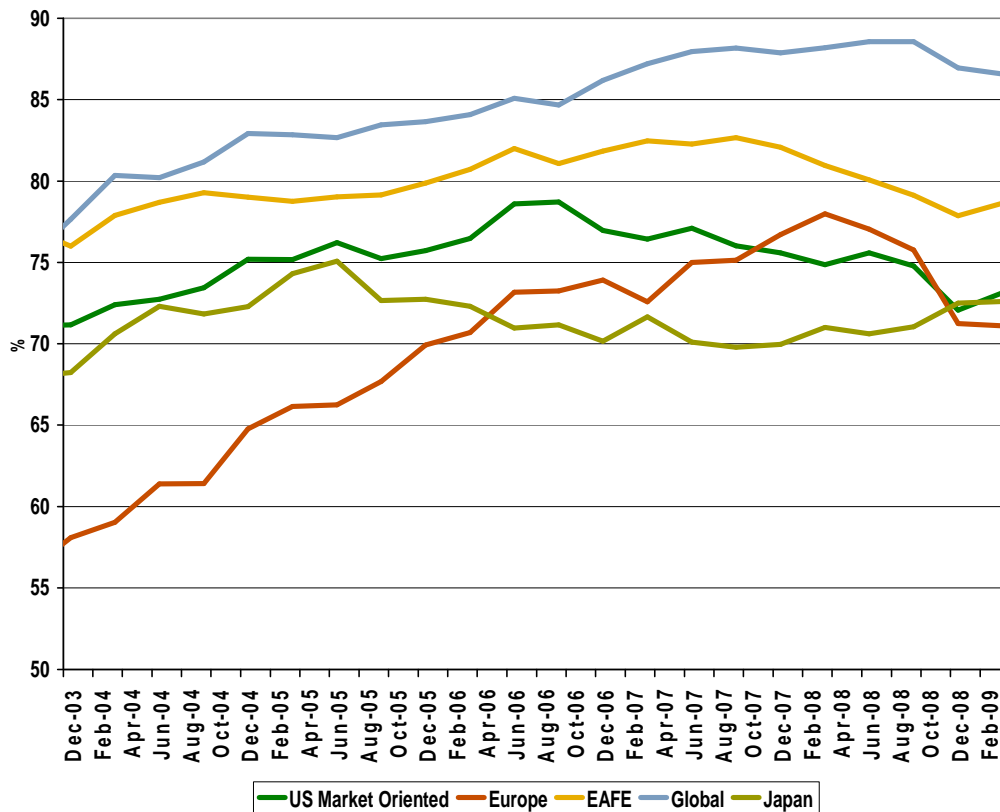
Beyond style (and substyle) proliferation, the increase in global equity products has led to an increase in the numbers of products that take on greater specific risk (tracking error) and focus on best ideas. There are a variety of ways to judge portfolio risk beyond just portfolio name count. Within Russell, we often talk about the percent of market value in the top 10 stocks; tracking error (both ex ante and ex post); and sector/country deviation compared to the benchmark, but one of our favorites is the level of “active money.” Active money, sometimes labeled “active

⁶ Source: Russell Investments. The Russell global equity universe consists of 222 managers (as of December 2009) followed closely by Russell analysts.

⁷ See footnote 3.

share” in the marketplace, measures the degree of difference between a portfolio and its benchmark by summing the absolute value of all active security bets (over- and underweights) in the portfolio and dividing by 2. For instance, imagine a portfolio with two securities, A and B, at 50% weights. The benchmark consists solely of Security A (100%). The active money statistic would be calculated as follows: 50 (from a 50% underweight to Security A) + 50 (from a 50% overweight to Security B) divided by 2 = 50. Russell recently conducted a study to examine average active money scores across various asset classes and the return patterns reflected in these levels.⁸

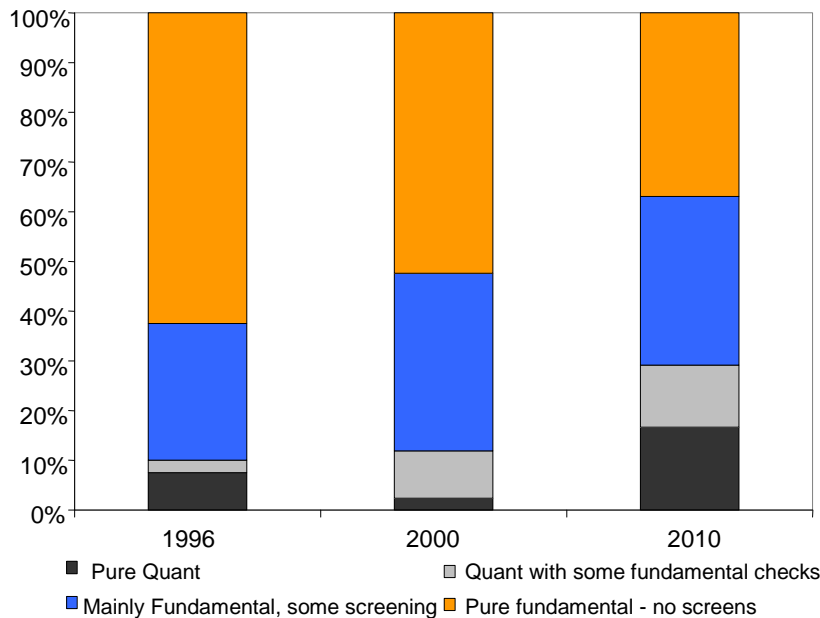
Exhibit 8 - Median active money for Russell Global Equity Universe (as of 12/31/2009)



Over the past seven years, global equity asset managers have had, on average, an active money statistic of over 85, higher than each of the regional asset classes they were compared to; and the average monthly active return achieved was also higher. Ironically, though global managers are a relatively nascent part of the overall active equity universe when compared to regional strategies, these strategies have bypassed the need to represent a broad equity beta and moved straight to high-conviction, alpha-seeking products – stacking the odds in their favor by emphasizing greater active money.

⁸ Russell Research, 12/31/2009.

Exhibit 9 – Distribution of Russell Global Equity Universe by process



In Exhibit 9, the results of another study conducted by Russell are shown.⁹ The study considered the extent to which a manager's process includes any of four discrete quantitative techniques. In 1996, processes that were purely fundamental in nature, using no screens or quantitative processes, comprised nearly two-thirds of the total global equity universe. However, with the adoption of IFRS (International Financial Reporting Standards) by more than 110 countries, global equity managers are now more able to cull the opportunity set through screening for fundamental factors that they believe will add value over time. This transformation has clearly aided innovations and advances in data management, financial theory and programming and financial modeling. Overall, managers now implement processes that are disciplined and repeatable, as compared to the more eclectic processes of the past. With these advances, by 2010 nearly 70% of all global equity managers are using some type of screen or have a quantitative dynamic in their process. Within the market-oriented space, the shift toward quantitative techniques is even more dramatic; now purely qualitative managers make up just one-third of the style grouping.

A last point to note in the discussion of the evolution of style universes is the impact of the market dynamics of 2007–2009. After the quantitative meltdown in August 2007, quantitative processes have struggled, broadly underperforming the Russell Global Developed Index by more than 1.2% over the two years ending March 2010. This has stalled the expansion of quantitative products, and the number of quantitative managers has held steady while growth managers have increased in number.

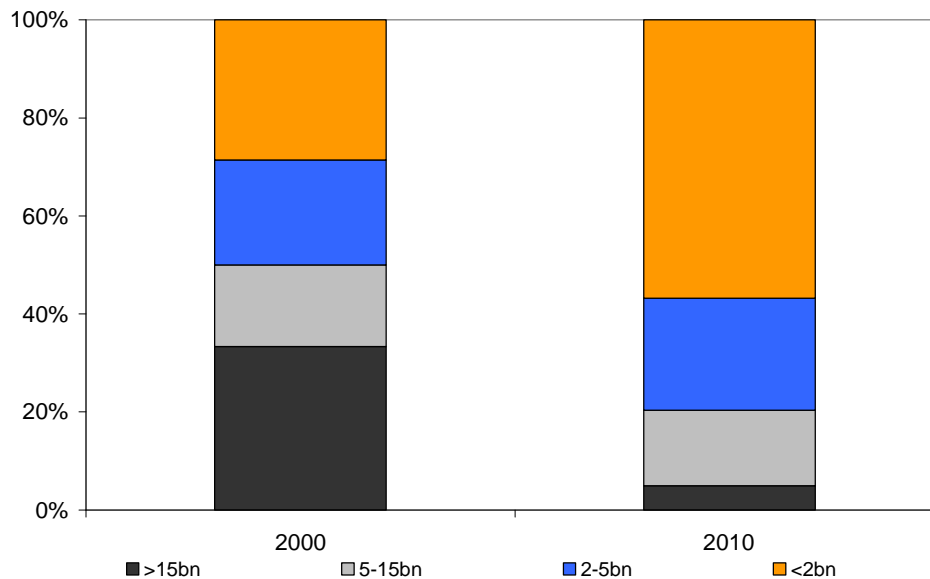
⁹ Source: Russell Investments. Analyst assessment is qualitative in nature and aggregated for this analysis.

It's not the size of the dog in the fight...

An additional dynamic that merits recognition is staff size in the firms that make up the global equity manager universe. Prior to 2000, firms lacked the aforementioned quantitative techniques to cull stocks in a large universe (there are more than 10,000 stocks in the Russell Global Index). To compensate, managers offering global equity products were generally large research teams with staff in locations around the world. A management firm needed an analyst in Japan to accurately cover Toyota or in the UK to cover Vodafone. In the information age we live in today, having analysts on the ground outside the home country is additive, but it is not a prerequisite for global investing. Increased ease of travel, advanced videoconferencing techniques and improved screening capabilities have made it easier for smaller firms to cover the large global investing universe.

In 1999, according to a 2008 study conducted by Morgan Stanley, the top 10 managers within the global equity asset class held nearly 90% of the assets in the space. This has subsequently fallen to just over 60% as of mid-2008. In a similar study conducted by Russell, we observed a similar transition from large assets under management (AUM) firms to smaller boutiques. Firms with more than \$15 billion assets under management in 2000 accounted for over a third of the total number of asset managers. The proportion of these managers has fallen over time, such that as of 2010, firms with less than \$15 billion in AUM make up more than 90% of the total marketplace.¹⁰ Pending government regulation of large money-center banks that house many of these large asset management firms points to a further diminution of numbers, in a trend away from large firms to smaller, employee-owned investment houses. The important thing here is that for many years, Russell has observed a positive correlation between boutiques and performance results (see Exhibit 10). We believe this correlation stems from an ability of firms with limited product sets and skilled, focused investment staffs to put money directly to work.

Exhibit 10: Distribution of Global Equity Universe by AUM



¹⁰ Source: Russell Investments.

The path to going global

Today, global equity asset managers have gained an enhanced ability to cover the entire opportunity set in a more efficient manner than was possible in the past. In the process they have become better able to understand and exploit global themes, navigate risky crosscurrents in ever-evolving world markets and allocate capital and select stocks with better-informed assurance. The changing dynamics mentioned above, clearly positive, will foster accelerated product development as well as increased demand from clients. We at Russell see increased ranges of choice and new, differentiated strategies as being nearly always beneficial to clients, and while we are not yet “spoiled for choice,” that time is approaching ever more rapidly.

In the next installment of this series, we will go into greater depth as to why the manager universe evolution excites us at Russell; why we think accessing global equity in the multi-manager context is the most prudent route for investors; and how we go about selecting products from among those offered in the global equity manager universe to select those we believe have a higher probability of achieving high excess returns.

Acknowledgements

Many of the findings presented in this paper stem from prior work done within the Russell global equity team by Phil Hoffman, Wenling Lin and Rob Balkema for a presentation entitled “Going global: changes within the universe of global equity managers.” given by Phil Hoffman at the 2008 Zurich Investment Conference.

For more information:

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