

## Comprehensive Indexing

*There are various strategies to construct a diversified portfolio, but if the goal is complete representation of the investable market, then the best way is to take 98% of the total market cap, market weight it, and adjust it for free float, according to Kelly Houghton. Transparency and objectivity are the other key elements of Russell's philosophy, as index membership is based on a strict set of rules available to everyone, not on the decision of a committee. Russell posts its index methodology and construction rules on [www.russell.com](http://www.russell.com).*

**Q: What is the philosophy behind creating the Russell indices?**

**A:** Our philosophy boils down to representing the market and trying to be comprehensive and consistent with what investors actually buy. The core belief behind the indexes is representing what's investable, or the securities that are available for purchase by investors. That's why we make adjustments for the free float, which is important both in and outside the United States as there are many companies with international holdings or cross-ownerships.

We believe that completeness and broad coverage offer the best way to represent the total investment market. The additional splits into market segments, such as large cap, small cap, growth and value, provides understanding of what's happening in the marketplace, but so does the mother index, and you need to start with the whole enchilada.

**Q: Could you give us a more technical description of the indices?**

**A:** The Russell 3000 index includes the 3,000 largest companies in the United States by market value. We chose this number more than 20 years ago after consulting with all the index fund managers in the United States to find

out how many stocks they can actually buy. The answer uniformly was between 3,000 and 3,200 stocks, which is about 98% of the market, so we chose a number that's pertinent with those people because of the nature of their business. When we started the index, many people thought that it was too broad, but today the Russell 3000 Index is the accepted institutional broad benchmark. We feel that it does represent the broad market and if you go too much beyond that, you begin to get into stocks that are difficult to buy.

The Russell 1000 index consists of the 1,000 largest companies in the United States by market value. That's a pretty straightforward index, which includes stocks like Wal-Mart, McDonald's, Johnson & Johnson, etc.

The Russell 2000 index includes the smallest 2,000 stocks, or stocks with market value in the general range between \$200 million and \$1 billion. It turned out to be our most popular index in terms of usage by the retail markets. When we first started it, investors thought that it was reasonable to do active management on the large-cap space, or Russell 1000, and passive management on Russell 2000, because



**KELLY HAUGHTON** serves as the strategic director for Russell indexes, part of a more accurate and comprehensive system for evaluating the performance of investment managers. In this capacity, he seeks new and expanded business opportunities and revenue streams, for Russell Investment Group, such as the development of various derivatives products based on Russell indexes. He also serves as a primary spokesperson on index-related issues since he was a leader in the development of Russell's family of U.S. equity indexes—the Russell 1000 Index, Russell 2000 Index, Russell 3000 Index, Russell Earnings Growth Index and Russell Price-Driven Index. Kelly joined Russell in 1982. He developed the first version of the asset allocation model used by Russell's investment management company and its bank partners in helping their clients allocate assets across the firm's funds.

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nobody understood those stocks and the transaction costs were too high for effective active management.

Now we've seen the reverse of that trend as the volume in futures, options, and ETFs went up substantially. As a result of separating out the iShares Russell 2000, the liquidity and the trading efficiency in the Russell 2000 have improved dramatically over the last 3 years. That's because the futures and the ETFs have provided tools for hedge funds and other investors to take positions in small-cap stocks and to hedge those positions however they find appropriate.

**Q: Why do think that it is better to track 3,000 instead of 30 stocks? There is an argument that you don't need more than 100 stocks for diversification.**

**A:** Our index philosophy is representing what you can actually buy, so for us having 3,000 stocks is 100 times better than having 30 stocks. The Dow Jones Industrial Average doesn't really represent an investment strategy. Charles Dow had to do his index calculations with paper and pencil, so I completely understand why he selected the methodology of following only 30 stocks. But with the computing power available today, we may as well do it right because we don't have to restrict ourselves.

We can use 3,000 stocks and we can calculate the Russell 3000 every 15

seconds using market capitalization weights, so we end up with a more accurate and complete representation of the market. The weighting scheme used by the Dow Jones Industrial Average came as a result of the limitations of technology and isn't really representative of the marketplace. That's why we have a different philosophy.

**Q: How does your weighting scheme differ from that of the Dow Jones Industrial Average?**

**A:** Charles Dow basically started with taking the average price. There are modifications, of course, but the general idea is based on the average price. This methodology doesn't take into account the difference in the number of shares purchased, so it is not representative of the market. Some investors run equally weighted investment portfolios and that's a fine approach, but it doesn't represent the market.

There are many investors out there trying to outperform the market, which is an honorable profession that leads to efficient capital allocation to businesses. But they do it by weighting the stocks available differently than the market, through equal weighting or through assigning a dual weight to most stocks, etc. A typical active investment manager selects a certain number of stocks, deciding that these are going to outperform the market. So he assigns a zero weight to all the other stocks available on the marketplace. My point is that there's a wide variety of weighting strategies called active management and that's fine, but represents an attempt to outperform the market, while we are trying to do something different.

**Q: What do you think of the S&P 500 as a broad representation of the market?**

**A:** That's an index which was a dramatic improvement over the Dow, but

it still isn't completely representative because, obviously, there are more than 500 stocks in the United States. The investment managers and the individual investors invest in a broader array of securities. I believe that the S&P 500 covers about 80% of the market, which is a good size but it just isn't 98%. If you're trying to represent the universe of securities from which investors select, that index is narrower than it should be. Once again, when S&P started out, we didn't have as fast and big computers as we do today. It is a good representative sample, but still a sample, not a comprehensive representation.

Also, in both the Dow Jones and the S&P, there's a committee that determines the membership. Our approach is to have objective and transparent rules published on the website for everyone to see. With that approach investors can figure out which stocks will be added or deleted from the index and why. We believe very strongly that the right way to run an index involves objectivity and transparency. We just determine the rules and the market determines which stocks are going to be in the index.

One of the interesting twists is that each year around index reconstitution time, we still receive calls from companies that ask us not to remove them from the index, but that's not in our hands.

**Q: What criteria should the companies meet to be part of the index?**

**A:** Our rule set is predicated on getting the best definition of the investable universe. We have been consistently refining our rule set over the last 5 to 10 years to make it easier for index fund managers to run funds against our index, because that is the ultimate test whether or not something is investable. I think we made significant improvements and we're pleased with the progress.

In June we announced that we'll launch a full set of global indexes soon. In addition, we have a family of Japanese equity indexes that we produce jointly with Nomura Securities. Those indexes have been picking up ground as benchmarks for Japanese investors over the past couple of years.

**Q: Could you explain your reconstruction process in more detail?**

**A:** The Russell 3000 simply represents the 3,000 largest companies in the United States by market value at the close of May 31. Because of the changing nature of the capital markets, the 3,000 largest stocks change over time. There are IPO's, mergers, bankruptcies, value changes, or private equity take-outs. The list of the 3,000 largest publicly traded companies by market value changes over time, and we reconstruct our indexes once a year. We use the data as of the end of May to determine the 3,000 largest companies but the reconstructed index becomes effective on the last Friday of June.

We've made several revisions to our process, which improve its efficiency and cost effectiveness. For example, because of the increasing scale of Russell's annual reconstitution, the NASDAQ exchange implemented a closing cost mechanism in which there is an auction at the end of the day to determine the final price. That has made our reconstitution process flow smoothly in determining the closing price.

**Q: Why have you chosen the end of May instead of the end the year or a specific quarter?**


**A:** December 31 would not be a good day as it is fairly illiquid. Many people are not at work at that time, including people who work at the stock market, so it wouldn't be representative. Originally, we picked the end of June, but there was a concern that there's

enough trading during that day related to the end of the quarter.

Regarding the announcement date, investors wanted to be able to have a weekend for their operations department to catch up, so we moved the date from the last trading day in June to the last Friday in June to allow the operations departments to catch their breath. The reason for having two separate dates is providing investors with plenty of time to get ready for the changes. Part of our transparency policy is to give everyone time to adjust and to be able to look at what's going to happen. It just makes the reconstruction easier for all the relevant parties.

The idea of the reconstitution process is to freshen up the index and make sure that it continues to be representative of the overall market. To illustrate why this is so important, I'll give you the example of Amazon. The stock was included in the Russell 3000 Index in 1998 as part of our reconstitution process, while it joined the S&P in 2005, when it was eight times the size in terms of market cap. The continuous updates are very helpful for making the index truly representative of the stocks that you can buy. For seven years Amazon was available for purchase and was not represented in the S&P.

**Q: So you'd have only a twelve-month lag in the worst case, while a committee may or may not decide to include a stock.**

**A:** That's correct. It may be never or it may be much later. Another rule that we've instituted is looking at IPOs and adding appropriately sized IPO's on a quarterly basis. So a brand new IPO would not even have to wait twelve months to be included. The delay, at the most, would be about three months. Just think about Microsoft, which was included in the Dow Jones 25 years after its IPO. 

## Russell Investment Group

### FUND FACTS

Website	<a href="http://www.russell.com">www.russell.com</a>
Address	Russell Investment Group 909 A Street Tacoma, WA 98402
Tel. No.	800-787-7354
Established	1936

### ASSETS BENCHMARKED (IN BILLIONS)

Total Assets	\$ 3,800
Passive Assets	\$ 0.53
Institutional Assets	\$ 2,500
ETFs	\$ 35
Mutual Funds	\$ 320

### INDEX INFORMATION

Number of Indexes	24
Style Indexes	Yes
Small Cap Indexes	Yes

### FUTURES & OPTIONS INFORMATION

Futures	CME, NYBOT, Eurex US
3 Year (Ann.)	AMEX, CBOE, ISE, PHLX, PCX

### ASSETS UNDER MANAGEMENT

Total Assets *	\$ 181
US Mutual Funds *	\$ 26
Number of Funds	240
Separate Accounts	Yes
Money Manager Analysts	97

### PRIMARY CONTACTS

Indexes - Kevin Lohman	1-877-503-6437
Data through: 3/01/06	

Source: Russell Investment Group

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