Insights

The leopard’s spots:

Russell Style Indexes keep growth and value in focus

“A leopard can’t change its spots,” is an old saying rooted in the belief that a person’s core character doesn’t change over time. The same cannot be said of the markets, public companies or investment strategies, which is why the Russell Style Indexes have become such powerful tools for portfolio measurement and construction.

1987 marked the launch of the Russell Style Indexes, the first benchmarks to systematically categorize “growth” stocks and “value” stocks. As a quick refresher: a growth company can be thought of as being more closely tied to the economic cycle and as being valued for potential future earnings vs. realized earnings; companies with market prices that may be discounted relative to their earnings or other fundamental measures are commonly referred to as value stocks. Many companies fall somewhere in between, with partial allocations to growth *and* value.

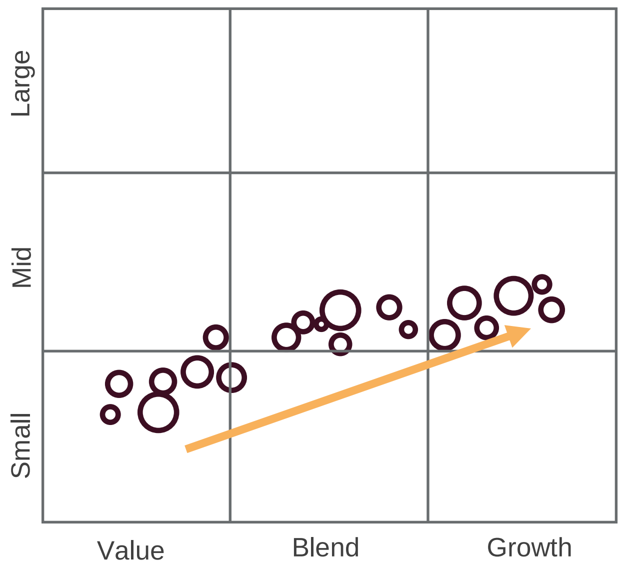
Professional asset managers built their portfolios around these two types of investment strategies for many years—the Russell Style Indexes were the first benchmarks with which to measure their performance.[1] Having identified the measurable size and style segments of the market, the Russell Indexes suite of benchmarks would grow to cover large caps with the Russell 1000® Index, small caps with the Russell 2000® Index, the corresponding growth and value indexes, and midcaps with the Russell Midcap® Index. With these, investors had the building blocks for US asset allocation and what would come to be known as the “equity style box”.

The equity style box allows investors to categorize the type of strategy an active manager/fund is using (large cap growth, or small cap value, for example) —ignoring how a fund is marketed to uncover its real DNA. This

[1] The seminal book “Security Analysis” by Graham and Dodd (1934) is widely credited for introducing concepts that would form the basis of value investing.

can be accomplished by comparing benchmark and fund data to reveal a match—giving a clear picture of a leopard's spots. [2]

The style indexes empower investors to quickly see whether a portfolio strategy that touts adherence to a particular investment goal, in practice reveals a lack of discipline—a leopard that changes it spots by chasing performance. Preventing style drift keeps investment managers honest and investors aware of unintended risk exposures.[3]



Hypothetical example: Plotting Style Drift on the Equity Style Box. This hypothetical investment portfolio started out buying small cap value stocks but subsequently drifted towards owning midcap growth stocks. (Rebalancing helps, but needs to be balanced with the negative impact of turnover).

In order to prevent the indexes themselves from "changing spots" they are reconstituted annually. Reconstitution is the rules-based process through which companies measured by the Russell US Index Series are re-evaluated. Companies whose characteristics have changed substantially—and companies can and do change—are moved to their more appropriate index.[4] Borrowing from our example above: if a small cap value company's business takes off, such that its size has grown significantly due to price appreciation or other corporate action, and earnings expectations are higher, that company might be reclassified at Reconstitution as a midcap growth company.

The integrity of the Russell Style Indexes process has become the standard for index users:

- **Consistent:** Russell Style Indexes are attractive for their objective rules based approach grounded in an annual rebalance process. Through annual reconstitution, the indexes avoid style drift—staying true to the intent of the investor's allocation (in other words, you know what you are getting).[5]
- **Strategic:** Style indexes can be used strategically to express a view on market conditions. When economic conditions are robust a growth-based product might be held in a greater proportion, and when economic sentiment is mixed, a portfolio might be shifted in favor of value.
- **Diversified:** The index user can measure and/or own style broadly. This avoids the concentration risks associated with portfolios that load up on certain stocks or sectors.

A leopard cannot change its spots, but certain investment products can. The Russell Style Indexes provide a framework through which to better understand investment strategies and how they behave over time. Additionally, index users can access broadly diversified exposures to the growth and/or value style.

[2] The equity style box concept was popularized by Morningstar after introducing it as an analytic tool in 1992. For more information please visit: http://corporate.morningstar.com/cf/documents/MethodologyDocuments/FactSheets/MorningstarEquityStyleBox_FactSheet_E.pdf

[3] Tuchman, M. (2014). Return envy: Why 'style drift' matters. Market Watch, retrieved on 8/31/2015 at: http://www.marketwatch.com/story/return-envy-why-style-drift-matters-2014-07-10

[4] For more about Russell Indexes Reconstitution please visit: http://www.ftserussell.com/research-insights/russell-reconstitution

[5] Financial Industry Regulatory Authority (FINRA). Mutual Funds. Retrieved on 8/31/2016 at: http://www.finra.org/investors/mutual-funds

For more information about our indexes, please visit ftserussell.com.

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