Do you have the right global equity index?

Index and benchmark issues for Australian & NZ-based global investors

Institutional investors usually believe they have more immediate issues to worry about than ensuring they have an appropriate index for the benchmarking of their active manager portfolios. However, this low profile subject is worth a little more attention than it has historically received.

Do you have the right global equity index?

Benchmarking and index choices are at all times a key plank in any asset-owner's equity strategy. Given their role as arbiters of performance, it is important that indices be objective and transparent, as well as being well-aligned with investor risk/reward objectives, and with manager style categorization. Appropriately matching equity benchmarks with manager geographic and capitalisation characteristics is also necessary, not least to avoid the confusion between passive universe choice, and active manager value-add.

Over and above these perennial issues, however, current developments in global equity management render equity index choice of particular relevance at the present juncture. US managers, with a domestic market equal to around half the total world equity market cap, are turning their gaze outwards with a fast-growing focus. Accustomed to using the Russell Indexes domestically, but other indices externally, this growing external focus is increasing the belief that the deployment of one single family of indices, pan-globally, would make sense. Moreover, looking ahead to the day when US-based investors become more comfortable with increasing their opportunity set by investing in ex-US small caps, there is a growing acceptance that it makes more sense to also use the familiar Russell Indexes outside the US, than it does to try to bring more narrowly-based, and less familiar indexes onshore.

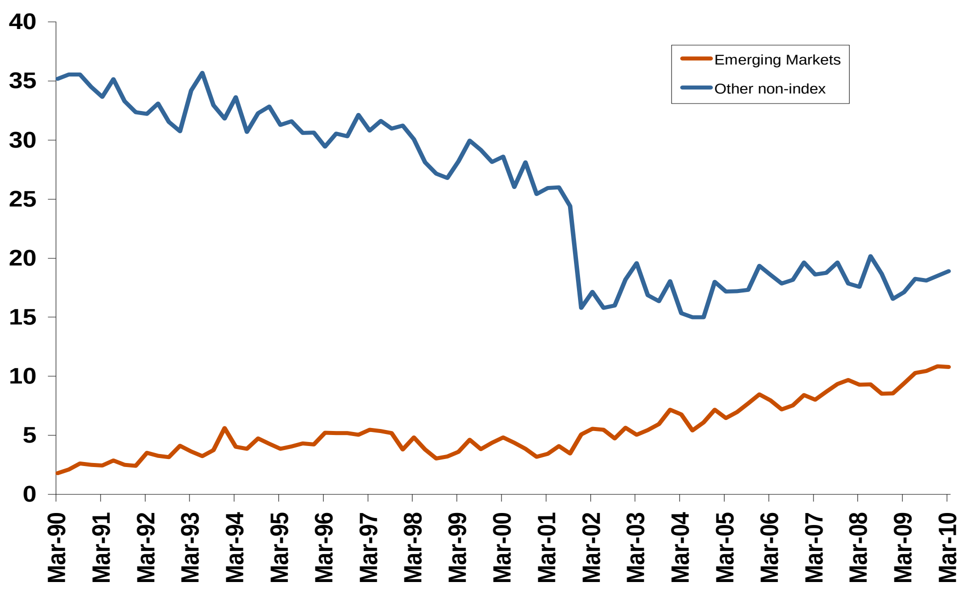
With specific reference to the Russell Indexes, this paper re-examines the principles of global equity index selection in general, and with reference to current developments in global equity management in particular. We would urge all of our clients to investigate the degree to which these issues may be relevant with respect to their own active manager mandates. We would also urge clients to evaluate the extent to which there may be a better index available for benchmarking purposes than they may be currently using. Ultimately, it is important for asset-owners to be clear about what they are trying to achieve with active equity mandates and to select a benchmark that aligns, not with what managers may want to do, but with what those objectives are.

Alignment to client objectives – risk/return

The Russell Indexes, because of their greater geographic and stock capitalisation spread, and their inclusion of higher growth emerging countries and companies, have historically performed better, and delivered a better risk/reward mix, than more narrowly based indices. Since asset owners typically seek to achieve the best risk/reward outcomes possible; and further, since it is not in asset owners interests to pay active-alpha manager fees for what is in fact no more than a passive beta tilt to emerging markets and/or small caps; the Russell Indexes are in those senses better aligned to client objectives.

Many investors, however, continue to use indexes that fail to cover the full universe of their active managers. This is especially problematic when the portion of the universe not covered by the index is meaningfully over-weighted by investment managers, and also outperforms. Under such circumstances an active manager may simply outperform as a result of off-benchmark bets as opposed to true skill. Research by Russell finds that investors have a tendency to benchmark their assets using indexes that fail to cover the full habitat of their active managers. The MSCI EAFE index is used by many US investors to benchmark their non-US equity portfolios and is a case in point. As figure 1 below indicates, the average allocation to off-benchmark stocks of managers benchmarked to the MSCI EAFE Index within the Russell manager universe has remained high.

Figure 1: Average allocation to off-benchmark stocks (MSCI EAFE benchmarked managers)



Source: Russell Investments

Over the period from the end of March 1990 to the end of March 2010, the portion of the universe not covered by the index used for benchmarking purposes did indeed consistently outperform. For an un-hedged US dollar investor over this period, the returns on the MSCI Emerging Markets and MSCI EAFE Indexes were 8.5% p.a. and 3.2% p.a. respectively. The MSCI Emerging Markets Index outperformed by a very sizeable 5.3% p.a. over this period.

For the international equity component of Australian-based investors, the return differentials for this period are even more marked. Over the same period as described above, the MSCI Emerging Market Index returned a compound annual return of 21.1% in Australian dollars, versus 10.8% for the MSCI Developed World Ex Australia Net Dividend Index. Under such circumstances, there is a danger that a portion of the manager's outperformance will be attributed to skill as opposed to an overweight position in emerging markets.

Even given this historical experience, however, there will still be a range of risk-return objectives across investors. Just because emerging markets are a bigger share of the global indices than in years gone by, and just because their historical performance has been good, does not automatically mean that they warrant a strategic weight in every client objective, or representation in every investor's index benchmark. The developed world indices remain a legitimate, more conservative risk/reward proposition than the global, all country alternatives for some investors.

Alignment to client objectives – manager categorisation

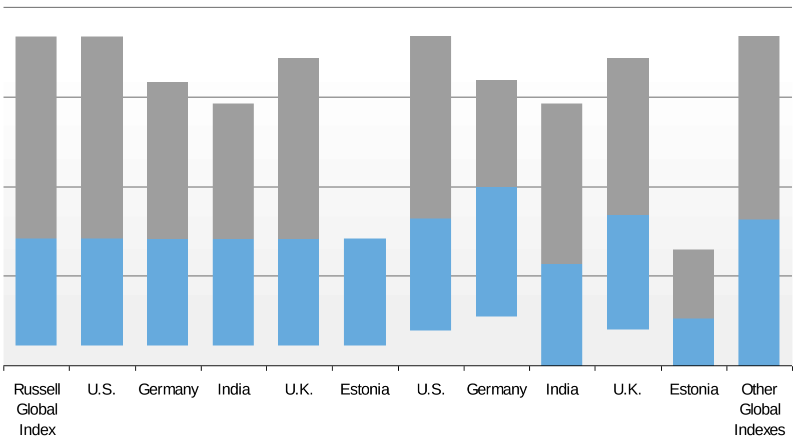
One of the key needs of asset owners and superannuation funds is the categorisation and benchmarking of style managers, specifically "growth" and "value" managers. The Russell equity style indexes are less complex, and are more forward looking than those of some competitors. More importantly, empirical analysis shows the Russell Style Indexes to be more effectively aligned with the returns of the value and of growth managers often engaged by asset owners. That is, the Russell Style Indexes better describe the actual behaviour and performance of style managers than most other indices, including more complex characterisations of style. The Russell Indexes are therefore particularly suitable for work in configuring, and assessing, style managers.

Realistic size definition

A significant differentiating feature of the Russell Indexes is the formulation of the small cap universe. The idea of what is "large" and what is "small" in any particular market depends on the point of comparison. If the division into large and small is conducted on a country-by-country basis, there will be a different result than if it is conducted on a global basis. This is one area in which there is a clear distinction between the methodologies adopted by Russell (which prefers the global-relative approach) and some other providers (which tend to be country-relative).

For example, no corporations in Estonia would count as "large cap" by U.S. standards or in global comparisons, while at the other extreme, in Russia some corporations that would be considered large in other markets appear small in the context of that country's mega-stock-dominated domestic market. The chart below – first produced by Feldman and Haughtoni and updated here – illustrates the difference between creating cap breaks based on country-by-country comparisons or on a global comparison.

Figure 2. Global-relative vs. country-relative cap breaks



Source: Russell Indexes

In the left hand side of the chart above we see that a global relative cut-off leads to different proportions of each market being classified as large and small. Estonia, for example, has no large cap stocks at all. On the right-hand side, we see the effect of using a country-by-country cut-off (while holding other aspects of the index construction the same). There would be substantial variation in the point at which a stock would be considered large cap, depending on its nationality.

Intuitively, we would expect that international money managers would adopt a largely global-relative mindset in building their research opportunity set. This intuition is confirmed by Feldman and Haughton, who compare actual manager portfolios and find that global investment managers do not build portfolios "in the way implied by country-relative definitions. If anything, they appear to do the opposite, tending to set higher cap floors in countries with generally smaller companies."

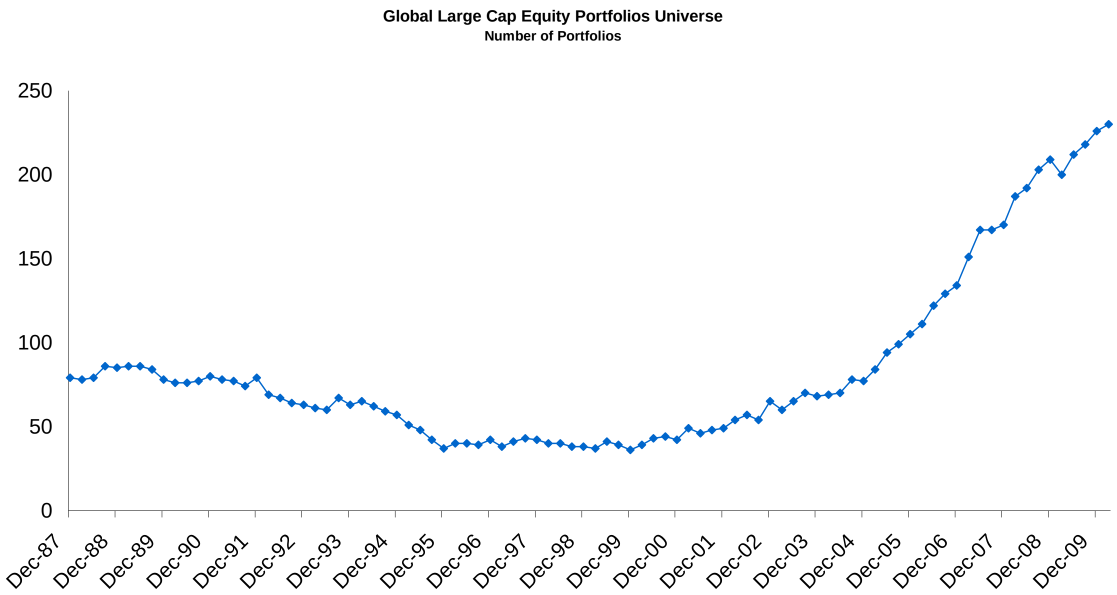
From the international investor's perspective, the global-relative approach appears to be more suitable, a view supported by examination of the actual behaviour of managers.

Benchmark migration – Small Cap Stocks ex-US

In recent years markets around the world have become easier to access, and investors have sought diversification across a growing list of asset classes and strategies. As a result, institutional investors have expanded their penetration of the global opportunity set, moving beyond only the largest companies in the most developed markets. The typical international portfolio extends below the bottom of the benchmark index's capitalisation coverage. That is, managers in practice are buying some stocks that are outside the benchmark's size cut-off.

The chart below shows the growth in the number of fully global equity products in Russell's manager research universe. In recent years there has been significant growth in the number of products available for institutional investors.

Chart 3. Significant Growth in Number of Global Equity Products



Source: Russell Investments

Current practice among global, US-based institutional investors is to significantly underweight non-domestic small cap stocks. Since a good benchmark should reflect, rather than dictate, strategic investment decisions, these investors may prefer an index with different cap depth for domestic and non-domestic markets. In the Russell Global Index family, this index is the Russell World Cap Index.

The Russell World Cap Index comprises a cap-weighted mix of the Russell 3000 and the RGI non-U.S. large cap index. In other words, it includes small cap within the U.S. but not in the non-U.S. markets (so it could also be described as a cap-weighted mix of the RGI large cap index and the Russell 2000 index). This is the dark "L" shaped region in Figure 4. Within the MSCI index family, a combination of the MSCI ACWI index and the MSCI U.S. small cap index would give similar exposure, although the weighting between the two indexes would need to be adjusted by the investor as the underlying market cap weights change.

Chart 4. World Geography and Size Perspectives, given US Dominance.

	Large cap.	*Small cap.*
US	**US Large Cap.**	**US Small Cap.**
Rest of World, ex US, Aust	**World ex-US, ex-Aust., Large Cap.**	**World ex-US, ex-Aust., Small Cap.**

Given the dominance of the US market – both as representing around 42% of a global index (inc. emerging markets), and as a domicile for many global equity managers – it is the US versus Rest-of-World split that matters, even for Australian-domiciled investors.

Looking ahead – as and when US-based global equity investors become comfortable with ex-US small cap investing, and seek to expand their opportunity set accordingly, the Russell Indexes are well-placed to accommodate that change (i.e. RGI – "Russell Global index").

Rules-based objectivity

Any and every index provider can be, or can be perceived to be, subject to conflicts and biases. Russell Investments is the only index provider that is also an investment manager for example; but other index players are listed, and have business imperatives to address; whilst still others are associated with investment banks or with market exchanges which in turn have their own agendas. Given these potential industry cross-currents, and given also that equity indices need to occupy a position of scrupulous fairness in their role as reference benchmarks, it is undesirable that they be open to arbitrary interference.

The Russell Indexes stand out as being rules-based and objective, because changes arise from the methodology itself and are independent of any ownership issues. This is in contrast to other approaches where stock decisions can be made "as determined by a committee", and where the migration of countries from Emerging to Developed status can occur on an ad hoc basis. The Russell indexes also stand out as being the most open to third-party scrutiny, and the easiest for external organisations to replicate.

Simplicity and transparency

No one index provider has a monopoly on intellectual capital, and the index provision industry has seen methodological convergence on a range of fronts over the decades. A number of Russell's innovations have become common – for example, the use of free-float factors; the degree of market coverage of smaller capitalisation stocks; the recognition that emerging markets are a key component of a global equity index; and the calculation of style indexes. However, whilst not all of Russell's innovations now still remain unique to Russell, competitor catch-up has often come at a cost to continuity and to clarity. Given this history, the Russell Indexes retain a demonstrable industry lead in terms of simplicity and of transparency.

Conclusion

An acceleration in the global scope of US equity managers at present makes this an opportune time to revisit the issue of global equity indices and benchmarks in general. The Russell Indexes are very well suited to coverage of developed and emerging markets; and also to addressing small cap mandates both as they now exist (i.e. broad universe US, large cap universe ex-US) and as they may become (i.e. broad global universe). The Russell Indexes offer superior alignment to client needs with respect to risk/return objectives, and also to manager style configuration. Last but not least, the objectivity and transparency of Russell's strict rules-based index construction approach underwrites investor confidence in the integrity of this important benchmarking process.

[1] Feldman, Barry and Kelly Haughton (2008), "Defining Global Small Cap." *Russell Research* (May).

Russell Investments

As of August 2010

World

Russell Global Large Cap Index Net

MSCI AC World Net Dividend Index

Performance Comparison (AUD)

	MTD	QTD	YTD	1 Year	3 Year	5 Year
Russell Global Large cap	-1.86	-0.95	-4.09	-1.42	-11.23	-2.18
MSCI AC World Net Index	-1.85	-0.97	-4.43	-1.97	-11.36	-2.24

Sector Exposure

	Russell	MSCI	≠
Consumer Discretionary	10.5	10.6	-0.1
Consumer Staples	8.7	9.1	-0.4
Energy	10.6	10.7	-0.1
Financial Services	22.4	21.6	0.8
Financials	0.0	0.2	-0.2
Health Care	8.4	8.5	-0.1
Industrials	0.0	0.0	0.0
Information Technology	0.0	0.0	0.0
Materials	0.0	0.2	-0.2
Materials & Processing	9.1	9.0	0.1
Producer Durables	10.4	10.1	0.4
Technology	10.9	11.2	-0.3
Telecommunication Services	0.0	0.1	-0.1
Utilities	8.7	8.6	0.1

Top 10 Holdings

	Russell	MSCI	≠
Exxon Mobil Corp.	1.2	1.3	-0.1
Apple Inc.	0.9	0.9	-0.1
Nestle S.A.	0.7	0.8	-0.1
Microsoft Corp.	0.7	0.8	-0.1
HSBC Holdings PLC	0.7	0.7	-0.1
Procter & Gamble Co.	0.7	0.7	-0.1
AT&T Inc.	0.6	0.7	0
International Business Machines	0.6	0.7	-0.1
Johnson & Johnson	0.6	0.7	0
General Electric Co.	0.6	0.7	0

Country Exposure

	Russell	MSCI	≠
Australia	3.1	3.3	-0.1
Austria	0.2	0.1	0.0
Bahrain	0.1	0.0	0.1
Belgium	0.4	0.4	0.0
Brazil	2.2	2.1	0.1
Canada	4.3	4.5	-0.2
Chile	0.3	0.2	0.0
China	2.4	2.4	0.0
Colombia	0.2	0.1	0.0
Croatia	0.0	0.0	0.0
Cyprus	0.0	0.0	0.0
Czech Republic	0.0	0.1	0.0
Denmark	0.4	0.4	0.0
Egypt	0.1	0.1	0.0
Finland	0.4	0.4	0.0
France	3.8	3.7	0.1
Germany	3.0	3.0	0.0
Greece	0.1	0.1	0.0
Hong Kong	1.1	1.1	0.0
Hungary	0.1	0.1	0.0
India	1.3	1.1	0.2
Indonesia	0.3	0.3	0.0
Ireland	0.3	0.2	0.0
Israel	0.3	0.3	0.0
Italy	1.2	1.1	0.1
Japan	7.9	8.9	-1.0
Jordan	0.0	0.0	0.0
Kazakhstan	0.0	0.0	0.0
Kuwait	0.1	0.0	0.1

	Russell	MSCI	≠
Luxembourg	0.2	0.1	0.1
Malaysia	0.3	0.4	-0.1
Mauritius	0.0	0.0	0.0
Mexico	0.6	0.6	0.0
Morocco	0.0	0.0	0.0
Netherlands	1.8	1.1	0.7
New Zealand	0.0	0.0	0.0
Norway	0.3	0.3	0.0
Oman	0.0	0.0	0.0
Peru	0.1	0.1	0.0
Philippines	0.1	0.1	0.0
Poland	0.2	0.2	0.0
Portugal	0.1	0.1	0.0
Qatar	0.1	0.0	0.1
Romania	0.0	0.0	0.0
Russia	1.0	0.9	0.2
Singapore	0.8	0.7	0.1
Slovenia	0.0	0.0	0.0
South Africa	1.0	1.0	0.0
South Korea	1.7	1.8	-0.1
Spain	1.5	1.5	0.0
Sweden	1.1	1.2	0.0
Switzerland	3.4	3.3	0.0
Taiwan	1.3	1.4	-0.2
Thailand	0.2	0.2	0.0
Turkey	0.2	0.2	0.0
United Arab	0.0	0.0	0.0
United Kingdom	7.5	8.5	-1.0
United States	42.9	42.0	0.9

For more information about Russell

Call: Sydney: +61 2 9229 5111
Melbourne: +61 3 9270 8111

www.russell.com.au

Disclaimer

First used: October, 2010