

Russell Research

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Active management headwinds reverse course

The environment for active management of equity portfolios has been notably unfavorable in recent years – but things are changing. Because cross-sectional volatility is increasing, opportunities for good managers to deliver strong returns are also increasing. Additionally, the pattern of increased return dispersion among securities generally applies to sectors as well. This is good news for skilled managers who can accurately predict which stocks and sectors are likely to outperform their benchmarks. We also find that although active managers were hurt by certain risk factors when investors became more risk-averse in 2008, the selective risk factors on which, in aggregate, active managers tend to bet should pay off as investor appetite for risk increases.

Introduction: Features of the current market environment that are driving active management results

The recent erosion in active returns has caused some investors to question the value of active management. Yet there is good reason to believe that this erosion has been a function of temporary or cyclical market forces.

The initial focus of this paper – which is based on US equity manager data – is on cross-sectional volatility and its relationship to active management returns. Commonly, there is greater (less) dispersion among active management returns when cross-sectional volatility increases (decreases). Historically during periods of high cross-sectional volatility, managers who have selected stocks that outperform their benchmarks have been rewarded beyond normal expectations. This is not necessarily because skilled managers have become more skilled or are taking larger bets; more likely, it has been the result of a higher level of cross-sectional volatility in the market, which tends to magnify successful bets.

Furthermore – and this is the focus of the second part of our paper – the current financial crisis has created opportunities that are explainable by changes in risk factors and sector dispersions that skilful managers can capture in their processes. Many of these dislocations were caused by indiscriminate selling of equities by investors who became significantly risk-

averse in the current economic crisis. When investors become willing to re-enter the equity markets and take more risk, such dislocations among the criteria important to active managers may provide alpha opportunities that are not possible with passive investing. Additionally, because changes in the risk factors important to active managers are not concentrated within a specific equity style, both growth and value managers may benefit in these extreme market conditions.

Cross-sectional volatility and active manager returns

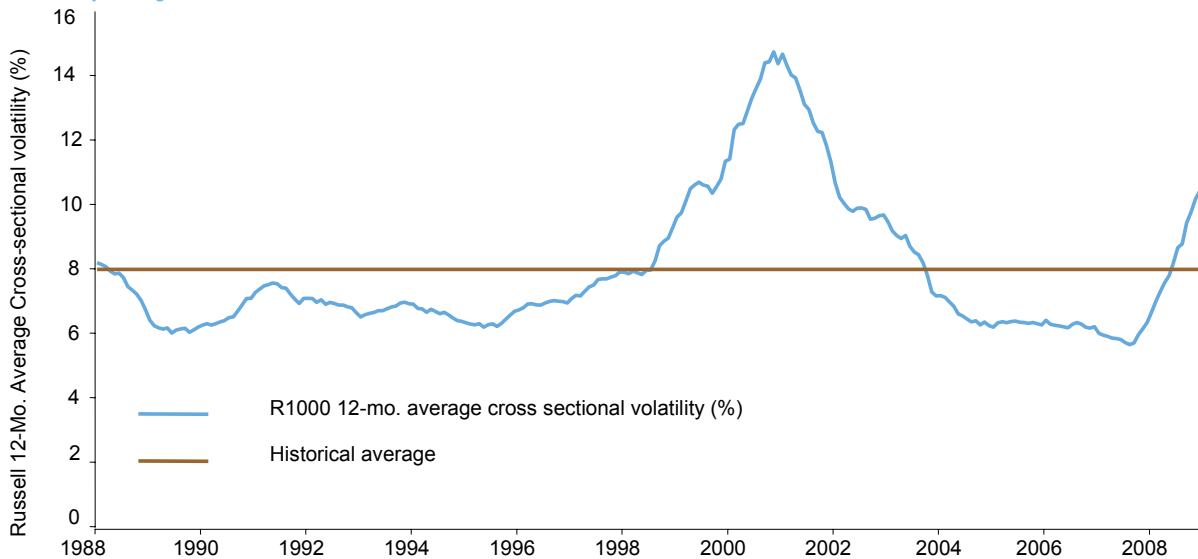
In recent months, implied volatility spiked to historically unprecedented levels and, correspondingly, so did cross-sectional volatility. This increased level of cross-sectional volatility lends advantage to those skilled managers who can accurately predict which stocks are likely to outperform their benchmarks—because the high cross-sectional volatility means that some stocks have potential to provide returns significantly higher than an index.

We define active risk among managers as being a function of both the cross-sectional volatility in the market and the aggressiveness of managers' bets. Success ultimately depends on managers' ability to select stocks that will perform better than the benchmark, and to represent this by active weights. We define cross-sectional volatility as the spread of returns between stocks and sectors within the market. Higher (lower) cross-sectional volatility often coincides with increasing (decreasing) dispersion in returns among active managers. For example, if the cross-sectional volatility of the equity market is zero, and if all stocks perform exactly the same, then all active portfolio returns equal the return of the benchmarks, regardless of differences in active bets. Therefore, in order to outperform benchmarks, stock weights must differ from the market as a whole, and cross-sectional volatility for the index must be greater than zero. As the dispersion in individual stock returns increases, variability among portfolios of stocks often increases as well, causing greater dispersion in returns among active managers.

Exhibit 1 illustrates the average twelve-month cross-sectional volatility at the securities level since 1988 in the Russell 1000[®] Index. For the period beginning 1988 and ending 1997, the average was 6.52 – below the historical average of cross-sectional volatility. A sharp increase in cross-sectional volatility in the Russell 1000 then followed, from 1998 through 2003; in that period, the average was 10.19 – sharply above the historical average.

Exhibit 1: Russell 1000[®] cross-sectional volatility – Security level

Monthly through December 31, 2008



Source: Russell, FactSet

Calculated as the cross-sectional weighted standard deviation of returns among stocks in the Russell 1000[®] Index. Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

The period beginning 2004 and ending 2007 was marked by historically low cross-sectional volatility in the Russell 1000[®] – on average, 5.92. Outperforming the benchmark during this period would have been difficult, because the structural headwinds of low cross-sectional volatility were present.

Everything changed in 2008, as cross-sectional volatility jumped well above historical levels. When there are higher levels of dispersion in returns among individual stocks, there often is larger dispersion in returns among active managers as well. Exhibit 2 compares Russell 1000 securities-level cross-sectional volatility to dispersion in active manager returns, which has been defined as the difference in quarterly total returns for managers between the 95th and 5th percentiles in the Russell 1000 (U.S. large cap) Market-oriented Active Manager Universe¹. Exhibit 2 illustrates that active manager return dispersion increases (decreases) when cross-sectional volatility increases (decreases).

¹ The Russell 1000 (U.S. large cap) Market-oriented Active Manager Universe includes managers and products that do not evidence a consistent preference for large cap companies emphasized in value or growth. However, two distinct types of organizations fall into this category: Those that construct portfolios with growth and valuation characteristics similar to the broad market over a market cycle; and those willing to make meaningful bets in growth or value emphasis across time, but with no consistent preference.

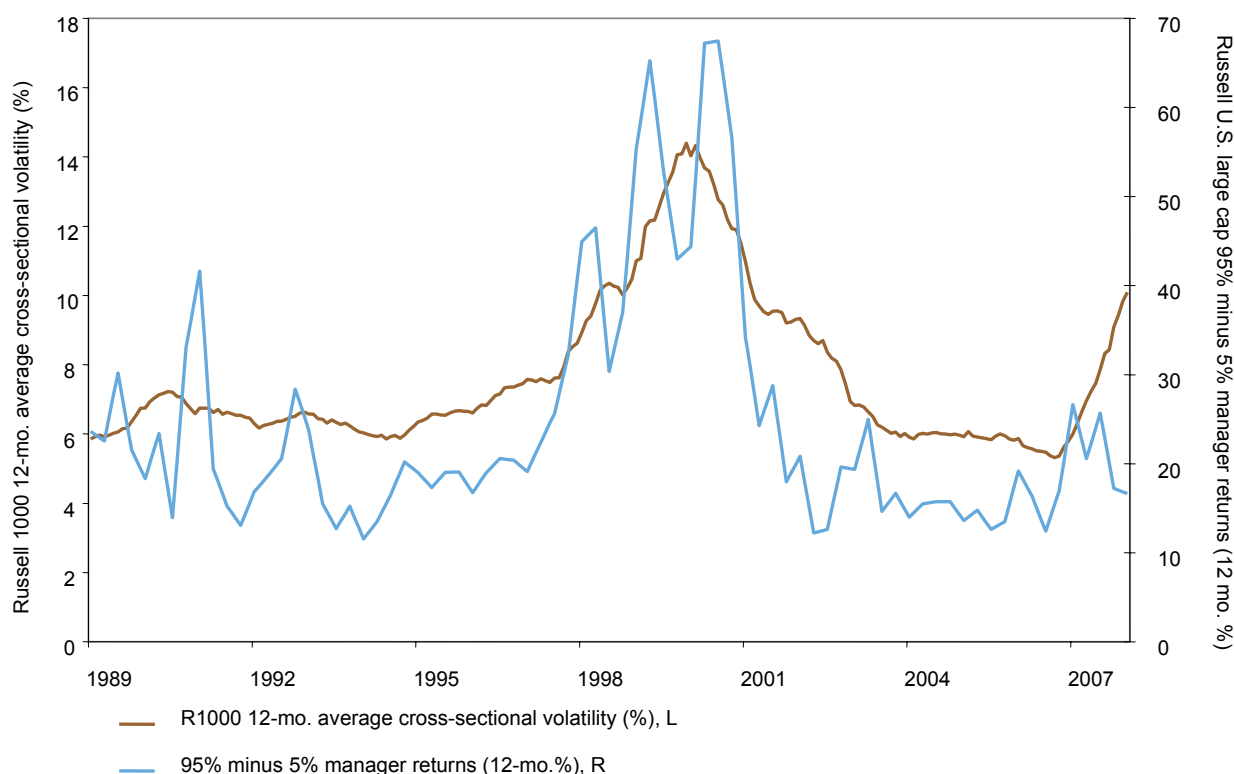
Market-oriented managers typically are willing to consider companies representative of the broad market when seeking investment opportunities. Portfolios may either be well diversified or take meaningful sector/factor bets relative to the market toward both growth and value over time. Average growth and valuation characteristics over time are near those of broad market indexes.

Most accounts represented in this universe are institutional separate accounts or pooled funds. Portfolios must be fully discretionary, equity-oriented with a value greater than \$5 million. Returns are represented as total returns, gross of fees.

The source of the data is internal Russell applications and tools, populated by data collected from individual managers by BNY Mellon then provided to Russell Research Database. Representative accounts provided by money managers to Russell / Bank of New York / Mellon (BNY/Mellon) on a quarterly basis. The data is not thoroughly verified by Russell and although deemed reliable, its accuracy is not guaranteed by Russell Investment Group or its affiliates. The universes in Russell research database that are used in the analysis cannot be purchased or held by any client. These products may or may not be hire-ranked by Russell or used in Russell funds or accounts.

Exhibit 2: Cross-sectional volatility and active manager dispersion of the Russell 1000® Index

Monthly through December 31, 2008



Source: Russell, Factset

Calculated as the cross-sectional weighted standard deviation of returns among stocks in the Russell 1000® Index. Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results. Performance is from the U.S. Equity Large Cap Market-Oriented Active Manager Performance Universe of approximately 250 managers. Results of the universe are total return (reinvestment of dividends) and gross of advisory fees.

During the period 1998 through 2003, dispersion among active manager returns was off the charts, and, as expected, so was the dispersion among U.S. stock returns.

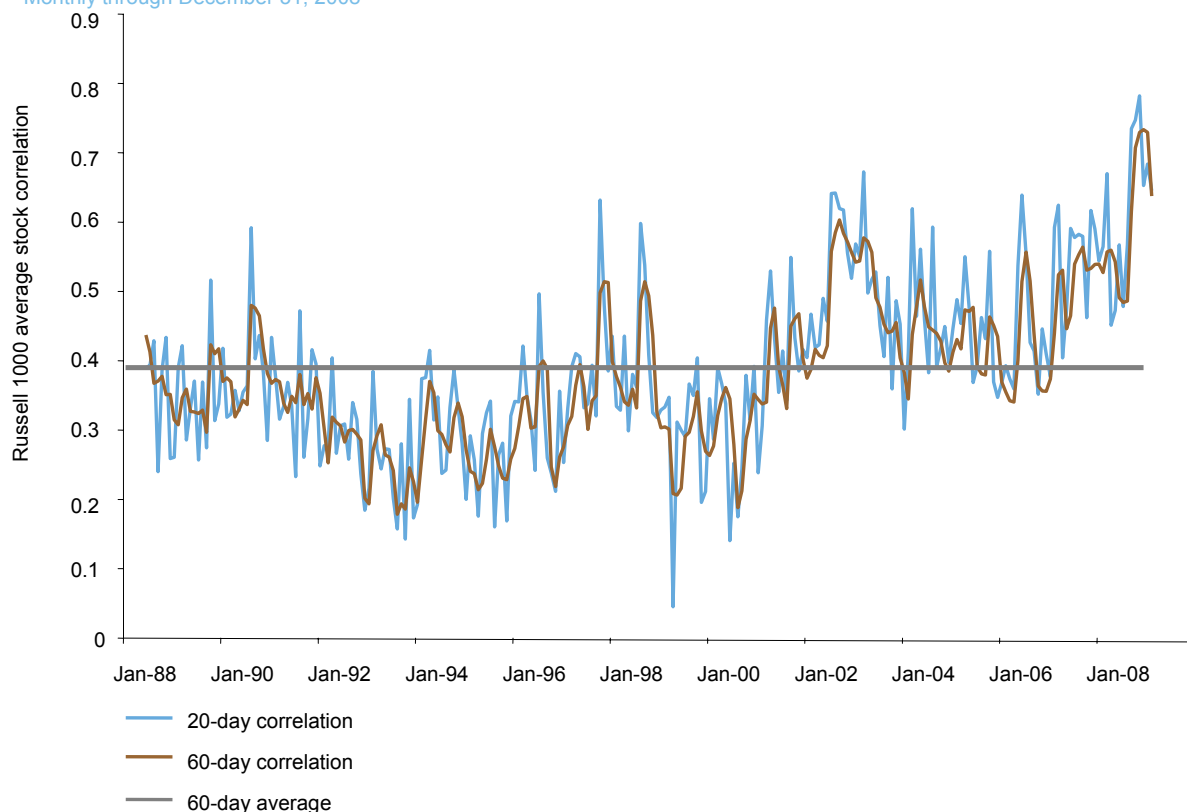
However, during the period 2004 through 2007, both cross-sectional volatility and active manager returns dispersion were low. This condition did not persist; equity markets entered another period of higher stock dispersion in 2008.

As we see in Exhibit 2, in recent months the spike in cross-sectional volatility has not corresponded to higher manager performance dispersion. One explanation could be that rising stock correlations have temporarily weakened this relationship. (See Exhibit 3 for a look at the average 20-day and 60-day correlation for stocks in the Russell 1000 Index.) The historical average correlation among stocks within the Russell 1000 Index is 0.39. For the period beginning 1988 and ending 1998, the average is 0.34 – episodic at times, but essentially below the historical average.

It then follows a sharp decrease in stock correlations, in 1999 and 2000, to the very low level of 0.29. However, after 2000, the story changes again, and correlations among U.S. stocks start increasing – to an average of 0.46 for the period 2001 through 2007. In 2008, there is an even more dramatic increase in stock correlations, with the peak being reached in November/December at 0.74 – the highest level of the last 20 years!

Exhibit 3: Russell 1000[®] Index average stock correlations

Monthly through December 31, 2008



Sources: Russell and FactSet

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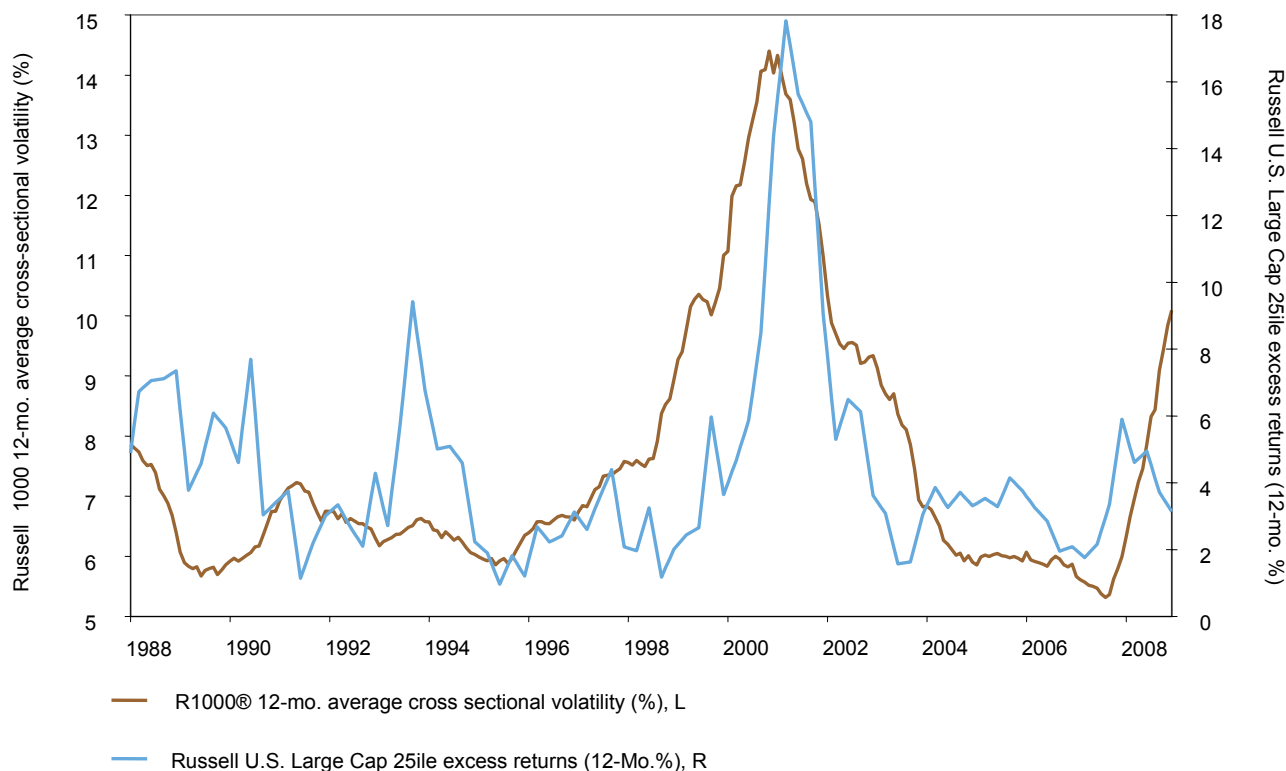
Rising return correlations among stocks might explain why active management performance dispersion has not yet widened with the recent rising cross-sectional volatility brought about by the massive investor sell-off of equities – and the resulting increase in correlations – experienced in the last half of 2008. Looking at the historical average, it is within reason to assume that stock correlations will drop in the near future and that portfolio managers should benefit from increased cross-sectional volatility if they are able to decisively differentiate winners from losers.

Higher dispersion among active managers' returns happens when cross-sectional volatility increases. Historically, the differences between the best and worst performances within universes of equity managers have increased in such times.

We stress that this was not because managers were taking larger bets or becoming more skilled, but rather that it resulted from the magnification of bets by the increased cross-sectional volatility in the market. Furthermore, Exhibit 4 illustrates that excess return ranges have been greatest when variation in stock returns was highest. The excess returns among the top 25th percentile of U.S. large cap managers shown in the universe were greatest when cross-sectional volatility was high and lowest when cross-sectional volatility was low. However, the sustainability of excess returns in active management is less clear. Managers in the top 25th percentile in one period might not be among the top performers in the next period, and excess returns depicted in this chart during periods of high cross-sectional volatility were attainable by some active managers but not by others.

Exhibit 4: Excess performance is greatest when cross-sectional volatility is highest

Monthly through December 31, 2008



Source: Russell, FactSet

Calculated as the cross-sectional weighted standard deviation of returns among stocks in the Russell 1000® Index. Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

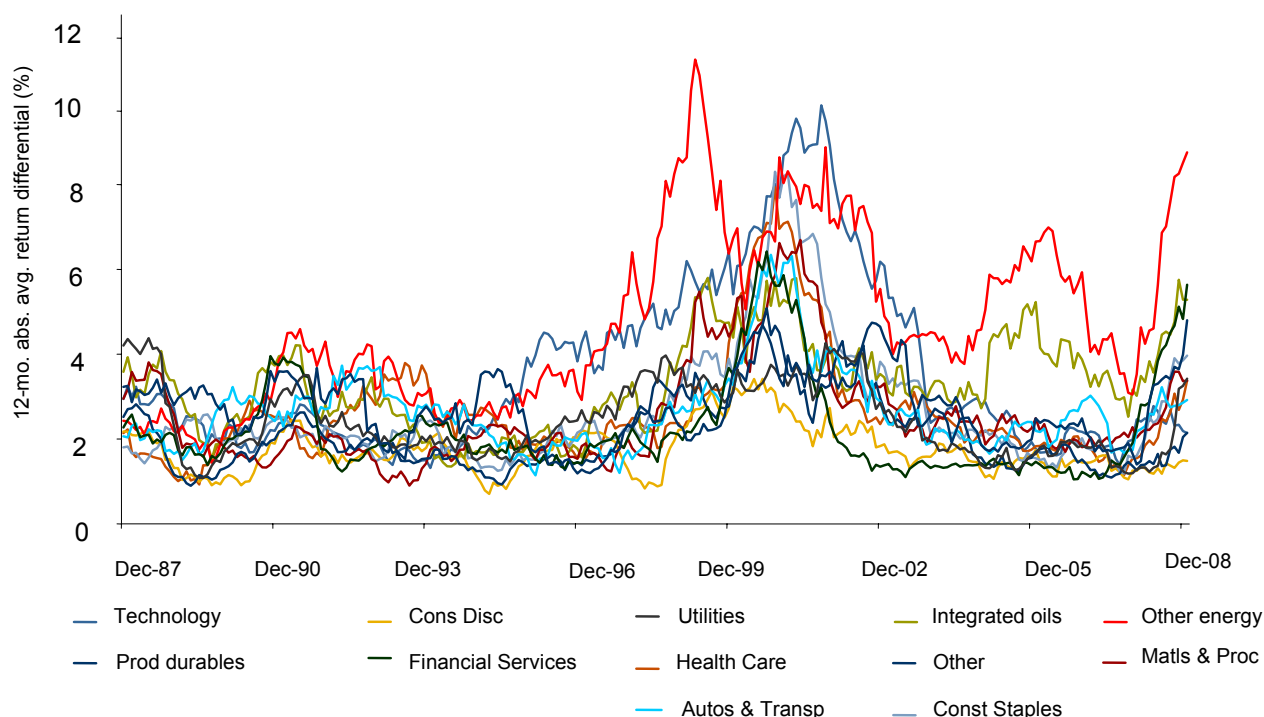
Sector exposures and the alpha opportunity

In general, the pattern of increasing return dispersion that applies to individual stocks also applies to sectors. Managers often expose themselves to sector risk with their relative benchmark weighting decisions. Even if the risk exposure is unintentional, the risk can be significant when sector dispersion increases to higher than normal levels.

Exhibit 5 illustrates the difference in sectors by comparing the 12-month average of the absolute difference in returns for each sector to that of the Russell 1000 Index over time. (We used absolute values for return differences to illustrate level of dispersion.) We observe that from 2004 through 2007, sector returns are fairly tight, except in other energy and integrated oils. During this period, the other energy sector outperformed the Russell 1000 Index by 131% and the integrated oils sectors beat the index by 94%. The bigger the bet to other energy or integrated oils, the larger the gain (or loss).

Exhibit 5: Russell 1000® Index sector deviations

Monthly through January 31, 2009



Source: Russell, FactSet

Sectors represent the rolling 12-month absolute average return differential from the Russell 1000® Index.

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In the past year, deviations in the index expanded to include the financial services and staples sectors, in addition to the other energy and integrated oils sectors. Other energy was the worst-performing sector and consumer staples the best-performing sector in the Russell 1000 Index; the differential in their returns was a whopping 36%. For the respective portfolio managers to have outperformed their benchmarks for the year, an overweight to the staples and integrated oils sectors and an underweight to the other energy and financials sectors would have been a huge benefit. If a portfolio manager diverged from these positions, sector allocation would have been a large headwind to performance. In other words, sector divergences were large and sector bets were magnified as cross-sectional volatility increased in the past year. The continued widening in sector deviations among a larger subset of sectors, instead of just a few, has the potential to open more opportunities for active managers.

Factor exposures characterize active managers

In addition to sector exposures, active managers take into account specific risk factors – such as valuation, momentum, earnings variation, and growth – as they seek to outperform a benchmark in order to earn a risk premium over time. Different processes affect the factors each manager uses to place bets. For example, some active managers focus on valuation factors (that is, price-to-earnings, price-to-book and dividend yield), and others focus on growth factors (that is, earnings improvement and long-term growth prospects). We will take a look at changes in valuation spreads and at the opportunities arising from the recent massive sell-off in equities as they affect the criteria active managers use in the aggregate. We will show why these changes produced a difficult environment for active managers in the past year and how they could yet benefit active managers going forward.

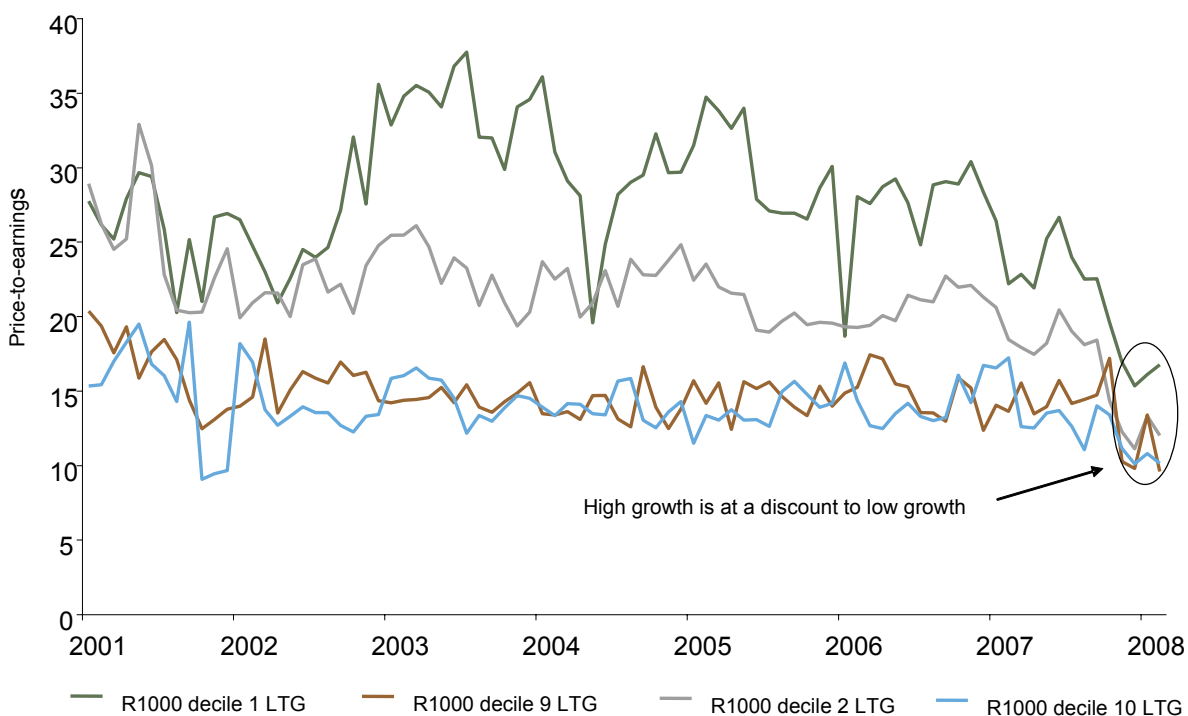
The underperformance of active management in 2008 can to some extent be explained by the significant contraction in price multiples seen in stocks with the highest long-term growth prospects. Exhibit 6 illustrates price-to-earnings for deciles 1, 2, 9 and 10 of long-term growth forecasts of the Russell 1000 Index. The first decile represents stocks with the highest long-term growth forecasts, and the tenth decile represents those with the lowest long-term growth forecasts. We see a sharp contraction in price multiples, in particular for the second decile of long-term growth forecasts. Generally, this would be a negative impact for active managers who maintained higher exposure than the benchmark(s) to long-term growth prospects throughout the year.

We can explain the contraction in price-to-earnings for stocks in the top decile of growth prospects to investors being unwilling to pay up for potential growth – probably because they do not believe the current earnings growth forecasts – and this is creating an opportunity for active managers. We say this because in an environment where growth is scarce, stocks with strong prospects and low price-to-earnings generally do well as investors start becoming less risk-averse.

In Exhibit 7, we illustrate the punishment high beta stocks have taken in the past year; they are now trading at a meaningful discount to low beta stocks. This can also explain the performance headwinds for active management in 2008. Active managers generally maintain higher betas than those of their respective benchmarks, and the past year was no exception. As investors gradually differentiate between stocks, strong companies with higher growth prospects and higher beta could perform well as investors increase their tolerance for risk.

Exhibit 6: Price-to-earnings ratio of long-term growth forecast of the Russell 1000® Index – IBES medians

Monthly through January 31, 2009

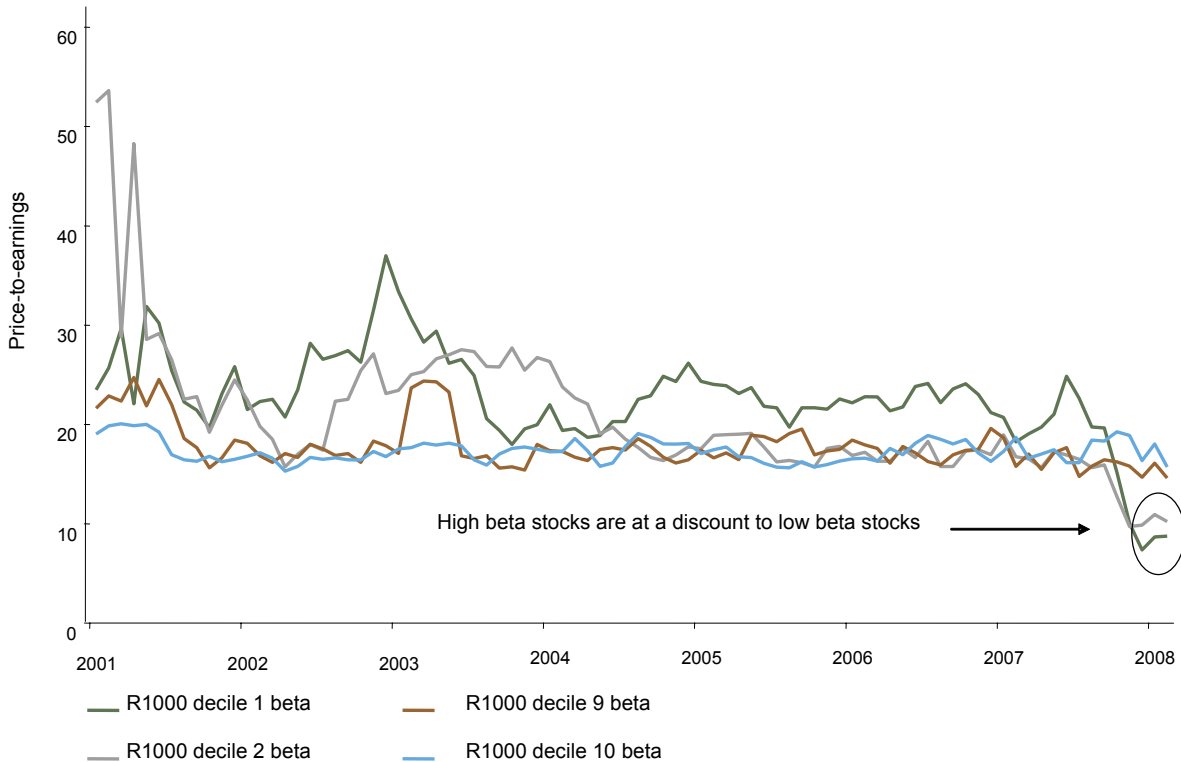


Sources: Russell and FactSet

Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

Exhibit 7: Price-to-earnings ratio of beta of the Russell 1000® Index

Monthly through January 31, 2009

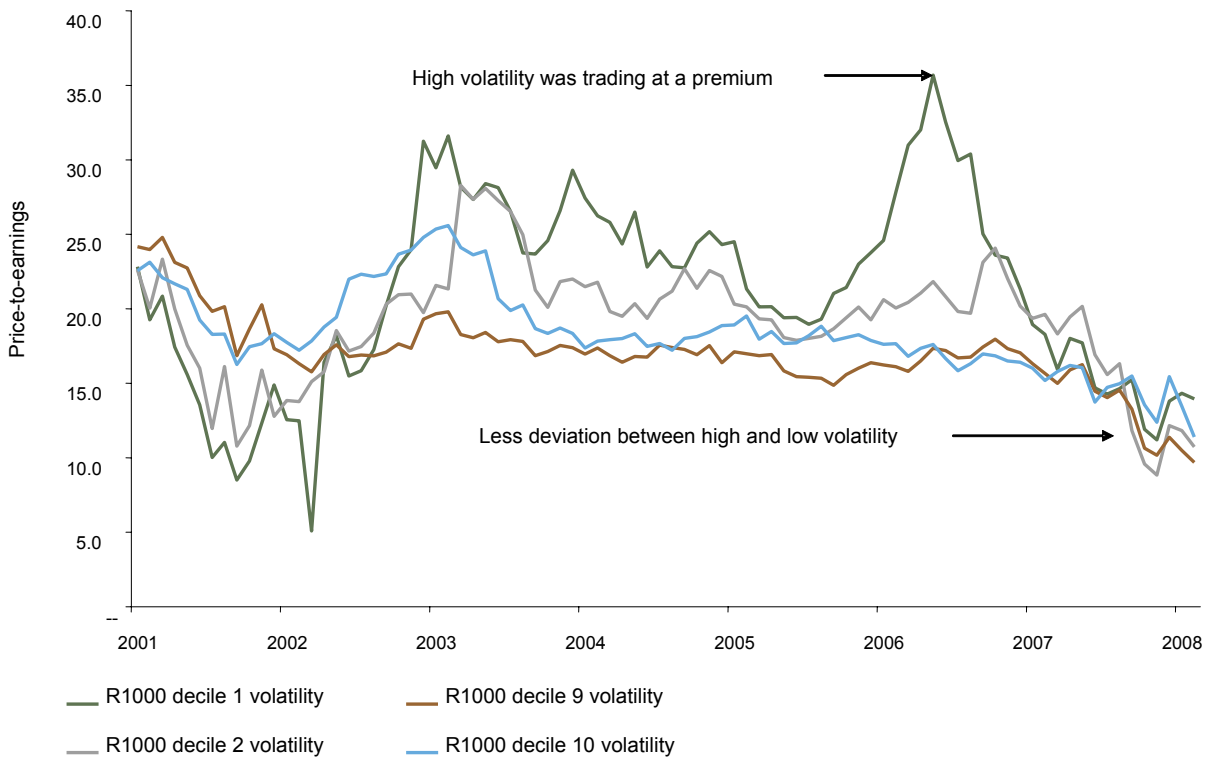


Source: Russell, FactSet

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Another point is that active managers tend to prefer volatile stocks, because the payoff for being right is larger. Active managers are in their ideal environment when an adequate percentage of more volatile stocks are outperforming their benchmarks. Exhibit 8 shows the price-to-earnings for deciles 1, 2, 9 and 10 of the 12-month standard deviation of returns for stocks in the Russell 1000 Index. The price-to-earnings ratio for highly volatile stocks fell sharply in 2008, and the magnitude of change in the top deciles of volatile stocks was massive. The compression in price-to-earnings multiples indicates that the market was discriminating against volatile stocks, and investors were not being rewarded for taking on risk. At the end of 2008, there was a small difference between the top and bottom deciles. As investors reassess their tolerance for risk, active managers may benefit from opportunities in an environment wherein a larger percentage of the high-volatility stocks are outperforming, as investors again seek higher returns.

Exhibit 8: Price-to-earnings ratio of standard deviation of stock returns of the Russell 1000 Index
 Monthly through January 31, 2009



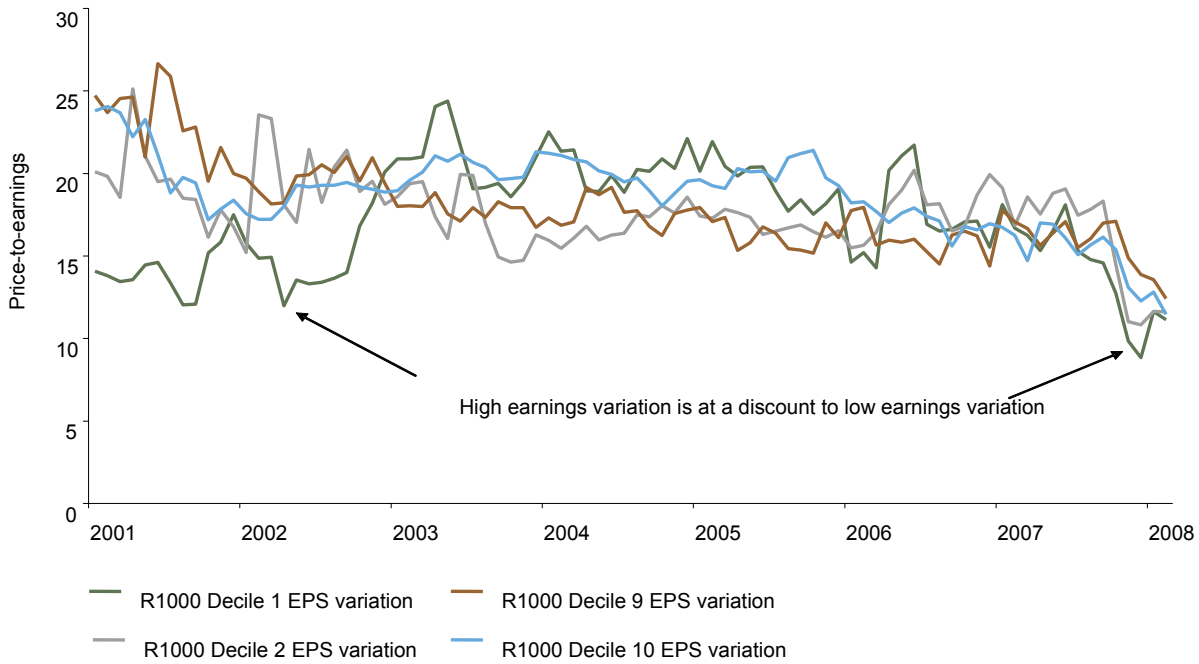
Source: Russell, FactSet

Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

Exhibit 9 shows the price-to-earnings for deciles 1, 2, 9 and 10 of earnings variation of the Russell 1000 Index. This compares the attractiveness of cyclical stocks relative to that of defensive stocks. In this case, stocks with more earnings variation are trading at a discount to stocks with less earnings variation. We can explain this drop in price-to-earnings for high cyclical stocks by the financial markets crisis, but the valuation differences within the sector are looking interesting, especially when we consider that the crisis has clearly resulted in a stampede to higher quality/more defensive positioning. Exhibit 10 compares the top half of the Russell 1000 Index in terms of higher quality/more defensive stocks to that of the bottom half. The quality score is a combination of several quality/defensive factors (such as debt-to-capital and earnings variability). A high number indicates that higher quality/more defensive stocks are cheaper (that is, trading at lower valuations); a low number indicates that higher quality/more defensive stocks are expensive (that is, trading at higher valuations). Generally, higher quality/more defensive stocks will trade at cheaper valuations due to their higher dividend yields and, often, lower future growth prospects. However, since mid-2008, there was a significant swing as defensive stocks became more expensive when investors flocked to them.

Exhibit 9: Price-to-earnings ratio of earnings variation for the Russell 1000® Index

Monthly through January 31, 2009

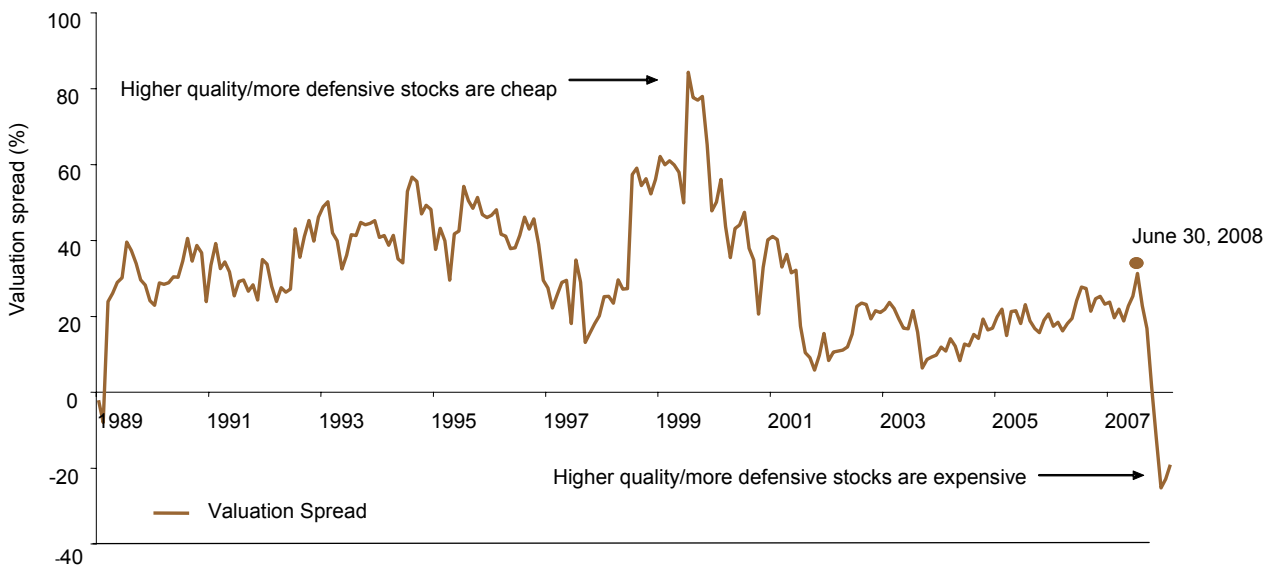


Source: Russell, FactSet

Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

Exhibit 10: Higher quality/more defensive fundamental dislocation for the Russell 1000 Index

Monthly through January 31, 2009



Source: Russell, FactSet

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Generally, the violent drop in the price of stocks exhibiting higher earnings variation was a significant headwind for many active managers, because such stocks commonly have more exposure to earnings variation than do their respective benchmarks. The stock market was relentless in punishing stocks deemed to be less defensive/of lower quality in the past year. The sell-off was broad, and the result was that stocks of many good companies reached new price lows. As economic prospects begin to improve, active managers should have an opportunity to identify those cyclical names that are most likely to outperform in improving conditions.

An interesting observation in the current environment is of the opportunities that exist between growth and value stocks. In general, if value stocks look attractive (unattractive), then growth stocks are often less (more) attractive. This offsetting pattern is generally caused by unique factors between the styles. Today, the broad selling of equities and the massive reassessment of risk has created valuation opportunities for both value and growth managers. Investors sold companies without regard to most valuation measures – creating a huge discount for value stocks. Investors also sold companies with above-average growth potential, because they were unwilling to pay up for longer duration growth that was viewed to be uncertain – creating a huge discount for growth stocks. Therefore, the current environment has provided opportunities for both growth and value managers to outperform their passive benchmarks by capitalizing on these market dislocations.

Conclusion: Attractive opportunities for active managers

The recent market crisis has created an environment which may offer significant opportunity for active managers. Many market dislocations were caused by indiscriminate selling of equities as investors became increasingly risk-averse (or, from an alpha perspective: the selling was discriminating in that it focused on different criteria than active managers use in the aggregate). However, active bets will result in bigger outcomes (good or bad). In such an environment, many active managers will generate substantial returns, and others will fail. Stock selection will be essential to performance, and common factor bets will continue to play an important role. Active managers' returns will increasingly become different from the market's, and from one another's, because of higher cross-sectional volatility and changes in risk factors. This means that there are now larger discrepancies among stocks as fundamental differences have become more significant – and the potential relative payoff is large for skilled active managers, regardless of the absolute return in equities. If investors respond to the current crisis by retreating to passive investing, the potential loss in alpha could be substantial.

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