

**Presenting
debate on
contemporary
and emerging
portfolio
construction
issues**



portfolio
construction

CONFERENCE

15 & 16 August 2007 | AJC Convention Centre, Randwick, Sydney



When Great Minds Think Alike

Peter Gunning
PortfolioConstruction Conference
August 2007

 Russell

Agenda

- A new source of alpha – exploiting the overlap between skilled managers
- When are two heads better than one?
- Constructing 'best ideas' portfolios
- Successful implementation

Some terminology

Alpha = return created from manager skill

Beta = the market return

Beta is getting cheaper

Alpha is valuable and getting harder to find

Important to identify new and untapped sources of alpha

Genesis of an alpha source

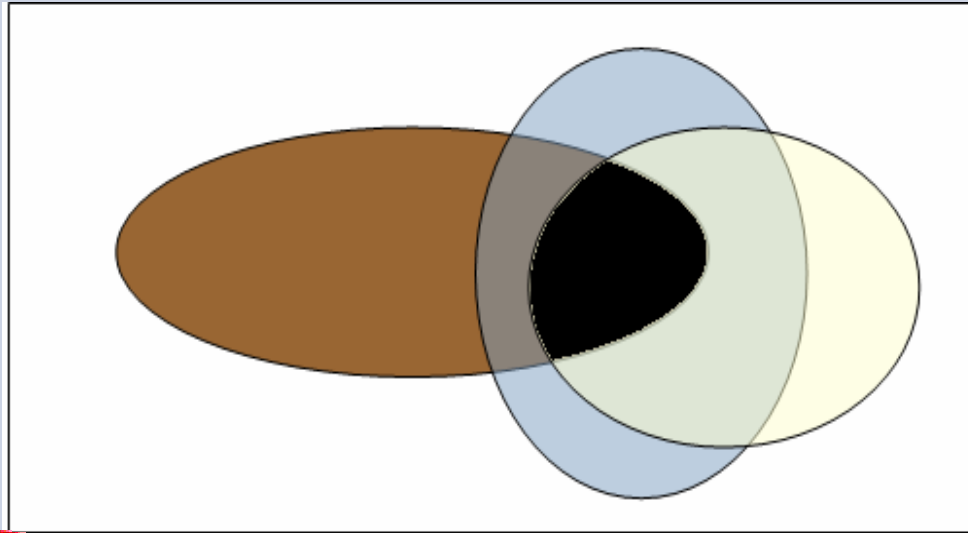
A simple question:

- Are two heads better than one, or do too many cooks spoil the broth?
- Translated.....
- Is overlap between managers good or bad?

The answer:

- Two heads really are better than one...
- ...as long as the heads know what they're doing!

Common Holdings: A Super-Portfolio or Unrewarded Risk?



Bull Case: If the managers have skill and have different investment processes, then common overweights should outperform unique overweights

Bear Case: Only unique bets carry the unique information that each manager brings to the table. Common bets are redundant and a drag on the fund.

Intuition

- If a manager has skill then an overweight bet serves as a signal the stock should outperform
- If many skilled managers, each using their own unique process, share the same view, this strengthens the signal
- Eg. two managers, each gets 60% of their bets correct
 - The bets they agree on will be right more than 60% of the time

History of the idea

- Russell research first documents the result in 2003
- First fund launched by Russell in the US in 2004
- Recent academic evidence also supportive
- Also been noticed in other fields
 - The 'wisdom of crowds' – thought diversity allows the predictive power of groups to rise above that of its individual members

The hidden gem

- Multi-manager portfolios naturally take advantage of manager overlap
 - Bets where managers agree are retained
 - Bets where they disagree are neutralised
- But...
 - We now know bets where skilled managers agree are more likely to be right
 - Therefore multi-managers show higher skill than the underlying single managers
 - Why not just concentrate a portfolio on these common bets?

The more (skilled) heads the better

- An illustrative example
- Assume 60% success ratio for skilled managers, 40% for unskilled
- Common bets are more likely to pay off, as long as the managers are skilled

Success Ratios	1mgr	2mgr	3mgr	4mgr	5mgr
With Skill	25%	35 %	65%	75%	89%
Without Skill	77%	58%	42%	23%	10%

Constructing 'best ideas' portfolios: Methodology

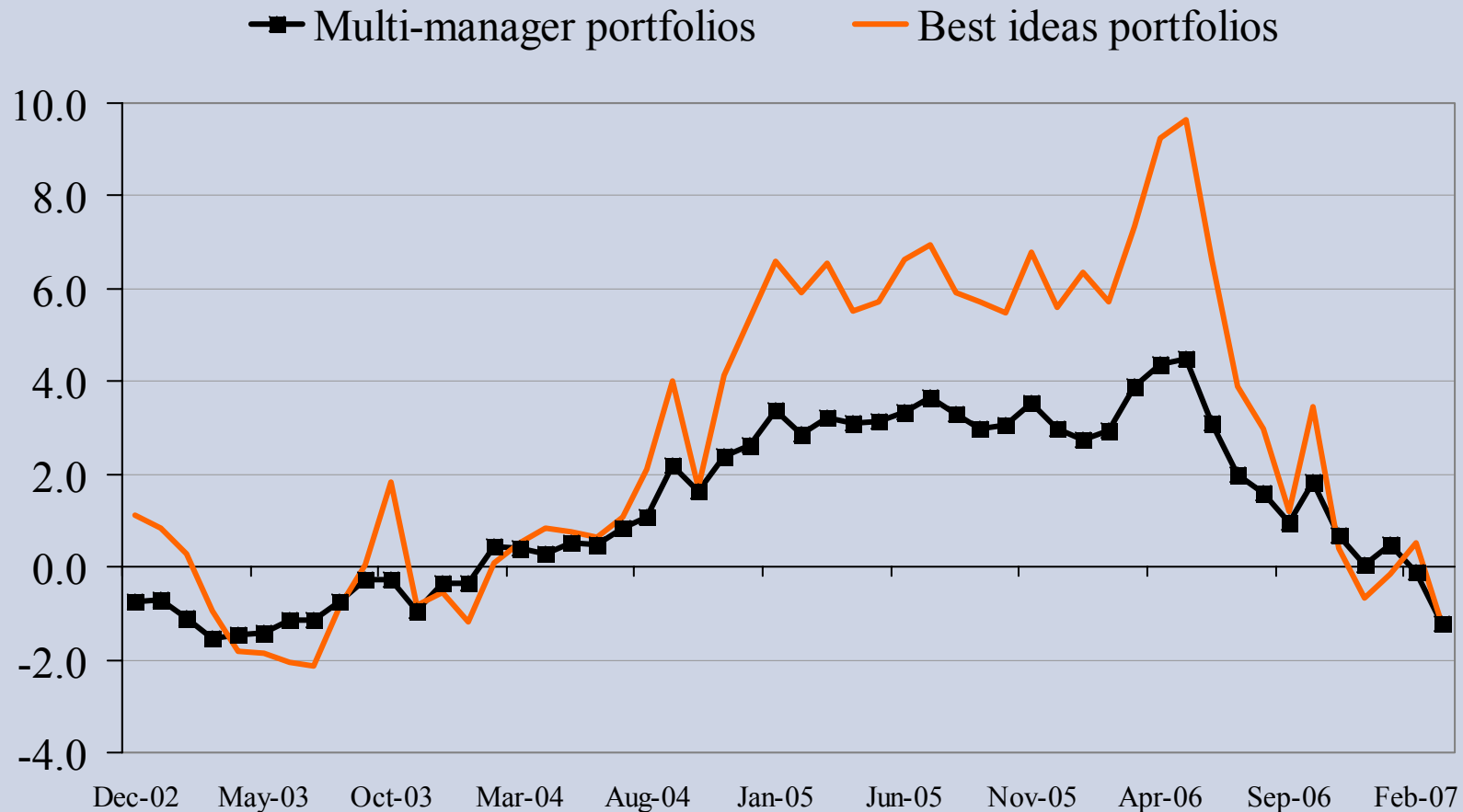
- Use data on Australian equity managers
- 27 hypothetical manager combinations
- 6 managers in each combination
 - 2 value, 2 growth and 2 market oriented
- Method*:
 - Short-list all stocks held by at least two managers
 - Rank according to number and size of overweight
 - Select the top 20 stocks and assign weights
 - Rebalance monthly

* This method is a simplified version of the Russell Select Holdings strategy

Constructing 'best ideas' portfolios: Performance

	Multi-manager portfolios	Best ideas portfolios
Excess Returns		
Average	0.94	2.41
St. Dev	0.34	0.82
Tracking Error		
Average	1.50	3.85
St. Dev	0.15	0.39
Information Ratios		
Average	0.63	0.63
St. Dev	0.23	0.24

Constructing 'best ideas' portfolios: Return patterns



Source: Russell Investment Group

Portfolio construction issues

- Need to select skilled managers
- Need to select complementary managers
- Imperfect link between bets and alpha forecasts
- Need a sophisticated quantitative process

Implications for investors

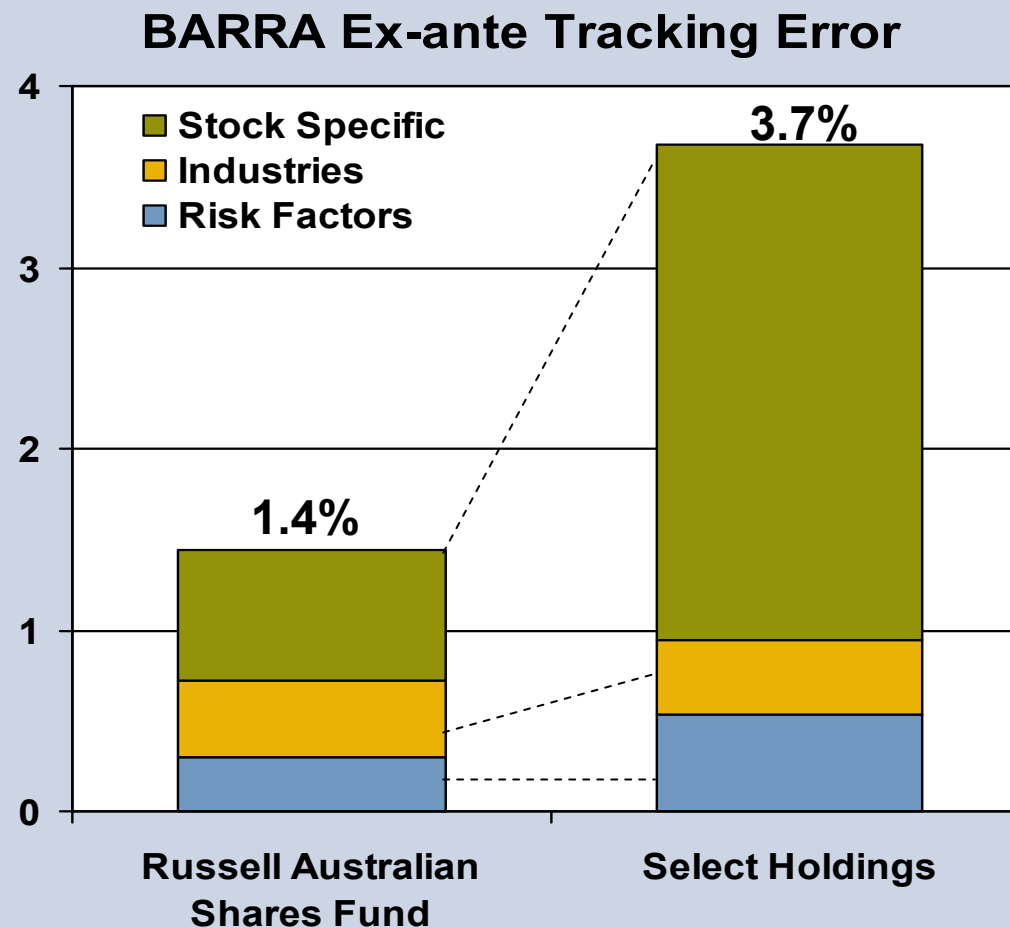
- 'Best ideas' portfolios are a powerful way to enhance returns, with increased risk
- Identifying skilled managers the key
 - Not as simple as observing past performance
 - Past performance is a poor predictor
 - Also leads to less diversity in managers
- A 'scaled-up' version of multi-manager
 - Increases the need for quality manager research and selection

Summary

- A new and untapped alpha source
- Common bets of skilled managers more likely to pay off than unique bets
- Better results from complementary processes
- Building 'best ideas' portfolios is complex but potentially very rewarding

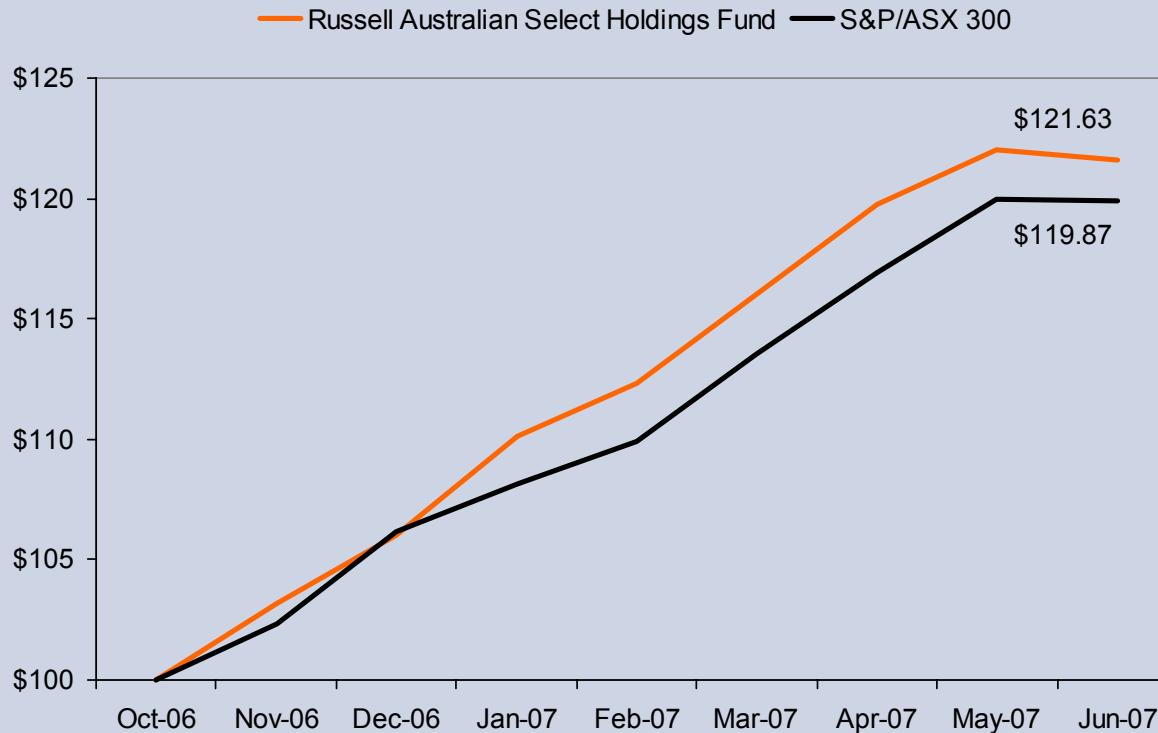
Russell Aust Select Holdings Fund

- High conviction portfolio – 20 stocks
- Built from underlying managers in Russell Aust Shares Fund
- Concentrates stock selection on common overweights
- Stock selection drives active risk/return



Based on Barra Ex-Ante Active Risk Measures – 30 June 2007

Russell Aust Select Holdings Fund Since Inception Performance



	Nov 06	Dec 06	Jan 07	Feb 07	Mar 07	Apr 07	May 07	Jun 07	Total
Select	3.21	2.69	3.92	2.00	3.29	3.18	1.92	-0.33	21.63
Index	2.37	3.67	1.89	1.62	3.30	3.00	2.64	-0.11	19.87
Excess	0.84	-0.98	2.03	0.38	-0.01	0.18	-0.72	-0.22	1.76

Past performance is not a reliable indicator of future performance



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Safety in Numbers

2005/6

Investment Research
Institution's only "Highly Recommended"
multi manager two years in a row

2000

Russell provides investment solutions for
2000 institutional clients in 44 countries

\$3.2
trillion

Russell advises clients on the investment of
\$3.2 trillion worth of assets worldwide

\$235

billion

Russell has \$235 billion worth of assets
under management worldwide

40,000,000

individual investors use Russell's services

44

operating in 44 countries around the globe