

Take Note

INTRODUCTION OF THE INCUBATOR PORTFOLIO TO THE CONTINENTAL EUROPEAN EQUITY FUND (CEEF)

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We have replaced AXA Rosenberg with a new "Incubator Portfolio" comprising two newly established products at Nicholas-Applegate and T. Rowe Price. The Incubator Portfolio will have a target allocation of 10%.

Background

No matter how much research we conduct prior to hiring an exciting, newly discovered manager, we always learn much more about them once they actually manage money for us. Once hired, we have a daily window into the manager's trading patterns. Our discussions with the manager are more revealing, more intense and based on greater transparency into the manager's process than would be possible through any research we could do prior to hiring the manager. This is especially true for new managers, be they start-ups or the creation of new investment offerings in established firms.

Why introduce an "Incubator Portfolio"?

We are introducing an "Incubator Portfolio" to allow us to speed up the process of getting high quality new managers into the Fund. "Pre-hire" research is, of course, necessary to establish confidence in a new manager. Research is a key part of Russell's multi-manager approach. But it is becoming increasingly important to accelerate the hiring of new, high interest managers for a number of reasons.

In capacity-constrained asset classes, being quick to hire is key to securing scarce capacity. This is well understood when it comes to investing in small cap equities and hedge funds, but is true elsewhere, as well. The better start-up firms, or interesting and innovative new products, often establish capacity limits early in their life, making early access critical.

In addition, there is empirical and anecdotal evidence that manager products in the early stage of their life cycle deliver superior returns. We often see in start-ups an acute focus on performance rather than on asset accumulation, plus a relative lack of size-related implementation hurdles that can be common in more mature products and strategies. Yet while early access to new products and managers is increasingly important, there are inevitably additional uncertainties that cannot be completely addressed through the manager research process, no matter how intense.

Start small to reduce risk

Depending on a number of factors, such as the number of managers in a fund and the risk level of portfolios run by the manager, we normally target exposure to a manager at 10% to 25% of a fund. For a new, untried manager, this level of allocation could represent too much risk.

There is, however, an alternative to taking the plunge and allocating such a large portion of a multi-manager fund to a newly established offering. We can make a more modest allocation until such time as our understanding of the manager confirms our initial confidence in their capabilities. While this small allocation will have only minimal impact on the risk of the total portfolio, hiring a new manager in an "Incubator Portfolio" provides us with a

number of important advantages:

- We can secure access and capacity in a manager that we believe has the opportunity to generate considerable outperformance.
- During the first few months after hiring the manager, we will learn a great deal more about the manager. Based on what we learn, we hope that we will become sufficiently confident in the manager to move to a more meaningful weight more quickly than if we relied solely on research of the manager before hiring. And if we don't like what we find, the exit costs will be much lower than if we had allocated a much larger pool of assets to the manager.
- The presence of a small number of managers in the "incubator" gives us greater flexibility in the event that we need to make a change amongst the other managers in the fund. While we are normally able to move from one manager to another reasonably quickly, the process of negotiating contract terms, setting up the required custody and trading accounts and ensuring that the incoming manager is registered with the relevant regulatory authorities takes time. If we have established an incubator portfolio with some good managers, this work is already done. This enables us to replace managers even more quickly, if developments at an incumbent manager require us to make a change.

Introducing the Incubator Portfolio to CEEF

We have recently introduced an Incubator Portfolio to the Continental European Equity Fund, at a weight of 10% of the Fund. The CEEF incubator will initially consist of two managers: Nicholas-Applegate and T. Rowe Price. While both firms are well known within the institutional asset management community, in both cases Russell is accessing portfolio managers and products that are brand new to their respective firms.

Nicholas-Applegate

Russell is providing the seed capital for a new European equity product managed by Vince Willyard whom we rate highly. We are delighted to be the launch customer for a European-only mandate run by Willyard, who uses a momentum-driven approach to investing in growth stocks. The firm has managed international equities for many years and was hired in Russell's international funds for US clients early this year. The momentum-driven approach to investing in growth stocks is unique in European equities, and as growth stocks have significantly underperformed value stocks over the past few years this appears to be a prudent time to gain exposure to such a strategy.

T. Rowe Price

T. Rowe Price is a large, well known American asset management firm, but our opinion of the firm's European management ability has until recently been lukewarm. Our view of the manager improved considerably, however, when Niall Gallagher joined T. Rowe Price in February. Gallagher was previously employed by Merrill Lynch Investment Management, where Russell's analysts ranked him a "Hire." We believe that Gallagher's appointment means that the core elements for success are now in place. While Gallagher currently runs less than €50m, we expect this to grow rapidly. Gallagher runs concentrated, high conviction portfolios, favouring attractively priced growth companies with positive earnings surprise.

Impact on the Fund

Along with the introduction of the Incubator Portfolio, we are terminating AXA Rosenberg. The resulting fund manager line-up is therefore:

Manager	Mandate	Previous Fund Weight (%)	New Fund Weight (%)
AXA Rosenberg	Terminated	10	0
Bernstein	Value-oriented stock selection	20	20
Invesco	Pragmatic stock selection, mix of quality, growth and valuation perspectives	15	15
Taube Hodson Stonex	Growth at a Reasonable Price (GARP)/Thematic	15	15
Schroders	Aggressive, all cap, focus on quality and relative valuation	10	10
BlackRock	Market-oriented with a growth bias	20	20
AQR	Quantitative stock, country and currency selection	10	10
Incubator Portfolio:	Allocation to new products: Nicholas-Applegate (Momentum/growth); T. Rowe Price (Growth/earnings surprise)	0	10

Conclusion

The introduction of the Incubator Portfolio into the Fund provides a number of benefits. We have secured early access to two new managers, both of whom offer the possibility of excellent future performance. As we gain confidence in the new managers, we will increase the range of manager options available to the Fund. We expect that over time we will increase the allocations to these new managers, but of course we are not obligated to do so. We will continue to invest with the Incubator managers only if our initial experience with them is positive.

We believe the Incubator Portfolio represents an appealing balance between the need to move rapidly when we discover a new manager of interest, and the desire to invest prudently with managers that have been subjected to the most intensive research possible. We anticipate introducing similar Incubator Portfolios to other funds in our product range.

If you have any questions about this new development in our approach to managing our funds, please do not hesitate to contact your Russell client service representative.

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