SOLUTION OVERVIEW

Market, methodology and maintenance: exploring the differences between indexes.

How your index is constructed and maintained may sound theoretical – but the potential impact on performance is real.

An index is an index – isn't it? The answer is no – all indexes are not created equal. Different index providers use different approaches and rules to govern a given index's market coverage, construction methodology and maintenance. And those structural differences between indexes can translate into significant differences in securities that get included and as a result affect how that index behaves in varying market conditions.

So, if you want to implement an investment strategy using a financial product that tracks an index, then you owe it to yourself and your clients to understand the index you are tracking. Because it might not be delivering the view of the market – or the asset class diversification – that you think it is. And that can pose a challenge in terms of capturing your investment requirements and evaluating success.

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Let's briefly look at the key components that determine an index.

Market coverage

A fundamental question is which market segments you seek exposure to – and how precisely a given index provides that exposure. Structural differences between indexes can mean that even two indexes purporting to follow the same market segment will not consistently include the same equities. And if that is the case, then there is significant potential for your index not to reflect the risk/return profile you intended.

The Russell Index approach is modular: our Indexes are designed to work together, so you know exactly what is in each index and you know there are no gaps or overlaps that could underweight or overweight you in particular areas. The large-cap Russell 1000 and small-cap Russell 2000 together form the Russell 3000, which provides approximately 98% coverage of the entire US equity market.

Construction methodology

You might assume that an index is driven by the "invisible hand of the market" – that is, once the rules are set, then index composition is, essentially, a function of what the market does. But such an assumption may not be accurate; some indexes incorporate subjective decision-making as well. Some indexes even have a committee whose vote is required to add or remove member companies. If, as part of the construction process, stocks are excluded, there can be significant potential to vary from the intended risk/return profile.

Russell Indexes construction summary[1]

1. Start with all us equity securities	>	2. Remove ineligible securities	>	3. Rank and capture top 4,000 securities above $30M	>	4. Create the **Russell 3000** for US securities
~10,000+ securities		~6,000 securities		4,000 securities		3,000 securities

The Russell approach to construction is objective, rules-based and transparent – all of which makes for increased accuracy and more predictable outcomes for financial advisors and their clients. After all, if an index is intended to be an unbiased view of a market, then what is the purpose of introducing the wildcard of human decision-making?

Ongoing maintenance

An index is "set it and forget it" – to a point: It also needs to be maintained over the short term and annually as well, in order to maintain the accuracy of the market exposure it provides.

Russell Indexes that are weighted by market cap are reconstituted annually, as research has demonstrated that annual reconstitution, along with quarterly IPO additions and quarterly share rebalances, provide accurate, comprehensive representation while avoiding unnecessary and attendant trading fees.

It's important to note that changes to the composition and weighting of Russell Indexes, whether prompted by M&A, IPOs or other corporate actions or simply fluctuations in market cap, are themselves part of an objective, transparent, rules-based process. Without such rigor and discipline, it would introduce an element of uncertainty into the markets, essentially defeating the purpose and usefulness of the index as a true measure of the market.

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1 If there are fewer than 4,000 eligible companies above $30M in size, the R3000E will contain fewer than 4,000 companies.

Disclaimer

About FTSE Russell

FTSE Russell is a leading global provider of index and benchmark solutions, spanning diverse asset classes and investment objectives. As a trusted investment partner we help investors make better-informed investment decisions, manage risk, and seize opportunities.

Market participants look to us for our expertise in developing and managing global index solutions across asset classes. Asset owners, asset managers, ETF providers and investment banks choose FTSE Russell solutions to benchmark their investment performance and create investment funds, ETFs, structured products, and index-based derivatives. Our clients use our solutions for asset allocation, investment strategy analysis and risk management, and value us for our robust governance process and operational integrity.

For over 35 years we have been at the forefront of driving change for the investor, always innovating to shape the next generation of benchmarks and investment solutions that open up new opportunities for the global investment community.

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