Russell Investments

Russell Market Expectations for first quarter 2014

SIGNAL DATE: January 1, 2014

Global equity markets (Russell Global Index), and particularly those in the U.S. (Russell 3000® Index), had a very strong year in 2013. Recognizing the constructive reaction to the Federal Reserve's taper announcement in December, our central (most likely) forecast remains for moderate upside potential for risk assets in 2014. This is provided that macro economic data supports the price multiple (valuation) currently attached to stocks in aggregate. As relative growth and valuation opportunities are less distinct, we continue to advocate a well-diversified global portfolio, which will likely benefit from both skilled active management as well as helping balance downside risks.

In 2014 we'll be actively monitoring U.S. macro economic data (nonfarm payroll, GDP growth, inflation) as well as 10-year U.S. Treasury yields. Any near-term rapid decline in government yields, will bode poorly for equity markets as it will likely signal a period of uncertainty for investors. In keeping with a positive intermediate forecast, we view such sell offs as a buying opportunity, although only for the nimble investor and likely best implemented through a staged/scaled redeployment in equities.

Please remember that the high level, simplified overview of our market forecasts presented in this document does not reflect the fully nuanced asset allocation capability at Russell and is not intended to be used as the basis for a trading strategy or asset class timing. Among other things, a client's individual risk tolerance and objectives, and more extensive details about the power and alignment of the various model signals, would need to be taken into account to form a robust trading strategy.

+ Outperform
++ Strongly Outperform

COMPARISON[1]	EXPECTATION	WHY WE CHOSE IT
U.S. Equities vs. U.S. Fixed Income	U.S. Equities +	Robust recent performance of U.S. Equities relative to U.S. Fixed Income makes momentum one of the strongest signals in favor of U.S. Equities now. Forward earnings-based fundamental valuation supports that preference while historical based multiples and long-term mean reversion are neutral indicators. In the aggregate, we have a preference for U.S. Equities in this pair. (U.S. Equities are represented by the Russell 3000® Index and U.S. Fixed Income by the Barclays U.S. Aggregate Bond Index.)
U.S. Small Cap Equities vs. U.S. Fixed Income	U.S. Small Cap Equities +	Momentum is currently the strongest signal in support of U.S. Small Cap Equities in this pair, following Small Cap's rapid appreciation in 2013. Additionally, forward-earnings tilt the scale toward U.S. Small Cap – although more modestly so than in 2013. In contrast, long-term mean reversion favors U.S. Fixed Income. (U.S. Small Cap Equities are represented by the Russell 2000® Index and U.S. Fixed Income by the Barclays U.S. Aggregate Bond Index.)
U.S. EQUITY STYLES		
Large Cap vs. Small Cap	Neutral / Large Cap +	After having outperformed Large Cap in 2013 it's no surprise that momentum currently favors Small Cap, though long-term mean reversion favors Large Cap. Price-to-book and price-to-sales comparisons are neutral, however price-to-earnings favors Large Cap, leading us to a neutral to slight preference for Large Cap in this pair. (U.S. Small Cap Equities are represented by the Russell 2000® Index and U.S. Large Cap Equities are represented by the Russell 1000® Index.)
Growth vs. Value	Growth + / Neutral	Virtually all signals in this pair cancel each other out or indicate an outright neutral position in Growth versus Value. We have a modest preference for Growth relative to Value as a result of the only compelling signal: price-to-sales valuation comparison in Small Cap. (Small Cap Growth is represented by the Russell 2000® Growth Index; Small Cap Value is represented by the Russell 2000® Value Index; Large Cap Growth is represented by the Russell 1000® Growth Index; Large Cap Value is represented by the Russell 1000® Value Index).
Defensive vs. Dynamic	Neutral / Defensive +	We currently hold a neutral to modest tilt to Defensive Equities relative to Dynamic Equities.
EQUITY REGIONS		
U.S. vs. Non-U.S. Developed	Neutral	Despite 60-month moving average price-to-earnings and price-to-book valuation modeling being reasonably favorable to Non-U.S. Developed Equities relative to U.S. Equities, all other signals are neutral, putting us at a near-neutral position. Within Non-U.S. Equities we have a modest preference for Japanese Equities from a fully-hedged perspective.

Not FDIC Insured. May Lose Value. No Bank Guarantee

COMPARISON[1]	EXPECTATION	WHY WE CHOSE IT (+ Outperform; ++ Strongly Outperform)
Global REITs vs. U.S. Equities	**U.S. Equities + / Neutral**	A healthy momentum signal and attractive valuation signals favor U.S. Equities relative to Global REITs. However, as the momentum signal stems from strong relative performance of U.S. Equities in 2013 and price-based multiples (price-to-earnings, price-to-book and price-to-sales) are neutral, these considerations temper our preference for U.S. Equities relative to Global REITs. (U.S. Equities are represented by the Russell 1000® Index and Global REITS by the FTSE EPRA/NAREIT Developed Index.)
U.S. vs. Emerging Markets	**Neutral / Emerging Markets +**	The modest and persistent valuation preference (price-to-sales and price-to-earnings) for Emerging Market Equities and a constructive reaction to the Federal Reserve's taper decision in December 2013, suggest that investors with sufficient risk tolerance may want to consider maintaining any existing overweight positions to Emerging Markets relative to U.S. Equities. However, we are not advocating an increase in those positions or establishing a new overweight at the present until medium-term impacts of global monetary policies become more evident. (Emerging Market Equities are represented by the Russell Emerging Markets Index.)
Non-U.S. Developed vs. Emerging Markets	**Neutral**	While we continue to forecast that medium-term valuations are likely to favor Emerging Market Equities over Non-U.S. Developed Equities later in 2014, all signals currently lie in their neutral ranges, leaving us with a neutral position in this pair.
Emerging Markets vs. Global REITs	**Emerging Markets +**	Price-to-earnings comparisons, yield and long-term mean reversion modeling favor Emerging Markets over Global REITs. However, this position may be more appropriate for the medium-term, as a result of potentially negative near-term implications of the U.S. Fed unwinding its Quantitative Easing program.
U.S. FIXED INCOME		
Corporate Bonds vs. Treasuries	**Neutral**	Despite interest rate spreads between U.S. Treasuries and Corporate Bonds narrowing, Corporate Bonds still hold an advantage from a relative yield perspective. However, that advantage is insufficient to justify a material overweight to Corporate Bonds relative to Treasuries in an overall fixed income portfolio at this time. (Corporate Bonds are represented by the Barclays U.S. Aggregate Baa Corporate Bond Index; U.S. Treasuries are represented by the Barclays U.S. Aggregate Intermediate Treasury Index.)
U.S. Fixed Income vs. Global REITs	**Neutral / Global REITs +**	Despite weak long-term mean reversion signals, reflecting the low yield environment of the last five years, relative yield comparisons cause us to have a neutral to slight preference for Global REITs in this pair.

How do we expect the U.S. dollar (USD) to compare to other currencies?[2]

OVERVALUED relative to USD	NEUTRAL relative to USD	UNDERVALUED relative to USD
Australian Dollar **Yen**	**British Pound** **Canadian Dollar** **Euro**	**Chinese Yuan/Renminbi**

[1] All asset class comparison are Large Cap unless otherwise noted.

[2] Currency rates may fluctuate significantly due to many factors including political developments in the U.S. or abroad. As a result, investments in non-U.S. dollar-denominated currencies may result in reduced returns.

Frequently Asked Questions

What is *Russell's Market Expectations*?

- This quarterly report provides **Russell's viewpoint on the direction of the market** based on which asset classes and currencies we think are undervalued as indicated by our proprietary models.
- The information is used to **estimate the relative performance of the two asset classes shown in the pair.** It does not provide insight into the absolute returns that an investor could expect. A model may suggest that asset A will offer a higher return than asset B if the relative valuation between the two returns to a historical level. However, the models do not suggest that asset A will provide a high return, simply a return that may surpass that provided by asset B. The returns of both asset A and B could be negative.
- The asset class and currency views are **pair-wise comparisons, based on the relative value of each asset class or currency**, and reflect the valuation of asset classes or currencies that may be most attractive compared to one another.
- Russell's proprietary models use financial theory, historical data and forecasts to measure relative valuation.

- Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Why is it important?

- *Russell's Market Expectations* can be used as **a reference point for providing context and perspective on the direction of the market** and as a viewpoint on the attractiveness of different asset classes and currencies.

Can I use Russell's Market Expectations as an asset class timing tool?

- **No. This report is not intended to be used as the basis for a trading strategy or as an asset class timing tool**.
- The signals displayed in *Russell's Market Expectations* are a high level overview of a limited subset of the insights from Russell's Enhanced Asset Allocation (EAA) Strategies and do not reflect the risk and conviction controls that are part of the EAA portfolio customization.

How should I interpret it?

- In simple terms, **the chart shows you the relative valuation of asset classes for this quarter**.
- Each pair-wise expectation contains two important data points: the asset class we believe will outperform – or a neutral expectation if we believe they will have similar performance – and, if applicable, the strength of the outperformance. **Moderate outperformance potential is indicated by a single plus sign (+), while strong outperformance potential is indicated by two plus signs (++).**
- The boxes shown to the right gives you a view on which major currencies we believe will be stronger, or weaker, than the U.S. dollar.
- No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate.

How often is it updated?

- *Russell's Market Expectations* is typically updated during the first month of each quarter.

Russell 2000® Value Index measures the performance of the small cap value segment of the U.S. equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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These views are subject to change at any time based upon market or other conditions and are current as of the date at the top of the page.

The information, analysis, and opinions expressed herein are for general information only.

Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Large capitalization (large cap) investments involve stocks of companies generally having a market capitalization between $10 billion and $200 billion. The value of securities will rise and fall in response to the activities of the company that issued them, general market conditions and/or economic conditions.

Small capitalization (small cap) investments involve stocks of companies with smaller levels of market capitalization (generally less than $2 billion) than larger company stocks (large cap). Small cap investments are subject to considerable price fluctuations and are more volatile than large company stocks. Investors should consider the additional risks involved in small cap investments.

Growth investments focus on stocks of companies whose earnings/ profitability are accelerating in the short term or have grown consistently over the long term. Such investments may provide minimal dividends which could otherwise cushion stock prices in a market decline. Stock value may rise and fall significantly base, in part, on investors' perceptions of the company, rather than on fundamental analysis of the stocks. Investors should carefully consider the additional risks involved in growth investments.

Value investments focus on stocks of income-producing companies whose price is low relative to one or more valuation factors, such as earnings or book value. Such investments are subject to risks that their intrinsic values may never be realized by the market, or, such stock may turn out not to have been undervalued. Investors should carefully consider the additional risks involved in value investments.

Dynamic style emphasizes investments in equity securities of companies that are believed to be currently undergoing or are expected to undergo positive change that will lead to stock price appreciation. Dynamic stocks typically have higher than average stock price volatility, characteristics indicating lower financial quality, (which may include greater financial leverage) and/or less business stability.

Defensive style emphasizes investments in equity securities of companies that are believed to have lower than average stock price volatility, characteristics indicating high financial quality, (which may include lower financial leverage) and/or stable business fundamentals.

Specific sector investing such as real estate can be subject to different and greater risks than more diversified investments. Declines in the value of real estate, economic conditions, property taxes and tax laws and interest rates all present potential risks to real estate investments.

Treasury Bills (T-bills) are short-term debt securities issued by the U.S. government with maturities of usually one year or less. Fixed income investors should carefully consider risks such as interest rate risk, credit risk, securities lending, repurchase and reverse repurchase transaction risk.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages.

Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

Non-U.S. markets entail different risks than those typically associated with the U.S. markets, including currency fluctuations, political and economic instability, accounting changes, and foreign taxation. Securities may be less liquid and more volatile.

Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and to political systems which can be expected to have less stability than those of more developed countries. Securities may be less liquid and more volatile than U.S. and longer-established non-U.S. markets.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

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

Barclays U.S. Aggregate Baa Corporate Debt Index is a measure of corporate fixed income securities that are rated investment grade (Baa by Moody's Investors Service and BBB by Standard & Poor's) and have at least 10 years to final maturity.

Barclays U.S. Aggregate Intermediate Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to- book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to- book ratios and lower expected growth values

Russell 2000® Growth Index measures the performance of the small cap growth segment of the U.S. equity universe. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

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Russell Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of emerging markets.

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