

Investor

Helping investors to be informed individuals

You survived
the financial storm.

NOW WHAT?

by Timothy Noonan

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The shock of the worst financial storm in generations is wearing off and you've made it through to the other side.

Although investing in the stock market seems too painful to consider, investors must not let the trauma of the past year and a half keep them away if they want to begin to recover their losses and ultimately achieve their goal of financial security in retirement.

The four stages of stock market grief—shock, survival, rebuilding and aftermath. Where are we now?

By most accounts, the worst of the nastiest financial storm in a generation has passed. That does not mean skies are blue and we may not yet see another good drenching or two or three. What it does mean, in our view, is that, at long last, we see glimmers of a brighter tomorrow on the horizon. As the economic cycle bottoms out, expectations for the economy to recover, and the markets along with it, appear to be just around the corner.

If you have opened your monthly statements and seen the extent of your loss, you have probably already experienced some degree of shock. But at some point you need to think about what comes next. Since you're reading this, you've survived the storm itself. Now you must think about rebuilding your portfolio, before moving onto the fourth and final stage, the aftermath, in which you try to make sure your portfolio is well positioned for an eventual recovery and fortified against any future downturns, as much as possible.

Our investment experience tells us that we're currently between the survival and rebuilding stages. We are confident that curatives such as government stimulus, here and across the globe, easing monetary policy, bank stress tests, are the preparatory steps for moving us from crisis to recovery. To put the final touch on our storm analogy, we believe we've transitioned from an environment in which gale force winds were threatening to blow our collective roofs off, to one that can still be fairly wet and cold, but livable nonetheless.

As we move into the “new normal,” we believe that actively managed funds will have an advantage over passively managed alternatives.

The new investment reality

No one expects investors who have lived through the past 18 months to simply shrug it off and enthusiastically resume investing with the same expectations of ever-rising wealth.

In the post-crisis market era (whenever that officially arrives), investing may be regarded less as something we like to do, and more as something we must do to increase our chances of outpacing inflation and enjoying the quality of life we dream of when we retire. If nothing else, the downturn has hammered home the notion that it's best to view investing in the stock market from this point forward as a serious and necessary exercise that, like it or not, most investors need to participate in. In the new reality, you may not like the stock market, but at a time when defined benefits and other forms of entitlement plans are no longer a reliable part of the retirement equation, it's the reality in which we live. Investing for retirement is best viewed as a means to an end, a long-term program with the goal of replacing your income after you've stopped working—there's little room for the feelings that can sometimes derail you from that long-term objective.

Taking baby steps to rebuild your portfolio

If you exited the stock market during the past year and are trying to decide how and when to get back into equities, here is a simple re-entry strategy that affords a chance to minimize the regret of not

participating in market rebounds that historically precede economic recoveries. We recommend a program of “dollar cost averaging” (DCA)*, an investment strategy that eases you back into the market. DCA is a technique designed to reduce market risk by investing a set amount at predetermined intervals regardless of fluctuating price levels. More shares are purchased when prices are low, and fewer shares are bought when prices are high. The goal is to lessen the risk of investing a large amount in a single investment at the wrong time. We believe DCA makes more sense than waiting for signs of a market turnaround and potentially missing significant market surges.

Bear necessities— Asset allocation and portfolio rebalancing

Nobody knows where the markets will be tomorrow, let alone in a year. What we are certain of, however, is that, asset allocation and portfolio rebalancing remain two important techniques to help manage risk and enhance returns.

Asset Allocation

It's critical to stay in the market, despite its constant ups and downs. But it's just as important to have the right mix of stocks, bonds and other assets for your age, objectives and expectations for asset class returns. Far and away one of the most important questions to ask your advisor is this: Does my asset allocation support the standard of living I'm envisioning in retirement?

While it may be tempting to change your asset allocation due to recent market events (either increasing or decreasing equity exposure), it is, in our view, unwise to do so unless there's been a permanent change in the risk/reward tradeoffs, which we don't believe has happened, or you're in or near retirement and have suffered a significant change in your personal wealth as a result of market losses. If you have many good earnings years ahead of you, we believe it's unwise to reduce your equity exposure now.

If you do revisit your asset allocation, you may decide that you need more or less risk to meet your goals. Such a decision should be based on a need to address a portfolio decline, not because you believe markets have fundamentally changed.

Portfolio Rebalancing

When markets perform as they have over the past year, one result is that your ratio of stocks and bonds has probably deviated dramatically from its intended target, becoming underweighted in stocks and overweighted in bonds.

The purpose of rebalancing is to ensure that your portfolio maintains its long-term asset allocation. This is done by periodically eliminating deviations from the target allocation caused by the movements of the market.

With the recent decrease in market volatility, now may be a good time to rebalance your portfolio in order to re-establish your optimal asset allocation mix.

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*Please consult with your Financial Advisor and carefully consider any tax consequences before making changes to your asset allocation. DCA does not assure a profit or prevent a loss in declining markets, and you should consider your ability to continue investing during low price levels.

Investor

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The case for active management going forward

When the market was routinely setting new records back in summer and fall of 2007, many investors believed it didn't matter where you invested, so long as you invested. As we move into the "new normal," we believe that actively managed funds will have an advantage over passively managed alternatives. Our rationale stems from the indiscriminate destruction of share prices of both good and bad companies. In a market driven by fear—like the 4th quarter of 2008—there was a major disconnect between the value of a stock and its price, and little room for stock research to make a difference in identifying good versus bad stocks.

We believe an actively managed approach has a big advantage now because of the need to separate stocks that have been unfairly beaten up from those that deserved it. Moreover, we believe that if the security selection is right, an active approach is a sensible risk that should help restore your losses faster.

The aftermath: Can you afford not to invest?

In the aftermath of the worst financial storm since the Great Depression, investors will need to understand that just as past performance was no guarantee of future results in good times, the same holds true in bad. Do not make the mistake of relying too heavily on what happened in the recent past when it comes to predicting the future.

Unless you already have all the money you'll need to fund your retirement, you still need to be invested to grow your portfolio in order to reach your goals. The level at which you set your equity exposure is a decision you should make with your advisor, but it should be based on your needs and goals, not just on how much risk you can handle or want. Finally, to underscore our key message, what matters most is not how you feel about investing, but rather how you can make use of the markets, in both stormy times and sunny times, to accomplish one of your most important goals of all—not outliving your nest egg.

Timothy Noonan is managing director capital markets insights for Russell Investments. Timothy heads the group responsible for shaping and delivering client service strategy, and delivering capital market information to private client advisors.

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No investment strategy can guarantee a profit or protect against a loss.

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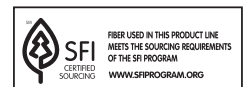
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First used June 2009. RFS 09-2105

01-01-166 (1 06/09)



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