Index Profile | Fixed Income – Russell Index

Investment precision for corporate bond investors

Russell Fixed Income Indices

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Introduction

FTSE Russell is introducing a new Russell 3000® Fixed Income Index and corresponding Russell 1000® Fixed Income and Russell 2000® Fixed Income sub-indices. These new indices deliver curated, market-weighted benchmarks for investors who seek precision allocation to track the US domestic corporate bond market. Investors already familiar with our flagship Russell US Indices now have a complementary set of fixed income indices that can add flexibility and transparency to their asset allocation strategy.

The new Russell 3000 Fixed Income Index extends the range of corporate fixed income choices. By centering on debt issued by Russell 3000 issuers, the index avoids the unintended risks of foreign asset exposures and improves transparency through public issuer focus. In contrast to the traditional market tracking indices in the US, the Russell 3000 Fixed Income Index naturally provides a passive 'crossover' element which captures corporate bonds straddling US investment grade and high-yield market, shortening overall duration. The alignment in selection and reporting of the fixed income indices with their equity counterparts should resonate with multi-asset investors seeking a balanced portfolio across US equity and fixed income assets.

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The case for Russell Fixed Income indices

US fixed income indices that currently exist and seek to measure the US corporate bond market tend to include all US-dollar issuance that fall within certain size, term, and credit quality buckets. For example, the FTSE US Broad Investment Grade Corporate Bond Index. However, our new Russell Fixed Income indices have several distinguishing features that offer a unique approach to indexing in the US corporate fixed income market. In particular:

– A complementary counterpart to the Russell equity index franchise, the Russell Fixed Income indices deliver **methodologically aligned investment strategies**.

– **A US-only focus** achieved by the link to equities through a selection of corporate bonds issued by the same companies, whose equity is included in the Russell index and deemed to have US nationality[1]. Multinationals and foreign entities not based in the US are excluded from the index. This allows for **controlled and strategic** foreign risk allocation.

– Both the Russell 3000 Fixed Income Index and Russell 1000 Fixed Income Index have a **'natural' bucket of high-yield bonds**, currently about 10% of mainly corporate bonds on average rated BB, that enhance yield.

– The Russell 2000 Fixed Income Index includes a cohort of bonds that cut across investment grade and high-yield credits, **creating a 'crossover' index**. This index has different risk characteristics from both bank-dominated, investment grade and more idiosyncratic high-yield issuers.

– Having an equity and fixed income index composed (predominately) of the same constituents opens the possibility for **multi-asset products** such as diversified 60/40 or risk parity indices.

– These new fixed income indices increase FTSE Russell's index coverage and **extend the investment precision** it can offer clients.

[1] Nationality assignment follows the Russell equity indices assigned in accordance with the nationality rules: View Methodology.

Russell Fixed Income index characteristics

The Russell indices are made up of the largest US companies, and the new parallel fixed income indices will reflect the bonds outstanding for these cohorts of names and their majority-owned US subsidiaries. This means the bonds of foreign and other entities outside of US regulatory reach are not included. Given not every constituent of the US equity indices issue debt, the constituents of the fixed income equivalents will not match exactly. However, those that do issue debt tend to have robust capital structures and larger market caps. As a result, while the cohort of constituents that make up the fixed income index is a smaller subset of those in the equity index (exhibit 1), it enjoys the same benefits of strong capital structure, and, arguably, more diversified funding sources.

Russell Index vs Russell Fixed Income Index

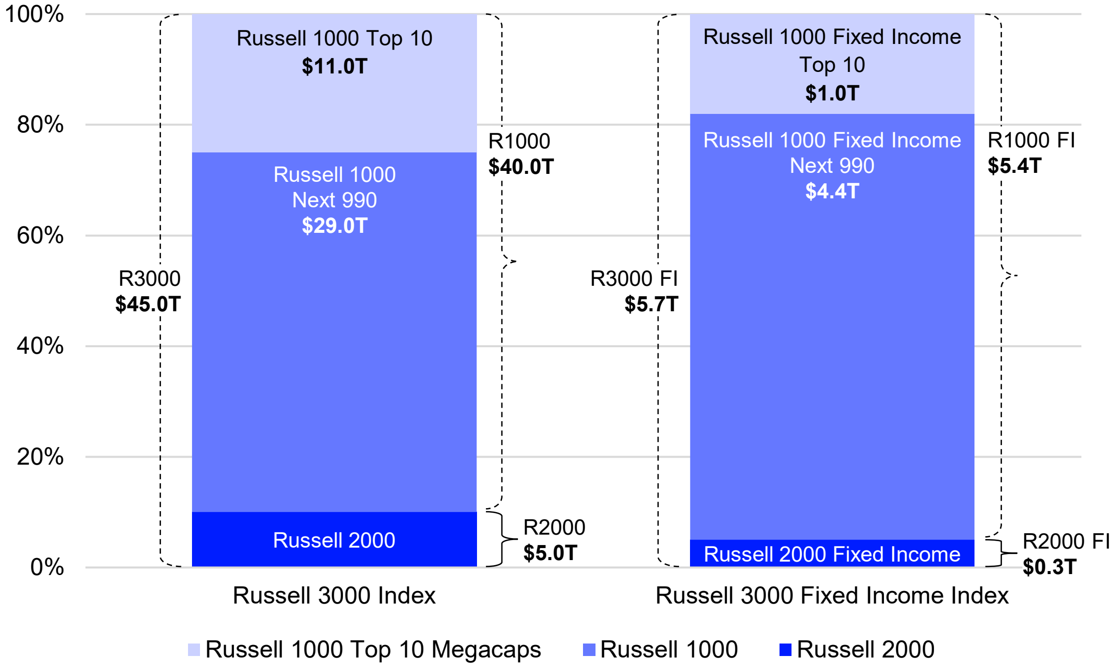
Exhibit 1. Number of equity and fixed income index constituents, as of the 2022 reconstitution

	Russell Indices (equities)		Russell Fixed Income Indices	
	Securities	Legal entities	Securities	Legal entities
Russell 1000	1,000	1,000	6,422	712
Russell 2000	2,000	2,000	636	293
Russell 3000	3,000	3,000	7,058	1,005

Source: FTSE Russell as of July 2022.

The table above illustrates that not all constituents of the Russell US indices raise debt through public bond issuance. While over 70% of Russell 1000 companies issue debt, a significantly smaller percentage of small cap companies participate in the US fixed income debt markets. Of the Russell 2000 Index, only 14% have issued bonds that qualify for inclusion in the index. Of the total constituents in the Russell 2000 Index, only 293 legal entities have names that qualify for inclusion in the fixed income index, compared to 712 in the Russell 1000 Index.

Exhibit 2. Structure and outstanding debt of the Russell 3000 Index and Russell 3000 Fixed Income Index, as of the 2022 reconstitution



Source: FTSE Russell as of July 2022.

Exhibit 2 illustrates the structure of the broad Russell 3000 Fixed Income Index, with the large cap Russell 1000 Fixed Income Index accounting for the major share of issuance. By comparison, the Russell 2000 Fixed Income Index, with double the number of small-cap constituents, only accounts for 10% of the combined market cap in the case of equities, and 5% for fixed income.

In both the equity and fixed income large-cap indices, the top ten 'mega cap' companies make up a significant proportion of the market value weight and thus can have an outsized influence on performance.

Exhibit 3. Market cap of top ten biggest entities in Russell 1000 Index and Russell 1000 Fixed Income Index, $B

Russell 1000 Index Mega Caps	Equity value
Apple Inc.	2,546
Microsoft Corporation	2,055
Alphabet Inc.	1,524
Amazon.com	1,168
Tesla, Inc.	897
Berkshire Hathaway Inc.	704
Meta	552
UnitedHealth Group	469
NVIDIA	468
Johnson & Johnson	464

Russell 1000 Fixed Income Index Mega Caps	Bond Value
Bank of America	174
JP Morgan Chase & Co.	156
Goldman Sachs Group, Inc.	109
Morgan Stanley	106
Citigroup Inc.	104
Wells Fargo & Company	99
Verizon Communications Inc.	78
AT&T Inc.	78
Apple Inc.	78
Comcast Corporation	70

Source: FTSE Russell as of July 2022.

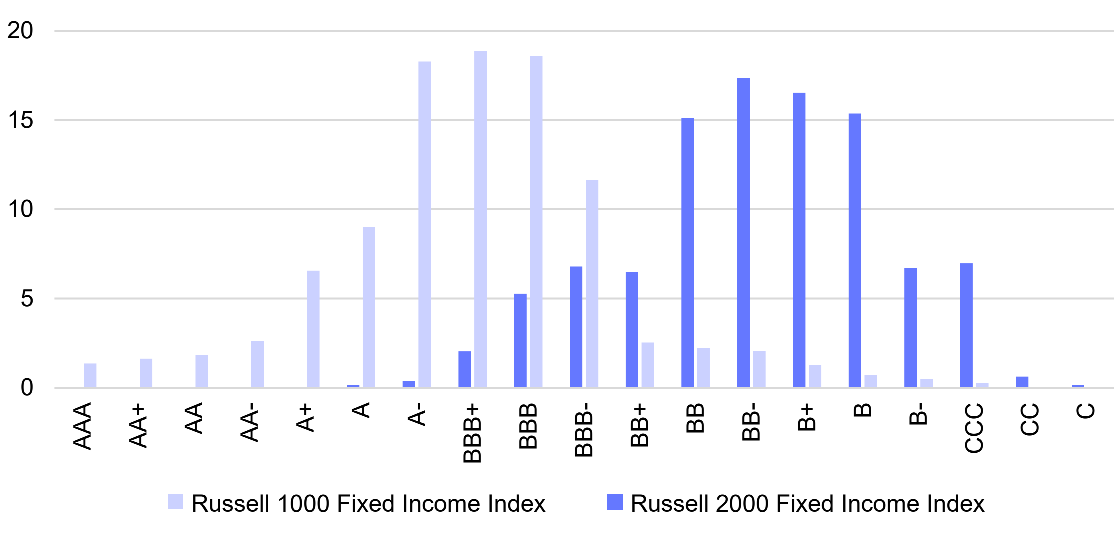
Exhibit 3 illustrates that there is a much bigger technology representation in equities, compared to the mega caps in bonds, which are dominated by financials – albeit significantly less so than in traditional US investment grade corporate indices, like the FTSE US Broad Investment Grade Corporate Bond Index. These financial mega caps dominate news flow and can be leading barometers of popular retail sentiment. In addition to leading the index through their sheer market-cap size, they also act as a bellwether for other better-known retail names. The news flow has more influence on the Russell 1000 Fixed Income Index than the Russell 2000 Fixed Income Index, where companies are less well known. Familiarity of names can have some performance implications, as we shall discuss later.

Ratings

The Russell 2000 Fixed Income Index is a small cap index. Exhibit 4 illustrates the strong correlation between small market-cap equity and a lower rating for debt. While the average rating for the large cap Russell 1000 Fixed Income Index is BBB+, the average rating for the Russell 2000 Fixed Income Index is BB-/B+. This makes the Russell 2000 Fixed Income Index universe more of a ’crossover’ index than that of the Russell 1000 Fixed Income Index. While the Russell 3000 Fixed Income Index expands to include cross-over segments, it should be noted that the credit profile of this index and the Russell 1000 Fixed Income Index remain close to their investment grade peers and are significantly better quality than the traditional high-yield credit indices. Below, we illustrate the risk characteristics of the different indices in terms of a typical fund mandate.

– **Russell 1000 Fixed Income Index**: Investment grade mandate with a 10% high-yield bucket down to B-
– **Russell 2000 Fixed Income Index**: Crossover mandate with 20% investment grade bucket
– **Russell 3000 Fixed Income Index**: Investment grade mandate with a 13% high-yield bucket down to C

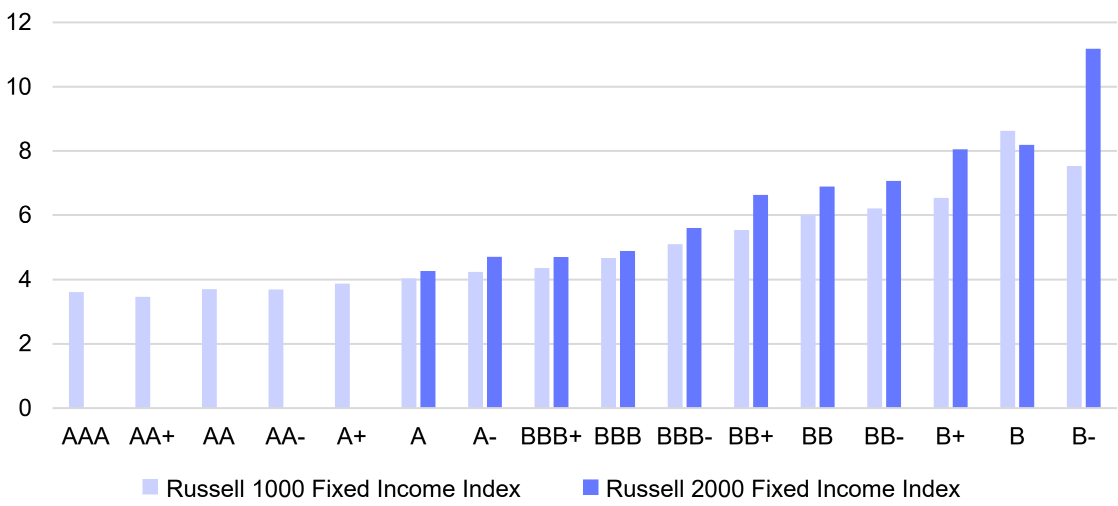
Exhibit 4. Distribution of the Russell 1000 Fixed Income Index and Russell 2000 Fixed Income Index by rating (%)



Source: FTSE Russell as of July 2022.

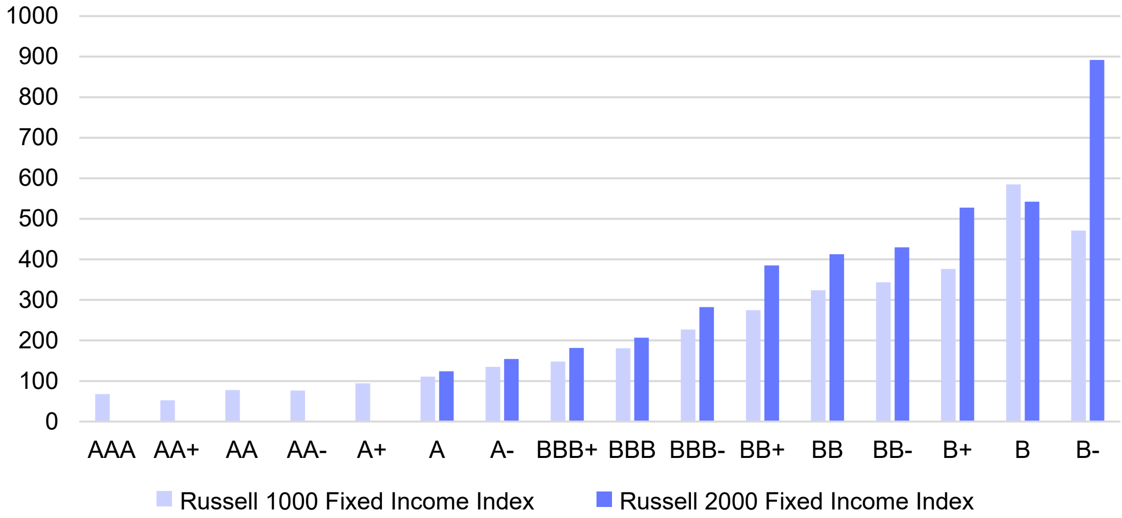
As illustrated in exhibit 5, the crossover component of the Russell 1000 Fixed Income Index offers a yield pick-up compared to traditional investment grade strategies, with the Russell 2000 Fixed Income Index, the yield pick-up is even greater. Exhibit 6 makes clear how issuers in the BB- to B- range offer an attractive yield pick-up relative to better-rated names. The higher investment grade weighting gives the Russell 1000 Fixed Income Index a different characteristic relative to the more high-yield/crossover in the Russell 2000 Fixed Income Index. Typically, corporate bonds with a higher spread are 'higher beta' too, meaning they will likely outperform in a rally but underperform in a sell-off. Additionally, the higher yielding crossover index can benefit from a higher carry and roll down return component.

Exhibit 5. Average yield of constituents of the Russell 1000 Fixed Income Index and Russell 2000 Fixed Income Index (%)



Source: FTSE Russell as of July 2022.

Exhibit 6. Average spread-to-treasuries of constituents of the Russell 1000 Fixed Income Index and Russell 2000 Fixed Income Index (basis points)



Source: FTSE Russell as of July 2022.

Domestic focus: explained

The Russell US Index is a domestic equity index where nationality determination is subject to a rigorous process and regular reviews for all companies considered. This means that their constituents are US companies, with full transparency in relation to regulatory and geopolitical risk. For standard fixed income indices, inclusion is dependent on the bonds being issued in US approximately 20% exposure to non-US entities, including those based in emerging market economies such as China and, before sanctions impacted eligibility, Russia.

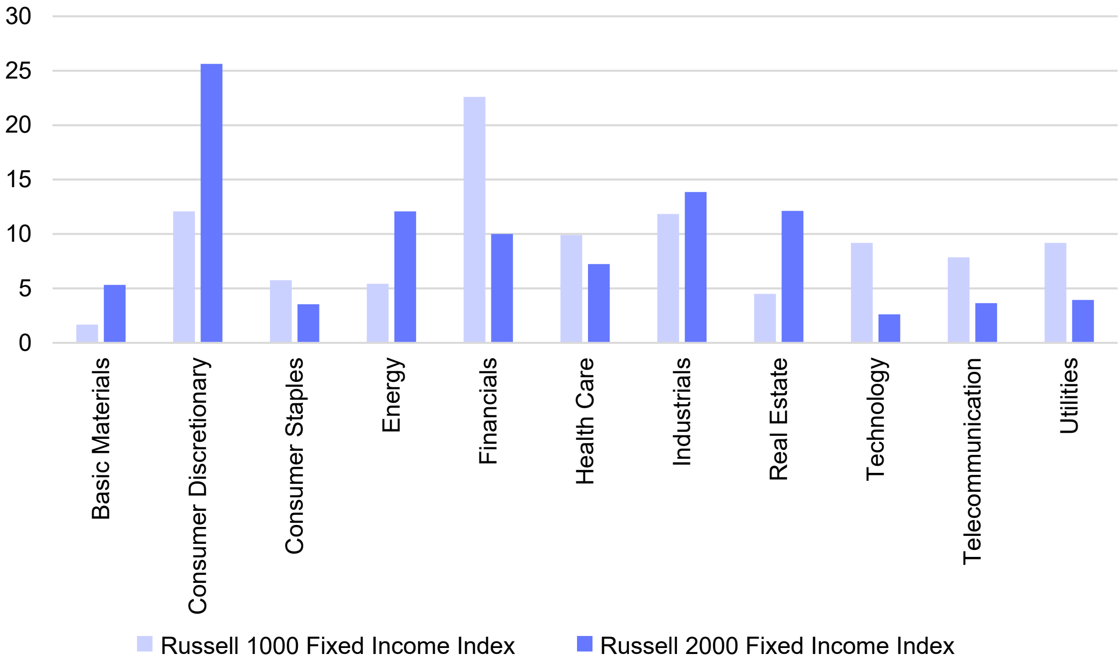
The concept of domesticity is of special consideration in the event of large multinationals raising capital in multiple jurisdictions. While the Russell index includes US multinationals, the index effectively screens out companies like Deutsche Bank or HSBC that are subject to a set of different geopolitical and regulatory considerations compared to the US-based multinationals like Goldman Sachs or Citibank. Perhaps more significantly, in a period of dollar strength, leveraged non-US issuers are likely to be more stressed than their US equivalents. The domestic lens of the Russell fixed income indices allow investors to be intentional about their foreign asset exposure.

Sector differences

The novel split into small and large cap, typically adopted in equity markets, also means that there are differences between sector distributions, which leads to different risk characteristics.

Exhibit 7 illustrates that the Russell 1000 Fixed Income Index has more banks and financials exposure than the Russell 2000 Fixed Income Index, while the latter index is more oriented toward industrials (see ICB for industry classification). The exposure to industrials in the Russell 2000 Fixed Income Index is almost 75%. The differences are more pronounced on closer inspection. The exposure to the financial sector in the Russell 1000 Fixed Income Index is mostly represented by banks, while the Russell 2000 Fixed Income Index includes brokers, servicers and other non-bank financials; companies which have a different risk profile. Banks tend to do better in a rising rate environment, for instance, in contrast to other financial institutions, which is another significant bias related to the risk profile of the Russell 1000 Fixed Income Index versus its Russell 2000 Fixed Income Index peer. Also, within industrials, there is a greater emphasis on energy and service providers in the Russell 2000 Fixed Income Index universe.

Exhibit 7. Industry weights: Russell 1000 Fixed Income Index and Russell 2000 Fixed Income Index (%)



Source: FTSE Russell as of July 2022.

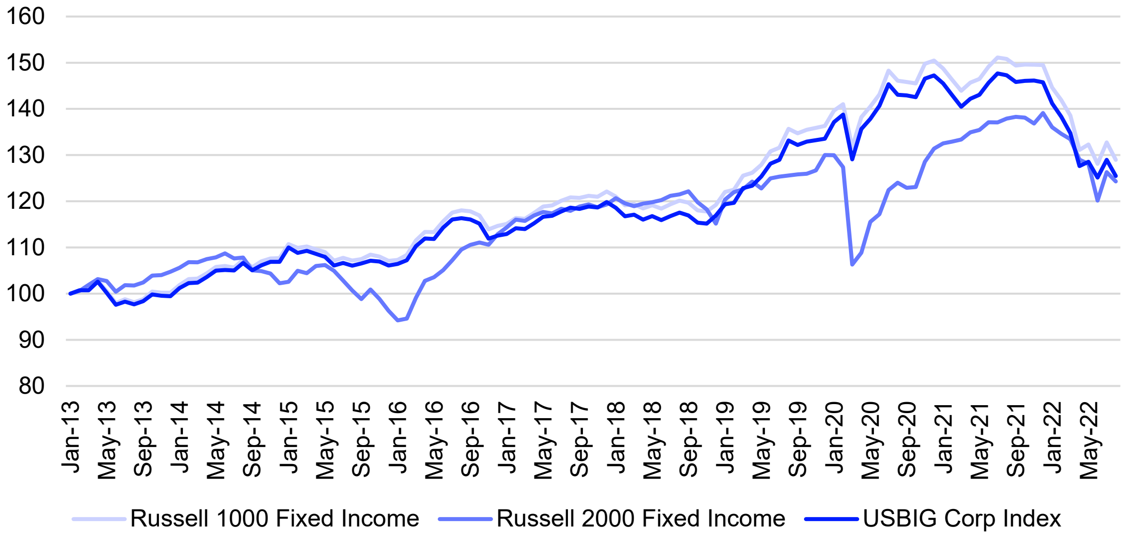
Differences in index characteristics can offer opportunities

The differences in index characteristics outlined above means that the two fixed income indices will perform differently over the economic cycle. For example, since the Russell 1000 Fixed Income Index has more bank exposure than the Russell 2000 Fixed Income Index, it is likely to do better in a rising rate environment. Differences in sector exposures allow asset allocators to take advantage of different risk profiles of the indices. Similarly, differences in the company size of constituents of the large-cap Russell 1000 Index and the small-cap Russell 2000 Index can drive differences in the return pattern of their respective fixed income indices, thereby increasing the opportunity set for asset allocators. On average, large-cap, and especially mega-cap, companies in both equity and fixed income tend to do well in the final phases of an economic cycle before a downturn. While the reasons for this are beyond the scope of this paper, here we need to consider the following. Investors concerned about a correction but who wish to remain invested tend to prefer ‘quality’ over ‘growth’, giving the advantage to larger companies. Additionally, retail investors tend to chase the rally with high profile names, again preferring larger, more established companies during periods of volatility.

This combination of factors means that, in a crisis, large cap tends to outperform as investors rotate into better-rated assets. However, the names that are more sensitive to market movements, or higher beta names, tend to sell off more in a downturn and rebound more once the market has recovered. When markets are not trending, these high-beta names tend to outperform due to a higher carry and roll.

These performance patterns can be observed in the history of the Russell 1000 and 2000 fixed income indices as shown in exhibit 8. For example, during the Covid-19 crisis, the Russell 2000 Fixed Income Index corrected more than the Russell 1000 Fixed Income Index. During rallies such as 2012-2014 and 2016-2018, the higher beta Russell 2000 Fixed Income Index outperformed.

Exhibit 8. Rebased cumulative returns for the Russell 1000 Fixed Income Index and Russell 2000 Fixed Income Index, and FTSE US Broad Investment Grade Corporate Index



Source: FTSE Russell as of June 2022.

Exhibit 9. Comparative statistics

	Annual return	Volatility	Return/vol ratio	Drawdown
Russell 1000 Fixed Income Index	3.03%	5.71%	0.53	-15.22%
Russell 2000 Fixed Income Index	2.49%	8.24%	0.30	-18.23%
USBIG Corporate Index	2.28%	5.69%	0.40	-15.28%

Source: FTSE Russell as of July 2022 calculated period January 2013 to July 2022.

Summary

The Russell 3000 Fixed Income Index brings a familiar equity brand to fixed income. It provides investors with a set of indices to complement our well-known Russell equity franchise and bridges equity and fixed income through methodological alignment. Transparent and US-only, the index is mindful of geopolitical risks and supports higher precision strategies of investing in the US corporate market. Through this precision, the index enables investors to be intentional about USD foreign exposure in their portfolios. It incorporates the innovation of crossover elements within the landscape of investment grade and can add the benefit of shorter duration and higher yield compared to traditional approaches. Upcoming phases of the economic cycle after the rates correction might offer new challenges and opportunities for investors, and Russell 3000 Fixed Income Index delivers an innovative, precise and duration-minded approach to navigating the new reality.

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