

State Street Global Advisors Limited

PRODUCT: S&P 400 MIDCAP

ASSET CLASS
Equity

GEOGRAPHIC EMPHASIS
US

STYLE
Index Fund

SUBSTYLE
Mid-Cap

State Street Global Advisors is flexible as to the level of tracking error they will take on for an index product.

INVESTMENT PHILOSOPHY/OBJECTIVES

State Street (SSGA) believes that their clients choose indexing for three main reasons. First, they want to gain broad-based equity exposure. Second, they want predictable variance around a given benchmark. And third, they want this exposure at the lowest possible cost. Their philosophy is to manage every index portfolio in a manner that ensures that all three of these objectives are met throughout the investment process – from the initial contribution to the ongoing management of the assets.

SSGA will implement their philosophy through a continuum of indexing methodologies. At one end of the spectrum are their highly sampled and optimized portfolios. At the other end are those portfolios that more closely reflect the benchmark composition and carry a much lower tolerance for security level misweights. Each approach has benefits and drawbacks depending on the circumstances of the particular investment. Their goal is to use the most appropriate indexing methodology in each situation, in accordance with the three objectives stated above. They consider several factors when making this decision including the size of the assets, liquidity of the benchmark, custody costs, tracking error tolerance, availability of data, and the maturity of the fund in question.

SSGA manages almost \$650 billion in passive index assets. Their indexing strategies currently span 66 countries and over 160 benchmark-weighting schemes.

External systems are used to analyze sources of tracking error.

INVESTMENT EMPHASIS

The goal of their S&P 400 Midcap Index Strategy is to replicate the returns and characteristics of the S&P 400 Midcap Index, therefore they do not seek sources to add value.

In monitoring the performance of the portfolio, they employ several external systems including BARRA, Wilshire and FactSet. These tools are used to analyze all sources of tracking error. Typical categories of tracking error in their index mandates include cash/futures holdings, cumulative misweights from the Fund's equity holdings, corporate actions, index changes, etc. The tools can show attribution at the sector, industry, or security level and provide us with easily accessible information such as the top 10 and bottom 10 contributors to the Fund's performance. In addition, the post trade analysis and monthly reporting from their systems allow the team to evaluate a portfolio prior to committing a trade to the desk. This allows them to modify their trades prior to execution to achieve the best tracking portfolio possible.

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John Tucker leads the U.S. Index team.

DECISION MAKING STRUCTURE

Paul Brakke oversees the entire decision making process for the Global Structured Products Group. He is responsible for coordinating their indexing effort both in Boston and in their non-U.S. investment centers. John Tucker heads the U.S. Equity passive index effort.

SSGA's portfolio management process is a team effort. They meet weekly to discuss upcoming cash flows, their approach to current index changes, new product development, systems and data issues, and all other topics involved in the management of their portfolios. In addition, each of the sub-groups mentioned above meet to discuss issues particular to those areas. The unit heads ensure that all investment decisions made by the team are implemented by the individual portfolio managers.

Each portfolio is assigned a lead manager and back-up manager. This attempts to ensure consistency in the management of their funds in the case of absences or personnel changes.

Finally, the SSgA Investment Committee plays an active role in the process. The Committee is comprised of investment professionals and heads of various investment and strategic groups within the firm. It is charged with setting investment policy, resolving investment policy issues and ensuring that the position of each investment discipline remains consistent with the firm's mission of providing creative and profitable solutions for SSgA clients.

No major deviations in stock-specific weights from the benchmark.

SECURITY SELECTION CRITERIA

The goal of their S&P 400 Index Strategy is to replicate the returns and characteristics of the S&P 400 Index. Therefore, security selection decisions are driven by the Index constituents and index changes. The timing of implementing the changes in the portfolios is at the discretion of the portfolio managers.

The goal of their S&P 400 Index Strategy is to replicate the returns and characteristics of the S&P 400 Index; therefore, the entire portfolio is invested in midcap issues. Their passive equity process objective is to remain fully invested in the equity market at all times.

Investment research is conducted by the Global Structured Products Group, the Advanced Research Center, and the Global Fundamental Research Group.

RESEARCH

In addition to the customized research SSGA provide clients, research is being conducted both inside and outside the Global Structured Products Group. Portfolio managers and dedicated research personnel within the Global Structured Products Group continuously address research issues brought to light by clients.

Investment research is conducted by three collaborative groups within SSgA: (1) portfolio managers, including the Global Structured Products Group, (2) the Advanced Research Center, and (3) the Global Fundamental Research Group.

Global Structured Products Group

A wide variety of research topics that arise in the area of passive investment

STATE STREET GLOBAL ADVISORS LIMITED

management are addressed within the Global Structured Products Group. Research topics range from practical issues such as transaction costs and index trading strategies to theoretical/strategic issues such as the composition of the market portfolio and the role of currency hedging in global passive portfolios. Eric Brandhorst heads the research effort in the Global Structured Products Group, and the following are examples of research projects recently addressed:

Advanced Research Center

Advanced Research Center - SSgA expanded its research capabilities with the formation of the Advanced Research Center (ARC) in 1997. The Advanced Research Center works on research projects unique and important to SSgA clients. In fact, the ARC is a strategic research partner with several SSgA clients, and also maintains significant affiliations with major academic institutions. The members of the Advanced Research Center work in conjunction with the investment areas to explore new ideas and technologies, thereby contributing to the continuing evolution of their investment processes. The ARC's research projects mainly focus on quantitative modeling of US and international equities, as well as international securities and markets.

SECTOR/INDUSTRY WEIGHTINGS

The S&P 400 Midcap Index Strategy employs a replication approach to construct a fund whose returns closely track those of the S&P 400 Index., therefore sector and industry decisions are based on the index.

Sales are made only when there are index changes, dividends, or cash flows.

SELL DECISIONS

Trades only occur when there are participant cash flows, index changes, or to invest accumulated dividends. As such, they would only sell holdings if it were necessary to accommodate a client redemption or to rebalance the portfolio to accommodate index additions and deletions.

With less liquid securities, State Street may trade opportunistically.

PORTFOLIO CONSTRUCTION

State Street's passive equity process objective is to remain fully invested in the equity market at all times. They tend to hold approximately 1-3% of the Strategy's value in suitable CFTC approved index futures contracts. This position in futures also allows the portfolios to accommodate cash flows into and out of the portfolio on a daily basis and to equitize dividend receivables to achieve closer tracking.

Managing the trade-off between costs and tracking error

The portfolios hold every index constituent in approximately its index weight. However, in some cases, minimizing tracking error can come at a high price. For example, buying all the securities in an index – regardless of liquidity and transactions costs – may prove to be exorbitantly costly. Therefore, they constantly manage the trade-off between minimizing tracking error and keeping costs low. This means acquiring smaller, illiquid names only through low cost trading opportunities such as internal and external crossing as mentioned above. It also means that they use cash flows to rebalance their

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portfolios whenever possible, rather than creating turnover within the portfolio. Their strategy is to buy and hold securities, trading only when there are participant cash flows, a change to the Index, or to reinvest cash from dividend income, tax reclaims, or corporate actions. They also manage the trade-off between tracking error and costs through the way in which they trade index changes. Rather than trading entire positions at the close of the change date, they try to take advantage of the often-predictable pricing patterns of securities being added and deleted from the benchmark. This may translate into buying and selling partial positions prior to or after the actual change date.

State Street crosses over 90% of trades.

TRADING

SSgA believes one of their biggest advantages is their ability to tap into their own internal liquidity. They have about \$650 billion in total index assets under management. These sources of internal liquidity can provide opportunities for free trading within and among their portfolios. Their distribution of cash flows across all markets (large and small cap, developed and emerging) can translate into free and low cost trading in areas where transaction costs can be highest. They achieve this by matching buyers and sellers internally whenever possible. These trades generally incur no commissions, taxes, bid/ask spread, or market impact. They generally follow a hierarchy of trading that begins with free internal crosses, low-cost external crosses, futures, and, finally, open market trades.

Internal Crossing: State Street's Department of Labor exemption allows SSGA to trade within or among certain portfolios at no cost to the participants. In-house crosses are "free trades" because they eliminate both market impact and broker fees.

External Crossing: SSgA has relationships with several crossing networks, including Lattice and POSIT, that allow the firm to take advantage of liquidity in the marketplace while eliminating market impact. In these systems, they trade at the mid-point of the current market's bid/ask spread and pay approximately \$0.02 per share.

Futures: In many SSgA portfolios, futures are used to provide liquidity for contribution and redemption activity and market exposure for dividend income received in the portfolio. Futures can provide a low cost way of gaining exposure to the underlying index without losing liquidity.

Market Trades: Once they have exhausted all of the low cost trading alternatives, they conduct agency trades, which are handled by the SSgA Equity Trading Desk. The traders employ a number of trade monitoring systems, such as Plexus, in order to control trading costs and ensure best execution.

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