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The CIO Monthly Perspective

January 3, 2022

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A YEAR OF TRANSITIONS

In the pandemic, public policies, and politics

Despite elevated absenteeism among the elves and reindeer due to the Omicron outbreak, St. Nicholas still managed to gift investors with a Santa Claus Rally to wrap up a memorable year. It was an impressive feat considering the macro headwinds: inflation at a 39-year high, the Fed's hawkish pivot to wrap up quantitative easing by mid-March and to raise interest rates thereafter, a raging Omicron wave, and Senator Manchin playing the Grinch with the Build Back Better bill. Some of these developments were nowhere to be found in the market consensus at the start of 2021. At the time, the Fed was expected to stay dovish through 2023 as central bankers were worried that inflation would remain elusive in the face of technological advances, aging demographics, and elevated debt burdens. Much of the world was in the throes of a deadly COVID-19 wave in early 2021, but we were told that the nascent vaccines would effectively shield the populace from infections and liberate us from lockdowns and restrictions. To borrow a line from Scottish poet Robert Burns, it just goes to show that, "The best laid plans of mice and men often go awry."

Despite these negative "surprises", 2021 still turned out to be a good year for most risk assets. The most powerful catalyst was that corporate earnings exceeded expectations by the widest margin in decades. At the beginning of 2021, the consensus expectation for the S&P 500 Index's aggregate earnings-per-share growth for the year was 23%. By year end, the growth expectation ballooned to 50%. The beat-and-raise pattern repeated during each earnings reporting season kept the market's upward momentum intact, and every market decline – the biggest drawdown during the year was only 5.2% – turned out to be a rewarding buy-the-dip opportunity.

As the calendar turns to the new year, our lives are once again disrupted by another COVID-19 wave. However, there is a glimmer of hope that the less virulent Omicron variant might just transition the pandemic into a more manageable endemic phase. Investor sentiment appears to be somewhat mixed – the optimism for another above-trend growth year is tempered by the Fed's hawkish pivot. Historically, equity returns in the third year of a bull market are more subdued as the Fed usually starts tightening in response to rising inflation risks. What is unique about the current cycle is that long bond yields have remained stubbornly low, which might have something to do with the Fed's $1.5 trillion of asset purchases in 2021. It remains to be seen how well asset valuations will hold up after QE is wrapped up. Market performance will also be affected by just how hawkish the Fed will turn out to be relative to the current expectation of three rate hikes in 2022. In short, financial markets will have to stand on their own for the first time in five years, as there will likely be no incremental help from either monetary and/or fiscal stimulus.

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CENTURY-OLD MISCALCULATIONS

By most accounts, 1922 was an inconsequential year in the annal of history; things were generally on the mend as the world was recovering from the dark days of the Great War and the Spanish Flu. However, there were a few political decisions which sowed the seeds of immeasurable pain and suffering in the years and decades to come.

In 1922, Lenin's Red Army had won the civil war and annexed neighboring countries such as Ukraine and Georgia. The socialist state's power was concentrated in the hands of a troika consisting of Lenin, Trotsky, and Stalin. Lenin's health was deteriorating, and Trotsky was regarded as the heir presumptive. However, Stalin, a savvier political operator, exploited a philosophical rift between Lenin and Trotsky to have Lenin nominate him as the party's General Secretary. It turned out to be a monumental mistake by Lenin, as Stalin went on to leverage the position to gain control of the party apparatus and to eventually become the sociopathic dictator responsible for tens of millions of deaths.

Shortly after Stalin became the General Secretary in the spring of 1922, Lenin suffered a massive stroke that left him partially paralyzed. Lenin had to spend his remaining days at his Gorki dacha, and Stalin acted as his main conduit to the Sovnarkom, the country's highest executive authorities. By late 1922, Lenin had lost trust in Stalin and tried to re-elevate Trotsky. However, his health was failing rapidly, and Stalin had gained the support of the bureaucracy. Following Lenin's death in January 1924, Stalin maneuvered to become the supreme leader, exiled Trotsky, and later had him assassinated. From 1928 to his death in 1953, Stalin unleashed various campaigns of terror – the Great Purge and the Great Famine (the Holodomor) – and brutally subjugated much of Central and Eastern Europe after World War II. He also inspired a faithful disciple by the name of Mao Zedong, who went on to emulate Uncle Joe's failed political, social, and economic policies that led to tens of millions of unnecessary deaths in the Middle Kingdom.

1,800 miles away from Moscow, a political newcomer in Italy named Benito Mussolini was making a daring grab for power in the autumn of 1922. Mussolini was elected to the lower house of parliament for the first time just a year earlier. In that election, his National Fascist Party had won only 35 of the 535 seats, and the National Bloc, an alliance to which the Fascist Party belonged, came in third in popular votes (19.1%) and seats (105 out of 535).

The Fascisti had organized armed squads of disgruntled veterans called the Blackshirts who would engage in street violence in the name of restoring order. At the Fascist Congress in Naples on October 24th, Mussolini called on the Blackshirts to march on Rome in order to grab power from the "miserable ruling class". As this ragtag group of roughly 10,000 men armed with clubs and knives marched toward Rome, Prime Minister Luigi Facta proposed to declare martial law to stop them. It would not have been hard to disperse the marchers as a group of 400 lightly armed policemen had already halted the Blackshirts' movement, prompting Mussolini to consider fleeing the country. However, in a shocking turnabout, King Victor Emmanuel III refused to sign the declaration of emergency, which gave Facta no choice but to resign. On the advice of another former prime minister, the King summoned the 39-year-old Mussolini to the palace and appointed him prime minister.

Equity Markets Indices[1]	11/30/21 Price	12/31/21 Price	MTD Change	YTD Change
MSCI All Country World	727	755	3.9%	16.8%
S&P 500	4567	4766	4.4%	26.9%
MSCI EAFE	2224	2336	5.1%	8.8%
Russell 2000®[2]	2199	2245	2.1%	13.7%
NASDAQ	15538	15645	0.7%	21.4%
TOPIX	1928	1992	3.3%	10.4%
KOSPI	2839	2978	4.9%	3.6%
Emerging Markets	1212	1232	1.6%	-4.6%
Fixed Income				
2-Year US Treasury Note	0.57%	0.73%	17	61
10-Year US Treasury Note	1.45%	1.51%	6	60
Bloomberg US Agg Corp Sprd	0.99%	0.92%	-7	-4
Bloomberg US Corp HY Sprd	3.37%	2.83%	-54	-77
Currencies				
Chinese Renminbi (CNY/$)	6.36	6.36	-0.1%	-2.6%
Brazilian Real (Real)	5.62	5.58	-0.9%	7.3%
British Pound ($/GBP)	1.33	1.35	-1.7%	1.0%
Euro ($/Euro)	1.13	1.14	-0.3%	7.4%
Japanese Yen (Yen/$)	113.2	115.1	1.7%	11.5%
Korean Won (KRW/$)	1188	1189	0.1%	9.4%
U.S. Dollar Index (DXY)	95.99	95.67	-0.3%	6.4%
Commodities				
Gold	1775	1829	3.1%	-3.6%
Oil	66.2	77.0	16.3%	58.7%
Natural Gas, Henry Hub	4.57	3.73	-18.3%	46.9%
Copper (cents/lb)	428	446	4.3%	26.8%
CRB Index	219	232	6.0%	38.5%
Baltic Dry Index	3018	2217	-26.5%	62.3%

Source: Bloomberg

Mussolini's meteoric rise was initially welcomed by the elites – he restored law and order by crushing the socialist and anarchist movements, and the economy benefited from tax cuts and trade liberalization. These accomplishments led to a landslide electoral victory in 1924, which he used to further consolidate power to create a dictatorship. The Blackshirts

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intimidated and even assassinated opposition politicians while a tightly controlled media, led by *Il Popolo d'Italia* (*The People of Italy* newspaper), created a cult of personality around Mussolini. By 1925, he had dismantled Italy's democratic institutions and assumed the title Il Duce ("The Leader"). As time went on, the state assumed greater control in all aspects of society while Fascist propaganda railed against individualism.

While Mussolini's control and conquests never extended much beyond the shores of Italy and the Horn of Africa, he did inspire an even more ambitious individual who would later leverage the fascist model to take over much of Europe. In 1922, as a 33-year-old political novice who had become the head of a fringe regional party just a year earlier, Adolf Hitler was searching for a way to accelerate the rise of his Nazi Party. Impressed by Mussolini's "March on Rome", Hitler started to emulate Italian Fascism as a model for the Nazi Party and Germany. He even staged a "March on Rome" coup in Munich in late 1923, which landed him in prison for a year. By 1930, as Hitler's stature in German politics grew, Mussolini started advising this fascist disciple via correspondence. Hitler was so smitten that he even asked Il Duce for an autographed photo, to which Mussolini obliged in 1931. In time, however, the pupil would surpass the teacher, as the Führer ultimately became the doyen of fascism and turned Il Duce into a junior partner in war crimes. The rest, as they say, is history, which would have been very different had Lenin and King Emmanuel III not made those miscalculations.

AN ERA OF MISTRUST

Mark Twain once said, "History doesn't repeat itself, but it often rhymes." In many respects, the world at the start of 2022 is quite similar to 1922 despite the tremendous progress made over the century. After all, human nature remains constant regardless of technological advances. Technology can magnify the impact of human virtues and foibles but cannot alter them.

One notable similarity between today and a century ago is the elevated social and cultural tensions. Beneath the façade of the 1920's rapid economic growth and technological advances, there were deep fissures created by ideological differences – socialism, communism, and anarchism vs. the status quo – and clashes in cultural and social issues such as immigration, gender equality, sexual morality, etc. The Bolshevik Revolution and the rise of fascism were reflective of the widespread dissatisfaction and disillusionment with the establishment. Today, our social fabric has been frayed by issues from income inequality, wokeism, immigration, and alarmingly, an erosion of trust in the "expert class". While many of these issues have always existed, recent surveys have shown a rapid plunge in Americans' trust in various institutions, including our supposedly apolitical and meritocratic military. According to the Reagan National Defense Survey conducted in November 2021, the number of Americans who claim to have a great deal of trust and confidence in our military has fallen from 70% to 45% over a three-year span.

Prior to the pandemic, simmering discontent and misgivings among the less well-off toward the elite's orthodoxies – free trade, multilateralism, outsourcing, etc. – have already fueled populism at both ends of the political spectrum. COVID-19 accentuated the distrust as the establishment had to make up controversial policies – from lockdowns to vaccine mandates – without the benefit of prior experience or sufficient data. The draconian response to the crisis and the lack of transparency in decision making have troubled many neutral observers, not to mention those with a penchant for conspiracy theories. For instance, in response to a group of scientists' Freedom of Information Act request for data relating to the approval of Pfizer's COVID-19 vaccine, the FDA asked a judge to allow it to release the data over *75* years. How can such a response not raise a few eyebrows? It did not help that, instead of speaking truth to power, the media has by and large conducted themselves like Russia's *Pravda* and Mussolini's *Il Popolo d'Italia* in their zeal to promote the government's agenda and suppressed dissenting views. The so-called "fact checkers" were weaponized to silence discussions on subjects from the origin of the virus to vaccine side effects. I got a chuckle out of Twitter putting warning labels on tweets from the American Heart Association and even the CDC regarding the risk of vaccines.

THE OMICRON CATALYST

The Omicron variant may turn out to be a watershed event in this pandemic era. It has spread like wildfire and wreaked havoc on many people's holiday plans. While data has shown it to cause relatively mild symptoms, it still has the potential to overwhelm the healthcare system and cause elevated fatalities as even the flu has incurred an average of 34,000 fatalities per season during the last ten years (a range of 12,000 to 52,000 deaths per year). So far, most countries have avoided reimposing highly restrictive measures as politicians realize that people have so much fatigue with the pandemic that they might just push back against policies deemed disproportionate with a rather mild variant. With more fully vaccinated individuals being infected by the Omicron variant, some will start to question why authorities still demand ID and proof of vaccination for people to gain access to public venues or to work. What purpose does it serve other than providing a false sense of security that the vaccinated people around us are not contagious? I suspect the Omicron variant will trigger a groundswell of opposition against many governments' "medical absolutism" which could make it harder for the authorities to sustain unscientific restrictions. Imagine being a dog owner in Quebec where the government just banned dog walking between 10 pm and 5 am in order to slow the spread of COVID-19; that looks loony to me.

Another development with the Omicron variant is that people can now discuss the role of natural immunity without the risk of being "cancelled". It is possible that the Omicron variant can confer natural immunity against other SARS-CoV-2 variants

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such that the pandemic can transition into endemicity. South Africa, with roughly 60% to 80% of its population having had past infections, has decided to stop contact tracing, and no longer requires asymptomatic individuals to quarantine. It's also worth exploring how Sweden, which elected for a low-intervention and non-coercive approach to deal with the pandemic, managed to fare better than so many countries.

In short, while COVID-19 will likely create more disruptions this winter, the Omicron variant may catalyze the needed changes to finally bring "normalcy" back for good. Of course, this may just be wishful thinking on my part as the SARS-CoV-2 virus has proven to be highly mutative. However, hope springs eternal, especially at the start of a new year. I also believe it is what the market will likely assume until proven otherwise.

POLITICAL CALCULATIONS

One of the main political events in 2022 is the U.S. midterm election, and the consensus at this time is that Republicans will recapture the House and perhaps score a victory in the Senate as well. Regardless of the outcome, it will likely lead to an identity crisis and much soul searching within both parties.

Within the Grand Old Party, there is an internecine feud between the MAGA camp and the traditional pro-business, right-of-center politicians. The latter will need to finesse around new litmus tests such as their stance on the integrity of the 2020 presidential election and the January 6th Capitol riot. Both issues will likely be further magnified in 2024 should Trump decide to run again – the ex-President will not let go of the former as he seems convinced of election irregularities, and the latter could be used by his opponents to draw an analogy with the Fascists' "March on Rome." It will be difficult for leaders McCarthy and McConnell to craft an agenda for 2023 and 2024 other than blocking President Biden's initiatives and holding hearings on politically charged issues.

Depending on the scale of their likely defeat at the midterm election, House Democrats may need to reposition the party in the post-Pelosi era. Losses among moderate Democrats will likely make it more difficult for the new leader of House Democrats, presumably Hakeem Jeffries, to rein in their hard-left colleagues. Party faithful will be pondering on how they can reclaim the center and whether President Biden should seek a second term. I suppose the party will focus on women's votes by playing up their right to choose as well as Trump's brutishness.

Despite Senator Manchin's opposition to the existing Build Back Better bill, Democrats will likely get a scaled down version of it passed in early 2022. It's hard to see the Biden White House getting more legislative accomplishment after that. The next Congress will be even more ideologically polarized with political operatives liberally accusing their opponents of being "socialists" or "fascists." The White House will likely rely on executive orders and regulatory measures to implement its progressive agenda.

As for stock market performance in this midterm election year, history suggests higher volatility but not the start of a bear market. According to Dan Clifton, Head of Policy Research at Strategas Research Partners, midterm election years since 1962 have experienced larger market drawdowns – an average of 19% vs. 13% in other years of the presidential election cycle. However, these drawdowns have turned out to be buying opportunities as the market, as measured by the S&P 500 Index, was up from the midterm election year lows one year out every time since 1962.

THE GREAT POWER RIVALRY

There are three important elections among our allies in 2022 – the presidential elections in France and South Korea, and the Australian federal election. France's Macron looks well positioned at this time to be re-elected, but the outcomes of the other two elections are far from certain. Australia and South Korea are key allies in America's policy of containment toward China. Australian Prime Minister Scott Morrison has been a thorn in China's side as he was the first national leader to call for an investigation into the origin of COVID-19. South Korea is squeezed in the great power rivalry as it depends on the U.S. for security while China is its largest trading partner. It has refused to join our diplomatic boycott of the Beijing Winter Olympics. Washington's China policy could suffer a setback should a more pro-Chinese leader emerge in either of these countries.

On the topic of China, there is a behind-the-scenes game of thrones among various factions in the Chinese Communist Party (CCP). It's somewhat similar to what Lenin, Stalin, and Trotsky had engaged in a century ago. For years, the real power in China was held in the hands of former President Jiang Zemin and his loyalists. It was widely believed that Jiang had supported the appointment of Xi Jinping as the General Secretary because Xi's bland personality and lack of a power base would not pose a threat to Jiang's interests. However, Chairman Xi wound up waging an anti-corruption campaign that has effectively taken every CCP official hostage. It enabled Xi to significantly weaken his opponents and consolidate so much power to vie an unprecedented third term, which is to be officially ratified at the party congress this autumn. With the 95-year-old Jiang reportedly in poor health, it's hard to see how his faction could impede Xi's ascendancy to be the most powerful Chinese leader since Mao. However, Jiang's faction is unlikely to concede without putting up a good fight, as it is literally a matter of life and death for some of them. As such, Chairman Xi will likely roll out policies that ensure healthy economic growth and social stability in the run up to the party congress.

Once Xi becomes a leader for life, as a third term would imply, Chinese policies could take a further turn to the left. Free of the intra-party constraints that existed during his first two terms, Chairman Xi will be able to pursue his China Dream with abandon. One of his long-held goals is to retake Taiwan, which

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would have to be done by force as the Hong Kong model for Taiwan is no longer tenable. Most observers would view a military incursion as a high-risk move for China, but Xi is a man of great ambition and action, and he believes the unification will immortalize his standing for generations to come. In short, the West will likely have to deal with an even more aggressive China on the world stage, and it could make investment in China even riskier.

THE HAVENSTEIN SCHOOL OF CENTRAL BANKING

The art of central banking has progressed tremendously over the last 100 years. In early 1922, central bankers had yet to understand the linkage between money supply and inflation. Rudolf Havenstein, then a highly respected President of the Reichsbank, kept the discount rate at merely 5% and printed money like mad to meet government expenditures even though prices were starting to surge at more than 100% a year. By mid-1922, inflation in the Weimar Republic went parabolic, which set the stage for the republic's collapse and the rise of Adolf Hitler. On this side of the Atlantic Ocean, officials at the Federal Reserve, which came into existence only eight years earlier, were just discovering that its open market operations – the buying and selling of government securities – would influence interest rates and credit conditions. This realization led to the creation of the Open Market Investment Committee a year later, which eventually evolved into the Federal Open Market Committee (FOMC).

The Rudy Havenstein school of central banking has been enjoying a revival in the last few years. While most investors tend to focus on the massive scale of quantitative easing in the U.S., the title of the world's most prolific money printer should go to the European Central Bank (ECB). Year-to-date through October 2021, the increase in the ECB's securities held for monetary policy purposes has absorbed a whopping 93% of the net debt issuance by not only governments, but also private entities in the eurozone. The ECB is, in essence, monetizing not only public-sector borrowing but also most private bond issuance in the region. Madame Christine Lagarde, President of the ECB, has maintained an ultra-loose monetary policy in the face of eurozone inflation hitting 4.9%, the highest since records began in 1997. It's no wonder she is dubbed by some as "Madame Inflation" and that the euro has lost 7% to the U.S. dollar in 2021.

While President Lagarde still insists that inflation in the eurozone is transitory, her two most important peers, Andrew Bailey, the Governor of the Bank of England, and Fed Chair Powell, have started to hedge their bets. The Bank of England became the first major central bank to raise interest rates in the COVID-19 era. However, the 15-bps hike was a baby step compared to the usual 25-bps moves, and the BOE also made it clear that it expects inflation to fall back materially in the second half of 2022. Chair Powell showcased his famous dance move, the pivot turn, by moving from a dovish tapering announcement at the November FOMC meeting to doubling the pace of tapering at the December meeting. The Fed is now positioned to wrap up QE by mid-March, and its most recent dot plot showed three rate hikes this year.

BOND VIGILANTES' DISAPPEARING ACT

Despite the Fed's recent hawkishness and a 39-year high in inflation, the U.S. Treasury market has been sending a bearish signal with declining long-bond yields. Many bond investors view Chair Powell's hawkish pivot as a policy mistake, and some have even proclaimed that the 10-year Treasury yield has already peaked for this cycle at 1.74%, which took place on March 31, 2021. Their thesis is that the U.S. economy would weaken materially as the effect of stimulus wanes, and the Fed's tightening in such an environment will roil financial markets, pull forward the next recession, and unleash deflationary forces. They also argue that China's troubled property market and recent growth challenges are harbingers of weaker global growth.

These arguments have some merit as they basically paint a picture of how most U.S. business cycles have ended historically. Between the end of WWII and the pandemic, the U.S. has had seven episodes of elevated inflation – by that I mean at least three readings of CPI above 5% within a year. Six of those instances ended with recession, as elevated inflation would prompt the Fed to tighten, which ultimately choked off economic expansion. The only exception was the inflation episode triggered by the Korean War. From the onset of the war in June 1950 to January 1951, U.S. inflation surged to an annualized pace of 11% as consumers spending rose sharply in anticipation of possible war-time shortages. The government reacted with price and wage controls, which successfully brought inflation down without damaging the economy.

Notwithstanding the historical precedents of tightening-induced recession, I still find long bond yields to be unjustifiably low at this point in the business cycle (the 10 and 30-year Treasury yields closed out 2021 at 1.51% and 1.90%, respectively). While there will eventually be a recession, which is stating the obvious, the timing is uncertain, and so is the level of inflation by that time. It remains to be seen if the Fed is really committed to an aggressive tightening campaign knowing that it could choke off economic expansion. Will Chair Powell blink again and slow the pace of tightening if the stock market throws a tantrum in the form of a double-digit correction like it did in the fourth quarter of 2018? My gut feel is yes.

Another complicating factor with long bond yields is the impact of COVID-19. The 10-year Treasury yield had dropped from 1.66% two days before Thanksgiving 2021 to 1.47% on Black Friday, when investors were spooked by the Omicron news out of South Africa. The collapse in long bond yields took place *before* Chair Powell surprised the market with his latest hawkish pivot. In the final days of 2021, the 10-year Treasury yield has climbed above 1.5% from the early December low of 1.34% as the news about Omicron became less threatening.

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With the Fed set to wrap up QE soon, I expect long bond yields to move higher as we get past the Omicron wave. Ironically, if bond investors are successful in keeping long bond yields artificially low out of their fear of a more imminent recession, it may extend the length of the economic expansion as low yields would put a lid on financing rates and keep financial conditions loose. I would be more worried about the business cycle should the 10-year yield suddenly gallop to 2.5%, which would materially tighten financial conditions.

A YEAR OF TRANSITIONS

2022 is shaping up to be a period of transition on many fronts. On the positive side, the highly transmissible but less severe Omicron variant might just confer natural immunity on so many people worldwide that we can finally get past the pandemic. On the public policy front, waning fiscal stimulus and tightening monetary policy in the U.S. will likely put financial markets to the test. They will likely result in higher market volatility – potentially a double-digit correction – and lower valuations. However, U.S. corporations, having dodged the tax hike bullet, are in a strong financial position and may increase share repurchases. On the political front, the U.S. midterm election is likely to be the Democrats' Waterloo. While market bears will point to the end of the fiscal gravy train as a blow to the market, bulls will emphasize that investors have historically preferred gridlock in Washington.

Another important transition is in China – will Chairman Xi be anointed leader-for-life and what will be the composition of the next politburo? Xi's crackdown on sectors from technology to real estate has made Chinese equities big laggards in 2021. As he seeks to stabilize the economy in the lead up to the party congress in late 2022, he may temporarily take his foot off the throats of some of these industries. Indeed, the People's Bank of China appears to be embarking on an easing campaign, and China's credit impulse, after eight straight months of decline, has shown a bit of stabilization in November 2021. Should the credit impulse start to improve steadily, it would signal a more supportive investment environment for China and emerging markets in 2022.

In the final analysis, with multiple transitions underway in 2022, financial markets are likely to experience higher-than-usual volatility. For the first time in years, financial markets will have to stand on their own without the benefit of fiscal or monetary largess. As Warren Buffett has said, "Only when the tide goes out do you discover who's been swimming naked." I suppose many investments will likely be put to the test this year as the tide of liquidity recedes.

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