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BOOK REVIEW

Robert D. Arnott, Jason C. Hsu, John M. West: The Fundamental Index—A Better Way to Invest

Wiley, 2008

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In *The Fundamental Index*, the leading industry thinker, Rob Arnott and his colleagues, present a new indexing method that captures more return for equity investors. They essentially argue that a portfolio whose holdings are proportional to a suitable measure of the efficiency of a firm will outperform one whose holdings are proportional to the market value or capitalization of the firm. In other words, an "efficiency-weighted" portfolio will outperform a "capitalization-weighted" portfolio. In this important new book, the authors explain how passive, market-capitalization-weighted index investing falls short and fails to serve investors by investing too much in overpriced stocks and too little in underpriced shares. In short, Arnott et al.'s innovative and straightforward strategy provides investors with a new tool for achieving excess returns in a projected low-return environment while preserving the many positive attributes of index fund investing. The book fills a gap in the literature by presenting the new idea of fundamental indexing for academics and for practitioners who have some knowledge of passive portfolio theory.

The book is divided into 14 chapters. Chapters 1 and 2 provide the foundation for the fundamental index concept. The efficient market hypothesis is challenged and the authors convincingly state that price does not equal fair value. In Chap. 1, they find empirical evidence that in a world with pricing errors, a cap-weighted index will suffer a return drag by systematically overweighting overpriced securities and underweighting underpriced securities relative to their "eventual intrinsic value weight." In Chap. 2, Arnott, Hsu, and West define the RAFI (Research Affiliates Fundamental Index) as a price-indifferent index built on the intuitions of their research. To mitigate the undesirable characteristics of single-metric indexes, RAFI combines four individual "fundamental index" constructs—sales, cash flow, book value, and dividends—to

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measure economic size, thus creating a multiple-metric index. The authors further show that a portfolio of companies constructed using this approach will accurately represent today's economy with complete neutrality, favoring neither growth nor value companies, relative to their economic scale, and paying no regard to valuation multiples or price. Other advantages of this portfolio are outlined in subsequent chapters. Chapter 3 discusses the alpha approach, which is the value added from investor skill. In contrast to most market participants, who are intent on identifying positive alphas, the authors focus on identifying and eliminating negative alphas by way of an equally weighted portfolio of a wide array of dissimilar markets, including, for example, real estate investment trusts (REITs), commodities, emerging-market bonds, and US Treasury Inflation-Protected Securities (TIPS).

Chapter 4 is devoted to the advantages of index funds and why this simple investment strategy has become such a valuable tool for investors. To illustrate its many benefits, the authors compare the index fund with its primary competition, the legions of actively managed funds. In short, the authors see the fundamental index concept as a sensible evolution in equity indexing. The main advantages of fundamental index funds involve the cost comparison, liquidity and immense investment capacity, diversification and representation of the broad market, low turnover and low taxes on realized gains, and ease of implementation and monitoring.

Chapter 5 defines a well-functioning index as one that is representative, replicable, transparent, rules-based, and with low turnover. Chapter 6 shows that if one ignores prices in building a passive portfolio, by using equal weights or fundamental measures of company size, the resulting nonprice-based portfolio will outpace traditional capitalization-weighted index funds on average over time. Building on the definition of Chap. 5, the first step in creating a fundamental index portfolio is to choose a set of simple and widely available nonprice-based measures of company size that can then be used to create a broadly representative, high-liquidity, high-capacity, low-turnover index. Ultimately, for the RAFI methodology, the authors select a composite approach that uses equally weighted measures of four size factors: sales, cash flow, book value, and dividends paid. Under this approach, a company's size is determined by averaging the weights of the four size metrics.

Chapter 7 empirically investigates fundamental index performance in US stocks. The authors' research shows that fundamental index portfolios outperform cap-weighted alternatives over long spans of time in the vast majority of markets. This finding is consistent with their core hypothesis: Excess return can be achieved by breaking the link between the price of a stock and its weight in the portfolio, thereby eliminating the return drag of price or capitalization weighting. Chapter 8 extends the analysis of Chap. 7 to global markets and provides evidence on how well the fundamental index strategy performs in 22 countries. The robust results achieved through the extension of the fundamental index concept to global markets underscore the negative alpha of capitalization weighting that, consistent with their hypothesis, prevails in nearly all markets. Chapter 9 builds a bridge between theory and empirical tests by validation of cap weighting by theory.

The fundamental index concept is not without its critics, of course. Critiques contend, for example, that the fundamental index strategy derives its benefit from a value tilt, that the RAFI concept does not create economically significant alpha, it just takes

on more value and small-cap risk, that the authors are data mining, that the strategy is costly, that the index is not an index, that no one knows ex ante which stock are overvalued, and, finally, that even if the strategy works, unexplained excess returns will disappear as others implement the strategy. The authors deal with each of these criticisms in Chaps. 10 and 11.

In Chaps. 12 and 13, the authors lay out a philosophical groundwork for the fundamental index concept. They follow this with a few more analytically oriented points to illustrate why they think the future efficacy of the fundamental index concept will differ little from what it has demonstrated in the past. The authors state that the capital markets will never become clear-sighted; they will never be able to correctly price all assets. To improve returns in a low-return world, they propose that prudent investors can turn to the fundamental concept, which rebalances equity portfolios and eliminates the return-chasing behavior of a cap-weighted index. In the final Chap. 14, Arnott et al. outline investment management solutions that draw on the strengths of the fundamental index concept. They examine how the strategy can affect asset allocation and risk management choices, and they explore the question of performance measurement, or benchmarking. They then outline unique considerations in applying the fundamental index concept to various categories of investors.

The book includes an appendix that provides a standard summary presentation of research results presented throughout the book. Each application includes a standardized performance table, a calendar-year performance table, and a 5-year rolling return scatter plot, all of which illustrate how the fundamental index compares to the cap-weighted index.

The Fundamental Index is a very accessible textbook that offers complete coverage of the fundamental index concept. The book's many anecdotes and economic and historical examples make it entertaining to read; however, sometimes the thematic connection between chapters is not immediately clear. I would recommend the book to all academics and practitioners who are interested in the new way of passive indexing, with the caveat that a basic understanding of portfolio theory and asset pricing will be of benefit in getting the most out of the text.