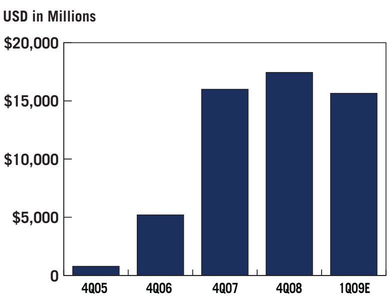
Fundamental Index® Newsletter · May 2009

rafi® fundamentals

Robert D. Arnott

RAFI® Managed Assets*



*Includes RAFI assets managed or sub-advised by Research Affiliates® or RAFI licensees.

research® affiliates
620 newport center drive, suite 900
newport beach, ca 92660 usa
phone +1 (949) 325-8700
fax +1 (949) 554-0192
info@rallc.com
www.rallc.com

MEDIA CONTACT
Tucker Hewes
Hewes Communications
+1 (212) 207-9451
tucker@hewescomm.com

THE GREAT CONTRA-TRADE

At its heart, rebalancing is a simple contrarian strategy. In ebullient times, this means taking money away from our biggest winners. In the worst of times, the process forces us to buy more of the assets that have caused us the greatest pain. Most investors acknowledge it as a critical part of the successful investor's toolkit. But recognition and action are two different things. Surrounded by bad news, pulling the trigger to buy securities down 50%, 75%, or even 90% is exceedingly difficult for even the staunchest of rebalancers. Many lose their nerve and blink, letting a healthy portion of the excess returns slip from their grasp.

Most investors focus some attention on rebalancing between asset classes, but not *within* asset classes. The Fundamental Index® strategy affects this uncomfortable, yet profitable, exercise within the stock market. Anchoring on company financial size, it annually rebalances stocks that have experienced the greatest price movements relative to their fundamentals. The past 15 months have been a frightful period challenging the efficacy of global Fundamental Index applications as they gravitated toward some of the sectors and stocks most afflicted by the financial crisis. Although it took a while, contra-trading against the markets fears finally paid off in recent weeks with remarkable outperformance of global Fundamental Index applications.

As we lamented in January 2009, 2008 wasn't much of a year for value investors, running contrary to most bear markets in which growth stocks lead the way downward. The beginning of 2009 was even worse with the Russell 1000 Value posting a –16.8% return, nearly 1,300 bps off of the Russell 1000 Growth's –4.1% in the year's first three months. It was the second worst relative quarter ever for the Russell 1000 Value, eclipsed only by the tech bubble induced fourth quarter of 1999. As value stocks were punished in the first quarter, their representation in the capitalization-weighted indexes shrank and shrank. The FTSE RAFI® series, meanwhile, conducted its annual rebalance at the end of March and bought whatever had decreased more in price than fundamental size. That translated into a huge purchase of financials, consumer discretionary stocks, and industrials, widening the overweights to these deep value sectors in many RAFI applications.[1]

Many observers credit the value tilt of RAFI strategies as the source of its long-term historical success. The reality is more subtle. The main source of value-added is not the average value tilt of the RAFI portfolios, but its dynamic contra-trading against the most extreme market bets. *Value stocks got cheaper and cheaper and—as a direct consequence—our value tilt got larger and larger.* These dynamic style tilts are primarily the result of contra-trading against the market's constantly shifting expectations, fads, bubbles, and crashes.

Where did the huge rebalance into large companies at rock bottom prices lead us at the end of March? As shown in **Table 1**, virtually all RAFI strategies showed tremendous tilts toward value as measured by relative

continued on page two

valuation multiples. The discounts in all areas (U.S. Large, U.S. Small, International Large, International Small, Emerging Markets, and All World) were the largest since the top of the bubble in 2000 for price/book, and the largest on record for price/sales. (The discounts on the dividend yield measures are more equivocal, because so many deep value companies have cut or eliminated their dividends.)

Table 1. RAFI Portfolio Discounts as of March 31, 2009

Portfolio	Price/Sales	Price/Book	Dividend Yield
FTSE RAFI US 1000	0.22	0.88	2.9%
Russell 1000	0.74	1.57	2.7%
RAFI Discount	**-70%**	**-44%**	**-5%**
FTSE RAFI US MS 1500	0.14	0.61	2.2%
Russell 2000 Index	0.55	1.11	1.9%
RAFI Discount	**-75%**	**-45%**	**-12%**
FTSE RAFI Developed ex US 1000	0.27	0.73	5.6%
FTSE AW Developed ex US 1000	0.55	1.12	4.4%
RAFI Discount	**-51%**	**-35%**	**-20%**
FTSE RAFI Developed ex US MS 1500	0.23	0.63	5.1%
FTSE AW Developed ex US 1500	0.39	0.89	4%
RAFI Discount	**-41%**	**-29%**	**-25%**
FTE RAFI All World 3000	0.25	0.80	4.3%
FTSE All World Index	0.64	1.33	3.6%
RAFI Discount	-61%	-40%	-17%
FTSE RAFI Emerging Markets	0.32	1.08	3.5%
FTSE AW All Emerging	0.65	1.46	3.5%
RAFI Discount	**-51%**	**-27%**	**-2%**

Source: Research Affiliates.

Unquestionably, the relative cheapness of the RAFI portfolio at the end of the first quarter was driven by large exposures to the unwanted and left-for-dead deep value companies. *But any asset is attractive at some price.* That price appears to have been reached near the end of March judging by recent performance. RAFI portfolios soared in April in absolute terms and especially relative to the cap-weighted alternatives. April was the best month *ever* for FTSE RAFI US 1000 relative to both the S&P 500 Index (9.33% excess return) and the Russell 1000 Value (8.18% excess return.) In fact, the U.S. large company segment was hardly alone as many FTSE RAFI portfolios had their best month ever as evidenced in **Table 2**. It's shocking to note that this result was achieved merely by reweighting the deeply loathed segments of the market back up to their economic scale, based on long-term sales, profits, dividends and current book values. These indexes include the growth stocks, at their full economic weight, not just deep value.

After the stellar results of April, the performance of RAFI indexes is now at or ahead of capitalization weighting for the month, the year-to-date, and the past 12 months. Extending the comparison to three years, seven of the nine RAFI applications show value add. For those that claim the Fundamental Index strategy is repackaged, backtested value investing, the FTSE RAFI All World 3000 Index has achieved excess returns of 2.9% above the MSCI All Country World Index since the beginning of 2005, when our methodology was already established and about to be published. But, it achieved an even larger 3.1% per annum excess return above the MSCI All Country World *Value* Index. Value *underperformed* over these 4 ¼ years, but RAFI portfolios prevailed handsomely and globally.

It feels like something of a vindication for an idea that was drawing increasing heat.[2] How did a concept go from goat to hero so fast? By simply following its annual rebalance of each stock to the company's long-term fundamental scale in the economy, the RAFI strategy *automatically* contra-traded against the greatest fear driven market of our lifetimes. On the flip side, what did the cap-weighted indexes reflect? Because their weights drift with price, they had next to nothing remaining in the left-for-dead financials and cyclicals that led the recent market rally.

Rebalancing isn't always a profitable activity. Ask any fiduciary that rebalanced *away* from stocks in the 1980s and 1990s or *into* stocks during the two extended bear markets of this decade. But it does pay off over longer periods. The same goes for rebalancing, for contra-trading, *within* the equity markets. What we've lacked in the past was a sensible anchor for rebalancing within the stock market. Equal weighting worked—the S&P Equally Weighted Index (SPEWI) has beat the S&P 500 consisting of the self-same companies by over 1.6% per year since the

Table 2. Quite a Month!

Asset Class	RAFI Index	Cap-Weighted Index	April Excess Return	Comparison Start Date	Monthly Rank
All World	FTSE RAFI All World 3000	MSCI All Country World	8.23%	2000	Best
Large Company US	FTSE RAFI US 1000	Russell 1000	8.78%	1979	Best
Small Company US	FTSE RAFI US 1500	Russell 2000	11.91%	1979	Best
Global ex US Large	FTSE RAFI Global Ex US 1000	MSCI EAFE	8.12%	1994	Best
Global ex US Small	FTSE RAFI Developed Mid Small Index (price return)	MSCI EAFE Small (price)	7.81%	2000	Best
Emerging Markets	FTSE RAFI Emerging Markets	MSCI Emerging Markets	3.57%	2000	4th Best

Source: Research Affiliates.

SPEWI was launched in 1990. But, equal weighting has no economically meaningful foundation for the chosen weight. The RAFI strategy uses the fundamental economic footprint that a company occupies within the broad economy as an anchor for rebalancing. That is, its main profit engine, not it's preference for value stocks per se.

Racing to short-term conclusions, whether pro (April 2009) or con (2008 and first quarter 2009), on a long-term strategy is foolish. Frightful times require rigorous discipline and the long view, both of which are inherent in the Fundamental Index concept.

Endnotes

1. As an example, the FTSE RAFI US 1000 added 10% to financials, 2% to industrials, and 1% to consumer discretionary while subtracting from defensive sectors like consumer staples (–4%), health care (–4%), and utilities (–3%).
2. Evan Hessel, "Can You Out-Index The S&P," April 27, 2009, Forbes. http://www.forbes.com/forbes/2009/0427/050-finance-can-you-out-index-standard-poor.html

Performance Update

TOTAL RETURN AS OF 4/30/09	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	2.37%	-35.10%	-10.84%	-1.74%	1.55%	17.04%
S&P 500[B]	SPTR	-2.49%	-35.31%	-10.76%	-2.70%	-2.48%	16.05%
Russell 1000[C]	RU10INTR	-1.39%	-35.30%	-10.76%	-2.32%	-2.03%	16.28%
FTSE RAFI® US 1500 Index[D]	FR15USTR	7.70%	-29.81%	-11.41%	0.10%	7.90%	21.55%
Russell 2000[E]	RU20INTR	-1.81%	-30.74%	-12.72%	-1.45%	2.53%	21.43%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	3.06%	-39.78%	-9.50%	3.38%	4.16%	18.29%
MSCI EAFE[G]	GDDUEAFE	-2.68%	-42.42%	-11.91%	1.12%	0.36%	17.52%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-1.37%	-42.14%	-11.02%	2.05%	1.26%	17.68%
FTSE RAFI® Developed ex US Mid Small[I]	FRSDXUS	5.48%	-36.34%	-12.49%	1.55%	NA	NA
MSCI EAFE Small[J]	MCUDEAFE	3.18%	-43.95%	-18.40%	-1.77%	NA	NA
FTSE RAFI® Emerging Markets[K]	TFREMU	20.39%	-37.29%	0.70%	18.05%	NA	NA
MSCI Emerging Markets[L]	GDUEEGF	17.85%	-42.71%	-5.23%	11.46%	NA	NA
FTSE RAFI® Canada[M]	FRCANTR	9.15%	-24.42%	-3.69%	5.94%	NA	NA
S&P/TSX 60[N]	TX60AR	5.63%	-29.36%	-3.89%	6.74%	NA	NA
FTSE RAFI® Australia Index[O]	FRAUSTR	6.13%	-23.35%	-3.93%	7.09%	7.73%	12.17%
S&P/ASX 200 Index[P]	ASA51	3.48%	-28.82%	-6.35%	6.71%	6.46%	13.02%
FTSE RAFI® Japan[Q]	FRJPNTR	2.51%	-34.29%	-16.79%	-2.54%	NA	NA
MSCI Japan[R]	GDDLJN	-0.73%	-38.32%	-19.69%	-4.66%	NA	NA
FTSE RAFI® UK Index[S]	FRGBRTR	3.55%	-24.29%	-7.04%	3.73%	NA	NA
MSCI UK[T]	GDDUUK	-2.41%	-27.09%	-7.67%	2.27%	NA	NA

Definition of Indices: (A) The FTSE RAFI® 1000 comprises the 1000 largest companies selected and weighted using our Fundamental Index methodology; (B) The S&P 500 Index is an unmanaged market index that focuses on the large-cap segment of the U.S. equities market; (C) The Russell 1000 Index is a market-capitalization-weighted benchmark index made up of the 1,000 highest-ranking U.S. stocks in the Russell 3000; (D) The FTSE RAFI® 1500 comprises the 1001st to 1500th largest companies selected and weighted using our Fundamental Index methodology; (E) The Russell 2000 is a market-capitalization weighted benchmark index made up of the 2,000 smallest U.S. companies in the Russell 3000; (F) The FTSE RAFI® Developed ex US 1000 Index comprises the largest 1000 non US-listed companies by fundamental value, selected from the constituents of the FTSE Developed ex US Index; (G) MSCI EAFE (Morgan Stanley Capital International Europe, Australasia, Far East) is an unmanaged index of issuers in countries of Europe, Australia, and the Far East represented in U.S. dollars; and (H) The FTSE All World ex-US Index comprises Large and Mid-Cap stocks providing coverage of Developed and Emerging Markets excluding the United States. It is not possible to invest directly in any of the indexes above; (I) The FTSE RAFI® Developed ex US Mid Small Index tracks the performance of small- and mid-cap equities of companies domiciled in developed international markets (excluding the United States), selected based on the following four fundamental measures of firm size: book value, cash flow, sales, and dividends. The equities with the highest fundamental strength are weighted according to their fundamental scores. The Fundamentals Weighted® portfolio is rebalanced and reconstituted annually. Performance represents price return only; (J) The MSCI EAFE Small Cap Index targets 40% of the eligible small-cap universe (companies with market capitalization ranging from US$200 to US$1,500 million) in each industry group of each country in the MSCI EAFI Index; (K) The FTSE RAFI® Emerging Markets Index comprises the largest 350 companies selected and weighted using the Fundamental Index® methodology; (L) The MSCI Emerging Markets Index is an unmanaged, free-float-adjusted cap-weighted index designed to measure equity market performance of emerging markets; (M) The FTSE RAFI® Canada Index comprises the Canadian stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (N) The S&P/Toronto Stock Exchange (TSX) 60 is a cap-weighted index consisting of 60 of the largest and most liquid (heavily traded) stocks listed on the TSX, usually domestic or multinational industry leaders; (O) The FTSE RAFI® Australia Index comprises the Australian stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (P) The S&P/ASX 200 Index, representing approximately 78% of the Australian equity market, is a free-float-adjusted, cap-weighted index; (Q) The FTSE RAFI® Japan Index comprises the Japanese stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (R) The MSCI Japan Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the Japanese equity market; (S) The FTSE RAFI® UK Index comprises the U.K. stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (T) The MSCI UK Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the British equity market

Source: All index returns are calculated using Total Return data from Bloomberg except for the FTSE RAFI Developed ex US Mid Small (FRSDXUS) and the MSCI EAFE Small (MCUDEAFE) which uses price return data.

powered by rafi®