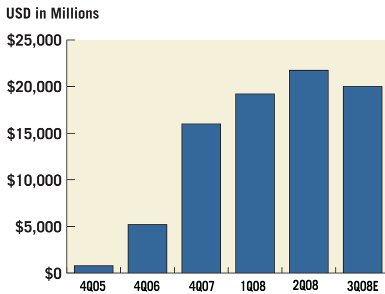
Fundamental Index® Newsletter · November 2008

rafi® fundamentals

RAFI® Managed Assets*



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

EMERGING MARKETS—RIPE FOR A (FUNDAMENTAL) RECOVERY

Emerging market equities have been savaged in the bear market of 2008 as the financial crisis has morphed into a nearly certain global economic slowdown. But with the category's "half-off sale" comes a potentially rewarding entry point for long-term investors willing to cope with high interim volatility. In this issue, we follow up April's article "Indexing in Inefficient Markets" by discussing further the application of the Fundamental Index® concept in emerging market stocks and how it compares with the performance of active management.

Even for this asset class with its mind-numbing declines in the past, the last few months for emerging market equities have been horrific. **Table 1** shows the history of drawdowns of more than 20% for the MSCI Emerging Markets Index (EMI). The data confirm that the recent stretch is the worst since the inception of the index in January 1988. But all of this pain does have a bright side. The asset class, for the first time in years, is offering attractive forward looking risk premiums. This is especially true when you add the historical excess return of the Fundamental Index concept, as we will see in a moment.

As of October 31, 2008, the FTSE All-World Emerging Index[1] had a P/E of 9.1, a 28% discount to the S&P 500 Index's ratio of 12.8. The dividend yield stood at 4.1% versus 2.8% for the S&P 500. Thus, the asset class is cheap on both absolute terms and in relation to U.S. equities.

Given recent performance, should investors abandon emerging market stocks today? We think not. As we have previously illustrated, long-term returns come from three distinct sources—income, growth in income, and change in valuation. Because economic growth rates are projected to be higher in the developing than in the developed world, it is reasonable to expect emerging market companies to experience higher earnings growth than the stocks of developed countries. Taking a five-year to ten-year secular view, we think long-term emerging market growth will be around 8%. Adding our 4% yield to 8% long-term earnings growth nets a 12% compound return for emerging markets, and it could be much more if P/Es rise from current levels. Although the pain has been dreadful, the asset class does offer opportunities for significant long-term capital appreciation from current levels.

The follow-on question is how best to implement an emerging market allocation. One can logically categorize emerging markets as inefficient because of the high level of "noise"—contagions, defaults, political crises, and bubbles—in developing countries' markets. These factors combine to produce an array of prices far removed from the eventual so-called fair value of emerging market companies. Conventional wisdom has been to use active management in the more inefficient markets on the basis of the belief that the ability to pick individual stocks—that is, the ability to invest in the winners and avoid the losers—will lead to better results compared to indexing. Mutual fund

[1]We apologize for referencing different emerging markets indexes. We selected the MSCI because of its longer track record for performance purposes but have used the FTSE All-World Emerging Index for asset-class characteristics because of the availability of recent data for it. Both indexes adequately represent the opportunity set.

Table 1. MSCI Emerging Markets: Drawdowns of More Than 20%

Peak Date	Trough Date	Decline (%)	Decline Duration (months)
July 1990	November 1990	–29.21	4
September 1994	February 1995	–25.46	5
July 1997	August 1998	–55.98	13
October 2007	October 2008	–56.22	12

Source: Research Affiliates.

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managers have done a poor job, however, of capitalizing on the inefficiencies. The EMI has outperformed the median mutual fund in Lipper's Emerging Markets Equity universe by 1.0 percentage point over the 10 years ended September 30, 2008.[2]

In the April edition of *RAFI Fundamentals*, we described how the RAFI Emerging Markets Index adds value on the order of 10 percentage points a year above the return of capitalization-weighted indexes. This added value is well beyond the excess returns to be found in developed market applications. Why the disparity? Recall the key driver in the Fundamental Index concept—namely, breaking the link between price and portfolio weight. By breaking this link, a Fundamental Index portfolio can avoid the return drag created by the propensity of cap-weighted indexes to overweight the overpriced stocks and underweight the underpriced stocks. Emerging markets, with their boom-and-bust cycles, suffer massive mispricings, leading cap-weighted indexes toward large positions in overpriced stocks and much smaller positions in underpriced stocks. The result is a considerable return drag.

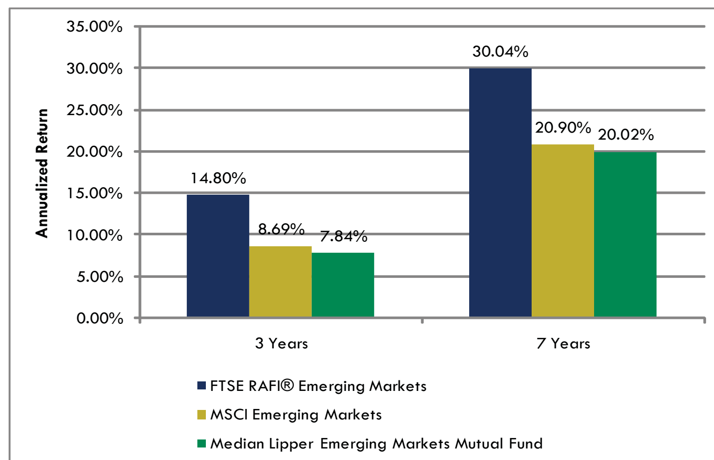
The drag is curable by using a non-cap-weighted index. **Figure 1** compares the returns for the median emerging market mutual fund, the cap-weighted EMI return, and the RAFI Emerging Markets Index return for a trailing seven years and more recent three-year stretch that fell after the publication of the Fundamental Index concept (to limit the backtest bias).[3] The results are striking: The RAFI index dominates both active managers and the cap-weighted index.

Half-off sales at the mall are greeted with glee by cost conscious shoppers. The truly magnificent sales—those offering high-quality merchandise at bargain basement prices—often produce lines stretching around the block. But in the capital markets, clearance prices are greeted by many with disdain. There may be lines from around the capital-market block, but they are to sell, not to buy! The savvy investor, however, takes a long-term view and gathers bargains, such as today's emerging market stocks, and inserts them into a well-diversified portfolio consistent with the investor's time horizon and risk tolerance. Nevertheless, the investor would do well to check the label on the resulting emerging market equity portfolio. We believe those powered by the RAFI concept will maximize this unique opportunity.

[2]Source: eVestment Alliance.

[3]Arnott, Robert D., Jason Hsu, and Philip Moore. (2005). "Fundamental Indexation." Financial Analysts Journal, vol. 61, no. 2, March/April: 83–99.

Figure 1. Emerging Market Return Comparison Periods Ended September 30, 2008



Source: Research Affiliates

Performance Update

TOTAL RETURN AS OF 10/31/08	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	-35.50%	-39.19%	-6.27%	0.85%	3.88%	14.96%
S&P 500[B]	SPTR	-32.84%	-36.10%	-5.21%	0.26%	0.40%	15.15%
Russell 1000[C]	RU10INTR	-33.55%	-36.80%	-5.51%	0.37%	0.75%	15.39%
FTSE RAFI® US 1500 Index[D]	FR15USTR	-32.82%	-37.82%	-6.04%	2.35%	9.36%	18.80%
Russell 2000[E]	RU20INTR	-29.02%	-34.16%	-4.79%	1.57%	4.90%	20.05%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	-43.65%	-46.73%	-3.81%	5.17%	5.89%	16.36%
MSCI EAFE[G]	GDDUEAFE	-43.25%	-46.34%	-4.83%	4.04%	2.05%	16.34%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-43.31%	-46.44%	-4.14%	4.63%	2.95%	16.55%

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.

Note: In November 2008 performance returns for all prior periods were restated to reflect a change in calculation methodology from using a 365 day period to annualize returns to a return calculation based on using monthly returns as of the last business day of each month to create a geometric return for each period.

Source: Based on price data from Bloomberg.

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