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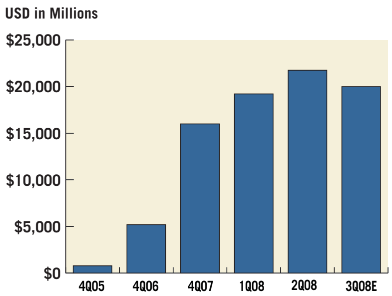
rafi® fundamentals

RAFI® Managed Assets*



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PATIENCE HELPS IN LOW-RETURN WORLD

Global tactical asset allocation (GTAA) is confused by many investors with market timing. Market timing, shunned by nearly all individual investors and many institutions, involves picking market tops and bottoms and, based on that information, making dramatic short-term shifts in asset-class exposures. Needless to say, the successful market timer must have remarkable clairvoyance. The variables that can heavily influence market returns over the short term—that is, a day, a week, a month, even a year—are practically limitless. And when the market timer is wrong, any performance advantage, especially in relation to peers and benchmarks, quickly evaporates.

GTAA is different: It involves seeking to bear risk when risk is likely to be rewarded but moving to a conservative, diversified posture when it is not. Today, despite a sharp sell-off in many risky assets during the past year, the pendulum in the market remains on the risk side, not on the return side. In the last bear market, many investors thought they saw wonderful opportunities a year too early, in 2001, but significant return opportunities did not abound until late 2002. Today, patience is the key to eventually reaping meaningful profits.

The Research Affiliates GTAA process begins with building a long-term forecast that anchors portfolio allocations amid the short-term noise of the markets. These projections start with the simple premise that asset-class returns come from three distinct sources: income, growth in income, and changes in valuations.

The first source, income, is obviously the largest driver of bond returns. But many investors are surprised to learn that since 1926, income from dividends has also been the largest contributor to stock returns—and the dominant source of real equity returns net of inflation.[1]

For bonds, with income "fixed," growth in income is, by definition, zero. Indeed, it is actually negative for most bond categories because occasional defaults inevitably take a bite out of the higher coupons. Equities, however, have positive expected income growth; that is, earnings that fund dividends grow along with the real economy. The rate of income growth, positive or negative, depends greatly on the economic and market environment, but the growth rate tends to revert back to a long-term average over time.

Finally, changes in valuations occur because investors may pay more or less for an asset class in 5 or 10 years. Changes in valuations over the short-term (up to a few years) are the most volatile and difficult to predict, and they can be the dominant source of positive or negative returns. But for spans of a decade or more, this component of returns diminishes in significance.

Because income and dividends comprise the lion's share of long-term asset-class returns, let's examine these elements in today's market. **Table 1** provides yields for eight asset classes as of July 2008 and March 2002.[2] Across the board, bond and alternative categories offered much more competitive yields in 2002 than they do today. Only U.S. equities offer a yield premium (2.3% versus 1.4%), but one could argue that this premium is hardly a bullish figure because today's current yield is virtually half of the long-term 4.4% contribution of dividends to stock market returns.[3]

We have combined these asset classes into efficient frontiers of portfolio choices in **Figure 1** to reflect the overall

[1]Ibbotson, Roger G., and Peng Chen. 2003. "Long-Run Stock Returns: Participating in the Real Economy." *Financial Analysts Journal*, vol. 59, no. 1 (January/February):88–98.

[2]We selected March 2002 because the S&P 500 Stock Index declined cumulatively by 21.5% from its March 2000 peak through March 2002, which is virtually identical to the 21.9% sell-off the market experienced from November 2007 through July 2008. Of course, the S&P 500 continued to fall in 2002 and into early 2003, so much so that March 2002 served only as the halfway point of that bear market.

[3]Indeed, today's dividend figure may be artificially high because of the contribution of financial institutions over the last year. On a going-forward basis, this significant sector is likely to see dividend cuts. Similarly, the 2002 figure was biased down by the still hefty presence of the technology sector, with its essentially zero dividend yield.

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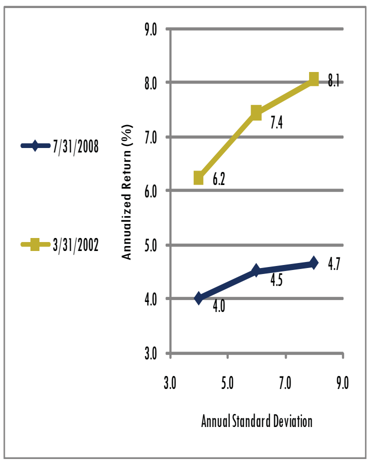
Table 1. Yields During Last Two Bear Markets

Index	3/31/2002	7/31/2008
Lehman Long U.S. Treasury	5.95%	4.52%
Lehman U.S. Aggregate	5.92	5.14
Lehman U.S. Long Corporate	7.72	7.19
Merrill Lynch High Yield Master II	12.05	11.35
Merrill Lynch Global Emerging Markets Sovereign Plus	9.73	6.96
NAREIT Total Yield	6.73	5.81
JPMorgan U.S. TIPS (10+ year)	3.47	2.15
S&P 500 Dividend Yield	1.37	2.27

Notes: REITS = Real Estate Investment Trust; NAREIT = National Association for Real Estate Investment Trusts; TIPS = Treasury Inflation-Protected Securities

Source: Research Affiliates.

Figure 1. Contrasting Efficient Frontiers: Projected Returns in March 2002 and July 2008



Source: Research Affiliates

risk/reward opportunities in the two bear markets.[4] In this analysis, income yields are combined with the other two sources of portfolio returns—namely, projected growth of income and changes in valuations.

The results shown in Figure 1 are striking in two ways. First, the current bear market, with lower yields than the previous bear market in every asset class but equities (which are still low by historical standards), offers little in the way of compelling long-term opportunities. This circumstance contrasts with the earlier bear market, during which attractive assets besides U.S. equities were plentiful.

An even more interesting aspect is the steepness of the two efficient frontiers. The difference in steepness implies that investors were significantly more motivated to bear risk in the earlier bear market. In 2002, a shift from the portfolio of 4% standard deviation to one of 8% standard deviation was projected to earn a return premium of 2.0 percentage points for bearing the incremental risk. Today, such a move would net only a projected 0.7 percentage point per year. This flat efficient frontier of today illustrates the relatively meager environment for upping one's risk exposure.

Successful investing is about compounding incremental positive returns, not a cocktail of huge gains mixed with large drawdowns. We are not uneasy about bearing risk; we just want to be paid properly for doing so! By showing patience in today's world of low returns, investors will have the resources to pounce on opportunities when a crescendo of fear drives some of our markets to far lower prices. Such circumstances will occur because far lower prices reflect demand for a far higher risk premium.

Have patience, practice risk management, and stay in the game are the rules for winning in today's GTAA environment. Concentrating on these three tenets now and taking calculated risks when they present themselves will ultimately earn us meaningful returns.

[4] These figures are for illustrative purposes only and are not actual projections used in any Research Affiliates portfolio.

Performance Update*

TOTAL RETURN AS OF 8/31/08	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	-13.71%	-14.89%	2.89%	7.93%	8.30%	13.66%
S&P 500[B]	SPTR	-11.39%	-11.14%	3.66%	6.92%	4.68%	14.19%
Russell 1000[C]	RU10INTR	-11.02%	-10.60%	3.85%	7.41%	5.21%	14.31%
FTSE RAFI® US 1500 Index[D]	FR15USTR	-5.94%	-9.42%	4.53%	11.37%	14.03%	17.10%
Russell 2000[E]	RU20INTR	-2.62%	-5.48%	4.80%	9.55%	9.53%	18.81%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	-17.42%	-13.85%	9.75%	15.68%	10.94%	14.70%
MSCI EAFE[G]	GDDUEAFE	-16.93%	-13.96%	8.57%	14.34%	6.74%	14.59%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-16.32%	-12.49%	9.54%	15.18%	7.84%	14.70%

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.

*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