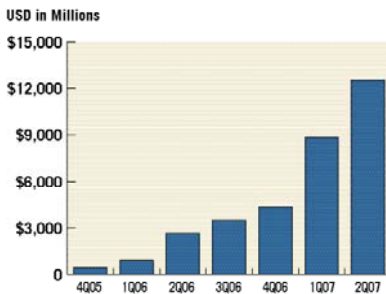


rafi[®] fundamentals

RAFI™ Managed Assets*



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



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DYNAMIC STYLE AND SIZE EXPOSURES

Viewed through the lens of cap-weighting, most Fundamental Index™ strategies have some degree of a value tilt. Imagine two companies with identical financial measures of firm size—such as sales, cash flow, dividends, or book value—but one with a market multiple twice the market average and the other with a market multiple half the market average. These two companies will receive the same weight in a Fundamental Index strategy and different weights in a cap-weighted index because the cap-weighted index will give twice the weight to the security with twice the market multiple, and half the weight to the stock selling at half the market multiple. This leads to a structural growth tilt in a cap-weighted index. By ignoring the role of valuations on portfolio weights, the Fundamental Index strategy typically holds less of the high P/E stocks than the cap-weighted index, thereby biasing it toward the value universe.

Interestingly, the RAFI™ strategy value bias is not static. It changes over time depending on market conditions and is a significant contributor to the long-term advantage of the Fundamental Index strategy. When growth stocks are trading at a particularly lofty multiple and value at a deep discount, the Fundamental Index strategy will resemble a deep-value portfolio because it pays no attention to those multiples and their impact on capitalizations. In fact, at the peak of the bubble, the RAFI 1000 had a greater value bent than even the Russell 1000 Value Index. When growth stocks are trading at more normal multiples, the RAFI 1000 has a much smaller value bias.

To better understand this dynamic, recall the market environment of the late 1990s. Prices of the era's highest flyers such as Cisco, Intel, Lucent, and AOL were appreciating at a breathtaking pace, representing a larger and larger portion

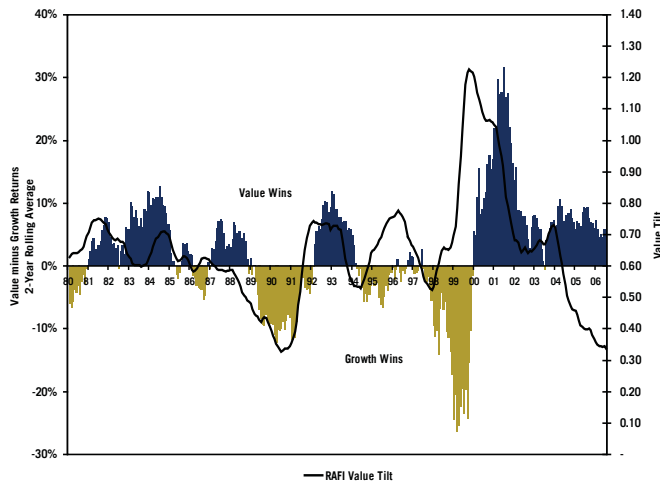
of the Russell 1000 Growth Index and causing many traditional growth stocks to be pushed into the Russell 1000 Value Index. The RAFI 1000 also held most of these high-flyer growth stocks—but in proportion to their economic size—measured using fundamental metrics, not their market size. This combination led to a deep value orientation for the RAFI 1000 relative to the Russell 1000 Value Index... right before value took off.

Currently, after seven years of strong value outperformance, the RAFI 1000 has a mild value bias relative to the Russell 1000 Index because the spread between growth and value multiples have narrowed considerably. In fact, the last time the RAFI 1000 had a value tilt this low was at the start of 1991, a year in which growth trounced value by more than 1400 basis points. Because RAFI 1000 had such a trivial value bent entering this growth-oriented period, it was able to match the return of the S&P 500 in what should have been a nasty year of relative performance for a value biased portfolio. We are now in another growth-stock dominated market. Through July, the Russell 1000 Growth Index is ahead 6.5% year-to-date contrasted to the 1.3% return for the Russell 1000 Value Index. Once again, the low value tilt of the RAFI 1000 entering the year has allowed relative returns to remain competitive in this growth market (see performance update on page 2).

The changing nature of the RAFI 1000 value exposure—resembling a deep value portfolio after strong growth runs and a mild value orientation after value outperformance—can be seen in Figure 1. The right-hand axis measures the RAFI 1000 value tilt. A value of “1” indicates a value tilt approximately equal to the Russell 1000 Value Index while a figure of “0” indicates a neutral bias

approximating a blended portfolio like the Russell 1000 Index. The left-hand axis details rolling outperformance of growth and value. The RAFI value tilt is most pronounced when value is beating growth and relatively modest when growth is beating value.

Figure 1. Dynamic Value Exposure: RAFI 1000



RAFI portfolios also have a dynamic exposure to company size. For example, RAFI 1000 had a dramatically smaller cap bias relative to the Russell 1000 in 2000. Similar to the dynamic nature of the value exposure, RAFI 1000 annually rebalanced away from the highest priced (and largest cap) stocks and into the lower-priced (and smaller cap) stocks. Since then, market leadership has shifted dramatically in favor of smaller stocks over the past seven years. RAFI portfolios were well positioned for the small-cap market. Just like the dynamic value tilt, the RAFI methodology tends to have its greatest small-cap exposure right before those stocks surge and a neutral bias to larger cap exposure at the end of a long small-cap run.

Markets tend to revert back to their long-term averages. Periods of strong relative outperformance are typically followed by significant changes in relative valuations. By dynamically adjusting exposure, RAFI portfolios are naturally positioned for the ebbs and flows over time. Currently, RAFI 1000 has a minor tilt to value and is virtually identical in its size exposure to the Russell 1000.

By construction, the Fundamental Index strategy is immune to the effects of valuations on index construction and avoids the trap of allocating greater percentages to the recent darlings of the market. In so doing, it adds considerable value over conventional cap-weighted indexes.

Performance Update*

TOTAL RETURN AS OF 7/31/07	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	10 YEAR VOLATILITY
FTSE RAFI™ 1000 Index ^A	FR10XTR	3.63%	16.47%	14.17%	14.40%	10.21%	14.12%
S&P 500 ^B	SPTR	3.64%	16.13%	11.76%	11.81%	5.98%	14.92%
Russell 1000 ^C	RU10INTR	3.87%	16.45%	12.50%	12.35%	6.37%	15.03%
FTSE RAFI™ US 1500 Index ^D	FR15USTR	1.83%	15.70%	15.63%	19.48%	13.35%	18.14%
Russell 2000 ^E	RU20INTR	-0.83%	12.12%	13.40%	16.02%	7.80%	19.85%
FTSE RAFI™ Developed ex US 1000 Index ^F	FRX1XTR	11.07%	27.20%	25.43%	22.63%	11.79%	14.85%
MSCI EAFE ^G	GDDUEAFE	9.47%	24.42%	23.49%	20.34%	7.70%	14.89%
FTSE All World Series Developed ex US ^H	FTS5DXUS	10.43%	25.27%	24.35%	21.12%	8.42%	14.91%

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.

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