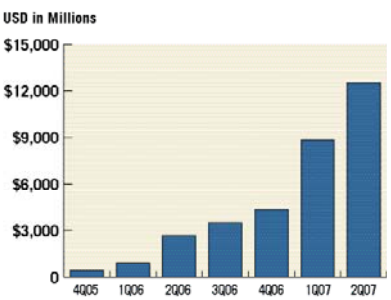
Fundamental Index® Newsletter · September 2007

rafi® fundamentals

RAFI® Managed Assets*



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

research affiliates

155 N. Lake Avenue, Suite 900
Pasadena, CA 91101 USA
Phone +1 (626) 584-2100
Fax +1 (626) 584-2111
info@rallc.com
www.rallc.com

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

DOES THE RAFI® STRATEGY PICK STOCKS?

The Fundamental Index® concept is not a stock picking strategy. It seeks to cure the return drag incurred by traditional cap-weighted indexes. When individual stocks—or entire sectors—trade away from fair value, a cap-weighted index will follow the price lead and place greater funds in overpriced securities and less in underpriced securities. In contrast, the RAFI methodology, by using financial measures of firm size such as sales or book value to weight securities in a portfolio, is price indifferent with significant benefits accruing to the end investor (see performance table on page 2).

The RAFI weighting approach will result in differing portfolio positions vis-à-vis cap-weighted indexes like the S&P 500 or Russell 1000. The resulting overweights and underweights often lead critics such as Jack Bogle to label the Fundamental Index concept as a stock picking strategy. Their argument goes as follows:

> *"This new breed of indexers—not, in fact, indexers, but active strategists—focuses on weighting portfolios by so-called fundamental factors… They argue, fairly enough, that in a cap-weighted portfolio, half of the stocks are overvalued to a greater or lesser extent, and half are undervalued.*
>
> *The traditional indexer responds: 'Of course. But who really knows which half is which?' The new Fundamental Index advocates unabashedly answer, 'We do.' They actually claim to know which is which."*[1]

The truth is, we don't. If the market is reasonably price efficient, a company's capitalization should closely reflect it's fair value.

In such a world, a cap-weighted index fund is the Investor's Dream Team, as Charley Ellis once claimed.[2]

A stock's price, after all, incorporates the combined judgment of all market participants including the investment world's very best—the leading analysts on Wall Street, the swashbuckling mega hedge funds, the Warren Buffetts, John Neffs, and Bill Millers of active investing. Their collective wisdom is captured in stock prices, and thus in cap-weighted index funds at fractions of the cost of an actively managed portfolio.

But, we know that frequently this collective wisdom gets it wrong. Examples abound—Cisco was massively overvalued in 1999, Krispy Kreme in 2001, Japan in the late 1980s, tech stocks in the late 1990s… the list goes on. Theories abound on the "whys" of pricing error but, for brevity, it may be simpler to quote Forrest Gump: "It happens." When pricing errors occur, the cap-weighted index systematically overweights the overvalued stocks and underweights the undervalued stocks, leading to a structural performance drag.

The Fundamental Index methodology does not eliminate overweights and underweights relative to true fair value. We fully admit that the Fundamental Index strategy will overweight some stocks that are overvalued and will underweight some stocks that are undervalued—but the overweights (underweights) are not structurally tied to the overvalued (undervalued) stocks, so the errors should cancel. In fact, with price absent from the weighting decision, it is natural to expect roughly half of a Fundamental Index portfolio strategy to be in overpriced stocks and half in underpriced stocks. The key point is that in a Fundamental Index portfolio, the over- (under-) valuations are not linked to portfolio weights.

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Price indifferent indexes do not attempt to identify underpriced securities. Rather, the goal is to eliminate the return drag from linking weights to price. To emphasize this point, let us return to another price indifferent index option—the S&P Equal Weight Index (S&P EWI).[3] As we showed in July, the S&P EWI outperformed the S&P 500 by 1.93% from 1990–2007. A quick scan of the S&P EWI weights will reveal hundreds of overweights and underweights relative to the S&P 500. No one claims this outperformance is achieved because the S&P EWI weights (0.2% in each of the 500 stocks) are right. This would imply the approximately 110 stocks in the S&P 500 with a position size greater than 0.2% are overvalued with the roughly 380 stocks with a weight smaller than 0.2% being undervalued. Neither would the 10 stocks whose market cap dictates a weight of 0.20% be considered fairly valued. Such an assertion would be ridiculous. Every leading American company—Exxon Mobil, Microsoft, QUALCOMM, Citigroup, etc.—would be labeled overpriced! Likewise, neither is the Fundamental Index advocate stating that the weights of the Fundamental Index strategy are "right."

The beauty of the Fundamental Index concept is the investor doesn't need to have an opinion on individual stock prices to achieve excess returns. Rather, it is solely designed to eliminate the structural flaw in cap-weighting that links pricing error to the stocks position in the portfolio, thereby eliminating the performance drag.

Notes:

1 John C. Bogle. 2007. *The Little Book of Common Sense Investing*. Hoboken, New Jersey: John Wiley & Sons, pp. 156–157.
2 Charles D. Ellis. 2002. *Winning the Loser's Game*. New York: McGraw-Hill, pp. 27–28.
3 We previously outlined in the July issue of *RAFI™ Fundamentals* that this methodology solves the return drag of cap-weighting but fails on many of the important characteristics important to index investors.

Performance Update*

TOTAL RETURN AS OF 8/31/07	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	4.47%	14.87%	14.19%	14.41%	10.68%	14.05%
S&P 500[B]	SPTR	5.20%	15.13%	12.16%	12.00%	6.75%	14.79%
Russell 1000[C]	RU10INTR	5.28%	15.27%	12.83%	12.53%	7.03%	14.93%
FTSE RAFI® US 1500 Index[D]	FR15USTR	3.19%	14.33%	16.68%	19.99%	13.21%	18.14%
Russell 2000[E]	RU20INTR	1.41%	11.36%	14.45%	16.60%	7.80%	19.85%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	9.71%	22.31%	24.79%	22.36%	12.44%	14.65%
MSCI EAFE[G]	GDDUEAFE	7.78%	19.20%	22.67%	20.01%	8.37%	14.68%
FTSE All World Series Developed ex US[H]	FTS5DXUS	8.95%	20.14%	23.59%	20.81%	9.05%	14.72%

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.