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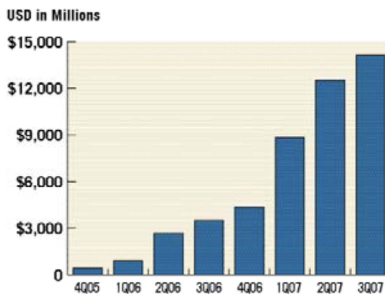
rafi® fundamentals

RAFI® Managed Assets*



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

AVOIDING NEGATIVE ALPHA

Confronted with the prospect of low returns in the years ahead, investors of all kinds are looking for ways to earn additional returns. Eliminating unnecessary slippage, or negative alpha, may be the most effective way of garnering incremental returns.

Today, no matter how fuzzy the arithmetic, it is difficult to justify long-term returns from conventional stock and bond balanced portfolios exceeding 5–7%. Many investors, with spending plans that require 8–9% returns, hope such seemingly bleak expectations prove off the mark. But hope is not a strategy.

Noting the gap between expected and required returns, many investors increasingly turn to "alpha" (value added from investor skill) as the elixir to cure their long-term ailment. Few people, however, bother to discuss the fact that alpha is a zero-sum game, *with an average alpha of zero, less the costs associated with the quest for alpha. This means that most alpha is negative!*

Interestingly, very few of today's market participants are focusing as aggressively on eliminating negative alpha, also known as implementation shortfall. Seeking, identifying, and eliminating negative alpha is as profitable (and infinitely easier) than seeking, identifying, and employing sources of positive alpha. Failing to rebalance, chasing winners, and cap-weighting are three sources of negative alpha that can be eliminated relatively easily.

Failure to rebalance. Buying low and selling high—through rebalancing—is a perennially underrated investment choice. Neglecting this simple exercise is an almost universal source of negative alpha, especially when we take account of risk. The strong tendency of the capital markets to mean revert translates to incremental profits for those willing to sell their long-term winners and buy their long-term losers. Our research suggests a disciplined rebalancing policy adds about 0.5% percent to risk-adjusted returns for a well-diversified portfolio.

Chasing winners. Chasing the latest investment craze is incredibly easy as we are bombarded with success stories at every turn—the neighbor who got in on the hot IPO, our brother-in-law with his 30% hedge fund return last year, and the advertising campaigns of the top mutual fund companies proclaiming their latest star performers. Collectively, these stimuli lure us like a siren's song to chase the latest winners. In the case of funds, the investment is often then sold at the bottom of its performance cycle after it has become a "proven" loser. Inevitably, it is replaced with the next "hot manager." Of course, these replacement firms' performance is near high tide and begins to recede not long after retention. This practice is the equivalent of selling low and buying high and its damage to investor wealth is devastating.

Consider a 2005 study by Russel Kinnel of Morningstar that dramatically illustrates the consequences of chasing winners.[1] In 17 equity mutual fund categories, the average dollar-weighted returns (return to the investors) were compared with time-weighted returns (return to the fund) over the previous 10 years. Kinnel found every single

[1] "Mind the Gap: How Good Funds Can Yield Bad Results," Morningstar FundInvestor, July 2005.

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category's dollar return trailed its time-weighted return with the average slippage amounting to 2.8% annually—a damning indictment of investors' tendency to chase recent performance.

Cap-weighting index funds. Virtually all traditional indexes and their associated index funds and ETFs use market capitalization to determine security weights. Those shares priced above their eventual intrinsic value (think AOL in 1999) will have an erroneously high capitalization and, therefore, a high index weighting. Thus, overpriced stocks will always be overweight in this construct. An index fund weighted by price will have the majority of its assets in these stocks—all of which subsequently underperform causing a return drag. Our research shows the slippage attributed to cap weighting is 2–3% annually.

Most wealth advisors are well aware of the first two sources of implementation shortfall, or slippage; thinking of slippage from cap-weighting is a relatively new concept. Our cure to cap-weighting slippage, the Fundamental Index® concept, interestingly derives much of its advantage from the fact that traditional indexes are vulnerable to the first two sources of negative alpha: they don't rebalance when stocks advance well ahead of—or retreat far below—their fundamentals, and they chase winners by adding stocks to the portfolio after they've been on a roll and dropping them after they've faltered badly.

Why emphasize rebalancing and avoiding chasing winners to managers, and then turn around and invest in an index fund that largely ignores them in the equity market?

Meanwhile, the Fundamental Index concept avoids return-chasing behavior and practices rebalancing. The annual rebalance ensures discipline and, unlike traditional cap-weighted indexes, forces the portfolio to buy low and sell high. Outperformers are rebalanced back to their economic size with the proceeds invested in shares that have recently fared poorly. As most enterprises' share prices loosely follow their economic scale, annual turnover remains very low—almost as low as with capitalization-weighting. All of this is accomplished in a formulaic and easily replicated manner.

Note: This issue of *RAFI Fundamentals* uses excerpts from John Mauldin's *Thoughts from the Frontline* entitled "Hope is Not a Strategy" written by Rob Arnott and John West (http://www.2000wave.com/article.asp?id=mwo083107). Copyrighted material is used with permission from John Mauldin.

Performance Update*

TOTAL RETURN AS OF 9/30/07	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	7.80%	15.68%	14.84%	17.76%	10.41%	13.99%
S&P 500[B]	SPTR	9.13%	16.44%	13.14%	15.45%	6.57%	14.75%
Russell 1000[C]	RU10INTR	9.30%	16.90%	13.77%	15.98%	6.86%	14.89%
FTSE RAFI® US 1500 Index[D]	FR15USTR	4.66%	14.36%	15.39%	22.20%	12.57%	18.03%
Russell 2000[E]	RU20INTR	3.16%	12.34%	13.36%	18.75%	7.22%	19.74%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	15.57%	28.24%	25.89%	26.52%	12.50%	14.66%
MSCI EAFE[G]	GDDUEAFE	13.57%	25.38%	23.75%	24.05%	8.35%	14.67%
FTSE All World Series Developed ex US[H]	FTS5DXUS	15.25%	27.00%	24.70%	25.05%	9.08%	14.74%

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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