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Fundamentals

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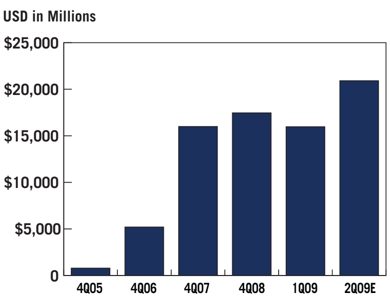
RAFI® Managed Assets*



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RAFI® STRATEGY AND QUALITY

Despite moderately high valuations, the equity markets roll on in the mother of all recoveries. The six months ending August 31, 2009, were the best six months of performance for the S&P 500 Index since 1975, a mirror image to the previous six months, the worst since 1932. Within equities, the Fundamental Index® methodology continues to add substantial value with almost all FTSE RAFI® applications worldwide; nearly 98% of the apples-to-apples comparisons have exceeded the returns for the corresponding capitalization-weighted indexes on a year-to-date basis through August 2009. The breadth of Fundamental Index outperformance was exceeded only by the magnitude. For example, year-to-date the FTSE RAFI All World 3000 Index achieved an excess return of 15.3% over the MSCI All Country World Index.

Are the FTSE RAFI portfolios adding value or is capitalization weighting underperforming? The answer depends on the frame of reference. From the market vantage point, RAFI portfolios are active, value-tilted portfolios, so they are delivering an impressive positive alpha this year, outpacing all previous years except 2000. But, there's another frame of reference: the economy. From the vantage point of the broad sweep of companies that comprise the broad publicly-traded economy, the market is making constantly-changing active bets on which companies have strong growth prospects deserving a premium multiple and that face challenges worthy of a deep valuation discount. From this economic frame of reference, the cap-weighted market is an active growth-tilted portfolio with the RAFI approach contratrading against these constantly changing market bets.

The excess returns for 2009 have been largely driven by the annual rebalance of the FTSE RAFI series in March when the Fundamental Index portfolios added to stocks whose share prices had fallen substantially more than their underlying economic fundamentals. Invariably, these net purchases occurred in the most distressed areas of the equity markets—financials and consumer discretionary stocks. True to mean reversion, these left-for-dead companies have led the market comeback. A recent Barron's article indicated the "…junk rally, in which financially dodgy companies that were granted a reprieve by healthier credit markets have seen their stocks double and triple and price."[1]

On the heels of RAFI outperformance in a low quality rally, some question whether the Fundamental Index approach is simply a permanent bet on "junky," lower quality companies. Our research indicates this is not the

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case. Rather, the RAFI methodology offers a mirror image of the cap-weighted market's bets relative to the economy. Whatever the market is bidding up—faster than its economic footprint is growing—we sell. Whatever the market is punishing with lower valuation multiples, we buy. At any snapshot in time, the RAFI portfolio looks like a value-tilted active portfolio relative to the market; but it's incremental return comes largely from this contratrading against the markets most extreme bets and constantly shifting expectations, rather than from the value tilt *per se*.

Recent Quality Performance

Although there is no definitive industry-wide classification system, quality stocks are generally associated with larger companies that have stable earnings, stable dividends, and low debt. On the other hand, low quality stocks are associated with companies that have more unpredictable earnings and higher debt. With this unreliability, lower quality stocks tend to trade at lower price-per-share levels. Thus, share price is a simple proxy for quality. By this admittedly crude measure, the past five months was unquestionably a low-quality rally as evidenced in **Figure 1**. We've whimsically referred to it as "garbage floating to the surface."

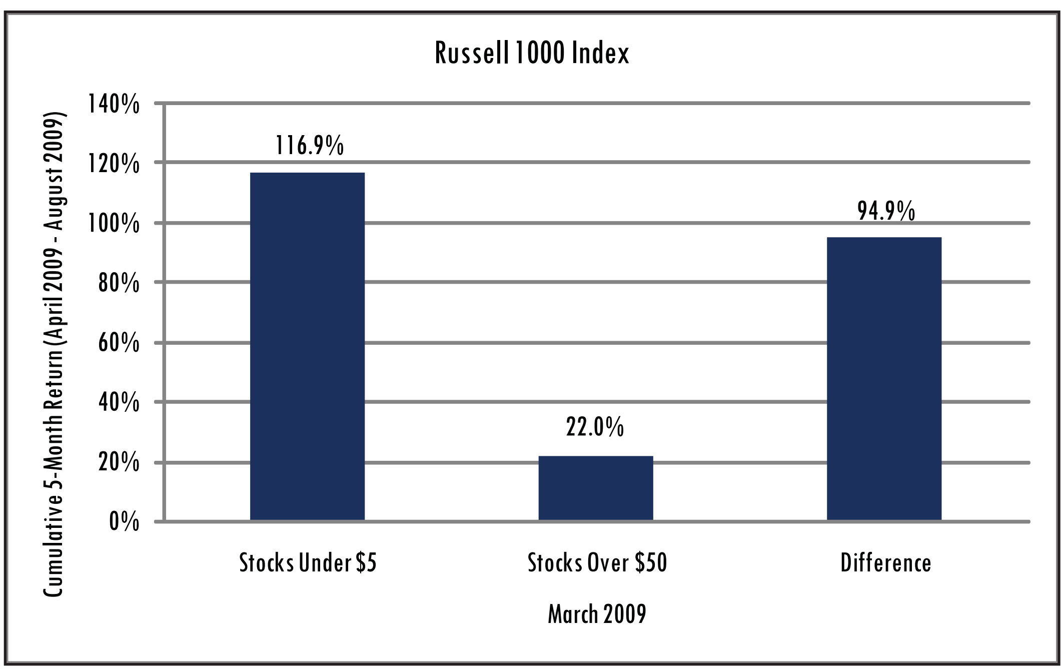
Stocks in the Russell 1000 Index priced below $5 per share (as of March 31, 2009) surged over 116% in the subsequent five months. Meanwhile, stocks priced above $50 per share—a loose proxy for higher quality—managed to post a more pedestrian gain of 22% over this period. Because these stocks were priced so low, the cap-weighted Russell 1000 only had an allocation of 1.5% as of March 31 while the FTSE RAFI US Large Company Index, fresh off of its March rebalance, held 11.2% in stocks priced under $5—many of them familiar blue chips, such as Citigroup and Ford Motor, that have since fallen on hard times.

Quality over the Long Term

The RAFI approach has unquestionably benefited from the massive 2009 rebound in low-priced and distressed stocks. But, is this a byproduct of recent markets or does the RAFI methodology have a structural bias to low quality stocks? To better ascertain this issue, we turn to *Standard and Poor's Quality Rankings*.[2] The rankings "…attempt to capture the growth and stability of earnings and dividends record in a single symbol." The single symbol was a letter grade from A+ (highest quality) to C and D (lowest qualities). In the analysis, Standard and Poor's produced calendar year returns for all the rankings from 1986 to 2004. What do we find over these 19 years?

In **Table 1**, "Quality" years are those where all A-rated stocks outperformed all stocks ranked B, C, and D on a market-value-weighted basis. On the flipside, "Junk" years are lower quality issues outperforming A-rated stocks. We find the RAFI methodology's win

Figure 1. Market Rebound Led by Low Priced Stocks



Source: Research Affiliates based upon data from Wilshire Atlas.

Table 1. Fundamental Index Performance in the Quality Cycle

			Annualized Returns		
	# of Years	# Years RAFI Wins	FTSE RAFI US Large Company	S&P 500	Difference
"Quality" Years	11	6	12.8%	10.3%	2.5%
"Junk" Years	8	5	16.9%	15.1%	1.8%
Total (1986-2004)	19	11	14.5%	12.3%	2.2%

Source: Research Affiliates based upon data from Standard and Poor's and Morningstar Encorr.

rate and annualized excess returns are not much different for "Quality" versus "Junk" years. In the 11 years when quality outperformed junk, the RAFI methodology produced an average annualized excess return of 2.5%. The RAFI methodology also outperformed in junk years, albeit by a somewhat ***smaller*** (!) margin of 1.8% per annum. In both environments, the RAFI methodology won between 55–63% of the time (in an admittedly small sample).

Over the entire period 1986–2004, the FTSE RAFI US Large Company finished ahead of the S&P 500 by 220 bps per annum, which is almost identical to the simulated results for the longer period January 1962–June 2009 of 210 bps per year. Further, high quality stocks actually outperformed low quality stocks by 100 bps per annum as all A-rated stocks achieved an annual return of 13% versus 12% for stocks rated B through D. Based on this data, it is hard to say that the RAFI methodology has a systematic tilt to low quality companies. Indeed, the correlation of excess returns for high quality over low quality and excess returns for the RAFI approach over the S&P 500 was positive at 0.16.

Conclusion

The Fundamental Index approach has recently benefited from larger exposures to the distressed companies that have led this market higher. These were still large companies despite having next-to-nothing in market capitalization! But does that mean the Fundamental Index approach will always have a structural bias to low quality? We think not. The key to RAFI methodology outperformance is contratrading out of what has risen most in price relative to fundamentals and into the recently downtrodden—out of the beloved and into the loathed. Capitalization weighting naturally does the opposite—riding recent winners to higher and higher allocations and losers to lower and lower weights. This can happen between growth and value, amongst sectors, between countries and regions, and, based upon this brief overview, between quality subsets of the equity markets.

Does the RAFI strategy have a value tilt? Of course. Does it have a small-cap bias? A little bit most of the time, but it's a reciprocal of the cap-weighted market's bias toward small growth companies. Does it have a low-quality bias? Perhaps somewhat, but it becomes pronounced only when the market is punishing lower-quality companies with Armageddon pricing. Isn't that the right time to load up on them?!

Endnotes

1 Santoli, Michael. (2009). "Big Stocks May Be Ready for Their Close-Up," *Barron's* (September 21). http://online.barrons.com/article/SB125331271959924169.html?mod=BOL_hpp_dc

2 *Standard and Poor's Quality Rankings—Portfolio Performance, Risk, and Fundamental Analysis*, October 2005. http://www2.standardandpoors.com/spf/pdf/media/QualityRankingWhitePaperFinal.pdf

Performance Update

TOTAL RETURN AS OF 8/31/09	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	34.66%	-6.35%	-2.90%	3.49%	4.67%	17.74%
S&P 500[B]	SPTR	14.97%	-18.25%	-5.78%	0.49%	-0.79%	16.22%
Russell 1000[C]	RU10INTR	16.36%	-18.39%	-5.61%	0.94%	-0.27%	16.47%
FTSE RAFI® US 1500 Index[D]	FR15USTR	40.54%	-7.78%	-1.52%	5.82%	10.49%	21.96%
Russell 2000[E]	RU20INTR	15.75%	-21.29%	-6.08%	2.21%	4.30%	21.55%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	39.93%	-4.92%	0.06%	9.74%	6.80%	19.07%
MSCI EAFE[G]	GDDUEAFE	24.78%	-14.47%	-4.27%	6.32%	2.66%	18.07%
FTSE All World Series Developed ex US[H]	FTS5DXUS	26.78%	-14.15%	-3.36%	7.24%	3.49%	18.27%
FTSE RAFI® Developed ex US Mid Small[I]	FRSDXUS	45.15%	1.22%	-1.34%	8.14%	NA	NA
MSCI EAFE Small[J]	MCUDEAFE	38.55%	-11.30%	-7.33%	4.40%	NA	NA
FTSE RAFI® Emerging Markets[K]	TFREMU	54.95%	-3.32%	11.45%	23.41%	NA	NA
MSCI Emerging Markets[L]	GDUEEGF	51.14%	-9.66%	5.47%	16.96%	NA	NA
FTSE RAFI® Canada[M]	FRCANTR	34.77%	-4.36%	3.43%	9.97%	NA	NA
S&P/TSX 60[N]	TX60AR	23.03%	-17.96%	1.06%	9.43%	NA	NA
FTSE RAFI® Australia Index[O]	FRAUSTR	27.57%	-0.39%	2.16%	9.76%	9.92%	12.48%
S&P/ASX 200 Index[P]	ASA51	24.75%	-8.06%	0.07%	9.48%	8.91%	13.11%
FTSE RAFI® Japan[Q]	FRJPNTR	18.23%	-19.22%	-12.02%	0.98%	NA	NA
MSCI Japan[R]	GDDLJN	13.87%	-23.10%	-14.82%	-1.16%	NA	NA
FTSE RAFI® UK Index[S]	FRGBRTR	26.77%	0.81%	-0.32%	7.44%	NA	NA
MSCI UK[T]	GDDUUK	15.03%	-8.48%	-2.20%	5.62%	NA	NA

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; (I) The FTSE RAFI® Developed ex US Mid Small Index tracks the performance of small- and mid-cap equities of companies domiciled in developed international markets (excluding the United States), selected based on the following four fundamental measures of firm size: book value, cash flow, sales, and dividends. The equities with the highest fundamental strength are weighted according to their fundamental scores. The Fundamentals Weighted® portfolio is rebalanced and reconstituted annually. Performance represents price return only; (J) The MSCI EAFE Small Cap Index targets 40% of the eligible small-cap universe (companies with market capitalization ranging from US$200 to US$1,500 million) in each industry group of each country in the MSCI EAFI Index; (K) The FTSE RAFI® Emerging Markets Index comprises the largest 350 companies selected and weighted using the Fundamental Index® methodology; (L) The MSCI Emerging Markets Index is an unmanaged, free-float-adjusted cap-weighted index designed to measure equity market performance of emerging markets; (M) The FTSE RAFI® Canada Index comprises the Canadian stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (N) The S&P/Toronto Stock Exchange (TSX) 60 is a cap-weighted index consisting of 60 of the largest and most liquid (heavily traded) stocks listed on the TSX, usually domestic or multinational industry leaders; (O) The FTSE RAFI® Australia Index comprises the Australian stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (P) The S&P/ASX 200 Index, representing approximately 78% of the Australian equity market, is a free-float-adjusted, cap-weighted index; (Q) The FTSE RAFI® Japan Index comprises the Japanese stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (R) The MSCI Japan Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the Japanese equity market; (S) The FTSE RAFI® UK Index comprises the U.K. stocks represented among the constituents of the FTSE RAFI® Global ex US 1000 Index, which in turn comprises the 1,000 non-U.S.-listed companies with the largest fundamental value, selected from the constituents of the FTSE Developed ex US Index; (T) The MSCI UK Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the British equity market

Source: All index returns are calculated using Total Return data from Bloomberg except for the FTSE RAFI Developed ex US Mid Small (FRSDXUS) and the MSCI EAFE Small (MCUDEAFE) which uses price return data.

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