

Fundamentals™



Schwab launches three funds driven by RAFI methodology!

Topic of the Month – A SMALL TWIST ON THE VALUE DEBATE

Critics have lamented that the Fundamental Index™ concept is nothing more than a re-packaged version of value and small-cap investing. Start with a broadly diversified equity portfolio, boil down the weighting of high-priced growth stocks, add a few quarts of low P/E shares, sprinkle some small caps to taste, and voilà, the Fundamental Index strategy is ready for mass consumption! Be careful, the critics contend, for this stew will leave the investor with a nasty case of heartburn once the small-cap and value stock party comes to an end. Before Fundamental Index investors rush to their Roloids®, a further dissection of our recipe is probably in order.

Recall that the Research Affiliates Fundamental Index (RAFI™) methodology simply weights stocks in proportion to their economic size as measured by a combination of sales, dividends paid, book value, and cash flow. Conversely, cap-weighted indexes use one metric –

capitalization – to determine a stock's weight. The different approaches to selecting stocks for their respective indexes are illustrated in Figure 1.

The top 700 or 800 *names* within the top 1,000 will be virtually identical between the cap-weighted Russell and the fundamentally weighted RAFI (though, by construction, their weights will differ). However, as we move into the bottom range of the Russell 1000 we begin to encounter companies that are small on an economic scale (cash flow, sales, etc.) trading at lofty enough multiples to make the top 1000 by capitalization. When ranked based on the fundamental measures of size, these companies fall into the RAFI 1500. Similarly, near the top of the Russell 2000 we encounter companies that are large on an economic scale trading at somewhat depressed multiples. In a fundamental framework, these companies

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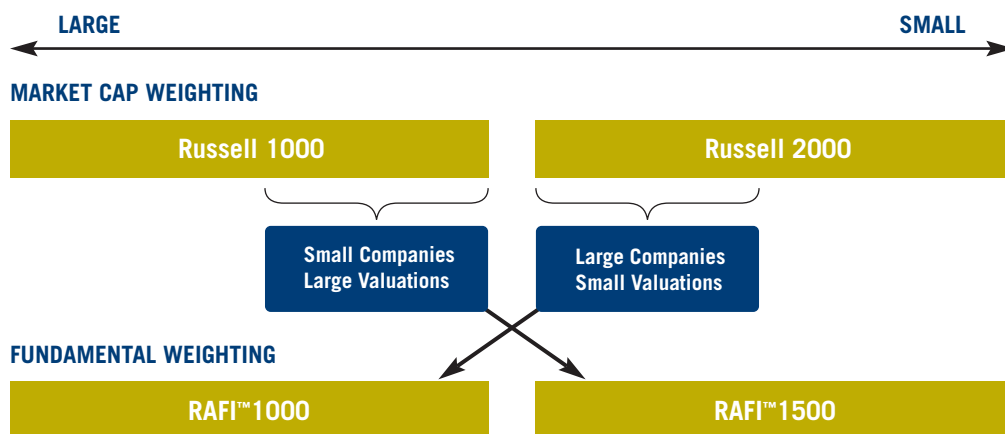


Figure 1. Index Stock Selection Differences Define Relative Value Tilt

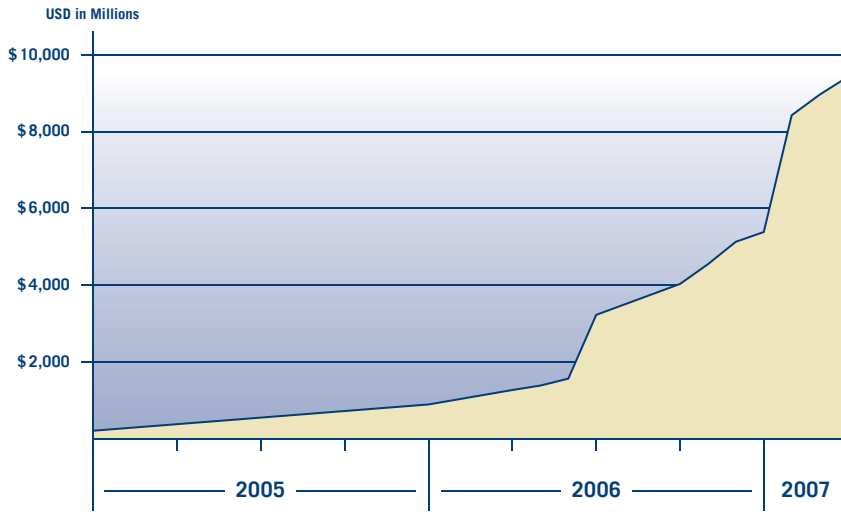
move up to the RAFI 1000, replacing the larger-cap small companies in rankings.

This exchange lowers the valuation multiples and market capitalization of the RAFI 1000. Conversely, the RAFI 1500 valuation multiples and size profile are boosted. Accordingly, the RAFI 1500

has a minimal value tilt (and occasionally a growth tilt) relative to the Russell 2000, and typically has a large-cap tilt!

If RAFI 1500 has a negligible value bias and a larger-cap tilt, efficient market proponents would claim it should underperform the smaller Russell 2000 over a long period. Are they right? Not even close! Since its inception in February 1990, RAFI 1500 has outperformed the Russell 2000 by approximately 4.6% per annum with less volatility. This is an even wider delta than the 2.1% advantage RAFI™ 1000 has historically shown in large companies. We have found similar results internationally. Furthermore, RAFI™ 1500 also exceeded the Russell 2000 Value Index over the same timeframe – by 1.9% annually. Recent short-term markets also prove that RAFI™ 1500 isn't solely reliant on the value premium – through March 31, 2007, year-to-date returns showed the Russell 2000 Growth beating the Russell 2000 Value by 1.0% while RAFI™ 1500 exceeded the Russell 2000 by 1.2%.

RAFI™ Managed Assets*



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

The long-run outperformance of value and small company stocks is well documented. However, we believe the results of our small company example undermine the argument that value and small-cap tilts are the sole reason for Fundamental Index™ outperformance.

Performance Update*

TOTAL RETURN AS OF 3/31/07	BLOOMBERG TICKER	YTD	12 MONTH	3 YEAR	5 YEAR	10 YEAR	ITD VOLATILITY
FTSE RAFI™ 1000 Index ¹	FR10XTR	1.74%	15.64%	13.05%	9.41%	12.42%	14.29%
S&P 500 ²	SPTR	0.64%	11.83%	10.06%	6.27%	8.20%	15.20%
Russell 1000 ³	RU10INTR	1.21%	11.84%	10.73%	6.92%	8.61%	15.30%
FTSE RAFI™ US 1500 Index ⁴	FR15USTR	3.12%	8.37%	14.87%	15.64%	15.92%	18.29%
Russell 2000 ⁵	RU20INTR	1.95%	5.91%	12.00%	10.95%	10.23%	19.98%
FTSE RAFI™ Global Ex US 1000 Index ⁶	FRX1XTR	4.87%	23.36%	22.15%	19.20%	12.84%	15.02%
FTSE All World Series Developed x-US ⁷	FTS5DXUS	3.95%	20.57%	20.72%	16.82%	9.38%	15.05%
MSCI EAFE ⁸	GDDUEAFE	4.15%	20.69%	20.31%	16.24%	8.67%	15.01%

*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: Bloomberg and FTSE



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Definition of Indices:

1. The RAFI™ 1000 comprises the 1000 largest companies selected and weighted using our Fundamental Index™ methodology.
2. The S&P 500 Index is an unmanaged market index that focuses on the large-cap segment of the U.S. equities market.
3. 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.
4. The RAFI™ 1500 comprises the 1001st to 1500th largest companies selected and weighted using our Fundamental Index™ methodology.
5. The Russell 2000 is a market-capitalization-weighted benchmark index made up of the 2,000 smallest U.S. companies in the Russell 3000.
6. 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.
7. The FTSE All World ex-US Index comprises Large and Mid Cap stocks providing coverage of Developed and Emerging Markets excluding the US.
8. 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 US Dollars.

Note - It is not possible to invest directly in any of the indexes above.