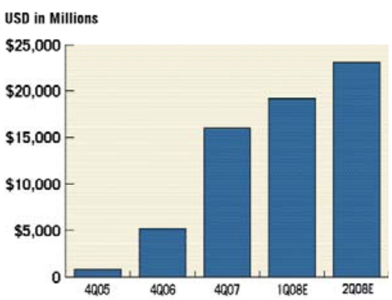
Fundamental Index® Newsletter · August 2008

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

THE ANTI-BUBBLE BURSTS

In 2000, we had a significant pricing bubble. Stocks of technology, media, medical, and telecom companies comprised more than half of the total value of the U.S. stock market. Most of us, with the blessings of hindsight, branded this situation a "bubble"; indeed, many of us labeled it as such even as it was happening. What is a bubble? It's a market in which valuations—for a company, a sector, or the broad market—rise beyond levels that any reasonable scenario would justify. The reciprocal, for which we suggest the expression "anti-bubble," is a market in which valuations fall below levels that any reasonable scenario would justify.

A Fundamental Index® portfolio weights companies according to their economic scale as defined by fundamental measures of company size. This approach gives the index a value tilt (as opposed to a growth tilt) relative to the capitalization-weighted market portfolio. Such a tilt is the exact mirror image of the market's bets on companies relative to their economic scale. So, the Fundamental Index portfolio benefits relative to a cap-weighted portfolio whenever the market weights for companies converge on their weights in the macro economy. Conversely, the Fundamental Index portfolio is penalized when market prices move sharply away from a company's stature in the economy, when markets are paying an ever-larger premium for growth stocks or are assessing an ever-larger discount for value stocks.

What we are now seeing is a "downside disconnect," or anti-bubble, in financials and certain other debt-dependent industries. If it evaporates, as we expect it will, that will have significant performance ramifications for followers of Fundamental Index strategies. Because the market has punished these stocks with lower and lower valuation levels, one of two things must happen: Either they will collectively outperform, or the financial measures of their economic scale will shrink to match their cap weights.

In our view, the financial services sector has been in an anti-bubble. Consider the following facts. For the past few years, financial services companies have represented about one-fourth of the publicly traded part of the U.S. economy, as measured by profits, book values, or dividends. Fewer than two years ago, the combined market capitalization of financial stocks reflected this economic footprint by equating to about 24%—by far the largest sector in the S&P 500 Index. Indeed, on September 30, 2006, four of the top ten stocks in the U.S. stock market, as measured by total market capitalization, were financial services companies: Citigroup, Bank of America, AIG (American International Group), and JP Morgan/Chase.

By early July 2008, not a single financial services firm—not one—ranked in the top 10 stocks in the market. It is remarkable that of the single largest sector, by far, of the publicly traded U.S. economy, only one stock is in the top 20 stocks, and only the lowest reaches of the top 20, of the stock market. And in reflection of this slide, by July 2008, the financial sector had dipped to slightly more than 14% of the S&P 500, placing it third behind energy and information technology.

Obviously, a massive stock price decline in financial stocks is behind these changing capitalization weights. In the trailing four quarters ending June 30, 2008, the financial sector has shed 42% of its market value, the worst such period of absolute performance of financials since Standard & Poor's began publishing sector returns in 1989. Furthermore, as **Table 1** shows, only the popping of the tech/telecom bubble earlier this decade

Table 1. Worst Rolling Four Quarter S&P 500 Sector Returns, September 1989–June 2008

	Absolute		Excess vs. S&P 500		Subsequent Three Years			
Sector	Return (%)	Ending Date	Return (%)	Ending Date	Dates	Sector	S&P 500	Excess
Consumer Discretionary	-26.8%	Jun-08	-17.8%	Jun-97	Jul-97—Jun-00	21.4%	19.7%	1.7%
Consumer Staples	-23.3%	Mar-00	-41.3%	Mar-00	Apr-00—Mar-03	5.7%	-16.1%	21.8%
Energy	-18.1%	Mar-03	-28.0%	Dec-98	Jan-99—Dec-01	7.2%	-1.0%	8.2%
Financials	-42.4%	Jun-08	-29.2%	Jun-08	Jul-08—Jun-11	TBD	TBD	TBD
Health Care	-21.9%	Sep-02	-32.1%	Mar-93	Apr-94—Mar-97	25.6%	15.7%	9.9%
Industrials	-29.1%	Mar-03	-17.7%	Dec-98	Jan-99—Dec-01	6.6%	-1.0%	7.6%
Info Technology	-63.4%	Sep-01	-39.8%	Mar-01	Apr-01—Mar-04	-3.5%	0.6%	-4.1%
Materials	-23.4%	Jun-00	-36.3%	Sep-00	Oct-00—Sep-03	10.4%	-10.1%	20.5%
Telecom	-57.0%	Sep-02	-36.5%	Sep-02	Oct-02—Sep-05	18.6%	16.7%	1.9%
Utilities	-35.4%	Sep-02	-30.2%	Dec-99	Jan-00—Dec-02	-8.5%	-14.6%	6.1%

Source: Research Affiliates

continued on page two

can come close to such a dreadful stretch of nominal returns from any sector. In other words, 7 of the 10 S&P 500 sectors have never experienced a four-quarter stretch like the most recent one for financials, although most have seen a similar relative performance downturn.

Of course, because we are in a bear market, we will witness large absolute losses in some sectors. (Note in Table 1 how all of the sectors had their worst returns during the 2000–02 bear market—arguably the worst market since the Great Depression.) Yes, but even taking into account performance relative to the entire S&P 500, we find financials posting their lowest results since 1989. So, these stocks have suffered a double whammy—the worst stretch of absolute performance and relative performance in nearly 20 years!

The gap between the cap weight and the fundamental economic scale of the financial services community has reached an extreme. The market has been pricing the financial services sector as if most firms in the sector have only a 50/50 chance of survival or worse.

Similarly, certain companies in the consumer discretionary sector (notably the auto companies) have been priced as if they are "dead men walking." General Motors was down 52% in the first six months of 2008, a 54-year low. Ford was off by 28%. Are they all truly on their way to the executioner's block?

In an effective capitalist system, no. They cannot all fail. Those that do fail—if they are allowed to do so—increase the pricing power of the survivors, which can then survive and prosper. In an effective capitalist system, those that made the most grievous errors exit the scene and clear the way for the future success of those that made fewer or less serious blunders.[1] Efforts to prop up the failed enterprises, as was done repeatedly for the airlines, means that those that did not make strategic blunders share the consequences of those blunders with those that did. Perhaps this is why eight of the nine sectors (excluding financials[2]) outperformed in the three years after experiencing their worst relative year. Moreover, the recoveries were not trivial; on average, these sectors beat the S&P 500 by 8.2% annually.

As with bubbles, anti-bubbles can be profitable for momentum players—until the anti-bubble bursts. One of the beauties of the Fundamental Index concept is that it provides us an anchor—the economic scale of a company or industry—for contratrading against the market's most extreme bets. Relative to the cap-weighted market portfolio, the FTSE RAFI US 1000 Index was overweight financials by only 1% as recently as March 2008; today, it is overweight financials by more than 7%. Why? Because it contratrades against the market's loathing of anything and everything in the financial sector. It is not rational to price the entire financial sector as though it has 50/50 odds of survival. Indeed, betting against that outcome is, in time, a profitable endeavor.

Bubbles and anti-bubbles are built on the two poles of our emotional globe—greed and fear. Greed pushes prices too high relative to economic worth, and fear pushes prices too low. Both bubbles and anti-bubbles rely on some extreme, implausible future outcome for justification. The financial sector and certain consumer discretionary companies certainly face challenges, but we believe they will avoid the dire outcomes embedded in their stock prices. (In fact, the gap between reasonable prices and panic-driven prices closed fast in recent weeks, after the demise of IndyMac Bank and near demise of Fannie Mae and Freddie Mac.) In short, although our belief in a turnaround for financials and consumer discretionary companies may prove to be premature, we believe this anti-bubble burst in mid-July.

[1] Unless society no longer requires the entire industry. But who among us can reasonably abandon the automobile? Or, when time and distance necessitate, air travel? The financial sector also is critical to an effective and productive capitalist system. Each failure strengthens the prospects for the survivors.

[2] We will have to wait and see on financials!

Performance Update*

TOTAL RETURN AS OF 7/31/08	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	-15.35%	-15.83%	1.86%	8.24%	6.45%	14.45%
S&P 500[B]	SPTR	-12.65%	-11.09%	2.85%	7.03%	2.91%	14.95%
Russell 1000[C]	RU10INTR	-12.23%	-10.62%	3.08%	7.55%	3.38%	15.12%
FTSE RAFI® US 1500 Index[D]	FR15USTR	-9.25%	-11.45%	2.92%	11.68%	11.32%	18.19%
Russell 2000[E]	RU20INTR	-6.02%	-6.71%	2.92%	9.75%	6.81%	19.85%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	-14.68%	-12.08%	11.97%	17.23%	9.98%	15.15%
MSCI EAFE[G]	GDDUEAFE	-13.44%	-11.73%	11.00%	15.84%	5.77%	15.09%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-12.82%	-10.06%	12.04%	16.69%	6.83%	15.23%

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.