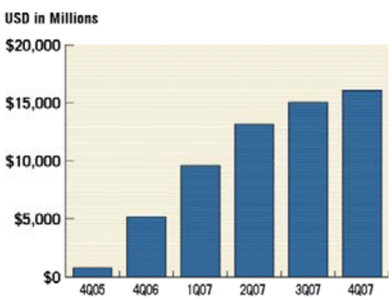
Fundamental Index® Newsletter · February 2008

rafi® fundamentals

RAFI® Managed Assets*



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

WILL THE *REAL* PASSIVE STRATEGY PLEASE STEP FORWARD?

Traditional indexers label the Fundamental Index® strategy as a new form of an age old investment product—active management. These old school adherents claim that only a cap-weighted portfolio is passive. After all, they assert the composition of a Fundamental Index portfolio differs, like active managers, from that of the cap-weighted indexes in order to produce above-index results. In this issue we examine this claim and conclude that the venerable cap-weighted index fund may not be so passive after all.

In our view, the choice of words used to describe the Fundamental Index strategy is really only a matter of semantics. If indexes are cap-weighted by definition, then the Fundamental Index strategy is active. However, if we use a more *pragmatic* definition of an index—such as, a portfolio that is objective, formulaic, transparent, historically replicable and has low turnover—then the Fundamental Index portfolio is an index, or at least a passive strategy, as it meets all five criteria. Most cap-weighted indexes do not. In fact, the S&P 500 qualifies on only one.

An even more enlightening question would be: Which construction method results in a more passive approach? To answer that question, we turn to a comparison of the industry sector allocations for a cap-weighted index versus a Fundamental Index portfolio.

Figure 1 illustrates the sector weights in a cap-weighted index of the top 1,000 companies (the Cap 1000) over the past 45 years. The fluctuation in sector allocations is startling. At the end of the 1990s, the power of the Internet and record profits led electronic equipment/technology stocks to surge to nearly a third of the index's total value. Similarly, rising oil prices more than doubled the energy sector's weight in just three years to an immense 30% in 1981. However, these projections of future technology and energy success proved off the mark and both sectors underperformed so dramatically in the ensuing years that their weights were sliced *in half*.

As **Figure 2** shows, the sector allocations using the Fundamental Index methodology are much less volatile; they follow a long-term secular pattern. For example, one can see the growing importance of financials and the declining American manufacturing base – but noticeably absent are the large intermediate swings. The aforementioned tech and energy run-ups (and their subsequent wealth erosion) are avoided as the Fundamental Index strategy's annual rebalance trimmed such shares back to their economic scope. Looking at these two exhibits, one has to question whether the cap-weighted approach is really the "passive" alternative.

Figure 1. Industry Sectors: Cap-Weighted

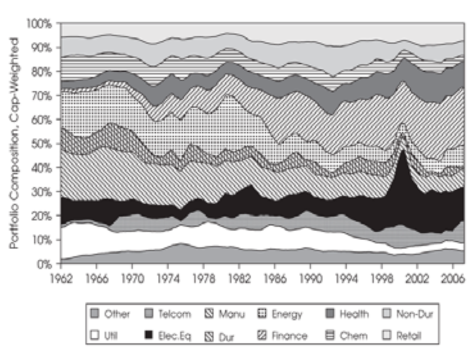
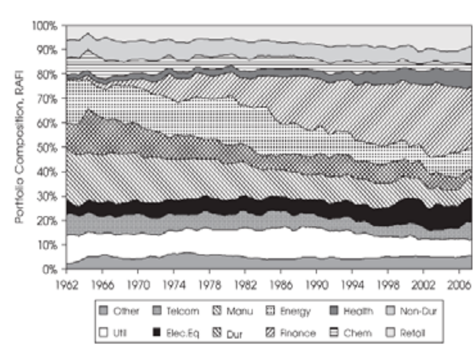


Figure 2. Industry Sectors: RAFI U.S. Large



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Likewise, an examination of individual stock weights reveals more of the shifting preferences of an active strategy embedded in cap-weighting relative to the Fundamental Index methodology. To get a sense, we compare the top 10 stocks held in each portfolio every five years since 1965. For the Cap 1000, 36 stocks make this crème de la crème list. The same analysis of a Fundamental Index approach shows significantly greater stability at the top with only 20 stocks having placed in the top 10 over the same period.

Trading is another metric for differentiating between an active or a passive strategy. Trading a cap-weighted index portfolio is minimal, relating to changes in the composition of companies in the index. Trading is higher for a Fundamental Index portfolio in that the strategy involves re-establishing the economic weights each period (in essence, the contratrade against the market's relative price movements). By this definition, the Fundamental Index portfolio might well be more "active" but the difference is marginal— 10% annual turnover versus about 6% for the Cap 1000—and is well below the turnover of the typical active strategy.

So which is the "passive" strategy? Looking at **Table 1**, it is easy to conclude that the Fundamental Index portfolio is the real passive strategy. Neither the Fundamental Index portfolio nor the cap-weighted portfolio explicitly claims to identify undervalued securities, so there is no difference in active stock selection.[1] The differences begin to develop in the degree of sector shifts with the cap-weighted portfolio displaying sizeable sector rotation, a classic active strategy. In the end, the answer depends on one's preferences—a stable, economically representative portfolio with marginally higher trading or a dynamically shifting portfolio with low trading that represents the constantly changing views of the market. Neither approach is necessarily wrong. But to claim cap-weighting has all of the elements of a true passive portfolio may be a bit of a stretch.

Table 1. Characteristics of a Passive Strategy

	Passive Management Characteristic			
	Explicitly Identifies Undervalued Stocks	Significant Shifts in Sectors	Significant Changes in Stock Weights	Greater Trading
Fundamental Index	No	No	No	Somewhat
Cap-Weighted Index	No	Yes	Yes	No

[1]See the September 2007 issue of *RAFI Fundamentals* for a wider discussion on whether the Fundamental Index strategy overtly selects stocks. http://rallc.com/ideas/pdf/Fundamentals0907.pdf.

Performance Update*

TOTAL RETURN AS OF 1/31/08	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	-4.84%	-3.96%	8.51%	14.61%	9.03%	14.11%
S&P 500[B]	SPTR	-6.00%	-2.31%	7.28%	12.04%	5.14%	14.87%
Russell 1000[C]	RU10INTR	-6.00%	-2.45%	7.77%	12.59%	5.46%	15.02%
FTSE RAFI® US 1500 Index[D]	FR15USTR	-6.20%	-8.75%	7.41%	18.78%	11.69%	18.29%
Russell 2000[E]	RU20INTR	-6.82%	-9.79%	5.81%	15.26%	6.50%	19.97%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	-9.21%	3.04%	16.39%	23.12%	11.43%	14.80%
MSCI EAFE[G]	GDDUEAFE	-9.23%	0.64%	14.29%	20.77%	7.50%	14.82%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-9.20%	2.83%	15.51%	21.63%	8.32%	14.93%

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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