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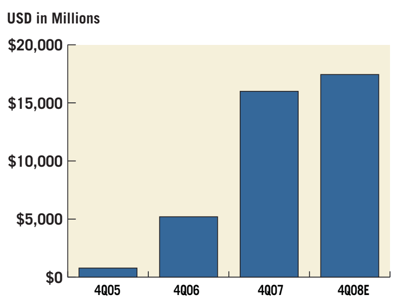
rafi® fundamentals

RAFI® Managed Assets*



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

2008—THE WORST YEAR EVER FOR ACTIVE MANAGEMENT?

Many people argue in favor of active management over passive management because they believe that "experts" actively managing a portfolio will be able to outperform the relevant passive alternative. The wisdom of this view has been debated for decades. We do not plan to review the arguments in this issue, but do note that the experiences of 2008 will likely lead to increased focus on the challenges of active management—and the benefits of allocating at least the core portfolio to a well-structured passive portfolio. Given current equity valuations, we think the time is right for investment committees to revisit their allocations to a well-structured passive strategy.

Active Management in 2008

The dust is still clearing on 2008—a horrendous year for the capital markets. Hidden within the dreadful returns of the market averages was the relatively uninspiring performance of active managers. By one measure, it was the worst calendar year of performance for a mainstream portfolio of active managers going back to 1990—exactly when manager excess returns were needed most!

Hedge funds, arguably the ultimate active management vehicle, fell 21.0% in 2008 as measured by the Hedge Fund Research Institute's Hedge Fund of Funds Composite Index—virtually matching the –22.1% slide of the traditional 60/40 stock/bond "balanced" portfolio.[1] This invites the question: Where was the manager skill, the ability to sidestep the worst of the equity markets? Free from the constraints of traditional manager guidelines, hedge funds can short securities (they are, after all, *hedge* funds!), employ leverage, and trade derivatives. Excluding government bonds, shorting was 2008's only path to positive returns. Perhaps the hedge funds were squeezed by the credit contraction. As Keynes once quipped, "The market can stay irrational longer than you can stay solvent." This especially rings true for the leveraged, but that doesn't provide much comfort for the hedge fund investor.

Interestingly, traditional managers with no leverage and only long exposure to mainstream stocks and bonds returned similarly poor performance. As **Table 1** shows, the median

[1] Using the S&P 500 for stocks and the BarCap Aggregate for bonds.

Table 1. 2008 Excess Manager Returns, Median Active Manager versus Benchmark

	Excess Return	Annual Rank Since 1990
eVestment Alliance Large Core Median versus S&P 500	1.08%	11th Worst
eVestment Alliance Large Growth Median versus Russell 1000 Growth	–0.41%	5th Worst
eVestment Alliance Large Value Median versus Russell 1000 Value	1.16%	13th worst
eVestment Alliance Small-Cap Median versus Russell 2000	–2.59%	2nd Worst
eVestment Alliance International Equity Median versus MSCI EAFE	–0.39%	3rd Worst
eVestment Alliance Core Plus Fixed Median versus BarCap Aggregate	–8.38%	Worst
60/40 Active Portfolio versus 60/40 passive	**–3.36%**	**Worst**

Source: Research Affiliates.

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active manager in 2008 underperformed the commonly used benchmark in four of the six core asset categories.[2]

The poor performance of active managers is not without precedent. As Table 1 shows, it has happened a number of times in the past 19 years. Core plus fixed-income underperformed the BarCap Aggregate by a whopping 8 percentage points in 2008—it's worst year ever. Small-caps had their second worst year with the median manager trailing the Russell 2000 Index by 2.6 percentage points. International equity active managers posted their third worst year since 1990 while large-cap value managers posted their fifth worst year. And these numbers are *before* fees.

The impact of the active management shortfall in 2008 is more sobering when we combine these active and passive asset class results into a classic 60/40 stock/bond portfolio.[3] Under this mix, we find that a portfolio of median active managers trailed a passively implemented portfolio by 3.4 percentage points, before fees. This shortfall more than doubled the previous worst calendar year (1998) when the active implementation would have only cost 1.4 percentage points in relative performance (again before fees!).[4]

Granted, making an assertion about active management with just one year of data is contrary to the "long termism" embedded in our investment culture. However, the cumulative hurdle of higher fees becomes relentless over longer time periods.

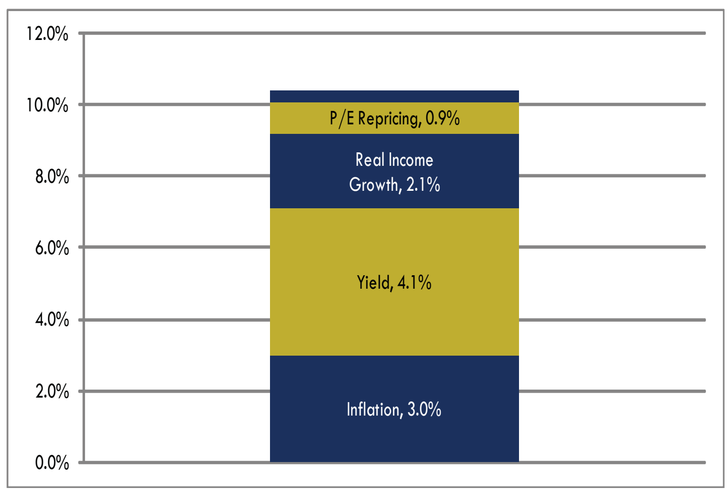
Looking Forward…

We see a silver lining in the aftermath of 2008: The global meltdown in virtually all risky assets has finally brought long-term return expectations to attractive levels. As we have stated in the past, dividend yields comprise the lion's share of stock market returns over long time periods.[5] As of February 27, 2009, the dividend yield on the S&P 500 Index was 3.9%, the highest since the recession in the fall of 1990. This figure is also very close to the historic return from dividends as shown in **Figure 1**. The premium for bearing market risk (as measured by equity dividend yields) is finally in line with the historical average. If it "pays" to be a long term investor, isn't it time to take a hard look at equities again?

We believe that last year's disappointment with active management will likely reignite the active–passive debate in investment circles, and that many investors will come down on the side of passive management. In short, we believe investors will favor simplicity over complexity, lower fees over higher fees, liquidity over lock-ups, and transparency over opacity. Beta exposure can get most investors in the ball park of their long-term return targets, without the risks and costs of active management. The recent headlines will accelerate this trend. How many times has an index fund been indicted for a multi-billion dollar fraud? If investors progressively embrace this view, their allocation to index funds will rise *as should their scrutiny on the way these indexes are constructed*.

In summary, we believe the recent investment disappointment combined with (finally) reasonable attractive equity valuations suggests advisors and investment committees would be well served to revisit their allocation to passive equity strategies in their portfolios.

Figure 1. S&P 500 Return Decomposition, 1926–2007



Source: Research Affiliates, based on data from Morningstar and Ibbotson.

[2]*Source*: eVestment Alliance. Returns are gross of management fees. Peer group data is notorious for biases, chief among them survivorship bias. Typically, trailing data only includes those products that were still in existence at the end period. Thus, it is only a snapshot of survivors who we can only predict had better performance than the funds that went the way of the dodo bird! eVestment Alliance partially protects against this bias as it still includes calendar year returns for "inactive" funds. The other primary bias embedded in this type of data is backfill bias, where a presumably strong performing manager can enter in previous calendar years when they begin entering regular data to the databases. In short, the historical data analyzed since 1990 is probably being overly generous to active manager performance.

[3]The portfolio is broken down as follows: 20% large core, 10% large value, 10% large growth, 10% small-cap, 10% international equity for a total of 60% equity; and 40% core plus fixed-income.

[4]We will not explore the impact of fees on net performance in this issue beyond noting the fact that the cumulative impact of fees on performance can be substantial.

[5]"Patience Helps in Low-Return World." 2008. *RAFI Fundamentals* (September). http://www.researchaffiliates.com/ideas/pdf/Fundamentals_200809.pdf

Performance Update

TOTAL RETURN AS OF 2/28/09	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index[A]	FR10XTR	-21.17%	-48.53%	-17.44%	-7.29%	-0.07%	15.91%
S&P 500[B]	SPTR	-18.18%	-43.32%	-15.11%	-6.63%	-3.43%	15.60%
Russell 1000[C]	RU10INTR	-17.66%	-43.62%	-15.23%	-6.38%	-3.02%	15.81%
FTSE RAFI® US 1500 Index[D]	FR15USTR	-22.32%	-47.71%	-19.34%	-6.66%	5.41%	19.87%
Russell 2000[E]	RU20INTR	-21.92%	-42.38%	-17.85%	-6.68%	1.22%	20.89%
FTSE RAFI® Developed ex US 1000 Index[F]	FRX1XTR	-20.26%	-51.58%	-14.69%	-2.12%	2.88%	17.20%
MSCI EAFE[G]	GDDUEAFE	-19.02%	-49.94%	-14.89%	-2.84%	-0.65%	17.02%
FTSE All World Series Developed ex US[H]	FTS5DXUS	-18.43%	-50.02%	-14.23%	-2.18%	0.27%	17.18%
FTSE RAFI® Developed ex US Mid Small[I]	FRSDXUS	-16.64%	-49.29%	-17.08%	-2.70%	NA	NA
MSCI EAFE Small[J]	MCUDEAFE	-15.21%	-53.39%	-21.40%	-5.52%	NA	NA
FTSE RAFI® Emerging Markets[K]	TFREMU	-13.81%	-53.98%	-7.55%	9.31%	NA	NA
MSCI Emerging Markets[L]	GDUEEGF	-11.68%	-56.03%	-11.65%	3.69%	NA	NA
FTSE RAFI® Canada[M]	FRCANTR	-11.25%	-35.57%	-8.97%	0.64%	NA	NA
S&P/TSX 60[N]	TX60AR	-9.16%	-36.63%	-7.33%	2.12%	NA	NA
FTSE RAFI® Australia Index[O]	FRAUSTR	-10.97%	-35.45%	-7.86%	3.74%	6.84%	11.65%
S&P/ASX 200 Index[P]	ASA51	-9.23%	-36.89%	-8.19%	4.37%	6.09%	12.86%
FTSE RAFI® Japan[Q]	FRJPNTR	-12.24%	-42.09%	-19.88%	-4.04%	NA	NA
MSCI Japan[R]	GDDUJN	-18.33%	-39.75%	-17.26%	-3.27%	NA	NA
FTSE RAFI® UK Index[S]	FRGBRTR	-15.37%	-36.33%	-11.52%	-1.11%	NA	NA
MSCI UK[T]	GDDUUK	-13.89%	-51.34%	-15.72%	-4.94%	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.