

# Fundamentals™



Assets managed using  
RAFI methodologies  
have increased 700%  
in 2006!



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## Topic of the Month – THE MULTIPLE METRIC APPROACH

The basic premise of the Fundamental Index™ concept is that when stocks are both selected and weighted in an index by financial measures of company size, the link between pricing errors and weights is broken allowing for maximization of investment returns for a passive investment product. Our original research<sup>1</sup> calculated the benefit to eliminating the return drag of capitalization-weighted portfolios at more than two percent over the 43 years tested. However, not all strategies are created equal. This issue of *Fundamentals*™ shows how different fundamental weighting methodologies can have dramatic implications for the uninformed investor.

A key provision of an index is its representation of the investor's opportunity set. Of course, a fundamentally weighted index will never reflect market weights. Rather, it can and should broadly reflect the *economic* opportunity set available to the investor. In so doing, each company will be weighted by its "economic footprint."

The same is true for publicly traded companies. Our original research recognized that any single metric of firm size has its own special vulnerabilities, exposing investors to a skewed sample of companies that fails to adequately reflect the economy. Looking at the four metrics of which *FTSE RAFI*™ Indices are comprised—dividends, sales, profits, and book value—we find:

- A dividend-based metric will exclude well over half of all publicly traded companies in the

market, including most growth stocks and essentially all emerging growth companies leading to potentially skewed sector allocations. In addition, dividends are a management decision which leads to the following question: should we let a management decision dictate the size of an organization? For these reasons, the *RAFI*™ methodology deliberately makes a special provision for zero-yield companies. Companies that have paid no dividends in the past five years are weighted equally according to the other three metrics.

- The sales-based metric is not consistently defined across industries. For example, sales are ill-defined in some of the service industries, notably financial services and trading companies. Further, relying only on sales to measure size may over-emphasize companies with lower profit margins.

- A profits-based metric may lead to over- or under-exposure to companies with highly cyclical income. Thus, sizeable deep value or distressed firms may receive little to no weight in a profits-based index.

- A book value metric may lead to over- or under-exposure to companies with aggressive or conservative accounting practices. It may also favor older firms with legacy assets on their balance sheets.

The *RAFI*™ four-factor methodology provides the additional advantages of lower

*continued on page two*

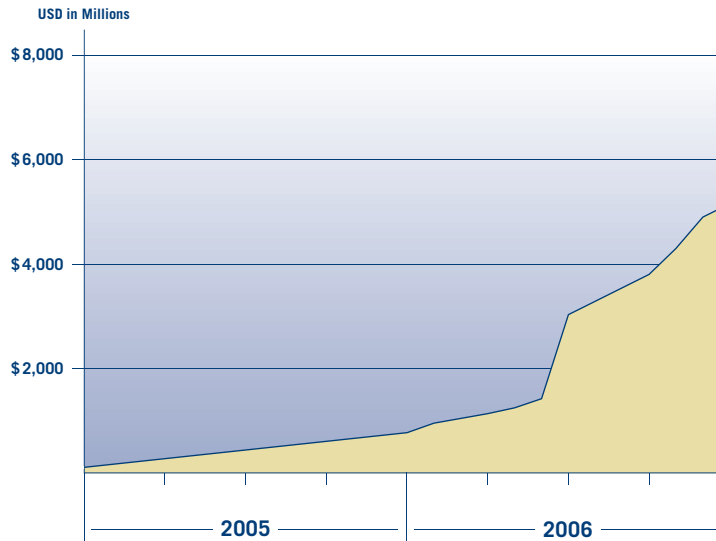
<sup>1</sup>Arnott, Robert D., Jason Hsu, and Philip Moore. 2005. "Fundamental Indexing." *Financial Analysts Journal*, March/April: 83-99.

turnover, lower transaction costs, and lower capital gains taxes compared to single metric approaches. A composite measure provides more stable weights than a single metric measure, particularly if it is based on multi-

year measures. *RAFI*™ indices will have lower transaction costs and capital gains taxes, key advantages synonymous with index fund investing. In addition, short-term swings in individual metrics caused by business cycle volatility are mitigated by the *RAFI*™ methodology, which uses five-year measures of sales, dividends, and cash flow.

We believe that a composite measure of four fundamental size metrics—specifically, sales, cash flow, book value and dividends—provides the greatest diversification, broadest cross section of companies within the economy, highest capacity and greatest tax advantages.

## RAFI™ Managed Assets\*



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

## Performance Update

TOTAL RETURN AS OF 2/28/07	YTD	12 MONTH	3 YEAR	5 YEAR	10 YEAR	ITD VOLATILITY
FTSE RAFI™ 1000 Index <sup>1</sup>	0.60%	16.11%	12.21%	10.28%	11.84%	13.41%
S&P 500 <sup>2</sup>	-0.47%	11.97%	9.09%	6.81%	7.63%	13.77%
Russell 1000 <sup>3</sup>	0.17%	12.25%	9.83%	7.56%	7.99%	13.62%
FTSE RAFI™ US 1500 Index <sup>4</sup>	1.88%	12.20%	14.85%	17.47%	15.31%	13.94%
Russell 2000 <sup>5</sup>	0.87%	9.87%	11.94%	12.43%	9.58%	14.31%
FTSE RAFI™ Global Ex US 1000 Index <sup>6</sup>	2.03%	23.72%	21.39%	19.92%	12.52%	14.11%
MSCI EAFE <sup>7</sup>	1.51%	21.57%	19.51%	16.87%	8.43%	11.21%

Source: Bloomberg and FTSE

<sup>†</sup>The material contained in this document is for information purposes only. This material is not intended as an offer or solicitation for the purchase or sale of any security or financial instrument, nor is its advice or a recommendation to enter into any transaction. The information contained herein should not be construed as financial or investment advice on any subject matter. Research Affiliates and its related entities do not warrant the accuracy of the information provided herein, either expressed or implied, for any particular purpose.

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Definition of Indices:

1. FTSE RAFI US 1000 Index comprises the largest 1000 US-listed companies by fundamental value, selected from the constituents of the FTSE US All Cap Index.
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 FTSE RAFI US 1500 Index comprises 1500 US-listed companies ranked 1001 – 2500 by fundamental value, selected from the constituents of the FTSE US All Cap Index.
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. 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.



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