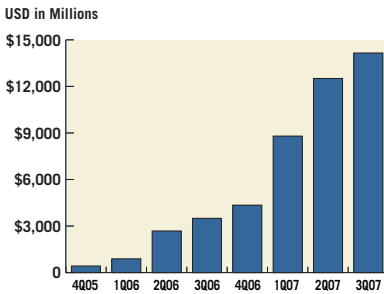


rafi™ fundamentals

RAFI® Managed Assets*



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

THE INTERNATIONAL FUNDAMENTAL INDEX® STRATEGY

The true testament to the merits of an investment strategy is its performance in out-of-sample markets and in adverse conditions. We'll focus on the former this month and the latter next. After our original research uncovered the Fundamental Index advantage in large company U.S. stocks, Nomura Securities, Japan's largest broker, examined the performance of the Fundamental Index idea in the 23 developed markets in the FTSE Developed World Index. They found the Fundamental Index strategy produced excess returns in all 23 countries with no exceptions. In this issue we examine the performance of a RAFI® international portfolio, particularly in contrast to active management.

Investors typically add international investments to diversify the equity risk of U.S. stocks, expanding the investor's opportunity set to the larger world market where many of the world's leading companies are domiciled. Indeed, only 8 of the top 20 companies in the Fortune Global 500 are domiciled in the United States. International investments also provide a hedge against the risks of a falling dollar or rising prices for imported goods and can sometimes protect investors from domestic stock market downturns. With this opportunity, however, comes increased risk. The benchmark MSCI EAFE (Europe, Australasia, Far East Index) has experienced annual volatility measured in terms of standard deviation of 17.5% over the past 20 years versus 15.3% for the S&P 500 Index.

Most investors choose to actively manage their international portfolios believing that their international managers will outperform the cap-weighted benchmarks. The evidence does not support this view. As **Figure 1** illustrates, the MSCI EAFE Index placed in nearly the top quartile of international equity large-cap core mutual funds over the past 10 years.

Even when the international managers have outperformed, it's usually been a result of the collective underweight of Japan by most investment managers during that market's prolonged malaise in the late 1990s. The recent trend is that the traditional index is hard to top; only 7% of international equity large-cap core funds added value over the past five years (2002–2007) versus 53% in the previous five years (1997–2002). Certainly indexing appears to be a simple and effective approach to filling international equity allocations.

We believe cap-weighted indexes can be improved through the Fundamental Index methodology to deliver better returns providing the type of value added hoped for (but rarely delivered) by active managers. The RAFI Global ex-USA Index consists of the top 1,000 non-U.S. companies headquartered in developed countries. Just like the U.S. versions, these stocks are selected and weighted by fundamental metrics of firm

Figure 1. Passive Versus Active in International Equities

	MSCI EAFE Index	Median Int'l Large Core Manager	MSCI EAFE Index Rank
10 Years Ended June 30, 2007	7.7%	6.9%	27
5 Years Ended June 30, 2007	17.7%	15.0%	7
5 Years Ended June 30, 2002	-1.6%	-1.4%	53

Notes: 92 products were in the peer group for the 10-year period and five years ended June 2002. 175 products were listed for the most recent five-year period. Net of expenses.

Sources: eVestment Alliance and Lipper.



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¹Tamura, H., and Y. Shimizu. 2005. "Global Fundamental Indices—Do They Outperform Market-Cap Weighted Indices on a Global Basis?" Nomura Securities Co. Ltd Tokyo, Global Quantitative Research (October 28).

size (cash flow, book value, dividends paid, and sales) rather than capitalization like traditional indexes. The result is a portfolio free from the return drag of overweighting overpriced stocks and underweighting underpriced stocks.

Our research shows that this simple and intuitive twist on the passive portfolio leads to terrific returns—the RAFI Global ex-USA achieves historical excess returns of 3.4% per year since 1984. Value added on the order of 3% annually would garner top decile peer group returns over intermediate to longer stretches. However, unlike the many top performing active portfolios with concentrated bets, it does so with great diversification—1,000 individual securities and broad exposure to most of the significant economic global sectors and countries. And for those concerned about tracking error relative to the cap-weighted EAFE benchmark, the RAFI Global ex USA generates a tracking error of only 4.4% for the 10 years ending June 30, 2007—a tame figure for those concerned with big deviations from the benchmark.

Expenses are always an important consideration for investors, and international investing is no different. Global equity research requires measurably more overhead—travel expenses, local offices, 24-hour trading platforms, multiple compliance and regulatory issues, and the like—than domestic

research. These additional costs, of course, get passed on to the consumer. According to Morningstar, the average international equity mutual fund annual expense ratio was 1.46% in May 2007. Available Fundamental Index vehicles sell to the retail investor for approximately half this figure and sell for substantially less to institutional-size mandates. Also according to Morningstar, the average international fund turned its portfolio over at an annual rate of 79% over the past five years versus the RAFI Global ex-USA long-term historical turnover of 13%.

So, does the RAFI concept fulfill the primary diversification goal of investors with international equity allocations? The answer is yes. It provides high correlation with traditional cap-weighted EAFE indexes and lower correlation with traditional U.S. indexes. From 1984 through March 31, 2007, the RAFI Global ex-USA posted a correlation of 0.67 with the S&P 500, which is comparable to the correlation for EAFE with the S&P 500 of 0.69. Furthermore, the RAFI Global ex-USA is less volatile; its annual standard deviation since 1984 has been 17.3% compared with 18.8% for EAFE and 15.6% for the S&P 500.

By providing ample diversification and reasonable similarity to traditional indexes, the Fundamental Index portfolio is a sensible, core international solution that can serve both passive and actively inclined investors.

Performance Update

TOTAL RETURN AS OF 11/30/07	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	ANNUALIZED 5 YEAR	ANNUALIZED 10 YEAR	ANNUALIZED 10 YEAR VOLATILITY
FTSE RAFI® 1000 Index ^a	FR10XTR	4.34%	6.28%	11.08%	14.18%	9.97%	13.99%
S&P 500 ^b	SPTR	6.23%	7.72%	10.09%	11.62%	6.16%	14.72%
Russell 1000 ^c	RU10INTR	6.47%	7.83%	10.62%	12.26%	6.48%	14.88%
FTSE RAFI® US 1500 Index ^d	FR15USTR	-0.26%	0.39%	9.77%	18.97%	12.54%	18.15%
Russell 2000 ^e	RU20INTR	-1.50%	-1.17%	7.87%	14.93%	7.27%	19.84%
FTSE RAFI® Developed ex US 1000 Index ^f	FRX1XTR	16.43%	20.23%	21.95%	24.59%	13.51%	14.58%
MSCI EAFE ^g	GDDUEAFE	14.20%	17.79%	19.91%	21.79%	9.38%	14.50%
FTSE All World Series Developed ex US ^h	FTS5DXUS	16.22%	19.56%	20.92%	22.71%	10.14%	14.61%

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- 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.
- 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.

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

