

Lowly Analyst Free Newsletter

Volume 8, Issue6, June 2008

CurtFey.com

In this Issue

The Market

Fundamental Index Funds II

The Market

The future of the stock market is cloudy. No matter what reasonable assumptions we make, the 8-10% returns of the past are unlikely to be seen in the future. For a low return environment, new innovative strategies must be employed. We will discuss in this newsletter one such promising strategy: Fundamental Indexing.

The US economy is shrinking in its global importance. Furthermore, the global economy is increasingly influencing the US economy. Emerging volatile economies are playing an increasing role. This will lead to increasing volatility for the US economy and US markets.

US government, businesses, and individuals have so far failed to adjust to the new world order and will have to pay for this lack dearly. A good example of how global the world has become is that I recently received resumes from all over the world for a position of administrative assistant. The resumes came from the US, Europe, Asia, Africa, and the Middle East. A highly qualified Indonesian applicant was willing to work for \$1/hr.

Commodity prices will continue to increase. Higher oil prices impose a tax on US consumers, reducing consumer spending. US debt payments put another drag on the economy. Such debt payments pose a challenge to the stock market despite repeated rally attempts.

Asset Classes. For the past month: Small Growth up 6%, Mid Growth 5%, Micro 4%, Mid Value 4%, Large Growth 3%, Small Value 3%, Large Value 0%.

Sector ETFs: For the past month: Metal & Mining 15%, Oil 11%, Steel 11%, Tech 10%, Intrnatl Energy 9%, Software 8%, Commodities 8%, Oil Eqpmnt 8%, Natrl Resrces 8%, Semiconductors 8%, Basic Mtrl 7%, Clean Energy 7%, Agriculture 7%, Natural Gas 6%, Telecom 6%, Transportation 5%, Intrntnl Utility 5%, Gbl Materials 5%, Energy 4%, Industrials 3%, Covered Calls 2%, Biotech 2%, Gbl Telecom 2%, Healthcare 2%.

Foreign Investing: For the past month: Russia up 18%, Brazil 10%, Latin America 9%, Canada 8%, Mexico 8%, BRIC 6%, Singapore 5%, Austria 4%, Emerging Mrkts 4%, So Africa 3%, Pacific-J 3%, France 3%, Germany 3%, RAFI Developed Mrkts-US 2%, World-US 2%, US 2%, Japan 2%, Sweden 2%, Netherlands 1%, Singapore 1%, RAFI Europe Small-Mid 1%, Italy 1%, Forgn Lrg Div 1%.

Fundamental Index Funds II

1. Not All Index Funds are Created Equal

Unfortunately investors cannot observe the true current value of a company, much less the future value. This lack of a measure leads to gross over valuations and under valuations. Index funds were created to protect investors from this problem.

We have shown in past newsletters that index funds generally outperform actively managed funds. Traditional capitalization weighted index funds still suffer from over- and under-valuation of securities Capitalization is share price times shares outstanding. We showed in a previous newsletter that fundamental index funds try to correct this problem by estimating the value of the firm by one factor, such as dividends. Some try to go further by estimating the true value of firms from multiple factors, e.g., book value, cash flow, sales and dividends, rather than just one factor.

2. Research Affiliates Fundamental Indexes

Fundamental ETF's constructed as described above are called Research Affiliates Fundamental Indexes (RAFI) ETF's. They were just recently created. Below are the RAFI ETF traded in the US for more than 18 months, and a comparable capitalization weighted ETF. Unfortunately the indices are not perfectly matched.

The list shows first the ticker symbols of the RAFI ETF and then below it, a comparable capitalization weighted ETF. The second column is the 1-yr total return, followed by the 18-month total return. The next column is the RiskGrade. The final column is the 18-month return divided by the RiskGrade/100. The RiskGrade is divided by 100 to scale it so that the US total market has a RiskGrade of 1.

3. Comparison Of RAFI and Capital Weighted ETF's

In our sample the RAFI ETF's had a median annual total return 1.2% higher than capitalization weighted indexes, and a median 3.2% lower RiskGrade. Research Affiliates estimated a 2% higher return and a 3% lower volatility over a longer period. A 2% higher return results in an increase in assets of 81% over a 30-year period. We also show back testing data from Research Affiliates that shows even higher increased returns.

The key advantage of RAFI is higher return at lower volatility because of less over and under valuation.

4. Domestic Indices

PowerShares FTSE RAFI US 1000 (PRF)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRF	-12.1%	8.2%	15	0.55
IWB	-7.7%	1.8%	79	0.02

PowerShares FTSE RAFI US 1500 Small-Mid (PRFZ)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFZ	-11.3%	-2.0%	99	-0.02
IWM	-11.0%	-3.4%	103	-0.03

5. Sector Indices

PowerShares FTSE RAFI Industrials (PRFN)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFN	-2.1%	13.0%	90	0.14
IYJ	-1.6%	12.6%	92	0.14

PowerShares FTSE RAFI Health Care (PRFH)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFH	-4.5%	-2.0%	66	-0.03
IYH	-10.3%	-1.3%	61	-0.02

PowerShares FTSE RAFI Consumer Services (PRFS)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFS	-16.4%	-8.4%	100	-0.08
IYC	-14.6%	-7.6%	112	-0.07

PowerShares FTSE RAFI Financials (PRFF)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFF	-31.4%	-27.1%	150	-0.18
IYF	-31.4%	-27.3%	154	-0.18

PowerShares FTSE RAFI Telecom & Tech (PRFQ)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFQ	-5.9%	6.0%	100	0.06
IYZ	-22.0%	-4.8%	112	-0.04

PowerShares FTSE RAFI Basic Materials (PRFM)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFM	7.9%	32.5%	119	0.27
VAW	13.9%	37.8%	129	0.29

PowerShares FTSE RAFI Consumer Goods (PRFG)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFG	-12.7%	-3.8%	77	-0.05
IYK	-4.5%	16.4%	68	0.24

PowerShares FTSE RAFI Utilities (PRFU)

	1YrRt	18MoRt	RiskGrade	Rt/Risk
PRFU	-2.7%	10.0%	69	0.15
IDU	-0.7%	14.0%	67	0.21

6. Back Tests of Domestic Sector Funds 1989-2007

	Sector Return		Value Added
	RAFI	S&P	
Information Tech	13.3%	11.0%	2.3%
Health Care	14.6%	12.3%	2.3%
Financials	13.9%	11.7%	2.2%
Consumer Financials	13.9%	11.7%	2.2%
Utilities	11.7%	9.5%	2.1%
Industrials	12.8%	11.0%	1.8%
Energy	16.3%	14.8%	1.5%
Materials	10.8%	9.4%	1.5%
Telecommunications	7.1%	6.7%	0.4%
Consumer Discretionary	7.7%	8.5%	-0.8%
Average	12.2%	10.7%	1.6%

7. Back Tests of Country Funds 1984/89-2007

	RAFI Return	MSCI Return	Value Added	
			Not Risk Adjusted	Risk Adjusted
Ireland	17.6%	9.5%	7.9%	8.6%
Austria	17.8%	12.5%	5.4%	6.4%
Norway	17.5%	13.3%	4.2%	4.3%
Portugal	13.2%	9.2%	4.0%	4.6%
France	16.9%	12.9%	3.9%	4.4%
England	15.0%	12.1%	3.0%	3.1%
Japan	7.1%	4.3%	2.8%	2.8%
US	14.4%	12.4%	2.0%	2.7%
Belgium	15.5%	14.0%	1.5%	2.3%
Finland	15.8%	14.7%	1.1%	5.1%
Netherland	14.0%	12.8%	1.1%	1.5%
New Zealand	7.2%	6.8%	0.4%	0.4%
Switzerland	11.6%	12.0%	-0.4%	-0.2%
Average	14.1%	11.3%	2.8%	3.5%

8. Back Tests of Global Sector Funds 1995-2007

	Sector Return		Value Added
	RAFI	S&P	
Information Tech	12.3%	10.3%	1.9%
Health Care	13.6%	12.2%	1.4%
Financials	12.9%	9.3%	3.6%
Consumer Financials	12.8%	11.3%	1.5%
Utilities	14.0%	11.2%	2.2%
Industrials	11.8%	8.6%	3.2%
Energy	17.5%	16.7%	0.8%
Materials	13.6%	10.9%	2.7%
Telecom	12.8%	7.8%	5.1%
Consumer Discretionary	9.8%	6.9%	2.7%
Average	13.1%	10.5%	2.5%

9. Discussion

Fundamental Indexes have been shown to outperform active investing and traditional index funds in theory, in back testing, and in actual funds and ETF's since 2007, a short period. No one has shown the contrary.

There is lively discussion about RAFI because there are the huge economic interests in traditional index funds. Some claim that RAFI funds are actively managed and are not index funds, that they have a value tilt, and that they have a small cap bias. All these criticisms are irrelevant for individual investors that care about increased returns and lower volatility. For a detailed discussion of Fundamental Index Funds see [Wikipedia](#) or R. D. Arnott, et.al., *Fundamental Index*, Wiley 2008.

10. Take Aways

- Fundamental Index Funds achieve higher returns at lower risk than actively managed funds and traditional index funds.
- RAFI Funds achieve their advantage by reducing over and under valuation of securities.