

DUNSTAN

Focus on the fundamentals

Inertia is preventing investment managers from profiting from fundamental index products, writes **Barrie Dunstan**.

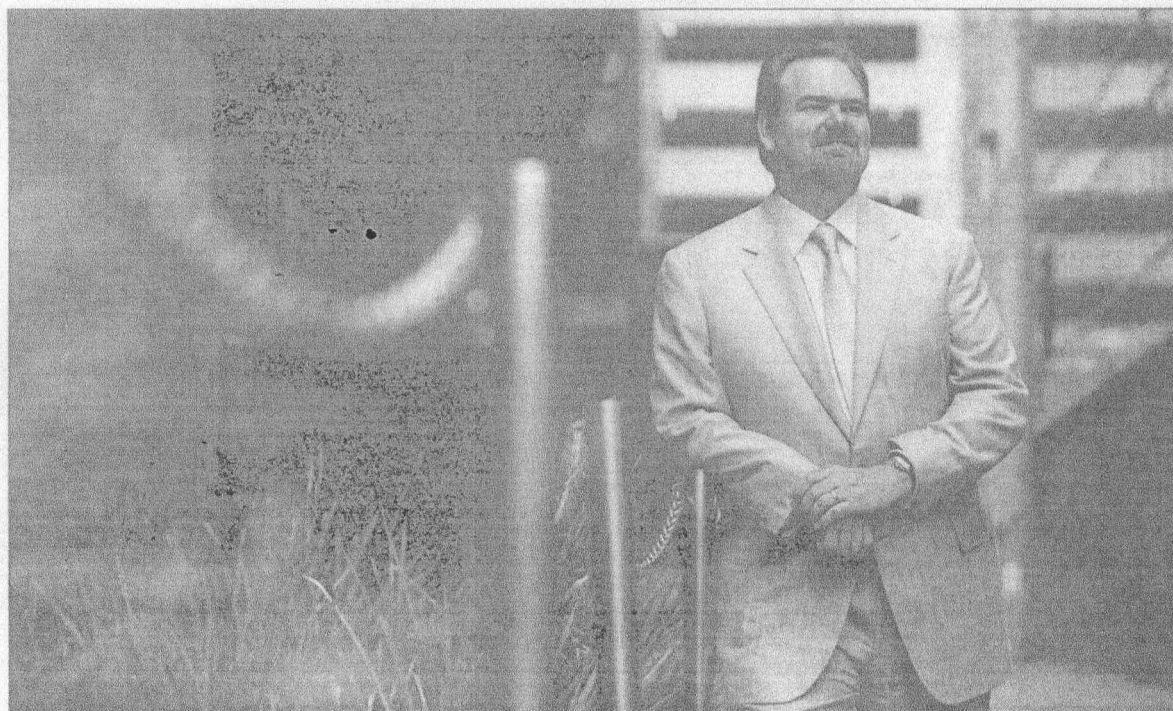
Robert Arnott is a leading US investment academic who over 30 years has also established his own asset management companies. But now he is engaged in trying to overturn what he sees as a dangerous inertia in investment management which continues to support the orthodoxy of the traditional form of index fund.

His company, Research Affiliates, has been marketing its so-called fundamental index products since 2004, making slow progress against the weight of traditional index funds run by the dominant players in the field — Barclays Global Investors, State Street Global Advisors and Vanguard.

In Australia, however, Colonial First State last year took up the idea of fundamental indexing and formed a joint venture with Research Affiliates, through a new Colonial FS subsidiary Realindex Investments headed by Andrew Francis. It has already launched four funds — two local equity funds (including a small companies fund) and two global funds (including a hedged fund) covering developed and emerging markets — and raised close to \$500 million locally.

So what makes fundamental indexing so different?

The Research Affiliates fundamental index (RAFI for short) uses measures such as a company's sales, profits, dividends and even the number of employees to establish the index weightings of companies. In contrast, the traditional index approach weights the companies based on the size of their capital.



Unorthodox approach . . . Robert Arnott is campaigning against traditional index funds.

Photo: PAUL JONES

The debate between the two index schools has continued unabated for more than five years, with Arnott's critics saying his approach in effect produces an enhanced index with a value investing tilt. On a visit to Australia recently Arnott replied that the traditional index fund is really a growth-tilted, active strategy, compared with the economy.

In a sense, the RAFI approach is really fundamentalist: Arnott says his approach takes the traditional investment analysis approach, championed by investors like Warren Buffett, arguing that people are investing in companies rather than just in pieces of paper.

Its believers say it outperforms the normal index fund because it represents more an exposure to the economy than just to the stockmarket and, because it emphasises profits and dividends, it has a tilt towards value, a style which Arnott notes tends to beat growth in the long term.

But in volatile markets, there is another powerful reason: the approach contra-trades against the stockmarket's most extreme bets. So a fundamental index in the recent downturn would have been buying financial services, industrial and

consumer durable stocks — a tilt which helped it in the rebound since March.

Arnott says fundamental indexing gives an objective basis for saying "this sector has soared; this sector has cratered. Their size in the economy hasn't changed much, so let's rebalance."

This approach doesn't reliably add value in the short term — "but

This approach relentlessly adds value long term.

ROBERT ARNOTT

it relentlessly adds value on a long-term basis".

Some investors worry that a fundamental index would be buying into so-called "value traps" which might fail rather than recover.

"The short answer is: yes, we will, but we will also buy into the survivors," Arnott says. That's called having survivor bias working in your favour because surviving companies will have less competition and more pricing power — "and that's not in the prices," he says.

For the average retail investor, Arnott says, "the best advice is really simple — don't buy what's popular. How many people selecting investments . . . look for the best [performers] for the past one, three and five years? Or how many look at the worst performers?"

In looking at the worst performers, it isn't necessarily with the idea of buying them all; rather it's to assess if there is a powerful reason for them to bleed and, if there isn't a reason but they're cheap, then buy them.

"But almost nobody does that," Arnott laments.

His group's contra-trading approach allows it to exploit the stockmarket's extreme and emotional overreactions. It's a bit like an ordinary investor rebalancing their portfolio.

He argues that the normal cap-weighted index concentrates on growth companies, overweights all overpriced stocks and underweights all underpriced stocks.

As a result, it participates fully in every market bubble and every market fall whereas the fundamental index, by using a company's fundamentals, ensures that stock price volatility doesn't impact the index target weights.

At present, there are still big

variations in how long people think the recession will last. Arnott thinks it will be "a pretty gruelling ordeal. But the question isn't how good or how bad . . . the question is: how much is in the price?"

He believes the possibility of a nasty recession isn't reflected in the current pricing of growth stocks. He says they are priced as if the economy will be back in solid growth mode in six to 18 months.

But value stocks are priced as if the poor conditions will linger for a long time — and junk bonds and convertible bonds are priced as if this is going to be as bad as the Great Depression. "So both camps can't be right."

He says if it turns out it is a mild depression and brisk growth resumes in 12 months, then value stocks and junk bonds are really cheap. But if this is right, growth stocks have a big leg down ahead and "this spread is the most interesting play in the marketplace today".

The RAFI group has about \$US20 billion managed via fundamental indices, up from around \$US16 billion a year earlier. The fall in the market hides the fact that new inflows were about \$10 billion — and this year is on track to match that, Arnott says.

But it's hard work. "Conventional indexes have a 50-year head start," Arnott admits.

It requires education — and there is a lot of inertia in the world's fund management industry. Globally, index funds only account for about 15 per cent of all funds — even though index funds have been beating active managers for 35 years, he says. "That's how much inertia there is."

He thinks index funds might account for a quarter of all invested funds in 10 years and wouldn't be surprised if fundamental index funds were about a 10th of total indexed money — or more than \$US1 trillion.

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