

Nomura Asset Management UK Limited

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Fundamental Indexation

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Introduction

Index funds are a compelling choice for investors

- Access to market returns at low cost
- Favourable portfolio attributes
- Superior performance over time relative to most active managers

The cap-weighted approach leads to a performance “drag”

- Overweights the overpriced shares relative to fair value weight
- Underweights the underpriced shares relative to fair value weight

The Fundamental Index approach eliminates this “drag”

- Weights stocks by non-price measures of firm size
- Achieves long-term excess returns of 2-4% in developed markets; greater in less efficient spaces
- Preserves many of the advantages of index fund investing

Problem with Cap-Weighting: Mispricing

If mispricing occurs, cap-weighting has a structural flaw

- Portfolio weights are inextricably linked to any pricing errors
- Overvalued stocks are overweighted
- Undervalued stocks are underweighted
- Portfolios are particularly vulnerable to pricing bubbles and subsequent corrections

Mispricing is an empirical reality

- Mispricing is evident in most markets
- Massive bubbles: South Sea, Dutch Tulip, “Nifty-Fifty”
- Smaller bubbles: Krispy Kreme Donuts, Crocs, Ethanol
- Recent bubbles: Technology and .com

What if Markets are NOT Efficient?

Some stocks will be overvalued and some undervalued

- The market will seek out true value over time

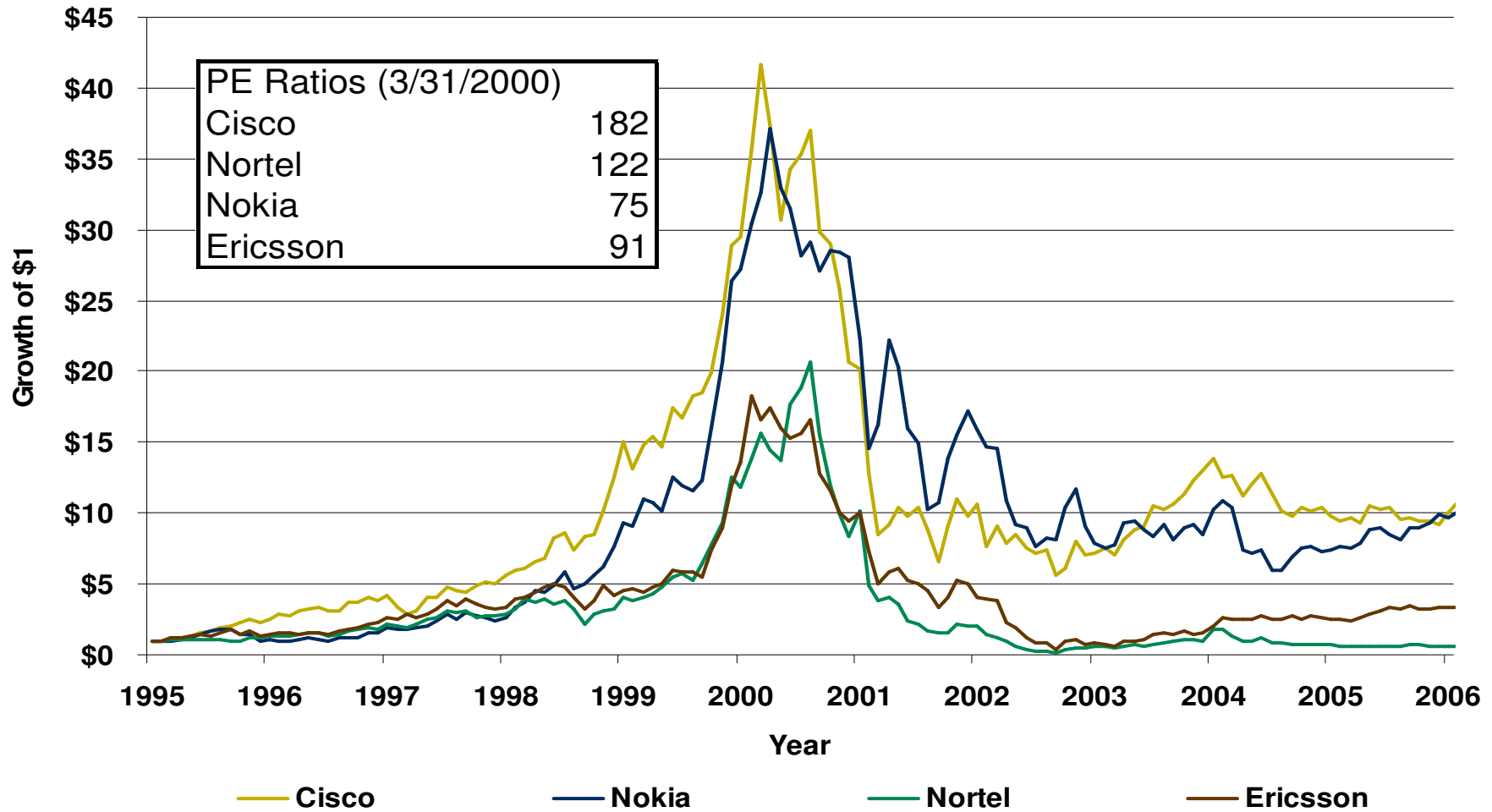
Cap-weighting will overweight overvalued stocks and underweight undervalued stocks

- Portfolio weights are positively correlated with pricing errors
- Performance drag is linked to the square of these errors

Empirical performance

- Vulnerable to pricing bubbles and subsequent corrections

The Rise and Fall of Tech Stocks



Based on month-end market close prices.
 Source: Research Affiliates, based on data from Bloomberg.

The Fundamental Index Approach

Create an index that reflects a company's economic footprint using fundamental measures of size

- Sales (5-year average)
- Cash flow (5-year average)
- Gross dividends paid (5-year average)
- Book value (Current Year)

The result, for any of these:

- Breaks the link between pricing errors and portfolio weights
- Pricing errors are uncorrelated (and cancel)
 - For example, both overvalued and undervalued stocks will be over-weighted and under-weighted, but the errors largely offset each other
- Retains many benefits of an equivalent cap-weighted index
- Outperforms equivalent cap-weighted index by more than 200 bps per year, on average*

*Research Affiliates historical data based on universe of U.S. equities 1962-2006.

Benefits of a Composite Approach

Any single-metric approach works well, but has structural biases:

- Sales: Overexposed to large companies with thin margins
- Cash flow: Overexposed to cyclical stocks at cyclical peaks
- Dividends: Overexposed to mature, high-yield companies and exclusion of growth companies
- Book value: Overexposed to companies with aggressive accounting

Composite approach improves methodology:

- Diversifies exposure to data source, sectors, and other risks
- Improves robustness of methodology
- Improves stability of factors
- Superior risk–return performance

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