

# PARAMETRIC PERSPECTIVES

NEWSLETTER

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“I can calculate the motions of the heavenly bodies, but not the madness of people.”

– Sir Isaac Newton

After losing a small fortune in the South Sea Bubble in 1721

## ► Fundamental Indexes: How can an index be active?

by Paul Bouchey, CFA — Parametric Senior Research Manager

In a sense, fundamental indexes are an attempt to avoid the “madness” that Newton referred to in his famous lament. Instead of weighting the portfolio according to market capitalization, they use fundamental factors to construct a broadly diversified portfolio that is designed to avoid over-valuations that are sometimes embedded in stock prices. For example, the FTSE RAFI 1000 uses a combination of dividends, book value, revenues, and cash flow to weight the portfolio, while the Wisdom-Tree family of indexes uses dividends only. The question is, if you were to invest in this kind of *fundamental* index, would you be considered a passive investor or an active one? This is not an easy question to answer.

These indexes are rebalanced infrequently and have low turnover, so they seem quite passive. On the other hand, they are designed to outperform market cap indexes. That sounds more like active management. Are fundamental indexes “a new paradigm” that will replace market cap indexes as the passive investment of choice, or perhaps we should call them quasi-active? While it has been entertaining to follow

this debate in the Wall Street Journal and other publications, these labels are confusing when they are not carefully defined. We use the term *structured portfolio* to describe any portfolio whose construction and monitoring is defined algorithmically and is implemented strategically rather than tactically. The term *active* describes a portfolio that seeks to outperform the market portfolio.

Using these definitions, we think of fundamental indexes as *active structured portfolios*. They are indexes in the sense that their performance is tracked and published, but they are not particularly useful as a benchmark to measure the ability of active managers and do not offer a better definition of the market portfolio.

Market-capitalization indexes, like the S&P 500 Index and Russell 1000 Index, provide “market exposure” in the sense that they provide the average return of all money invested in the market (before fees and taxes). They exploit information embedded in prices, which are essentially a set of consensus forecasts. This systematic approach to investing is low cost, tax-efficient, and very difficult to beat. Few active strategies

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## Fundamental Indexes

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have consistently outperformed these indexes. However, because market capitalization—price times the number of shares—includes price, it is a forward-looking measure, making these indexes subject to mis-pricings that may occur in the market.

In contrast, fundamental factors are backward looking. For example, in order to measure revenues, cash flows, and dividends, RAFI uses 5-year historical averages. By consciously ignoring price, it successfully resists the siren song of high growth, high price-to-earnings stocks. Investing in a fundamental index is essentially a “plug your ears and lash yourself to the mast” kind of strategy.

A back test for the FTSE RAFI 1000 Index showed an excess return of 2% a year from 1962 to 2006 Q2 over the S&P 500. It did exceptionally well for the five years ending 2006 Q2 with an excess return of 4.0%. This performance comes in the context of a broadly diversified portfolio with only a 2 to 3 percent tracking error to the Russell 1000 and with comparable total volatility. The WisdomTree Dividend Index also outperformed the S&P 500 with an excess

return of 1.4% per year from 1964 to 2005 with 1.5% less annual volatility. There are several theories for where this performance comes from, but they are all difficult to test.

**Theory 1:** For psychological reasons many investors overpay for growth expectations. These stocks are then over-weighted in a market cap index. Ignoring prices and avoiding these over-weights creates the excess returns.

**Theory 2:** Value and small cap stocks are more risky; the excess return is compensation for incurring this extra risk.

**Theory 3:** Excess return is created by systematically rebalancing in the midst of volatility.

It is tempting to label RAFI a value index and be done with it. It is true that some portion of the excess return of RAFI can be attributed to a value tilt. Remember, however, it doesn't exclude growth stocks like a value index would, it just doesn't overweight them. It would be more accurate to say that RAFI is a broad market index with a value tilt. Careful study of the portfolio characteristics of RAFI shows that it is quite distinct from the Russell 1000 and the Russell 1000 Value Indexes.

From the perspective of a tax-managed core portfolio, these indexes are very interesting. Because they are broadly diversified and have low turnover (averaging around 13 to 14 percent) fundamental indexes are good candidates for aggressive tax loss harvesting.

For example, if we assume an 8 percent market return and 2 percent excess return, we can estimate the after-tax returns:

	PRE-TAX %	AFTER TAX %
Fundamental Index	10.0	8.8
Cap-Weighted Index	8.0	7.3

If we implement with active tax management, the after-tax returns improve:

	PRE-TAX %	AFTER TAX %
Fundamental Index	10.0	9.3
Cap-Weighted Index	8.0	8.3

Having experienced the recent technology bubble, it certainly seems reasonable to try to avoid over-weighting securities that could be over-valued. For example, is Google actually one of the largest companies in the US? Is it really worth over \$120 billion? Consider that a RAFI 1000 portfolio would hold Google at only a 0.12% weight, while a Russell 1000 portfolio would hold more than 5 times that amount, or 0.68%. An S&P 500 portfolio would hold even more at about 0.75%, now that Google is included in that index.

Will this strategy continue to outperform in the future? A quote from Yogi Berra comes to mind: “It's hard to make predictions, especially about the future.”

*Parametric manages portfolios to a variety of fundamental indexes, including the FTSE RAFI 1000 and the WisdomTree LargeCap Dividend Index.*

## PORTFOLIO CHARACTERISTICS AS OF SEPTEMBER 30, 2006

	RUSSELL 1000			RAFI 1000			RUSSELL 1000 VALUE		
	PERCENT	PERCENT	DIFFERENCE	PERCENT	PERCENT	DIFFERENCE	PERCENT	PERCENT	DIFFERENCE
Tracking Error to R1000	—	2.2	—	3.1	—	—	3.1	—	—
Basic Materials	4.1	4.4	0.2	4.6	4.6	0.5	4.6	4.6	0.5
Commercial Services	3.3	2.7	-0.5	1.5	1.5	-1.8	1.5	1.5	-1.8
Consumer Cyclical	7.4	10.3	2.8	3.3	3.3	-4.1	3.3	3.3	-4.1
Consumer Noncyclical	7.7	8.5	0.8	7.5	7.5	-0.2	7.5	7.5	-0.2
Consumer Services	5.4	5.3	-0.2	5.2	5.2	-0.3	5.2	5.2	-0.3
Energy	8.1	8.1	0.0	13.0	13.0	4.8	13.0	13.0	4.8
Financial	23.9	26.8	2.8	38.2	38.2	14.2	38.2	38.2	14.2
Health Care	12.8	9.2	-3.6	7.7	7.7	-5.1	7.7	7.7	-5.1
Industrials	2.8	2.6	-0.1	1.6	1.6	-1.1	1.6	1.6	-1.1
Technology	15.8	10.4	-5.4	5.0	5.0	-10.8	5.0	5.0	-10.8
Telecommunications	3.5	4.5	1.0	6.1	6.1	2.7	6.1	6.1	2.7
Transport	1.7	1.6	0.0	0.7	0.7	-0.9	0.7	0.7	-0.9
Utilities	3.5	5.8	2.3	5.6	5.6	2.1	5.6	5.6	2.1
Number of Securities	878		877			556			556
Dividend Yield	1.8		2.1			2.4			2.4
Price/Earnings	23.5		20.6			20.4			20.4
Price/Book	5.0		3.5			2.6			2.6
Return on Equity	19.7		16.1			16.9			16.9
Market Capitalization (\$M)	86,487		82,388			102,170			102,170



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# PARAMETRIC PERSPECTIVES

## ► Market Commentary

by Tom Seto — Parametric Director of Portfolio Management



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For the first time in over two years, the Federal Reserve did nothing. After seventeen straight interest rate increases, with oil retreating to \$60/barrel and the housing market slowing down, the Federal Open Market Committee twice left interest rates untouched during the third quarter, anticipating a cooling economy would ease the threat of inflation. In response, the S&P 500 Index had its best quarter of the year, up 5.7%.

Large-cap stocks were the primary beneficiaries of a moderating Federal Reserve, outperforming mid-cap and small-cap stocks (S&P MidCap 400 Index, -1.1%; S&P SmallCap 600 Index, -0.9%). The best performing sectors in the third quarter were last quarter's worst performers:

- Telecommunications, +10.6%
- Health care, +10.2%
- Technology, +8.5%.

Energy was the weakest performing sector, -1.7%, as crude oil slid more than 20% from its mid-July highs. Style was not much of a factor, as growth and value performed similarly in the third quarter (S&P 500/Citigroup Growth Index, +6.1%; S&P 500/Citigroup Value Index, +5.3%).

While effective in tempering inflation, slowing economic growth does not bode well for the stock market, especially if consumer spending slows. However, forecasts for the coming earnings reporting season are for double-digit profit growth for companies in the S&P 500 Index. With potentially tight Congressional races in the coming November elections thrown into the mix, our broadly diversified, sector-neutral Tax Managed Core portfolios will provide a great opportunity to capture the next market leaders, while doing so in a tax efficient manner.



Source: Russell, S&P, MSCI, KLD, FTSE. We believe the information provided here is reliable but do not warrant its accuracy or completeness.



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## About Parametric

Parametric is the industry-leading provider of structured portfolio management. Headquartered in Seattle, Washington, Parametric offers a variety of structured portfolio solutions, including customized core equity portfolios (US, Non-US, Global Tax-Managed Core™), and overlay portfolio management (OverlayOne™).

## Total AUM:

\$17.8 Billion

## Established:

1987

## WHAT'S NEW?

### Lower minimums for non-US and global Tax-Managed Core (TMC) portfolios

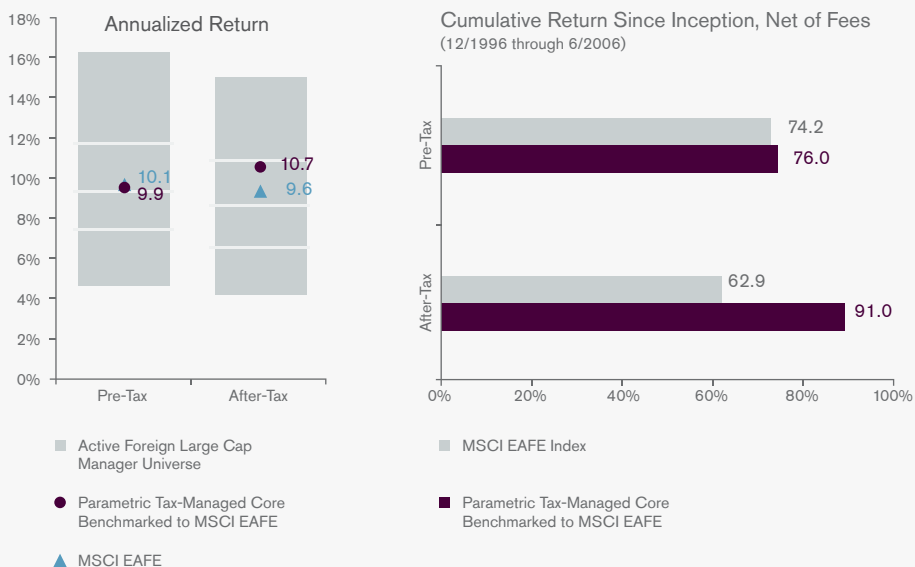
The continued evolution and development of Parametric's portfolio management systems has made our non-US and global portfolio management processes more efficient. As a result of these improvements and a steady increase in investor interest, we are reducing our non-US and global separate account portfolio minimums significantly. As an example, a MSCI EAFE Index TMC portfolio will be available for minimum investments of \$250,000 depending on the custodian/platform. "We've seen increased interest in non-US and global tax-managed portfolios from many wealth managers and their clients. We wanted to make our products in these areas even more accessible," says Brian Langstraat, CEO of Parametric.

Global portfolios combining US and Non-US market exposure or "beta" in a tax-efficient, customizable separate account are also garnering increased attention. Parametric has the ability to tailor an investor's US/Non-US allocation to a custom target and maintain these allocations through various types of rebalancing.

#### Key points on the Non-US Tax-Managed Core:

- Minimum account size as low as \$250,000.
- American Depository Receipts (ADRs) are used to reduce trading and custody costs. A typical portfolio holds 250 to 300 securities.
- Optimization is used to manage tracking error risk to between 1.5% and 2% of the MSCI EAFE Index.

The charts below show pre-tax and after-tax results for our 5-year Tax-Managed Core composite versus a peer universe (annualized) and versus the index (cumulative).<sup>1</sup>



1. Source: Parametric. Five years ending 6/30/06. All reported composites are net of fees and include only accounts funded with cash and free from client-directed investment restrictions. Because Parametric manages each account to reflect client specific characteristics, accounts funded with securities and/or subject to restrictions can experience varying performance. The Active Foreign Large Cap Manager Universe consists of 259 mutual funds (classified by Morningstar as Foreign Large Blend, Foreign Large Growth and Foreign Large Value). Returns are net of fees. Maximum Federal tax rates are used for each period.