Abstract
For over 40 years, our industry has relied on the Capital Asset Pricing Model (CAPM) beta and the capitalization-weighted market portfolio for asset allocation, for market representation and for our default core equity investments. This elegant world-view is now under siege from various directions.

The “fundamentalists” advocate a portfolio that weights companies in accordance with the recent economic scale of their businesses, thereby resembling the composition of the economy rather than the composition of the stock market. The “minimum variance” crowd points to the value of consistency between investor objectives and portfolio construction. The “egalitarians” advocate equal weighting. Historically, these alternative index strategies have delivered higher return and lower CAPM beta, which can help an investor to target either more return or less risk or a bit of both. Each of these strategies—along with the ever-dominant cap weight indexes—has strengths and weaknesses, some minor and some major.

The cap-weighted standard is also facing a more subtle source of attack as investors reassess their risk budgets. Increasingly, investors are reassessing their risk budgets, usually downward, which can create pressure to move from active into passive strategies and to lower a fund’s exposure to an undiversified single-factor equity risk. But, can we lower our risk profile without abandoning our return goals? Perhaps it is time to consider a bigger tent, allowing for the merits of multiple broad-market indexes and multiple betas.

We explore the comparative merits of four major categories of quasi-passive “index” construction. We do so from a global perspective. And we explore the surprising efficacy of combining multiple index strategies into a diversified beta portfolio.
Introduction

Historical concepts regarding market efficiency and single-factor beta are losing favor as markets have whipsawed even the best-diversified portfolios. Just as many investors are increasing exposure to passive strategies, they face a new and unsettling prospect of “benchmark regret,” to borrow from the terminology of behavioral finance, as it’s no longer clear that Cap Weight is the only legitimate benchmark or core portfolio choice. In fact, institutional investors can choose from a wide array of alternative beta strategies, including Equal Weight, Minimum Variance and Economic Size (also known as the Fundamental Index approach), to name a few.

These alternatives have generally offered better return or lower volatility, or both, when compared with Cap Weight, both in historical tests and on live assets, albeit over a shorter span than Cap Weight and on a smaller asset base. If the performance advantage of the alternatives persists, a decision to commit to Cap Weight and to ignore the alternatives may someday be second-guessed as an overly narrow and costly mistake. Although some in the mainstream indexing community dismiss these alternative beta strategies as cleverly packaged active management strategies, we believe that these alternatives provide useful alternatives to the cap-weight index portfolio.²

The historical record for each of these alternative index strategies suggests some particular competitive advantage. Equal Weight has the longest live track record of value-added, dating back to the early days of the Value Line index; Minimum Variance offers the highest historical Sharpe ratio and lowest risk; Economic Scale portfolios offer the highest information ratio; and Cap Weight offers vast scalability, theoretical purity—in an efficient market, the others should not win on a risk-adjusted basis—and, of course, the lowest tracking error relative to the stock market, which is inherently cap-weighted.

In the rapidly changing world of indexing, any investment decision is an active choice, even a switch from active into passive exposure. The decision to invest passively provides only a starting point for determining which passive or quasi-passive approach best meets an investor’s needs. Cap Weight is no longer the only compelling choice, not to mention that there are many cap-weighted indexes to choose from.

Our research focuses on a few of the “index” strategies that are gaining traction in the marketplace and explores the potential value of a diversified approach in our quest for beta. Some call these new ideas beta-prime, some call them enhanced indexing, still others dismiss these approaches as active management in drag. Whatever we call them, few would deny that they are fast changing the investing landscape.

² In an effort to finesse the controversy regarding the terms “active,” “passive,” “index,” and “strategy,” as relates to non-cap-weighted portfolios, we generally refer to all of these indexes, including Cap Weight, as “strategies” or “portfolios.” We offer our observations on this discussion in the Appendix.
Deleveraging and Non-Cap-Weighting

Many investors are reducing their risk budget—some term this de-risking—for a host of reasons. Some are doing so to reduce the sometimes-frightful gap between assets and liabilities. Others are acting out of a fear of an over-leveraged global economy and the impact that this leverage can have on capital markets’ volatility. Others are doing so to rein in the impact that funding ratio volatility can have on their earnings. And many are doing so because of a fear that the current low yield for stocks, paired with an uncertain inflation outlook, that cast a cloud of doubt over the future prospects for the much-vaunted equity risk premium.

Keith Ambachtsheer, Marty Leibowitz, and Peter Bernstein have noted repeatedly over the past quarter century that there’s a peculiar link between inflation and real equity returns. When inflation is low and stable, equity valuation levels rise and returns are handsome. When deflation strikes, government bonds prices soar and equity valuation levels crater. The correlation between stocks and bonds tumbles. And, when reflation leads to sustained high rates of inflation, bond yields soar (bond prices fall) and equity valuation levels tumble. The correlation between stocks and bonds soars.

It is far beyond the scope of this paper for us to weigh in on the sometimes vitriolic debate about the relative risk of deflation, reflation, stagflation or hyperinflation in the years ahead. However, it is well worth noting that there are remarkably few observers of current markets who harbor hopes for a benign move back to the low, stable, and well-orchestrated rates of inflation of the 1990s and pre-crash 2000s. Because either extreme—deflation or stagflation—tends to be rather savage to equity valuation levels and real earnings growth prospects, these fears fuel additional calls for de-risking.

De-risking an institutional portfolio can mean many things. Typically, de-risking involves investors shifting from riskier assets into more defensive assets. This can mean lower overall equity allocations, lower beta strategies and/or allocating more of our risk budget to passive management and away from active management. Shifting assets from active to passive management is a popular choice for many reasons, including lower total costs and the empirical evidence that most – but assuredly not all! – active managers fail to add value.

A more subtle reason for de-risking, which can be observed but not measured, is public anger at a perception of “Wall Street greed.” The low costs of Cap Weight, and its new quasi-index brethren, means that more of the return of the holdings flows to the investors, and less to the managers, brokers, custodians, and other intermediaries. This pleases many customers!

For all of these investors, the non-cap-weighted “index” strategies are important additions to the investment tool-kit. If these strategies offer higher return and/or lower volatility on average over time, as history would suggest, at a fraction of the cost of fully active strategies, then investors can choose to reach for more return at the same portfolio risk or can choose to reduce equity market exposure without necessarily reducing the return.
Index Alternatives

Of the alternatives, we have chosen to explore—and combine—the four approaches that are garnering the most attention as alternative core equity strategies. As we delve into their characteristics, let’s also examine the principles and tacit core assumptions that lay a foundation for each.

Some of the key attributes for the four index strategies are summarized in Table 1. For purposes of evaluating global results, across all four types of strategies, currencies were hedged by using interest rate differentials to approximate the impact of continuous hedging and did not include the impact of actual hedge costs (Lazard, 2009).

[Table 1 goes here]

**Cap Weight.** Market capitalization remains immensely popular as the incumbent and theoretically efficient choice, despite doubts about whether its core theoretical underpinnings—the Efficient Market Hypothesis (EMH) and CAPM—are precisely correct. Cap Weight tacitly assumes that share-price-implied consensus expectations, regarding the net present value of each company’s future growth prospects, are an unbiased view of the future. Furthermore, Cap Weight offers very low turnover, trading costs, and tax consequences, which the newer alternatives can’t quite match.

As EMH and CAPM gained traction in academia, the theoretical result—that a single portfolio could be optimal—was revolutionary. The theoretical purity of Cap Weight, along with the difficulties faced by the average active manager, in time gave rise to passive investing. The growth in “index funds” was fueled by the historical fact that the average active manager has had a hard time beating cap-weighted indexes, after taking account of fees and transaction costs.

No student of the capital markets should find this the least bit surprising. After all, if we divide the market into the passive, cap-weighted indexes and the combined holdings of all active, non-cap-weighted portfolios— including individual investors—the former matches the market in both holdings and performance, which means that the latter must also match the market. Before costs. So, net of costs, the non-cap-weighted active managers must collectively lag Cap Weight. None of this requires market efficiency; nor is it necessary to believe that we cannot “beat the market.” We need only admit that winning active managers must have losing managers on the other side of their trades! Even as indexing gained traction, a growing body of empirical evidence suggested that patient investors could achieve above-market performance, with statistical significance, most notably with a value tilt.

If EMH and CAPM are mere approximations of the real world, then the assured dominance of Cap Weight, on a risk-adjusted basis, evaporates. Suppose we believe that markets are inefficient, and that investors are subject to errors that result in share prices that deviate from their fair valuations. When investors construct portfolios that weight companies proportional to capitalization, they inherently overweight the overpriced stocks and underweight the underpriced stocks. This truism has been acknowledged by many in the indexing community, and dismissed because of the equally relevant truism that we cannot know which companies are over- or under-
valued. But, if we can sever the link between over- or undervaluation and portfolio weight, perhaps we can improve upon Cap Weight. Or so the “fundamentalists” suggest.

**Economic Scale (or Fundamental Index).** The Economic Scale approach uses a company’s fundamental economic size—weighting companies according to sales, cash flow, book value and dividends, then averaging the four measures—both to select the 1000 largest companies and then to assign portfolio weights to each company in an index.³

The “fundamentalists” point out that if the market is inefficient and prices may stray above or below a company’s future true fair value (which Bill Sharpe whimsically terms its “clairvoyant value,” since only a clairvoyant could know that value), the cap weight of every overvalued company will be above its fair value weight, and the cap weight of every undervalued company will be below its fair value weight. This truism means that a Cap Weight portfolio will experience a performance drag relative to a clairvoyant-value-weighted portfolio.⁴ This is not controversial. As we cannot know future cash flows on our investments, and so cannot construct the clairvoyant-value-weighted portfolio, so what?

Suppose we break the link between over- and under-weighting relative to clairvoyant value weight (the clairvoyant error in weight) and over- and under-valuation relative to clairvoyant value (the clairvoyant error in price). In other words, suppose that there’s no correlation between the two “error gaps”—clairvoyant error in price and clairvoyant error in the weight in our portfolio. We still have overvalued and undervalued companies; we still have companies that are above or below fair value weight. But, these are no longer identically the same lists. The errors cancel.

If we weight companies by their fundamental economic size, we enjoy many of the attractive attributes of the Cap Weight portfolio, such as liquidity, low turnover, scalability and objectivity. But we no longer assuredly overweight the overvalued stocks and underweight the undervalued stocks, relative to the unknowable “clairvoyant value weight” of each company. In so doing, if the market is inefficient and the price contains a mean-reverting error, we arguably eliminate the greatest Achilles’ heel of Cap Weight: the performance drag associated with its assured overreliance on the overvalued companies.

Selecting and weighting companies for a stock market index, using fundamental economic measures of company size, was introduced by Arnott, Hsu, and Moore in 2005. Some such approaches rely on single measures, such as dividends or revenues. Others rely on multiple measures. The result is a portfolio where position size is proportional to some measure of a company’s “economic footprint.” Just as our footprint in the sand at the beach has multiple measures—length, width, depth—the footprint of a company in the economy has multiple

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³ The Economic Scale approach uses the standard Fundamental Index methodology to determine the weights in an index. See Arnott, Hsu, and Wood (2005) for details on the methodology. Fundamental Index® and related labels and concepts are protected by trademarks, copyrights and patents, owned by Research Affiliates, LLC.

⁴ We cannot know “clairvoyant value” for any asset today. We can know the past clairvoyant value of most assets, especially if we go far back in time, so that the long subsequent history of distributions can be discounted back to an ancient starting date. For a detailed exploration of the nuances and surprisingly rich implications of clairvoyant value, see Arnott, Li, Sherrerd (2009a and 2009b).
measures. The FTSE RAFI methodology, which we use in this research, relies on four measures of the size and recent success of a company, including sales, cash flow, book value, and dividends. This methodology creates a representative portfolio, weighted to mirror the look and composition of the publicly-traded economy, rather than the look and composition of the stock market.

The “fundamentalists” argue that this economic scale serves as an anchor for contratrading against the constantly shifting expectations of the market, and that this contratrading is the primary profit mechanism of Economic Scale portfolios. Some even suggest that Economic Scale strategies do not earn an alpha at all; rather, they suggest that Cap Weight incurs a negative alpha, against its opportunity set, which Economic Scale partly corrects.

The Economic Scale portfolios do not have a monopoly on this advantage: the same holds true for any index method that provides a steady anchor for contratrading against the market’s most extreme bets. This same argument may be made for any weighting scheme that does not take share price into account, in setting our portfolio weights, which brings us to the other two index structures that we wish to explore in this paper.

**Equal Weight.** The Equal Weight approach assigns an equal weight to each company in an index, thereby tacitly assigning zero information value to all public and private information about a company except for its inclusion in the source index. For instance, the S&P 500 Equal Weight Index (S&P EWI) tacitly assigns value to a stock’s inclusion or exclusion from the S&P 500 Index, but no value to any differentiating information, which might lead us to prefer any one company over any other. Equal weighting was the basis for the first index futures (the Kansas City Value Line Index Futures from the early 1980s), has the longest history of the “index” alternatives, and provides an interesting counterpoint to Cap Weight.

Suppose we assume that it is impossible for any investor to predict a security’s risk or return, or the covariance matrix. Then, it follows that holding an equal amount of each investable security results in the portfolio with the lowest predicted risk, at no sacrifice to our expected return. Put another way, if the Cap Weight portfolio reflects the view that the aggregate investor universe fully incorporates return and risk forecasts, then Equal Weight assumes that the aggregate investor universe has zero ability to forecast anything.

For practitioners, the elegant simplicity of an equally weighted portfolio is compromised by implementation issues. Because Equal Weight means that we hold small companies on the same scale as large ones, the strategy results in higher transaction costs and lower capacity than Cap Weight. Still, absent trading costs and any view on forecasting return or risk, equal weighting has considerable appeal on a risk-return basis.

One nuance that has received startlingly little attention in the academic and practitioner journals is: Equal weighting of what index? If Cap Weight has a bias towards including overvalued companies, then Equal Weight may exacerbate this bias. For instance, a clairvoyant might assert that the future prospects of 150 companies in the S&P 500 do not justify inclusion in the index. Their “clairvoyant value” market cap is too low. Because they will assuredly underperform eventually, they will pull down the S&P 500 return relative to our mythical clairvoyant value
Beyond Cap-Weight: The Search for Efficient Beta

So, what list should we use?

Suppose, instead, we equal weight the 1,000 largest companies, measured by their economic footprint. We know that the 1,000 largest market-cap stocks have considerable overlap with the 1,000 largest companies measured in terms of economic footprint (a Fundamental Index portfolio). Large companies are usually large-cap, and vice versa. There would typically be 700–800 overlapping companies. So, if we equal-weight a large-cap 1,000-stock index, there will be 200–300 companies in the portfolio that are—by definition—small companies trading at lofty enough multiples that they become large-cap. Empirically, many of these subsequently disappoint.

Reciprocally, by equal weighting the 1,000 largest companies selected based on fundamental Economic Scale, we include 200–300 companies that are—by definition—large companies trading at deep enough multiples to be small-cap. While these might comprise 3-5% of the Economic Scale portfolio, they comprise 20-30% of the equally-weighted Economic Scale portfolio. Many of these are of good clairvoyant value and many are not; it’s a more random result. The empirical result is sharply higher performance than equally weighting an index that has been selected by market cap.

We should note that no one has built a product based on equally weighting a Fundamental Index portfolio, but we think it’s a very interesting idea. It has similar merits and demerits, when compared with the now-widely-accepted equal weight portfolios based on cap-weighted indexes such as the S&P 500. In an efficient market, these two equal weight portfolios should have much the same return. In practice, they do not. Accordingly, to mitigate the potentially serious problem of selection bias, we construct two equally-weighted 1,000-stock portfolios—Cap Weight and Economic Scale—and then equal weight the 1,000 largest, based on the combined rankings of size. And we test all three. Applied globally, we get our Global Equal Weight portfolio.

Minimum Variance. Minimum Variance portfolios are designed to reduce portfolio risk. In an efficient market, this should not improve our risk-adjusted returns. But, if equity returns are not linearly related to beta, as CAPM predicts, it may generate high risk-adjusted returns. This approach, introduced in the early 1990s, has been gaining traction recently. It builds portfolios without reference to a benchmark, by using historical measures of risk with the goal of minimizing the portfolio volatility. Its efficacy depends on the market mispricing risk. In a world increasingly focused on risk, it is unsurprising that this concept is gaining attention.

Investors have traditionally created equity portfolios that manage risk relative to market indices; less attention has been paid to the question of which index best meets investors’ needs. Minimum Variance portfolios are constructed to create high risk-adjusted returns by minimizing
volatility without reference to return expectations. Haugen and Baker (1991) were pioneers in this domain; their U.S.-focused research principally concluded that, due to investor restrictions on short selling, tax situations, and return and risk expectations, portfolios could be constructed that dominated the market portfolio in terms of risk-adjusted returns.

Alternatively, this incremental return could potentially be explained by the presence of additional unidentified risk sources in the low-volatility portfolio. An alternative explanation of the incremental return is that these portfolios systematically favor risks that the market has mispriced. Risk can be mispriced due to differences in measurement as well as the relative importance that investors place on different measures of risk. The classic definition of risk as the volatility of total return is inconsistent with investor experience. Falkenstein (2009) suggests a utility function that measures risk within the context of relative wealth and that this is an outcome of investor preference for status. This perspective is consistent with the institutional investor focus on information ratio as the preferred measure of risk-adjusted returns. Evidence that risk preferences vary among individual investors is provided by Dorn and Huberman (2009) who examined a large number of broker accounts and found that holdings tended to cluster by volatility. Portfolio risk considerations are secondary to return expectations and the comfort of stocks that are within preferred risk habitats.

A related opportunity has been identified to invest in stocks with low volatility. This portion of the universe has been found to have greater-than-market returns, while stocks with high volatility empirically tend to deliver lower returns. Ang, et al (2006) documented this effect while researching a broad universe of U.S. stocks and concluded that the effect could not be explained by size, book-to-market, momentum, and liquidity. Similar effects were found in European and Japanese markets by Blitz and van Vliet (2007) who controlled for illiquidity and found the results to still be intact: low volatility stocks deliver higher risk-adjusted returns, even when controlling for value and size. Investors have used this approach within both active and quasi-passive styles.

Minimum Variance offers an interesting challenge for our purposes: there are as many ways to construct a Minimum Variance portfolio as there are ways to measure past, present or future risk! The strength of the academic evidence in favor of Minimum Variance has prompted benchmark providers, such as MSCI Barra, to calculate their own Minimum Variance portfolios. The MSCI World Minimum Volatility Index, launched in 2008, experienced approximately 30% lower volatility than the MSCI World Index over the simulated history (1995–2007), with a 50% improvement in the Sharpe ratio. But, the MSCI Barra methodology is proprietary, so we cannot replicate it for our purposes.

It is not our intent to be exhaustive in exploring the many permutations of Minimum Variance, so we have adopted the approach that our authors from Lazard use in one of their Minimum Equity Risk strategies. Risk measurement is based on a diversified approach that incorporates multiple measures, including interest rates, oil prices, region, and sector as well as size, yield,

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5 Tacitly, this means that a forecast for the covariance matrix drives our portfolio construction. The "forecast" incorporated within the Minimum Variance models relies purely on observed and actual historical data. No actual forward looking forecast is embraced, at least none inasmuch away from actual long term figures.
and growth, as calculated by the Northfield Global Risk model. We minimize the absolute risk of the portfolio, subject to some constraints to assure broad diversification and investability.

Combining the Indexes

These methods provide discrete choices to the investor, with very different and surprisingly complementary characteristics. This is by no means an exhaustive list. For instance, two organizations in France, TOBAM and EDHEC have developed very interesting “maximum diversification” and “efficient index” portfolios. The TOBAM team, formerly members of the Lehman Brothers quantitative research group, constructs a “maximum diversification” portfolio that has an equal and lowest-possible correlation with its constituent holdings, and for which all excluded assets would boost the correlations, if included. The EDHEC “efficient index” portfolio is based on presuming that return is linearly linked to a general measure of total risk (semi-deviation) and then using Markowitz mean-variance optimization to identify the tangency portfolio. Both ideas are fascinating variants of the broad concept of Minimum Variance. For another example, see Held (2008), for equal-weighted sector rebalancing.

We think the four strategies that we include in our research are the most widely accepted passive and quasi-passive alternatives. They can be combined to create a compelling investment – and a “diversified beta” – that incorporates many of the historical advantages of passive portfolios while perhaps earning higher returns or experiencing less risk. This paper reviews the comparative characteristics and returns for each approach. We then consider the use of a diversified set of methods in combination and provide some concluding comments and suggestions for further research.

To test whether investors are better off using combinations of passive strategies, we look at two additional strategies. The first is an “Efficient Beta” which is calculated by equally weighting Cap Weight, Economic Scale, and Minimum Variance strategies. We call this combination “Efficient Beta,” as it has relatively low transaction costs and substantial investment capacity. The second equally weights all four indexes. We tacitly assume monthly rebalancing of the three or four strategies back to equal weights. Trading costs are also explored, even though the resulting turnover for all of these strategies is relatively slight, so this layer of costs will be minimal.

Currencies were hedged by using interest rate differentials to approximate the impact of continuous hedging and did not include the impact of actual hedge costs. As is reasonably standard in published index returns, our results do not reflect transaction costs. However, trading costs matter, even with low-turnover index and quasi-index strategies. The impact of transaction

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6 We incorporate a proprietary size factor that controls relative size exposure so the portfolio is not dominated by small, illiquid companies. We also impose constraints that limit GICS sectors to a maximum of 20% and individual securities to 1.5%, and an additional measure that moderates GICS Industry Group exposures to ensure that the portfolio offers a broad distribution of exposure across industries. We also restrict the investable universe by market cap and trading volume, to ensure that the strategy invests only in liquid stocks, as measured from the perspective of a large investor in this strategy. The market cap and volume constraints do not materially change the return and risk characteristics of the portfolio, but they do have a bearing on scalability and investability.

costs can be inferred based upon the annual turnover and average market cap of the respective portfolios, as we briefly summarize later.

Relative Performance

Our research covers global equity strategies that are fully hedged back into U.S. dollars, covering the period January 1993 through June 2009. This relatively recent span is a function of available global data. We required sufficiently detailed information across global markets to permit construction of all four strategies, and information complete enough to include all non-surviving companies of sufficient scale to enter any one of our portfolios.

Critics may point to the short history in this study, style biases in these alternative core portfolios, implementation challenges, and so forth. Because we wanted to test these ideas on a global scale, and across all four methods, the research is necessarily rooted in a relatively short historical span, covering just over 16 years of equity market results. However, the results mirror the country-by-country results of others, testing single methods, and mirror the longer-span results observed in less-than-global applications. Although this history is not as long as we might prefer, these results do span several market cycles, including much of the secular bull market of the 1990s and the secular bear market since.

For a proper apples-with-apples comparison, we created a simulated Cap Weight portfolio. Because the Economic Scale and Global Equal Weight portfolios each span 1,000 companies, we wanted to create a Cap Weight developed markets index that is as objective as possible. This portfolio is comprised of the 1,000 largest companies domiciled in the 23 developed economies contained in the FTSE and MSCI developed world indexes, selected and then weighted by market cap. as the methodology is analogous to a developed world “Russell 1000.” It will come as no surprise that it tracks very closely with the published currency-hedged FTSE and MSCI developed world indexes.

The year-by-year results, in Table 2, show that there are markets in which each will shine. Cap Weight is best of the bunch in 1998, 1999, and 2007, years in which growth won handily and active managers generally struggled. Economic Scale was best in three years and the equal-weighted Economic Scale portfolio was best in another four years. And Minimum Variance was best in seven years, surprisingly not just in the weak years for stocks, when shunning risk would be expected to win.

Of course, the composite strategies can never be best or worst, because that would require them to beat all of their constituent portfolios or losing to them all, over an individual year. This affects the combined Global Equal Weight portfolio, as well as the Efficient Beta and All Four Combined strategies.

[Table 2 goes about here]

They also exhibited differing “batting averages” when compared with Cap Weight, ranging from 14 wins and 3 losses for Economic Scale, to 10 wins and 7 losses for equal-weighting the Cap Weight portfolio. We should point out that, with only 17 years (actually 16 ½!) of data, a batting
average of 13-to-4 is required for 95% two-tail confidence statistical significance\(^8\). Although many practitioners think of 17 years as a long time, statistically it is not.

As Table 3 shows, all of the non-cap-weighted strategies offer superior performance over the simulated Cap Weight strategy over this span. Interestingly, the two sub-indexes of the Global Equal Weight portfolio have very different results. When we equal-weight the 1,000 largest companies by market capitalization, we outpace the market cap portfolio by some 75 bps per annum with notably higher risk. When we equal weight the 1,000 largest companies, based on a blend of four measures of the scale of a company’s business, we outpace the Economic Scale portfolio by a smaller margin of 54 bps, again with higher risk. When we combine the two universes (equal weighting the 1,000 largest, based on the sum of the two rankings), we beat Cap Weight by 210 bps per annum while falling less than 100 bps behind the Economic Scale portfolio, with risk very near the average of Cap Weight and Economic Scale.

Each strategy has its own strengths and weaknesses. Cap Weight tautologically has the lowest tracking error and should maximize risk-adjusted return—if EMH and CAPM hold fully and perfectly true. Minimum Variance achieves its objective with the lowest volatility of 10.70% and highest Sharpe Ratio of 0.52. The Economic Scale portfolio, measured relative to the Cap Weight portfolio, has the highest information ratio, 0.62, and ties with its own equal-weight variant for best statistical significance for alpha, with a \(t\)-statistic of 2.31. Equal weighting the Cap Weight portfolio offered the lowest tracking error of the non-cap-weighted strategies, but also delivered the highest volatility.

[Table 3 goes here]

The combinations are surprisingly robust. When investors are uneasy about a singular reliance on Cap Weight for their core holdings—and, so, choose either beta combination strategy—both beta combinations result in higher performance and lower volatility when compared to an exclusive use of the Cap Weight strategy. Even relative to the constituent non-cap-weighted strategies, for both of the combinations that we test herein we wind up with an array of attractive attributes:

Our return is modestly higher than the average of the individual strategy constructs, while our risk is similar, leading to a slightly better Sharpe ratio than the average of the constituent single portfolios.

The tracking error is about 10% less than the average of the constituents, leading to an information ratio that’s quite a bit higher than the average.

The same holds true for the combination of all four index methods (Cap Weight, Economic Scale, Global Equal Weight, and Minimum Variance). Indeed, adding Global Equal Weight to our Efficient Beta leads to results which are almost indistinguishable on most dimensions from our Efficient Beta portfolio.

\(^8\) This assumes independence of relative performance between years, which is a reasonable approximation of the observed empirical results.
The main conclusion that we draw from these results is that all five alternatives to the Cap Weight portfolio, as well as both combined strategies, have historically dominated Cap Weight in returns and/or risk-adjusted returns. A classical return attribution would suggest that this is at least partly due to the size and value tilts inherent in these various strategies. Alternatively, as we’ve suggested in other papers, this advantage is perhaps because the non-cap and combined strategies all contrtrade against the market’s constantly changing expectations, as reflected in a company’s share price and market capitalization.

Intuitively for an investor, these results are best demonstrated with conventional dollar growth charts. The behavior of all of these portfolios is very similar. Naturally, bull and bear markets and the corresponding peaks and troughs, happen at roughly the same time. One notable exception is the market peak in 2000. The non-cap-weighted portfolios all peaked over a year later than the Cap Weight portfolio. By not loading up on the Ciscos and Nokias of the world, we are less hurt by the collapse of the tech bubble.

Consistent with the strategy’s design, Figure 1 shows the lower risk of the Minimum Variance portfolio, as is clearly evident in the more stable return stream. When compared with a market capitalization index, the returns are weaker in extreme market rallies and more resilient in bear markets. It is a nicer ride—to very nearly the best end-point wealth!—with stable returns for investors who are concerned about total volatility. We should readily acknowledge, however, that the tech bubble of 1999-2000 would have tried the patience of any adherent to the non-cap-weighted alternatives!

For the conservative investor who does not like putting all eggs into the same “beta basket,” a good alternative may be to diversify among different beta strategies. The Efficient Beta portfolio and All Four Combined portfolio preserve some of the good characteristics of the economic weighting and Minimum Variance approaches. The cumulative performance of the blended strategies is displayed in Figure 2. It is remarkable to note that the two combined strategies—despite All Four Combined including a very different Global Equal Weight strategy—are near-identical in returns, risk and other characteristics. Adding Global Equal Weight does nothing for us.

When adjusting results for beta, relative to our simulated Cap Weight portfolio, both Economic Scale and Minimum Variance have positive CAPM alphas of 3.53% and 5.17%, as shown in Table 4. Betas of the strategies are 0.93 and 0.94 for Economic Scale and Global Equal Weight respectively; for Minimum Variance, the beta is vastly lower, at 0.64, exactly as we should expect for a low volatility strategy that is not constructed with reference to a benchmark.

The striking difference that comes from our risk-adjusted results is that the statistical significance soars. If much of our tracking error is attributable to a lower beta, then the residual
risk is actually smaller than the tracking error, notably for Minimum Variance; for much the same reason, the value-added is larger than it seems. Adjusted for market risk, only the Global Equal Weight portfolio and the equally weighted portfolio which is drawn from Cap Weight lack statistical significance. The Economic Scale and Minimum Variance portfolios loft to startling statistical significance for so short a span. *And, in a gratifying surprise, the Efficient Beta portfolio rivals the highest risk-adjusted information ratio of any of its constituent strategies, with higher statistical significance than any single strategy.*

In Table 5, we examine the outlier risks of the various portfolios. All portfolios have excess kurtosis and negative skewness, which are well-known characteristics of most equity investing strategies. Drawdown characteristics are similar, with Minimum Variance showing the smallest drawdowns and Global Equal Weight showing the largest. Reciprocally, Minimum Variance sharply reduces the largest gains in strong months and quarters, though this weakness disappears over 12-month spans. The Minimum Variance portfolio also has the highest negative skewness. Of course, this asymmetric characteristic in the Minimum Variance return distribution—more extreme losers than winners—is mitigated by the significantly lower volatility of this strategy as noted in Tables 2 and 3.

*Table 5 goes here*

The combined Efficient Beta portfolio’s outlier characteristics are more similar to those of the Cap Weight portfolio than any of the individual non-cap strategies. This may serve to reassure the risk-averse investor: moving from a singular reliance on cap weighting to a more diversified approach does not subject our portfolio to any significant increase in the downside risk. In each time span, Efficient Beta’s greatest win is larger than for Cap Weight while its greatest loss is smaller.

*Table 6* reconstructs the Fama–French–Carhart methodology, based on the global cap-weighted 1,000 stock portfolio.9 In this multivariate context, the beta relative to the Cap Weight soars well above the betas shown in Table 4. The SMB size factor loading is far smaller than most might expect, because other risk factors—notably Beta—can proxy in a multivariate regression. Meanwhile, Economic Scale and Minimum Variance portfolios both have quite a substantial HML value tilt relative to Cap Weight, while the equally weighted portfolios have only modestly more HML value tilt than the strategies from which they were sourced. Because Global Equal

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9 The Fama–French factors are recalculated using Cap Weight portfolio, consisting of the 1000 largest market cap companies in the 23 countries in the FTSE and MSCI developed world indexes. To construct SMB and HML factors we use MSCI Small Growth, MSCI Small Value, MSCI Medium Growth, MSCI Medium Value, MSCI Large Growth and MSCI Large Value, which we use to compute factor returns:

\[
\text{SMB} = \frac{1}{2}(\text{Small Value} + \text{Small Growth}) - \frac{1}{2}(\text{Large Value} + \text{Large Growth})
\]

\[
\text{HML} = \frac{1}{3}(\text{Small Value} + \text{Mid Value} + \text{Large Value}) - \frac{1}{3}(\text{Small Growth} + \text{Mid Growth} + \text{Large Growth})
\]

To define Momentum we use Cap Weight portfolio, consisting of the 1500 largest market cap companies in the 23 countries in the FTSE and MSCI developed world indexes, which we sort monthly into 3 tiers of 500 stocks based on the prior return measured from month -12 to -2. Momentum return is the difference of returns of the top tier equally weighted portfolio minus the bottom tier equally weighted portfolio.

Factor loadings of the portfolios are calculated based on a multivariate regression of portfolio returns against these factors.
Weight is partly sourced from Economic Scale, which has a large HML value tilt, it also has a reasonably large value tilt.

[Tables 6 goes here]

Even though much of the alpha is driven by size and value effects, both Economic Scale and Minimum Variance have quite sizeable annualized alphas of 2.07% and 1.81% respectively, net of the Fama-French-Carhart factors. The alpha is considerably more significant in all cases than the simple CAPM alphas shown on Table 4, even thought the alphas are smaller once we net out the impact of size, value and momentum effects. Indeed, all of the non-cap-weighted strategies, without exception, exhibit far more statistical significance net of these “style tilts” than they do on either simple value-added or a CAPM alpha basis.

The other surprise is the soaring efficacy of the combined strategies. Whether we choose Efficient Beta or All Four Combined, the statistical significance of the positive alpha sharply exceeds 99.9% significance, once we adjust for the value, size and momentum effects. Diversifying between different indexing strategies does not hurt performance, even—or perhaps especially—adjusting for these risk factors. At the same time, the HML loading of 0.31 in the case of Efficient Beta and of 0.32 in the case of All Four Combined contributes some of the incremental return, documented in the previous tables.

To model the impact of trade costs and market impact we created a hypothetical $1 billion portfolio for each strategy as of January 1, 2009. The average two-way turnover for the strategy was divided by the number of rebalance dates and this percentage was used to create a proportional slice of the portfolio that was then assessed for commissions, fees, and market impact. Trade costs were estimated using the ITG ACE® model. Estimated commissions, taxes, and fees were then included to create a total estimated transaction cost. The resulting costs were then multiplied by the number of rebalance dates to determine annualized trading costs.

For the rightmost column, we modeled capacity using another simple set of assumptions. We assume that our portfolio will become difficult to manage – tracking the intended “index” will be challenging – for any holdings that exceed 10% of current float or 10% of annual share volume. We then find the portfolio size at which 5% of the portfolio would be running up against one or another of these thresholds—i.e., would become “difficult.” To our surprise, Cap Weight shows a “capacity” based on these limitations of less than $700 billion in size. The other core strategies would run into these same barriers at anywhere from $50 billion to a quarter-trillion in assets. These are not small sums. But, we can probably infer that these thresholds are pretty conservative, based on the simple fact that Cap Weight is used to index vastly more than $700 billion in assets!

[Table 7 goes here]

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10 The model incorporates stock-specific econometric models of volatility and price impact and provides the expected cost of trades as shown above. Its key inputs are stock specific volatility, bid/ask spread, volume, closing price, intra-day volume and volatility distribution as well as trade specific size, side, strategy and expected time to completion. The model attempts to balance the competing forces of cost (spread cost and market impact) versus risk (opportunity cost of uncompleted trades).
Having the option of higher alpha and somewhat lower volatility is quite helpful for the overall investor’s portfolio. To see this we plot on Figure 3 the Minimum Variance frontier of a diversified basket of various asset classes where we compare the frontier with equity being represented by Cap Weight and Efficient Beta indexes. The optimized frontier with Efficient Beta providing equity exposure is clearly expanding the set of returns attainable to the investor. Over this history, at least, investors could achieve the same returns with lower levels of risk, or earn higher returns while keeping the same level of risk in the portfolio.

[Figure 3 goes here]

Intuitively, this is represented on Figure 4 where we plot excess annualized returns of the Efficient Beta over Cap Weight against excess volatility, on rolling three-year spans. Just as in standard mean-variance charts, the “northwest quadrant” is the preferred position for the investor—higher returns with lower volatility. This figure shows that selecting the Efficient Beta moves investors in the desired direction most of the time. With the caveats that our history is not terribly long and that past is not assuredly prologue, the portfolio never once offers higher volatility than Cap Weight, and delivers less return in less than 10% of the rolling 3-year spans in our study, all centered on the peak of the tech bubble.

[Figure 4 goes here]

Conclusion

This study focuses on two interrelated pragmatic questions: If we want less risk, do we have to lower our equity exposure? Alternatively, can we achieve our intended long-term return goals with less in equities? Apropos of that simple question, our work explores the simple merits of diversifying our core portfolio – in effect, our beta – risk. In a world in which many investors are considering ways to reduce portfolio risk, whether because of management pressure or because of fear of the consequences of misaligned risks, few would disagree that a bigger tool-kit—a wider array of interesting alternatives—will be broadly welcomed. Some will choose to “de-risk” by lowering their equity market exposure, by aligning assets with liabilities, by reducing their active management risk, or by exploring ways to achieve better returns with similar risk in their core equity holdings.

One can make a very good case that these strategies do not offer alpha, but offer “better beta.” After all, none of these portfolios uses “stock selection” in any classical sense of the term. There are no interviews with management, no forecasts of future business prospects and no careful parsing of financial statements. In one case, we ask: “How big is the company’s current book of business?” That defines both the selection and weight for the Economic Scale portfolio. In another, we ask: “Can we create a portfolio that is designed to achieve high risk-adjusted returns without the use of return expectations?” That defines the Minimum Variance portfolio. In yet another, we ask: “Why should we favor any stock over any other?” That leads to Global Equal Weight, for which the only active decision—a non-trivial decision!—is to select the universe that we will equal weight.

Our research shows that a combination of Cap Weight, Economic Scale, and Minimum Variance creates a compelling risk/return profile. The purists will presumably argue that classical finance
Beyond Cap-Weight: The Search for Efficient Beta

theory supports only one of these, Cap Weight; they would, of course, be correct. Others—all
tacitly believers in some form of market inefficiency—might argue for one or another alternative
to Cap Weight. Advocates of the status quo, with its singular reliance on Cap Weight for core
indexed portfolios, will undoubtedly point to the fact that past is not prologue: “past performance
is no guarantee of future results.”

Cap-weighted indexes are widely used; they are the generally accepted benchmark for gauging
investment success. This simple reality creates “maverick risk”—a risk of underperforming our
peers—for those investors who choose any of these alternative approaches, including a blended
approach. Still, the selection of quasi-passive investment strategies within equities need not be
limited to Cap Weight, nor need we forever rely on a cap-weighted benchmark. Perhaps
investors can better serve their long-term needs by assessing which of these strategies—or
combination of strategies—best conforms to their appetite for risk.

Fixed-income investors have a long history of considering risk and exposure when choosing the
duration and credit of active and passive bond portfolios; broad bond market index funds are far
less widely used than stock index funds. Similarly, currency investors typically do not use
“market cap” or even GDP as a guide for anything other than liquidity. Perhaps it’s time to
revisit our automatic reliance on Cap Weight as the sole strategy for measuring stock market
success, or as the default choice for our core equity holdings.

It is not our intent in this paper to explore the theoretical implications of our work, though we
acknowledge that they may prove significant. These results—as with so many before—are not
consonant, in aggregate across time, with an Efficient Market. The empirical results suggest
some global inefficiencies that may prove to reflect an immense gap between expected risk and
subsequent observed risk, or between expected return and expected utility, or between priced risk
factors and the risk factors that should be priced in an Efficient Market. It is well beyond the
scope of this simple empirical study to explore these nuances.

If an investor does not have a compelling view that favors one of these strategies over any other,
then a diversified approach to beta can perhaps give us access to broad market exposure, without
undue tilts to any single method, without undue reliance on market efficiency, and with stronger
empirical results than any single method.
Appendix: What Is a Passive Index?

Indexes have traditionally served multiple purposes: as benchmarks, as investment strategies, or as the starting point for making active portfolio bets. This “one size fits all” approach to fulfilling competing priorities has led to several unintended consequences. Only Cap Weight can serve as asset class proxy, passive strategy, and active management benchmark. The structural consistency of a single index that serves all three needs, while conforming to finance theory, is compelling.

Arguably, this may be the reason that other index construction methods received scant attention until recently. But, the potential costs of making this obvious choice are hidden and significant, most particularly if markets are not perfectly efficient. Investors can benefit by selecting a quasi-passive management approach that better reflects the investors’ unique return and risk preferences.

Passive strategies and indexes have similar characteristics, but slightly different purposes and requirements. Indexes were originally designed to measure the performance of the broad market—for which purpose, cap weighting is *de rigueur*. They quickly began to serve as benchmarks, which ideally should match the associated investment style of an investment strategy. Meanwhile, passive investment *portfolios* are designed to provide market exposure, along with the benefits outlined above. Using these definitions, market cap weighting is not a requirement, but is merely one of many options for both core portfolios and benchmarks alike.

Much of the controversy over the labeling of these alternative methods for index construction, as “indexes” or as “passive” strategies, can be viewed as a matter of semantics, the definition of our terms. To many in the indexing community, any departure from Cap Weight is—by their definition—an active strategy, not a passive index. But, even this assertion ignores an inconvenient fact: In a pure Sharpe CAPM context, nothing short of the entire global investible market, arguably even including human capital, is a true passive market portfolio. And even that portfolio changes second by second, with every corporate action, with each birth and with each death. By the CAPM definition, the S&P 500 represents a mere sliver of the true market portfolio. This controversy is arguably a distraction from a far more central issue, namely the relative merits of an array of choices, any one of which may be deemed active or passive depending upon one’s frame of reference or one’s definition of those terms.

A broader definition of passive investing or indexing might include: objective rules-based construction, whether based on theory or empirical evidence, objective historical replicability, transparency, investability, representativeness across a market or an economy, low turnover, and low management costs. By this broad definition, it may be argued that several of the existing cap-weighted “indexes” do not qualify. For example, what are we to make of the subjectivity in selecting the membership for the S&P 500 or the MSCI EAFE indexes, to name just two, or the float adjustments for many of the most widely recognized indexes?

The debate over whether or not the new roster of alternative strategies are mislabeled, when we call them “indexes,” is a distraction from more important issues. It is of comparatively little relevance to the central issue of meeting the obligations that our portfolios are intended to serve.
In this paper, we generally refer to the alternatives—Global Equal Weight, Economic Scale, Minimum Variance, and Cap Weight—as portfolios or strategies. Readers should view this as convenient shorthand, and nothing more. Call them what we will, they all may have considerable merit, as part of our tool-kit in serving our fiduciary obligations.
Table 1. Portfolio Construction Comparison

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>Relative Size Determination</th>
<th>Required Forecasts</th>
<th>Turnover and Trading Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td>Market Cap</td>
<td>None(^a)</td>
<td>Minimal</td>
</tr>
<tr>
<td>Economic Scale</td>
<td>Fundamental size</td>
<td>None</td>
<td>Somewhat higher than market cap</td>
</tr>
<tr>
<td>Global Equal Weight</td>
<td>Equal</td>
<td>None(^b)</td>
<td>High</td>
</tr>
<tr>
<td>Equal Weight Cap 1000</td>
<td>Equal</td>
<td>None(^b)</td>
<td>High</td>
</tr>
<tr>
<td>Equal Weight Econ 1000</td>
<td>Equal</td>
<td>None(^b)</td>
<td>High</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>Risk contribution</td>
<td>Volatility and correlations</td>
<td>Somewhat higher than market cap</td>
</tr>
</tbody>
</table>

\(^a\)If we wish to believe that the Cap Weight portfolio is mean-variance efficient, then we tacitly assume an efficient market, which means that the market’s consensus forecast for future risk and return are correct, give or take a random error.

\(^b\)There is a selection bias issue explored in the text: which stocks do we select for our equal weighting?

Source: Research Affiliates, LLC

Table 2. Annual Comparative Returns, 1/1993-6/2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Cap Weight</th>
<th>Economic Scale</th>
<th>Equal Weight</th>
<th>Equal Econ Wgt</th>
<th>Equal Cap Wgt</th>
<th>Minimum Variance</th>
<th>Efficient Beta</th>
<th>All Four Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>18.8%</td>
<td>26.5%</td>
<td>21.3%</td>
<td>26.4%</td>
<td>19.3%</td>
<td>20.3%</td>
<td>21.9%</td>
<td>21.8%</td>
</tr>
<tr>
<td>1994</td>
<td>0.3%</td>
<td>1.6%</td>
<td>0.7%</td>
<td>1.4%</td>
<td>-0.7%</td>
<td>-2.3%</td>
<td>-0.1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>1995</td>
<td>20.2%</td>
<td>22.7%</td>
<td>20.3%</td>
<td>20.4%</td>
<td>20.3%</td>
<td>22.6%</td>
<td>21.8%</td>
<td>21.5%</td>
</tr>
<tr>
<td>1996</td>
<td>16.6%</td>
<td>19.0%</td>
<td>16.0%</td>
<td>17.8%</td>
<td>15.7%</td>
<td>20.7%</td>
<td>18.7%</td>
<td>18.1%</td>
</tr>
<tr>
<td>1997</td>
<td>22.5%</td>
<td>25.0%</td>
<td>19.7%</td>
<td>19.5%</td>
<td>20.3%</td>
<td>28.6%</td>
<td>25.4%</td>
<td>24.0%</td>
</tr>
<tr>
<td>1998</td>
<td>19.9%</td>
<td>17.0%</td>
<td>16.0%</td>
<td>15.2%</td>
<td>16.2%</td>
<td>15.1%</td>
<td>17.4%</td>
<td>17.1%</td>
</tr>
<tr>
<td>1999</td>
<td>32.7%</td>
<td>27.7%</td>
<td>20.7%</td>
<td>20.3%</td>
<td>24.3%</td>
<td>8.8%</td>
<td>22.8%</td>
<td>22.3%</td>
</tr>
<tr>
<td>2000</td>
<td>-8.3%</td>
<td>8.8%</td>
<td>9.6%</td>
<td>13.2%</td>
<td>-1.5%</td>
<td>14.0%</td>
<td>4.6%</td>
<td>5.9%</td>
</tr>
<tr>
<td>2001</td>
<td>-14.0%</td>
<td>-4.7%</td>
<td>-4.7%</td>
<td>-4.0%</td>
<td>-9.3%</td>
<td>-12.2%</td>
<td>-6.7%</td>
<td>-6.2%</td>
</tr>
<tr>
<td>2002</td>
<td>-22.3%</td>
<td>-20.0%</td>
<td>-18.7%</td>
<td>-16.4%</td>
<td>-20.3%</td>
<td>-13.5%</td>
<td>-18.6%</td>
<td>-18.6%</td>
</tr>
<tr>
<td>2003</td>
<td>26.5%</td>
<td>30.5%</td>
<td>31.5%</td>
<td>35.1%</td>
<td>29.3%</td>
<td>17.6%</td>
<td>24.8%</td>
<td>26.4%</td>
</tr>
<tr>
<td>2004</td>
<td>12.6%</td>
<td>13.8%</td>
<td>17.3%</td>
<td>18.4%</td>
<td>16.4%</td>
<td>20.6%</td>
<td>15.6%</td>
<td>16.0%</td>
</tr>
<tr>
<td>2005</td>
<td>18.6%</td>
<td>19.5%</td>
<td>22.3%</td>
<td>23.3%</td>
<td>22.4%</td>
<td>20.3%</td>
<td>19.5%</td>
<td>20.2%</td>
</tr>
<tr>
<td>2006</td>
<td>18.3%</td>
<td>22.2%</td>
<td>20.8%</td>
<td>21.8%</td>
<td>19.7%</td>
<td>22.3%</td>
<td>20.9%</td>
<td>20.9%</td>
</tr>
<tr>
<td>2007</td>
<td>7.4%</td>
<td>6.2%</td>
<td>4.8%</td>
<td>2.9%</td>
<td>6.5%</td>
<td>6.3%</td>
<td>6.6%</td>
<td>6.2%</td>
</tr>
<tr>
<td>2008</td>
<td>-38.6%</td>
<td>-38.4%</td>
<td>-40.1%</td>
<td>-39.9%</td>
<td>-41.1%</td>
<td>-29.1%</td>
<td>-35.5%</td>
<td>-36.6%</td>
</tr>
<tr>
<td>2009</td>
<td>5.7%</td>
<td>7.7%</td>
<td>10.3%</td>
<td>14.3%</td>
<td>10.2%</td>
<td>0.5%</td>
<td>4.7%</td>
<td>6.1%</td>
</tr>
</tbody>
</table>

Source: Research Affiliates, LLC
Figure 1. Growth of $1, in Different Beta Strategies vs. Cap Weight, 1/1993-6/2009

Source: Research Affiliates, LLC

Figure 2. Growth of $1, in Combined Beta Strategies vs. Cap Weight, 1/1993-6/2009

Source: Research Affiliates, LLC
### Table 3. Return Characteristics, 1993–June 2009

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>Ending Value of $1</th>
<th>Geometric Return</th>
<th>Volatility</th>
<th>Sharpe Ratio</th>
<th>Excess Return vs. Cap-Weighted</th>
<th>Tracking Error vs. Cap-Weighted</th>
<th>Information Ratio</th>
<th>t-Statistic for Excess Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td>2.78</td>
<td>6.39%</td>
<td>14.50%</td>
<td>0.18</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Economic Scale</td>
<td>4.44</td>
<td>9.46%</td>
<td>14.35%</td>
<td>0.40</td>
<td>3.07%</td>
<td>5.00%</td>
<td>0.62</td>
<td>2.31*</td>
</tr>
<tr>
<td>Global Equal Weight</td>
<td>3.83</td>
<td>8.48%</td>
<td>14.44%</td>
<td>0.33</td>
<td>2.10%</td>
<td>4.65%</td>
<td>0.45</td>
<td>1.71</td>
</tr>
<tr>
<td>Equal Weight Cap 1000</td>
<td>3.12</td>
<td>7.14%</td>
<td>15.10%</td>
<td>0.22</td>
<td>0.75%</td>
<td>3.09%</td>
<td>0.24</td>
<td>1.05</td>
</tr>
<tr>
<td>Global Equal Weight Econ1000</td>
<td>4.82</td>
<td>10.00%</td>
<td>14.86%</td>
<td>0.42</td>
<td>3.61%</td>
<td>5.98%</td>
<td>0.60</td>
<td>2.31*</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>4.31</td>
<td>9.26%</td>
<td>10.70%</td>
<td>0.52</td>
<td>2.87%</td>
<td>7.39%</td>
<td>0.39</td>
<td>1.20</td>
</tr>
<tr>
<td>Efficient Beta</td>
<td>3.80</td>
<td>8.43%</td>
<td>12.81%</td>
<td>0.37</td>
<td>2.04%</td>
<td>3.71%</td>
<td>0.55</td>
<td>1.83</td>
</tr>
<tr>
<td>All Four Combined</td>
<td>3.81</td>
<td>8.45%</td>
<td>13.18%</td>
<td>0.36</td>
<td>2.06%</td>
<td>3.75%</td>
<td>0.55</td>
<td>1.89</td>
</tr>
</tbody>
</table>

* - Significant at 95% confidence level.  ** - Significant at 99% level.

Source: Research Affiliates, LLC

### Table 4. CAPM Characteristics, 1993–June 2009

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>Ending Value of $1</th>
<th>Geometric Return</th>
<th>Correlation with Cap-Weighted</th>
<th>CAPM Beta vs. Cap-Weighted</th>
<th>Excess Return vs. Cap-Weighted</th>
<th>CAPM Alpha vs. Cap-Weighted</th>
<th>Information Ratio of Alpha</th>
<th>t-Statistic for CAPM Alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td>2.78</td>
<td>6.39%</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Economic Scale</td>
<td>4.44</td>
<td>9.46%</td>
<td>0.94</td>
<td>0.93</td>
<td>3.07%</td>
<td>3.53%</td>
<td>0.72</td>
<td>2.56*</td>
</tr>
<tr>
<td>Global Equal Weight</td>
<td>3.83</td>
<td>8.48%</td>
<td>0.95</td>
<td>0.94</td>
<td>2.10%</td>
<td>2.45%</td>
<td>0.54</td>
<td>1.91</td>
</tr>
<tr>
<td>Equal Weight Cap 1000</td>
<td>3.12</td>
<td>7.14%</td>
<td>0.98</td>
<td>1.02</td>
<td>0.75%</td>
<td>0.62%</td>
<td>0.20</td>
<td>0.95</td>
</tr>
<tr>
<td>Equal Weight Econ 1000</td>
<td>4.82</td>
<td>10.00%</td>
<td>0.92</td>
<td>0.94</td>
<td>3.61%</td>
<td>3.99%</td>
<td>0.67</td>
<td>2.48*</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>4.31</td>
<td>9.26%</td>
<td>0.87</td>
<td>0.64</td>
<td>2.87%</td>
<td>5.17%</td>
<td>0.99</td>
<td>2.72**</td>
</tr>
<tr>
<td>Efficient Beta</td>
<td>3.80</td>
<td>8.43%</td>
<td>0.97</td>
<td>0.86</td>
<td>2.04%</td>
<td>2.96%</td>
<td>0.96</td>
<td>2.90**</td>
</tr>
<tr>
<td>All Four Combined</td>
<td>3.81</td>
<td>8.45%</td>
<td>0.97</td>
<td>0.88</td>
<td>2.06%</td>
<td>2.84%</td>
<td>0.86</td>
<td>2.68**</td>
</tr>
</tbody>
</table>

* - Significant at 95% confidence level.  ** - Significant at 99% level.

Source: Research Affiliates, LLC
### Table 5. Outlier Risks, 1993–June 2009

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>Skewness</th>
<th>Excess Kurtosis</th>
<th>Maximum Monthly Return</th>
<th>Minimum Monthly Return</th>
<th>Maximum 3-Month Return</th>
<th>Minimum 3-Month Return</th>
<th>Maximum 12-Month Return</th>
<th>Minimum 12-Month Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td>-0.94</td>
<td>1.39</td>
<td>10.11%</td>
<td>-16.05%</td>
<td>23.27%</td>
<td>-29.66%</td>
<td>38.96%</td>
<td>-41.75%</td>
</tr>
<tr>
<td>Economic Scale</td>
<td>-0.76</td>
<td>2.23</td>
<td>16.01%</td>
<td>-14.94%</td>
<td>32.90%</td>
<td>-27.52%</td>
<td>46.38%</td>
<td>-44.08%</td>
</tr>
<tr>
<td>Global Equal Weight</td>
<td>-0.98</td>
<td>3.12</td>
<td>15.08%</td>
<td>-18.50%</td>
<td>30.26%</td>
<td>-32.27%</td>
<td>48.87%</td>
<td>-44.17%</td>
</tr>
<tr>
<td>Equal Weight Cap 1000</td>
<td>-0.95</td>
<td>2.46</td>
<td>13.43%</td>
<td>-18.86%</td>
<td>28.41%</td>
<td>-33.08%</td>
<td>44.56%</td>
<td>-44.22%</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>-1.20</td>
<td>2.09</td>
<td>6.38%</td>
<td>-12.20%</td>
<td>15.61%</td>
<td>-20.42%</td>
<td>42.35%</td>
<td>-31.40%</td>
</tr>
<tr>
<td>Efficient Beta</td>
<td>-1.04</td>
<td>1.97</td>
<td>10.56%</td>
<td>-14.39%</td>
<td>22.44%</td>
<td>-25.94%</td>
<td>41.39%</td>
<td>-39.26%</td>
</tr>
<tr>
<td>All Four Combined</td>
<td>-1.04</td>
<td>2.25</td>
<td>11.69%</td>
<td>-15.42%</td>
<td>24.37%</td>
<td>-27.55%</td>
<td>41.48%</td>
<td>-40.51%</td>
</tr>
</tbody>
</table>

* - Significant at 95% confidence level.  ** - Significant at 99% level.

Source: Research Affiliates, LLC

### Table 6. Four-Factor Model in Global Universe, June 1994–June 2009

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>Beta</th>
<th>SMB</th>
<th>HML</th>
<th>Momentum</th>
<th>Monthly Intercept</th>
<th>4-Factor Alpha</th>
<th>4-Factor Info Ratio</th>
<th>Alpha t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic Scale</td>
<td>1.06</td>
<td>0.03</td>
<td>0.43</td>
<td>-0.04</td>
<td>0.17%</td>
<td>2.07%</td>
<td>0.78</td>
<td>3.17**</td>
</tr>
<tr>
<td>Global Equal Weight</td>
<td>1.06</td>
<td>0.18</td>
<td>0.36</td>
<td>-0.07</td>
<td>0.15%</td>
<td>1.82%</td>
<td>0.82</td>
<td>3.33**</td>
</tr>
<tr>
<td>Equal Weight Cap 1000</td>
<td>1.04</td>
<td>0.19</td>
<td>0.05</td>
<td>-0.07</td>
<td>0.11%</td>
<td>1.27%</td>
<td>0.59</td>
<td>2.39*</td>
</tr>
<tr>
<td>Equal Weight Econ 1000</td>
<td>1.08</td>
<td>0.24</td>
<td>0.47</td>
<td>-0.10</td>
<td>0.26%</td>
<td>3.08%</td>
<td>1.09</td>
<td>4.42**</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>0.82</td>
<td>0.02</td>
<td>0.50</td>
<td>-0.07</td>
<td>0.15%</td>
<td>1.81%</td>
<td>0.54</td>
<td>2.18*</td>
</tr>
<tr>
<td>Efficient Beta</td>
<td>0.96</td>
<td>0.02</td>
<td>0.31</td>
<td>0.01</td>
<td>0.11%</td>
<td>1.29%</td>
<td>0.88</td>
<td>3.57**</td>
</tr>
<tr>
<td>All Four Combined</td>
<td>0.98</td>
<td>0.06</td>
<td>0.32</td>
<td>-0.01</td>
<td>0.12%</td>
<td>1.42%</td>
<td>0.98</td>
<td>3.97**</td>
</tr>
</tbody>
</table>

* - Significant at 95% confidence level.  ** - Significant at 99% level.

Source: Research Affiliates, LLC
### Table 7. Estimated Transaction Cost

<table>
<thead>
<tr>
<th>Portfolio/Index</th>
<th>One-Way Turnover %</th>
<th>Annual # Rebalances</th>
<th>Rebalance Trade Cost bps of trade</th>
<th>Annualized Trade Cost bps of portfolio</th>
<th>Capacity of Current Portfolio (in $Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weight</td>
<td>6.8</td>
<td>1</td>
<td>33</td>
<td>5</td>
<td>$690</td>
</tr>
<tr>
<td>Economic Scale</td>
<td>15.2</td>
<td>1</td>
<td>41</td>
<td>12</td>
<td>260</td>
</tr>
<tr>
<td>Global Equal-Weight</td>
<td>29.7</td>
<td>1</td>
<td>60</td>
<td>36</td>
<td>140</td>
</tr>
<tr>
<td>Equal-Wgt Cap 1000</td>
<td>34.4</td>
<td>1</td>
<td>63</td>
<td>43</td>
<td>88</td>
</tr>
<tr>
<td>Equal-Wgt Econ 1000</td>
<td>28.9</td>
<td>1</td>
<td>60</td>
<td>35</td>
<td>80</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>12.7</td>
<td>4</td>
<td>34</td>
<td>9</td>
<td>51</td>
</tr>
<tr>
<td>Efficient Beta</td>
<td>15.8</td>
<td>12</td>
<td>36</td>
<td>11</td>
<td>139</td>
</tr>
<tr>
<td>All Four Combined</td>
<td>21.1</td>
<td>12</td>
<td>43</td>
<td>18</td>
<td>113</td>
</tr>
</tbody>
</table>

*Source: Research Affiliates, LLC*
Figure 3. Efficient Frontier with Efficient Beta and with Cap Weight, 1/2993-6/2009

Source: Research Affiliates, LLC

Figure 4. Rolling Three-Year Risk and Return Relative to Cap Weight

Source: Research Affiliates, LLC
References


