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### 'Godfather' of Fundamental Indexing Faces Challenge

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By Lawrence Carrel, TheStreet.com Senior Writer

A year ago this week, when **WisdomTree Investments** launched its first 20 exchange-traded funds, it threw down the gauntlet in the rarified world of indexing.

At the time, it was the largest number of ETFs tracking indices based on fundamental criteria -- primarily dividends -- rather than stock prices.

It was also a challenge to Rob Arnott, the godfather of fundamental indexing. Arnott's investment firm, Research Affiliates, had licensed the first ETF based on a fundamental index a year earlier and filed a patent application for all indices based on fundamentals.

But WisdomTree didn't seek Arnott's blessing for its new products. In essence, the firm was saying that fundamentally weighted indexing isn't the property of Research Affiliates but of the entire world.

Typical indices weight companies according to their stock market valuation, also known as market capitalization. This value is calculated by multiplying the total number of outstanding shares by the stock's price. The criteria give a greater weighting to large companies and higher-priced stocks over small companies and lower-priced stocks. It's the basis for the **S&P 500** and most other market benchmarks.

The theory behind fundamental indexing is that market-cap-weighted indices were overweighted with overpriced stocks, while fundamentally-weighted indices captured better returns with lower volatility.

WisdomTree promoted the new ETFs with a splashy marketing campaign, including newspaper and TV ads featuring endorsements from two of its famous backers, legendary hedge-fund manager Michael Steinhardt and Wharton finance professor Jeremy Siegel. But the highlight of the marketing blitz was an opinion piece on *The Wall Street Journal's* op-ed page in which Siegel lobbed a grenade at the "efficient-market theory," the philosophical foundation for the market-cap indices.

The theory is that at any one point in time, a stock's price represents the best, unbiased estimate of its true value. Siegel countered that "a new paradigm claims that the prices of securities are not always the best estimate of the true underlying value."

This touched off a lot of sturm and drang in the indexing community. John Bogle, the founder of the Vanguard 500 (VFINX), the first index mutual fund, and Burton Malkiel, author of *A Random Walk Down Wall Street*, the book that brought the efficient-market theory to the masses, issued a stinging rebuttal. They said fundamental indexing wasn't a new paradigm but merely a more expensive index with a bias toward small-cap and value stocks.

But amid all this excitement, Arnott was noticeably silent.

Arnott literally wrote the book on fundamental indexing. In the March 2005 issue of the *Financial Analysts Journal*, he and two associates published a paper called "Fundamental Indexation." In it, he concluded that market portfolios constructed using metrics of company size other than cap-weighting outperformed the S&P 500 over a 43-year span by an average of 2 percentage points.

As chairman of Research Affiliates, an investment management firm in Pasadena, Calif., Arnott also realized he had a marketable investment strategy. He trademarked the name Fundamental Index and created the Research Affiliates Fundamental Index, or RAFI, based on four fundamental metrics: revenue, book value, free cash flow and gross dividends.

One year after the challenge from WisdomTree, Research Affiliates' patent is still pending, and no lawsuit has been filed. And variations on his trademark "Fundamental Index" are quickly becoming the way to describe this new movement in indexing.

Realizing it may be a long and difficult fight, Arnott is playing it cool.

"We're swimming upstream on protecting our brand name, but I leave this in the hands of our 'intellectual property' team and don't devote much time or attention to it," he says in an interview. "And competition is fine. But I'm less comfortable when people can't come up with their own ideas or their own brand name for a product. But we aren't trying to get into fights. My goal is to reach amicable agreement with those who want to pursue similar ideas."

Bruce Lavine, president and chief operating officer of WisdomTree, counters that the concept of fundamental weighting has been around for 20 years. "There are many people who did this prior to Rob Arnott getting involved," he says. "This goes back to the late 1980s with Robert Jones at **Goldman Sachs** and David Morris in the United Kingdom. Barclay's iShares developed a dividend fund in 2003 that is clearly not a cap-weighted fund. We feel very comfortable that there is prior art here in many areas."

"There is no action between us, because nobody has any patent rights," says Lavine. "We have our own patent application. We have great confidence that we have independently developed our IP and won't have an issue on the patent side. But this will play out over the long term."

Even if RAFI's patent application fails, fundamental indexing has caught the imagination of investors, and there should be enough business to go around for both firms. Especially since the two firms have different business models. WisdomTree creates its own indices and issues its own funds. It currently has 37 ETFs with \$4 billion in assets under management.

Meanwhile, Research Affiliates' business is to license its index to many ETF issuers. Powershares has 11 ETFs linked to RAFI indices in the U.S., Claymore Investments has five in Canada, and there are a total of nine offered in Europe by Lyxor and XACT, a unit of Handelsbanken.

In addition, Pimco, **Charles Schwab** and Pro Financial of Canada each offer three mutual funds based on the RAFI index. The combined total assets under management for all licensees of the RAFI concept are over \$10 billion.

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