

**LETTER TO THE EDITOR**

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04 Jan 2007

***When I was told my long-time friend Rob Arnott was writing a "rebuttal" ("An Overwrought Orthodoxy," December 2006) to my piece on fundamental indexing (The Value of Fundamental Indexing, October 2006).***

To the Editor:

When I was told my longtime friend Rob Arnott was writing a "rebuttal" ("An Overwrought Orthodoxy," December 2006) to my piece (The Value of Fundamental Indexing, October 2006), I naively and arrogantly thought there was nothing to rebut. This is not because of any great skill of mine, but because Fundamental Indexing is exactly, precisely and provably a simple value-tilt, something that has been studied and implemented for many years. It is a mathematical identity. I thought that once I said that out loud, the emperor would not dare to rebut in the nude. My bad. Nice abs, Rob.

I now understand. Rob did not rebut my piece. Rather he took the occasion to restate his arguments in spite of, and ignoring much of, my essay. In the course of doing so he coopted another long line of academic literature postulating that noise in prices may be behind value's efficacy. He adds this to his (and others') already accomplished usurpation of "value" and "index." There is literally nothing new here. Academics have been discussing and debating all of these issues for quite a while. If Rob wants to take sides in the long-running battles (efficient vs. inefficient markets, why value works, etc.), that's fine. But Rob is not joining these battles; he's claiming the academic results as his own discoveries, ascribing a fair amount of intellectual heroism in the face of withering oppression to himself and craven careerism or lack of vision to others. That is dirty pool! In particular, Rob's somewhat paranoid assertion that academics who advance such views as his are crushed under the boot heels of reactionary doyens is just nonsense. I speak from experience, having written a dissertation under Gene Fama and Ken French showing price momentum works. Although I had their full support, they might be surprised to see Rob has anointed me their "disciple." All of the arguments Rob is making are already championed by respected members of academia whose careers still flourish. Prominent advocates of the inefficient view include Josef Lakonishok, Bob Shiller, Andrei Shleifer, and Gene Fama's colleague Dick Thaler. Rob contends, in the face of overwhelming evidence, that those arguing against market efficiency in academia are systematically oppressed. That's not even close to true. What is ruthlessly crushed in academia is the repackaging of others ideas and selling them as one's own.

Let me be 100 percent clear and speak directly to Rob. Rob, I am not arguing with you over whether reasonable versions of FI will work. Of course they will. It takes a one line equation to show FI is exactly a value tilt, and we already know value works. Nor do I argue when you show FI works everywhere around the world and within different size classes. This is just a restatement of something everyone working in this area has agreed about for years. I would be happy to provide references for lots of published papers that show the value effect is pervasive; it works in the U.S., it works internationally, it works in developed countries, it works in emerging countries, it works for big stocks, it works for small stocks, and it works for tiny stocks. And since FI is just value, it is not surprising that FI works in all the places value works. Rob, I'm also not arguing with your finding that one specific version of your index, the FTSE RAFI 1000, outperforms one other specific value index, the Russell 1000 value index. I would have been disappointed if your index did not beat the Russell 1000 value index. We already know from all those inconvenient academic studies that the value effect is stronger among small stocks and, as you point out, the Russell Indices split just the largest 1000 firms. Moreover, I presume that the four specific value measures you use to form your index were chosen at least in part based on past performance. That's okay, Rob, I do it too; I just call it quantitative value investing. But, again, please remember your portfolio is exactly a tilt away from market capitalization that's precisely a function of your four relative valuation ratios. To claim what you do is not "value investing" because of a non-apples-to-apples cumulative return difference with the Russell version is just madness.

In addition, Rob, I am not arguing over whether this all occurs because "noise" is an important part of security prices. You seem to think this too is a new breakthrough finding of yours and your team. No, this has long been a hypothesis of those many (flourishing) academics who think markets are not efficient. In fact it is pretty much the starting point for behavioral finance, which then spends it's time on the more interesting question of what that noise looks like. Finally, I do disagree most vociferously with the idea that there is anything new in your observations or assertions. Rob, you keep claiming FI is very "controversial." Not so. The only thing controversial here is your attempt to repackage 20 years of labor by many academics as your own.

Rob, if you simply said the following, I would have no problem: "Like a vast number of researchers before me, I find value investing works everywhere I've looked (i.e., an active tilt toward cheaper assets beats a capitalization- weighted benchmark over time). Furthermore, I side with the many academics who argue that value works for 'inefficient markets reasons' and thus believe value investors get somewhat of a 'free lunch.' Thus I advocate that investors move in this direction. One simple way to implement a disciplined value tilt is what I call a Fundamental Index. It is a one-theme (value) tilt away from cap-weighting in the pursuit of alpha. I still think there's an opportunity to do more of it before, like all alpha strategies, it goes away if I convince too many. Finally, like all active value managers, I have some arguments why my value strategy is better. Thank you."

Okay, I'm speaking to the reader again. Sadly, rather than the modest and accurate description above, in Rob's world he and his small band of courageous revolutionaries have found a secret way to add value that the "man" wants to keep down (knowing some of those Rob considers the insidious "man" here brings on a chuckle). It just ain't so. Rob's new packaging may become a successful investment product. It is a good (but common) story for why value works and a very clean, easy-to-explain, portfolio construction methodology that may have appeal. But that's it. It's not one iota of the intellectual breakthrough that Rob amazingly continues to claim.

Aside from the above, as Rob challenged none of my essay I have no additional counterrebuttal better than my first version. Rob should read it again. Years from now he may write something similar. I hope I get a mention.

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