

Build a Smarter Portfolio With Fundamental Strategies

Schwab believes an optimal portfolio contains exposure to fundamental strategies, market-cap strategies, and active management. Find out how to build one based on your individual needs and risk tolerance.



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Key Points

- Fundamentally weighted indexes are an evolutionary step forward in index construction.
- Schwab believes an optimal portfolio mix contains exposure to fundamental strategies, market-cap strategies, and active management.
- Portfolio construction is both art and science. Find out how to adjust your allocation to these strategies based on your individual needs and risk tolerance.

The first generation of ETFs, developed in the early '90s, offered investors cost-effective, tax-efficient market exposure. ETFs were originally designed to mimic popular market-cap indexes like the S&P 500[®] Index, Russell 1000[®] Index, and MSCI EAFE[®] Index.

As ETFs evolved, index providers sought to provide more innovative strategies. One notable development has been Fundamental Index[®] strategies pioneered by Robert Arnott and his colleagues at Research Affiliates[®].

Fundamental strategies can serve as an effective complement to market-cap strategies and active management, with the potential to create more attractive risk-adjusted portfolios. Let's look at the attributes of each of these strategies and ways you might use them in your portfolio.

Integrated approach

Schwab believes that passive approaches like market-cap and fundamental strategies should be used together with active management in building portfolios. Here's a look at the nuts and bolts of each:

- **Market-cap strategies:** Most major indexes are market-cap weighted—that is, stock weights are calculated by multiplying the price of each stock by its number of shares outstanding. This means the largest company by market capitalization has the largest weight in the index. The primary appeal of strategies benchmarked to market-cap indexes is their ability to provide cost-effective exposure to a broad market or a market segment.
- **Active management:** Active managers of mutual funds generally seek to outperform their fund's benchmark. For example, a large-cap manager may be benchmarked to the S&P 500 Index, which tracks large-cap U.S. companies. Active managers have greater flexibility and adaptability in responding to changing market conditions, so investors may benefit from increased returns and/or the potential for a reduced risk of loss. However, many managers have not been successful in outperforming their benchmarks over time, particularly after accounting for fees.
- **Fundamental strategies:** Like market-cap strategies, fundamental strategies can provide broad-based market exposure, but securities are selected and weighted based on financial metrics that assess some aspect of a company's business or payout to shareholders—like earnings, sales, or dividends.

Key features of the three strategies

	Fundamental	Market-Cap	Active
Portfolio weighting	Economic factors	Cap weighting	Varies by manager
Portfolio construction	Value tilt	Larger-cap bias	Varies by manager
Portfolio turnover	Reconstitution and rebalancing	Reconstitution	Buy and sell discipline
Tax-efficient	Typically	Typically	Not typically
Cost structure	Low cost	Lowest cost	Varies by manager and vehicle
Alpha/beta	Potential alpha	Beta	Varies by manager
Investment process	Rules-based	Passive	Active

Source: Schwab Center for Financial Research

How to allocate

Are you trying to decide how to allocate your funds between fundamental strategies, market-cap strategies, and active management? The Schwab Center for Financial Research has identified four levers to help you evaluate your situation:

- **Tracking error**—the difference between your return and that of the benchmark you were attempting to track.
- **Loss aversion**—your desire to avoid losses. Academic research has shown that investors react far more strongly to losses than gains. In fact, researchers have found that the pain of loss is about twice as intense as the euphoria of gain.¹
- **Potential alpha**—measures how much better you did than your benchmark. Comparing an investment's risk-adjusted performance to that of a benchmark index yields its alpha.
- **Costs**—or expenses—are an important consideration for investors.

Let's see how fundamental strategies, market-cap strategies, and active management stack up in terms of the four levers.

- **Market-cap strategies** are primarily used to gain low-cost exposure to the market. They generally experience little or no tracking error, although fees could incur a small drag. However, they do not offer the potential for either downside protection or alpha (excess return).
- **Fundamental strategies** provide cost-effective exposure to the markets, and have the potential for alpha over a full market cycle. There are periods of time when fundamental strategies will outperform or underperform the market. They have a higher tracking error than market-cap strategies and do not offer the potential for downside protection.
- **Active managers** seek to outperform their benchmark. Managers have the potential to provide alpha and/or a degree of downside protection over time. They have greater flexibility to adjust their strategies in difficult markets and can become more defensive, based on their market outlook.

How to personalize your portfolio

Key Lever	Fundamental	Market-Cap	Active
Tracking error	Higher	Low	Varies by manager
Loss aversion	No downside protection	No downside protection	Potential downside protection
Potential alpha	Yes	No	Varies
Costs	Low cost	Lowest cost	Varies by manager and vehicle

Source: Schwab Center for Financial Research

Depending on your sensitivity to the four levers, you might overweight or underweight your allocation to fundamental strategies, market-cap strategies, and/or active management.

Ask yourself:

- Are you concerned with tracking a benchmark? If yes, consider overweighting market-cap strategies. If no, consider overweighting fundamental strategies or active management.
- Do you have time to devote to finding superior active managers? If yes, consider overweighting active management. If no, consider overweighting a passive strategy, such as market-cap or fundamental strategies.
- Are you concerned about the potential for alpha or excess return? If yes, consider overweighting fundamental strategies or active management. If no, consider overweighting market-cap strategies.
- Is cost your primary concern? If yes, consider overweighting market-cap strategies. If no, consider overweighting fundamental strategies or active management.

An optimal strategy mix

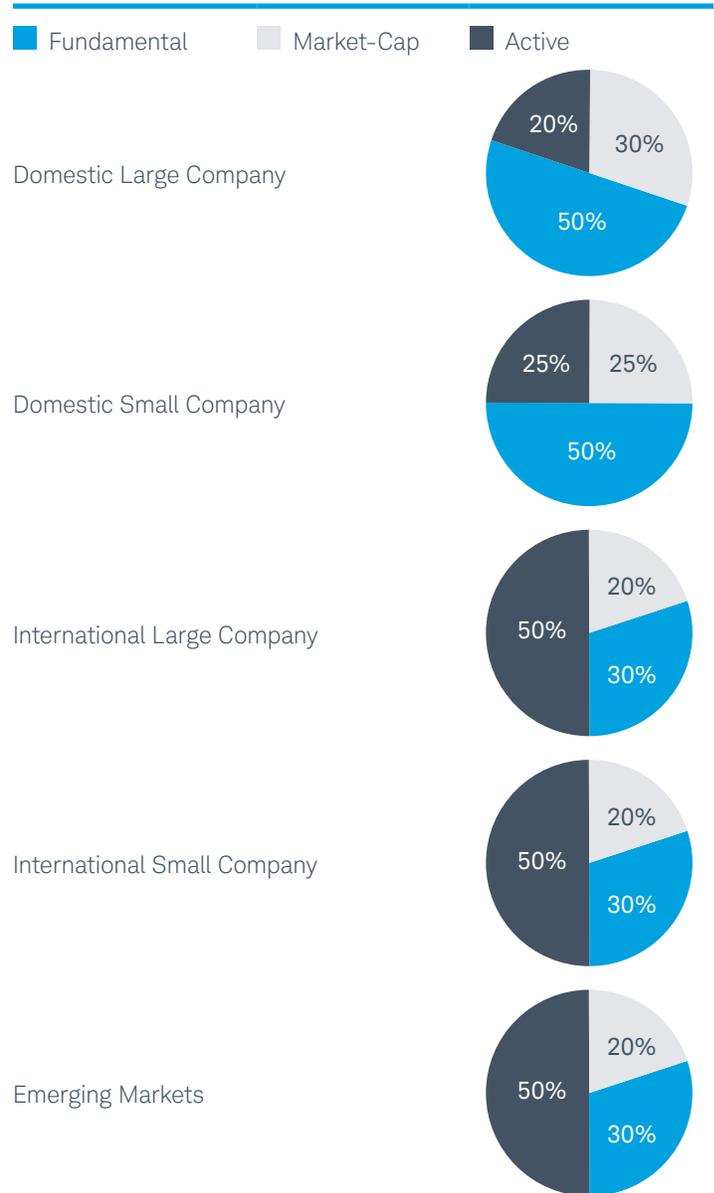
To the right are sample portfolio allocations for fundamental strategies, market-cap strategies, and active management across various market segments. Since the large-company domestic market is relatively efficient, we have allocated 80% of the portfolio to the indexing (passive) strategies, with 50% allocated to fundamental, due to its alpha-generating potential. For the international large-company portfolio, we allocated 50% to active and 50% to passive. We would suggest allocating a higher percentage to skillful active managers in the emerging markets portfolio.

Tailor your portfolio

We believe that portfolio construction should incorporate elements of art and science. While we can suggest allocations across strategies, we can't lose sight of investors' individual needs and risk tolerance. So keep in mind the four levers—tracking error, loss aversion, potential alpha, and costs—and your sensitivity to them, when reviewing your portfolio.

An integrated portfolio

Sample portfolio allocations for fundamental strategies, market-cap strategies, and active management.



Source: Schwab Center for Financial Research

¹ Kahneman and Tversky, "Prospect Theory: An analysis of decision under risk," 1979.

Important Disclosures

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The Russell 1000[®] Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000[®] Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

MSCI EAFE[®] Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the United States and Canada.

Indexes are unmanaged, do not incur management fees, costs and expenses, and cannot be invested in directly.

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