ARTICLE

Winning the Long Game with RAFI

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Key Points

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Introduction

For baseball fans like us, spring is our favorite time of year. The cold of winter fades, the national pastime returns, and every team opens the season with a chance at a World Series title.

As managers finalize their opening day rosters, one role has become increasingly indispensable: the utility player. With only 26 spots to fill, versatility is not a luxury but a strategic imperative. A player who can field different positions helps managers optimize matchups, adapt to changing conditions, and extract more value from otherwise limited resources. These athletes are the Swiss Army Knives of modern baseball, valued not for their specialization but for the breadth of their contributions.

Constructing a portfolio has similar challenges to building a baseball team. Capital is finite and every allocation must earn its place. Capitalization-weighted indices are ostensibly "neutral," yet they systematically allocate more capital to companies as their prices rise. This embeds valuation and concentration risk into the portfolio.

Traditional value and equal-weight strategies seek to correct this imbalance, but each method has trade-offs: They use either a sub-optimal selection process or mechanically uniform weights that are untethered from economic scale. The RAFI Fundamental Index (RAFI) is designed to address these issues at their source by breaking the link between price and portfolio weight and anchoring allocations to measures of a company's fundamental size. This creates a rebalancing process that harvests alpha by systematically trading against the market's most extreme bets.

With over more than 20 years of live implementation, RAFI has proven to be a strong utility player for investors. It can serve as a cap-weight alternative, a systematic value allocation, or a disciplined rebalancing framework, it can effectively steal bases, switch hit, and field defensive positions. RAFI's durability reflects a simple but powerful premise: Portfolios anchored to economic scale rather than market price can provide a more flexible foundation for long-term equity exposure.

RAFI Overview

The RAFI methodology is relatively simple. It selects and weights securities by fundamental measures of company size such as adjusted sales, adjusted cash flow, dividends plus buybacks, and book value plus intangibles. As such, it seeks to avoid the structural overweighting and underweighting of overvalued and undervalued

securities, respectively, of its cap-weighted counterparts. It then reinforces this foundation through a series of pragmatic refinements. It applies multi-year fundamental averages to dampen procyclicality, combines several accounting measures to reduce reliance on any single metric, and rebalances in a manner that accounts for implementation costs. The result is a thoughtfully designed index that integrates economic intuition, empirical testing, and real-world investability.

Exhibit 1. RAFI vs. Value, Equal Weight, and Cap-Weight

RETURN CHARACTERISTICS

United States (1990 - 2025)	Annualized Return	Annualized Volatility	Sharpe Ratio	Tracking Error	Information Ratio
RAFI	11.79%	14.56%	0.62	4.69%	0.21
Value	9.81%	14.68%	0.48	5.25%	-0.19
Equal Weight	11.13%	16.37%	0.51	5.39%	0.06
Cap-Weight	10.80%	14.73%	0.54	--	--
Developed ex US (1999 - 2025)	**Annualized Return**	**Annualized Volatility**	**Sharpe Ratio**	**Tracking Error**	**Information Ratio**
RAFI	8.40%	16.45%	0.39	3.65%	0.66
Value	6.82%	17.12%	0.28	3.97%	0.21
Equal Weight	7.39%	16.63%	0.32	3.78%	0.37
Cap-Weight	6.00%	16.26%	0.24	--	--
Emerging Markets (1999 - 2025)	**Annualized Return**	**Annualized Volatility**	**Sharpe Ratio**	**Tracking Error**	**Information Ratio**
RAFI	12.98%	22.22%	0.49	5.16%	0.82
Value	8.86%	20.67%	0.33	3.59%	0.03
Equal Weight	8.65%	20.71%	0.32	5.36%	-0.02
Cap-Weight	8.76%	20.70%	0.32	--	--

FACTOR REGRESSIONS

United States (1990 - 2025)	Alpha (Annual)	Beta (Mkt-Rf)	Value (HML)	Size (SMB)	Momentum (WML)
RAFI	1.1%	0.93	0.32	-0.07	-0.06
Value	-0.9%	0.93	0.37	-0.10	-0.04
Equal Weight	0.5%	1.01	0.25	0.07	-0.13
Cap-Weight	0.0%	0.99	0.00	-0.14	-0.01
Developed ex US (1999 - 2025)	**Alpha (Annual)**	**Beta (Mkt-Rf)**	**Value (HML)**	**Size (SMB)**	**Momentum (WML)**
RAFI	0.4%	1.01	0.32	0.00	-0.05
Value	-0.7%	1.03	0.33	-0.10	-0.09
Equal Weight	0.8%	1.00	0.13	0.26	-0.13
Cap-Weight	-0.4%	1.01	-0.02	-0.14	0.01
Emerging Markets (1999 - 2025)	**Alpha (Annual)**	**Beta (Mkt-Rf)**	**Value (HML)**	**Size (SMB)**	**Momentum (WML)**
RAFI	3.4%	1.02	0.20	-0.08	-0.11
Value	-0.4%	0.96	0.23	-0.08	-0.09
Equal Weight	-0.4%	0.95	0.07	0.28	-0.14
Cap-Weight	-0.2%	1.00	-0.05	-0.16	-0.03

Notes: U.S. indices are the RAFI Fundamental US Index, Russell 1000 Value Index, S&P 500 Equal Weight Index, and S&P 500 Index. Developed ex-U.S. indices are RAFI Fundamental Developed ex-US, and the MSCI World ex-US Value, Equal Weight, and Cap-Weighted. Emerging Markets indices are the RAFI Fundamental Emerging Markets Index and the MSCI Emerging Markets Value, Equal Weight, and Cap-Weighted indices.

Source: Research Affiliates, based on data from FactSet, Compustat, CRSP, WorldScope, and Datastream. RAFI performance prior to launch is simulated. Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly. Please see important information regarding simulated data in the disclosures.

RAFI is often described as a "better core" portfolio. Why? Because, like a cap-weighted index, it holds the full opportunity set. The critical distinction is that each company's weight reflects its economic footprint relative to the broader universe, not its market capitalization or stock price. As a contrarian rebalancing strategy with a stark value tilt, RAFI is frequently compared to traditional value approaches. At the same time, by dissolving the connection between price and portfolio weight, it is also evaluated alongside equal-weight strategies. In practice, it shares features with all three strategies yet remains structurally distinct from each.

Exhibit 1 shows the performance and factor exposures for RAFI and its traditional value and equal- and cap-weighted counterparts across U.S., Developed ex-U.S., and Emerging Markets (EM). Over the full sample, RAFI outperforms all three in every region, both in absolute and risk-adjusted terms, by approximately 1.4% per year in the U.S. and Developed ex-U.S. and 4.3% per year in EM.

Why RAFI is an Effective Core

What explains RAFI's historical outperformance versus capitalization-weighted indices? At its core, the answer is structural: Fundamental indexing is designed to avoid the market's most extreme bets. Basing portfolio weights on a company's economic footprint can provide stability. When firms outperform, RAFI rebalances them back down to their fundamental weight. When they underperform and their valuations become more attractive, RAFI rebalances into them. The result is a disciplined, rules-based process that systematically leans against extremes and embeds a structural buy-low, sell-high discipline into the portfolio.

Recent market concentration illustrates this point. The Magnificent Seven stocks have dominated returns. As their valuations have expanded, their weight in cap-weighted benchmarks has increased commensurately. As of year-end 2025, these seven companies represented nearly 35% of the S&P 500 but only about 17% of the RAFI Fundamental US Index. RAFI does not exclude them; it simply refuses to allow price appreciation alone to dictate portfolio weight. (For more on the Magnificent Seven and how it compares to the tech bubble, see Arnott, Commins, and Liu, 2025.) When valuations mean revert, this structural guardrail against concentration risk becomes a source of relative outperformance.

Though described as neutral, cap weighting implicitly assumes that the largest and most expensive companies will justify their valuations. RAFI instead anchors exposure to economic size. Arnott and Wu (2012) demonstrate that the largest firms by market capitalization have historically underperformed both their in-sector peers and the broader market over the subsequent decade. Market leadership is never permanent.

By systematically rebalancing toward fundamentals, RAFI aims to reduce concentration risk and temper exposure to speculative excess. A core allocation should represent diversified exposure to the overall economy while maintaining a consistent mechanism for managing valuation risk. By breaking the link between price and weight, RAFI is designed to provide a more resilient foundation for long-term capital growth than a benchmark whose risk profile expands with market exuberance.

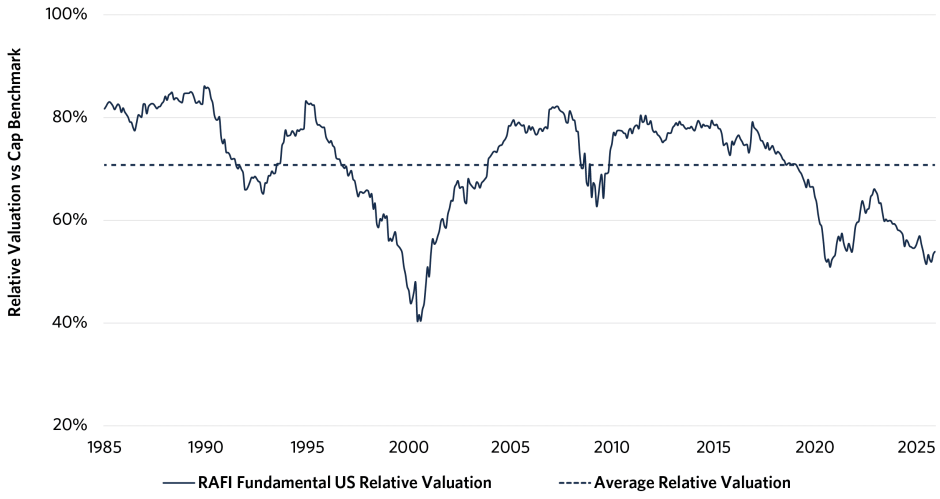
Why RAFI is a Stronger Value

As a systematic rebalancing strategy, RAFI has a natural value tilt. Yet to call it a value strategy would be accurate but incomplete. The more important point is that RAFI is a differentiated way to access value that seeks to address a core inefficiency embedded in conventional value indices. Traditional value indices identify cheaper stocks through such valuation metrics as price-to-book or price-to-earnings ratios but still weight them by market capitalization. As prices rise, weights rise; as prices fall, weights fall. Even in a value universe, capital drifts toward more expensive names. The mechanics of cap weighting dilute the discipline of value.

RAFI intends to correct that flaw. By divorcing price from portfolio weight, it instills a systematic contra trading discipline across the entire portfolio. In **Exhibit 1**, RAFI and traditional value have approximately the same loading to the value factor. But there is more to the story. RAFI has a dynamic value exposure that deepens as valuation spreads widen. When growth stocks command extraordinary premiums, conventional value indices become cheaper relative to the market but still allocate more capital to the pricier stocks within the value universe. RAFI leans more aggressively into dislocations because its weights remain anchored to fundamentals.

Exhibit 2 shows RAFI's dynamic value as measured by RAFI's relative valuation over time versus the cap-weighted benchmark.[1] On average, RAFI has a valuation discount of approximately 70% relative to cap. That is, RAFI trades at a 30% discount to the cap-weighted index. However, at any given time, RAFI's value tilt could be much larger or smaller. During extreme valuation spreads like the dot-com bubble or the global financial crisis (GFC), RAFI's value tilt was much deeper, with 40% and 63% relative valuations, respectively. Amid today's more concentrated market and stretched valuations, RAFI trades at a significantly cheaper relative valuation than its 70% average.

Exhibit 2. Relative Valuation: RAFI vs. Cap-Weight
(January 1, 1985 to December 31, 2025)



Notes: The "Relative Valuation" is measured by dividing each of the following valuation metrics for the RAFI Fundamental US Index by the S&P 500 Index (as measured by the SPY ETF): the average discount across P/S, P/CF, P/Div, and P/B multiples. The four discounts are then averaged to determine the overall relative valuation discount. Holdings prior to 1/31/2017 for the RAFI Fundamental US Index are simulated. Please see important information at the end of this presentation regarding simulated data.[CH1.1] Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.

Source: Research Affiliates, based on data from FactSet.

Importantly, RAFI's historical excess return is not primarily about superior earnings growth forecasting or identifying hidden winners but rather structural portfolio construction. Any strategy that anchors weights to market prices inherits the return drag of over allocating to popularity and under allocating to its absence. A valuation-indifferent strategy can harvest that drag over time. RAFI operationalizes this insight in a scalable, rules-based framework. Based on a combination of simulated and live history, **Exhibit 1** demonstrates that RAFI has outperformed traditional value both in U.S. and international markets over long horizons.

Why RAFI is an Effective Equal Weight

When explaining RAFI to investors, we sometimes describe it as a modified equal-weight strategy. RAFI and equal-weight approaches share some important features. Both can reduce market concentration risk by breaking the direct link between price and portfolio weight and by rebalancing against market price movements. We believe the key distinction, however, is that RAFI implements this concept more thoughtfully. An equal-weight index assigns the same weight to every stock in the portfolio. For example, each company in the S&P 500 Equal Weight Index has a 0.2% weight. While intuitive, this simplicity has three significant drawbacks: It lacks an underlying economic rationale, often produces higher volatility, and is costlier to implement. (For more on this, see Liu, Lundberg, and Verghese, 2024.)

• **No Economic Rationale:** In an equal-weight index, portfolio weights are determined solely by the number of securities rather than by a company's overall impact on the economy. Since RAFI uses fundamental measures of size as its selection and weighting mechanism, each company's weight reflects its economic scale, or more simply, how much it contributes to overall economic activity. Should Apple

and Hormel Foods carry the same portfolio weight simply because they occupy the same index?[2] Equal weighting says yes; fundamental weighting says no.

This simple weighting mechanism creates a pronounced tilt toward smaller companies, as additional weight is systematically allocated to lower-capitalization stocks. Once again, as **Exhibit 1** shows, equal weight has positive loading toward the size factor: 0.07 in the U.S., 0.26 in Developed ex-U.S., and 0.28 in EM. RAFI's size exposure is either negative or neutral across those markets. The equal weight index's weighted average market capitalization is approximately $127 billion, while RAFI's is $769 billion and the cap-weighted benchmark's is $1,390 billion. Investors allocating to equal weight to reduce concentration may not fully appreciate the implicit bet on smaller companies.

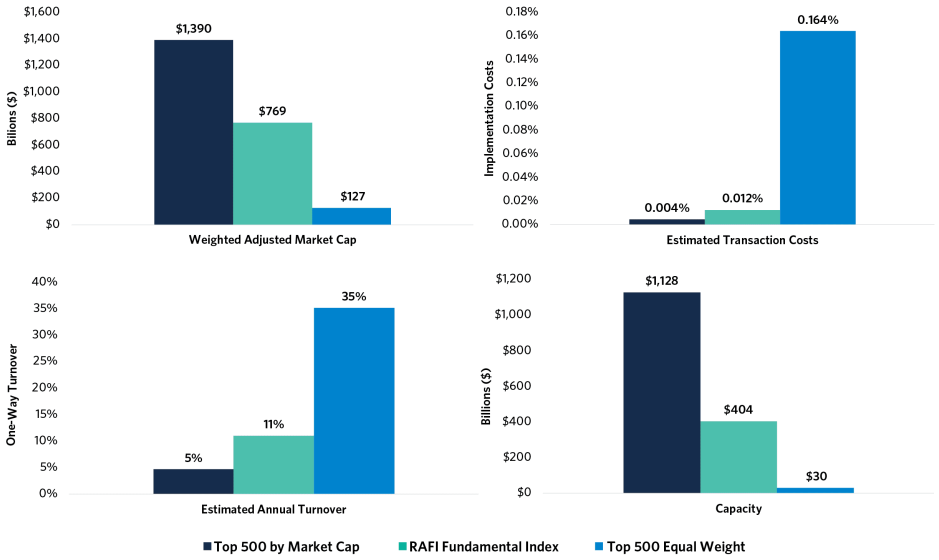
• **Volatility:** Given their structurally greater exposure to smaller-cap stocks, equal-weight strategies tend to exhibit higher volatility than fundamentally weighted and cap-weighted indices. In the U.S. market, equal weight has delivered volatility approximately 10% higher than the RAFI Fundamental US Index. The impact becomes more pronounced when viewed through a risk-adjusted lens. RAFI's Sharpe ratio is roughly 20% higher in Developed ex-U.S. markets and more than 50% higher in both the U.S. market and EM.

• **Implementation Costs:** Implementation costs further differentiate the two approaches. Equal weighting's small-cap tilt results in higher trading costs. By contrast, RAFI's fundamental weighting leads to greater allocations to larger, more liquid companies that are less expensive to trade.

In addition, RAFI also doesn't rebalance as often. Equal-weight strategies must do so quarterly to prevent drift back toward cap weighting. This leads to higher turnover. Rather than a full annual rebalance, RAFI uses quarterly staggered rebalancing (QSR). The QSR technique is designed to reduce the risks and costs associated with executing a full portfolio rebalance on a single day. Instead of trading the entire portfolio at once, the strategy is divided into four equal tranches, with one tranche rebalanced each quarter toward the annually determined target weights.

By spreading trades across multiple points in time, QSR helps diversify entry point risk and reduces market impact, lowering transaction costs and improving implementation efficiency. In addition, RAFI's lower turnover combined with its emphasis on more liquid securities can meaningfully reduce implementation costs and increases capacity. The difference is often material. Estimated market impact costs are 0.01% for RAFI versus 0.16% for an equal-weight strategy, as displayed in **Exhibit 3**.

Exhibit 3. Equal Weighting vs. Fundamental Weighting: The Practical Difference



Notes: The S&P 500 and S&P 500 Equal Weight portfolios are represented by a stimulated top-500 market-cap index. RAFI is represented by the RAFI Fundamental Index. Please see important disclosures at the bottom regarding simulated data.

Source: Research Affiliates, based on Compustat and CSRP data as of December 31, 2025.

Conclusion

In baseball, the most valuable players are not always the flashiest or most expensive stars but the ones who consistently create optionality for their team. The utility player gives a manager more choices, stabilizes the roster, and quietly compounds value over a long 162-game season. RAFI performs a similar role in a portfolio. It's built to maintain broad market exposure like a traditional core, express a disciplined value tilt like a systematic value allocation, and integrate equal weighting's rebalancing discipline of equal weight without inheriting its structural inefficiencies. By anchoring weights to economic scale rather than market price, RAFI aims to avoid cap weighting's concentration risk, strengthens the implementation of value, and delivers equal weighting's diversification benefits in a more economically coherent and cost-efficient framework. Allocators seeking a durable foundation for long-term equity exposure, may want to consider adding RAFI to the roster.

"RAFI aims to avoid cap weighting's concentration risk, strengthens the implementation of value, and delivers equal weighting's diversification benefits in a more economically coherent and cost-efficient framework."

End Notes

1. Relative valuation is measured by dividing each of the following valuation metrics for the RAFI Fundamental US Index by the S&P 500 Index (as measured by the SPY ETF): Price/Sales, Price/Cash Flow, Price/Dividends, and Price/Book. The four discounts are then averaged to determine the overall relative valuation discount.

2. As of December 31, 2025, Hormel Foods had a market capitalization of approximately $13 billion, while Apple had a market capitalization of over $4 trillion! Apple's weight was 4.8% in the RAFI Fundamental US Index, 6.9% in the S&P 500 ETF (SPY), and 0.2% in the S&P 500 Equal Weight ETF (RSP) compared to 0.03%, 0.01%, and 0.2%, respectively, for Hormel Foods.

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