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Outgrowing Glamour: A Fundamental Approach to Growth Investing

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"Growth" is one of the most beloved and misunderstood attributes in investing. Investors benefit from a company's ability to deliver growing profits to its shareholders while not overpaying for those opportunities. Hence, the irony that many growth indices today incorporate market capitalization in both their selection and weighting processes: In our view, they effectively conflate price appreciation with business growth and systematically steer investors toward the most glamorous and expensive stocks in the market rather than those with actual growth potential. The result is narrow and expensive growth exposure that is vulnerable to valuation reversals.

> *"[M]ost growth indices today incorporate market capitalization in both their selection and weighting processes: In our view, they effectively conflate price appreciation with business growth."*

We introduce a fundamentally different approach.

Eschewing the notion that expensive equates to growth, we abandon the peculiar constraint that growth and value indices must collectively span the market[1] and instead start with a simpler premise: Growth should be defined by a company's ability to expand its economic footprint. Growth investors may improve outcomes not only by reimagining how growth stocks are selected but also by moving away from market-cap weighting and toward a weighting method that reflects a company's macroeconomic growth.

Selecting with Fundamental Growth

If conventional growth indices, in practice, tend to select what is expensive, the key question becomes: What actually signals real growth? We begin with measures that demonstrate past and future business growth. This leads us to focus on income statement growth rather than balance sheet growth. The distinction is important. Income statement growth rewards shareholders through increasing sales and profits, while balance sheet growth often reflects capital accumulation that does not necessarily translate into shareholder value.

Key Points

- By equating price appreciation with business growth, market capitalization-weighted growth indices tend to favor expensive stocks over those with real growth potential.
- Portfolios constructed based on sales and profit growth, among other income statement metrics, prioritize business performance and innovation over value retention and distribution and tend to outperform portfolios built on more balance sheet-related criteria.
- The RAFI Fundamental Growth Index is designed to identify real growth companies that deliver tangible expansion in actual growth metrics while reducing exposure to glamorous stocks with frothy valuation multiples.
- Since index launch, the RAFI Fundamental Growth US Index outperformed the S&P 500 and a blend of growth benchmarks by 7.7% and 10.4%, respectively, with security selection rather than sector allocation driving most of the excess gains.

From a shareholder's perspective, the most relevant growth indicators will capture superior sales and profit growth and sustained innovation as drivers of continued growth. **Exhibit 1** shows these measures in blue.[2] By contrast, book value and dividend growth, highlighted in yellow, tend to be associated with empire building and bond-like income distribution. Past research indicates that these types of growth do not add value.[3] Balance sheet growth, in particular, can be backward-looking or capital-intensive, while income-statement growth is economically scalable and more closely tied to future economic outcomes.

Exhibit 1. Examples of Growth Metrics

Growth Fundamental	Economic Role & Focus	Financial Statement
R&D Growth	***Innovation***: Using internal funds to innovate and fuel future growth	Income Statement
Sales Growth	***Business Performance***: Achieving scale and winning market share	Income Statement
Gross Profit Growth	***Business Performance***: Turning top line into sustainable profits	Income Statement
Book Value Growth	***Building Balance Sheet***: Preserving financial strength and competitive position	Balance Sheet
Dividend Growth	***Returning Capital to Owners***: Distributing free cash flow to shareholders	Balance Sheet and Cash Flow

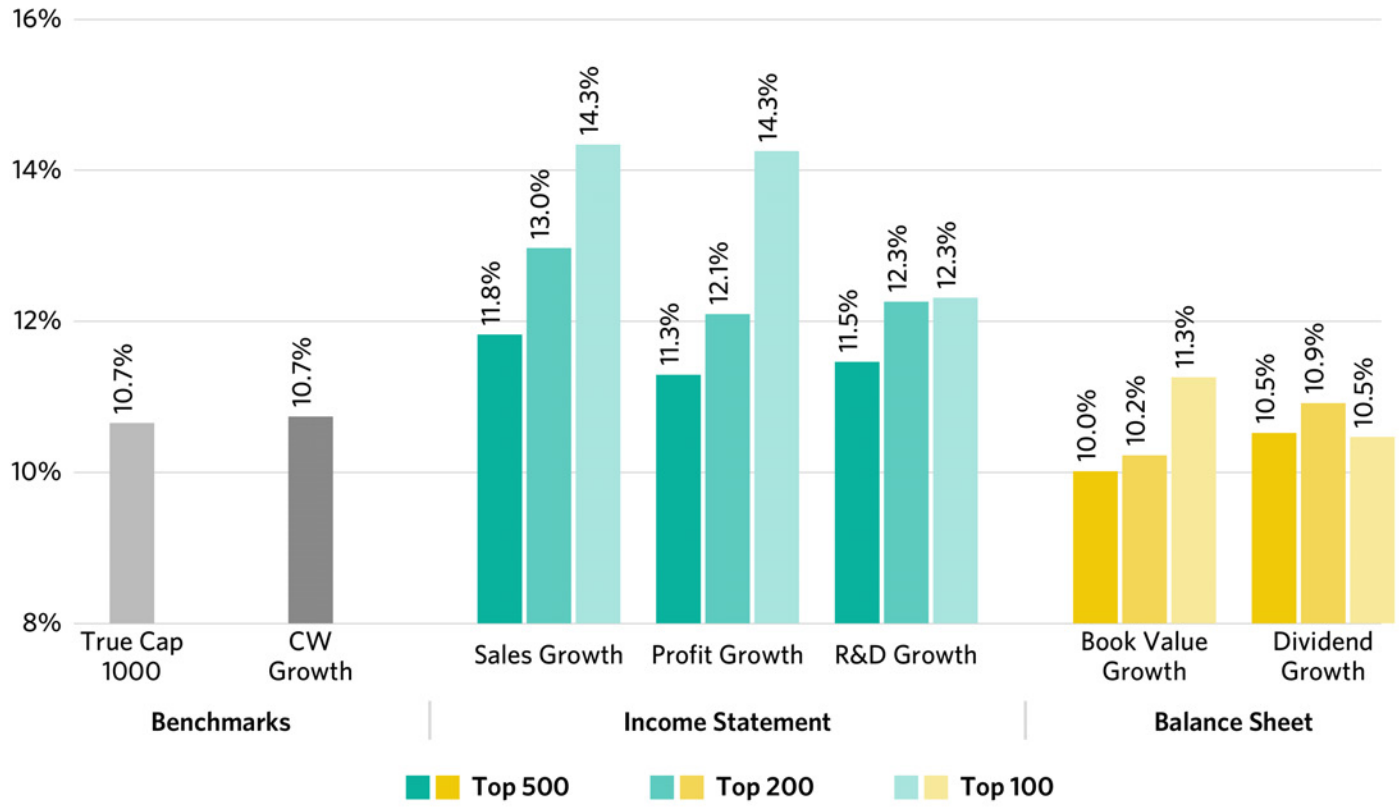
Source: Research Affiliates.

To test these priors, we form portfolios using each growth fundamental to select stocks.[4] We calculate growth over a five-year period and normalize by sales per share to allow for meaningful comparisons across different-sized firms. This includes those with zero or negative profits, dividends, and R&D, and accounts for possible dilution. We describe this as the *rate* of growth. A sample calculation for R&D is as follows:

$$\text{R\&D Growth Rate} = \frac{(\text{R\&D})_t - (\text{R\&D})_{t-5}}{\text{Sales}_{t-5}}$$

Next, we construct cap-weighted portfolios with varying concentrations of 500, 200, and 100 stocks and rebalance annually in March. We also simulate two benchmarks: True Cap 1000 and Cap Weight Growth (CW Growth). True Cap 1000 selects the top 1,000 stocks by market cap while CW Growth creates a generic growth index by following a methodology similar to other standard growth indices. (Historical simulated returns are comparable to the legacy growth indices.) By building our own CW Growth index, we can examine a longer time series that spans more than a half-century.[5] **Exhibit 2** shows our results.

Exhibit 2. Annualized Returns of Selective Growth Portfolios and Benchmarks (March 1969–June 2025)



Source: Research Affiliates and CRSP/Compustat. True Cap 1000 and CW Growth Benchmarks represent performance based on simulated index data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

In the income statement growth metrics, returns exceed benchmarks and rise monotonically with concentration. For balance sheet growth metrics, the results are mixed at best: Only two of the six beat the market, by insignificant margins, and greater concentration doesn't necessarily help. This confirms our intuition that portfolios focused on business performance and innovation tend to deliver excess returns, while those that prioritize value retention and distribution do not.

Weighting by Fundamental Growth

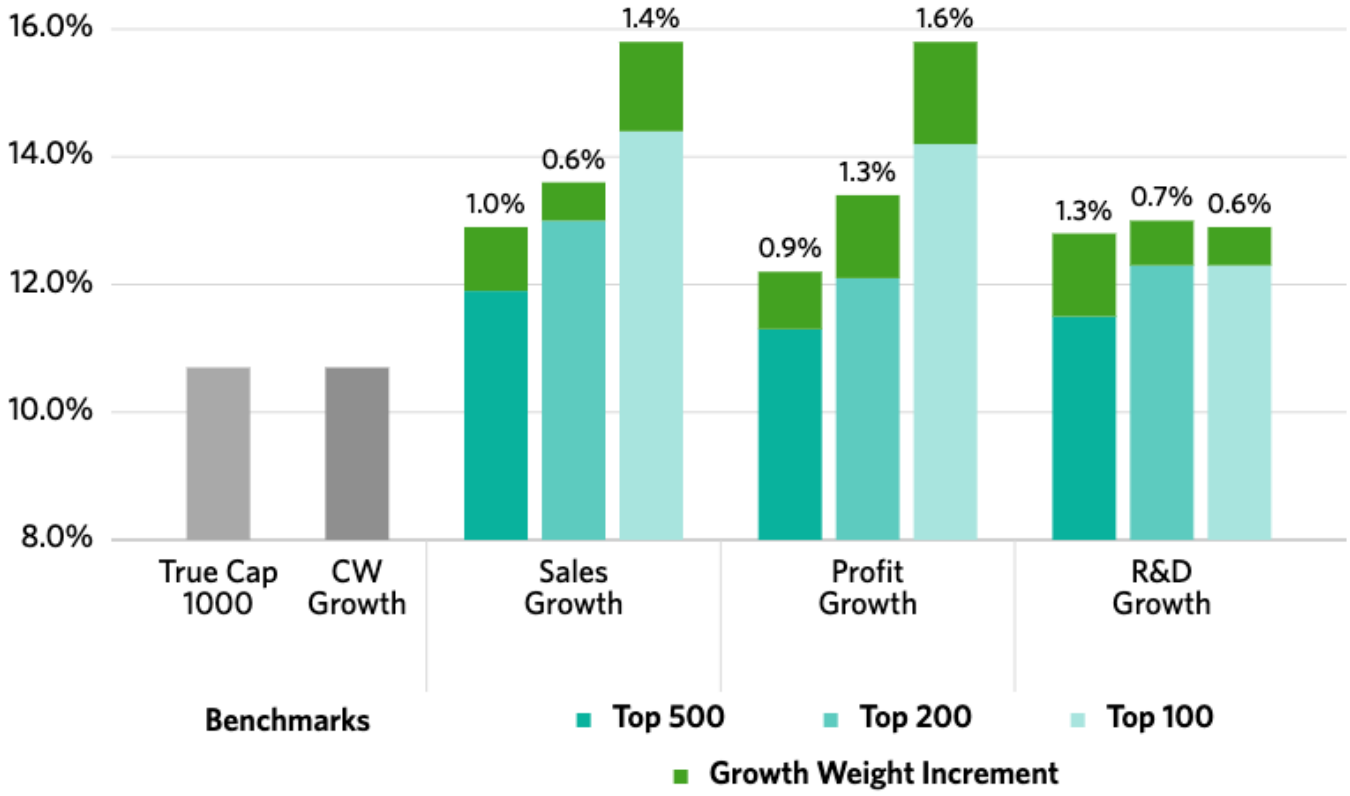
Selection determines which companies to own. Weighting determines how much to own. For growth investors, this distinction is critical. Our portfolio tests use cap weighting to facilitate comparison with cap-weighted benchmarks. While often treated as neutral, cap weighting can embed a specific assumption: It systematically allocates more capital to the most expensive stocks. For growth investors, this is not a neutral stance, it is an active bet that the most richly priced growth stocks will exhibit the greatest valuation expansion.

We employ a different framework.[6] Rather than weighting by market value, we propose weighting by the growth *magnitude* as a claim on economic growth itself. Whereas the *rate* of growth is normalized by sales, growth *magnitude* is the raw dollar change, as this sample calculation shows:

$$\text{Sales Growth Magnitude} = \text{Sales}_t - \text{Sales}_{t-5}$$

To avoid negative weights, we establish a floor of zero for companies with negative growth. Weighting by growth magnitude sizes each stock in proportion to its contribution to total economic growth. The results in **Exhibit 3** confirm that market-cap weighting leaves money on the table for growth investors, while weighting by growth magnitude improves outcomes across all concentration levels.

Exhibit 3. Impact of Growth Magnitude Weighting (March 1969-June 2025)



Source: Research Affiliates and CRSP/Compustat. True Cap 1000 and CW Growth Benchmarks represent performance based on simulated index data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see information at the end regarding simulated data.

Fundamental Growth

To increase robustness, we combine these growth metrics into a single composite measure that captures multiple facets of growth without over-relying on any single growth dimension.

For *selection*, we compute the composite growth rate by normalizing each firm's growth rate using z-scores and then averaging across these z-scores. To calculate the composite *weighting*, we measure each firm's dollar magnitude as a percentage of the aggregate of all stocks that made the cut and average the growth weight across the three metrics.

Exhibit 4 shows the results for the Fundamental Growth portfolios, both for cap weighting each portfolio (CW) and for fundamental growth magnitude weighting (FG) at various concentration levels.

Exhibit 4. Growth Composite Portfolios (March 1969-June 2025)

Strategy	Return	Volatility	Sharpe Ratio	CAPM Alpha	t-stat
True Cap 1000	10.7%	15.6%	0.39	0.1%	0.74
CW Growth	10.7%	17.6%	0.35	-0.1%	-0.12
Fundamental Growth 500 (CW)	11.5%	17.0%	0.40	0.7%	1.50
Fundamental Growth 500 (FG)	12.7%	17.5%	0.46	1.6%	2.88
Fundamental Growth 200 (CW)	11.9%	20.2%	0.36	0.8%	0.73
Fundamental Growth 200 (FG)	13.3%	20.1%	0.43	2.0%	1.88
Fundamental Growth 100 (CW)	13.4%	23.2%	0.38	2.0%	1.30
Fundamental Growth 100 (FG)	15.2%	22.9%	0.46	3.6%	2.41

Source: Research Affiliates and CRSP/Compustat. The portfolios presented herein represent performance based on simulated data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

The composite portfolio outperforms both cap-weighted growth benchmarks and cap-weighted versions of the same portfolios at all levels of concentration, with the largest outperformance at the most concentrated level. As we narrow our lists of rapidly growing companies, returns increase monotonically, as do the incremental returns from FG weighting. Fundamental weighting may also improve Sharpe ratios.

Return Decomposition

To better understand the source of outperformance, we examine returns along statistical and fundamental lines. **Exhibit 5** shows the statistical decomposition, which applies the Fama-French-Carhart four-factor model.

Exhibit 5. Risk Decomposition of Portfolio Returns (March 1969-June 2025)

Portfolio	Alpha	t-stat	Market	SMB	HML	WML	R2
CW 1000	0.1%	1.30	1.00	-0.11	0.00	0.00	1.00
CW Growth	1.3%	3.21	1.04	-0.11	-0.35	0.01	0.97
Fundamental Growth 500 (CW)	1.6%	4.14	1.03	-0.11	-0.22	-0.01	0.97
Fundamental Growth 500 (FG)	2.4%	4.22	1.04	0.06	-0.09	-0.04	0.95
Fundamental Growth 200 (CW)	3.3%	3.82	1.09	-0.06	-0.52	-0.05	0.90
Fundamental Growth 200 (FG)	4.0%	4.30	1.09	0.13	-0.35	-0.06	0.89
Fundamental Growth 100 (CW)	5.4%	4.27	1.16	-0.01	-0.69	-0.06	0.84
Fundamental Growth 100 (FG)	6.4%	4.80	1.14	0.18	-0.51	-0.07	0.82

Source: Research Affiliates and CRSP/Compustat. The portfolios presented herein represent performance based on simulated data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

As with the raw returns, the simulated FG versions dominate their CW peers, and with larger alphas and stronger significance based on their t-statistics. Increasing concentration boosts alpha, which rises from 2.4% for FG 500 to 6.4% for FG 100. More striking is traditional value's role in the Fundamental Growth portfolios. At each level of concentration, the growth-weighted version has a larger (i.e., less negative) HML exposure relative to its cap-weighted equivalent. This means that fundamental weighting harvests growth without systematically overpaying for it.[7] As a result, FG 200 delivers three times the factor-adjusted alpha as CW Growth and one-third more statistical significance, with the exact same classically defined HML growth bias.

Our fundamental decomposition provides further insight. We decompose returns into the key components of income, EPS growth, and valuation change (P/E expansion)[8] to distinguish between sustainable fundamentals-driven returns (income, EPS) and less sustainable multiple expansion-driven returns. We conduct this decomposition on excess returns relative to True Cap 1000 to assess and compare the sources of relative performance. **Exhibit 6** shows our findings.

Exhibit 6. Excess Return Decomposition by Return Source (March 1969-June 2025)

Growth Portfolio	Log Excess Return	=	Income Return	+	EPS Growth	+	Valuation Change
CW Growth	0.1%		-0.8%		0.9%		0.0%
Fundamental Growth 500 (CW)	0.8%		-0.8%		1.7%		-0.2%
Fundamental Growth 500 (FG)	1.8%		-0.6%		2.8%		-0.3%
Fundamental Growth 200 (CW)	1.2%		-1.4%		3.1%		-0.5%
Fundamental Growth 200 (FG)	2.4%		-1.2%		4.0%		-0.4%
Fundamental Growth 100 (CW)	2.5%		-1.9%		4.9%		-0.4%
Fundamental Growth 100 (FG)	4.0%		-1.8%		6.0%		-0.2%

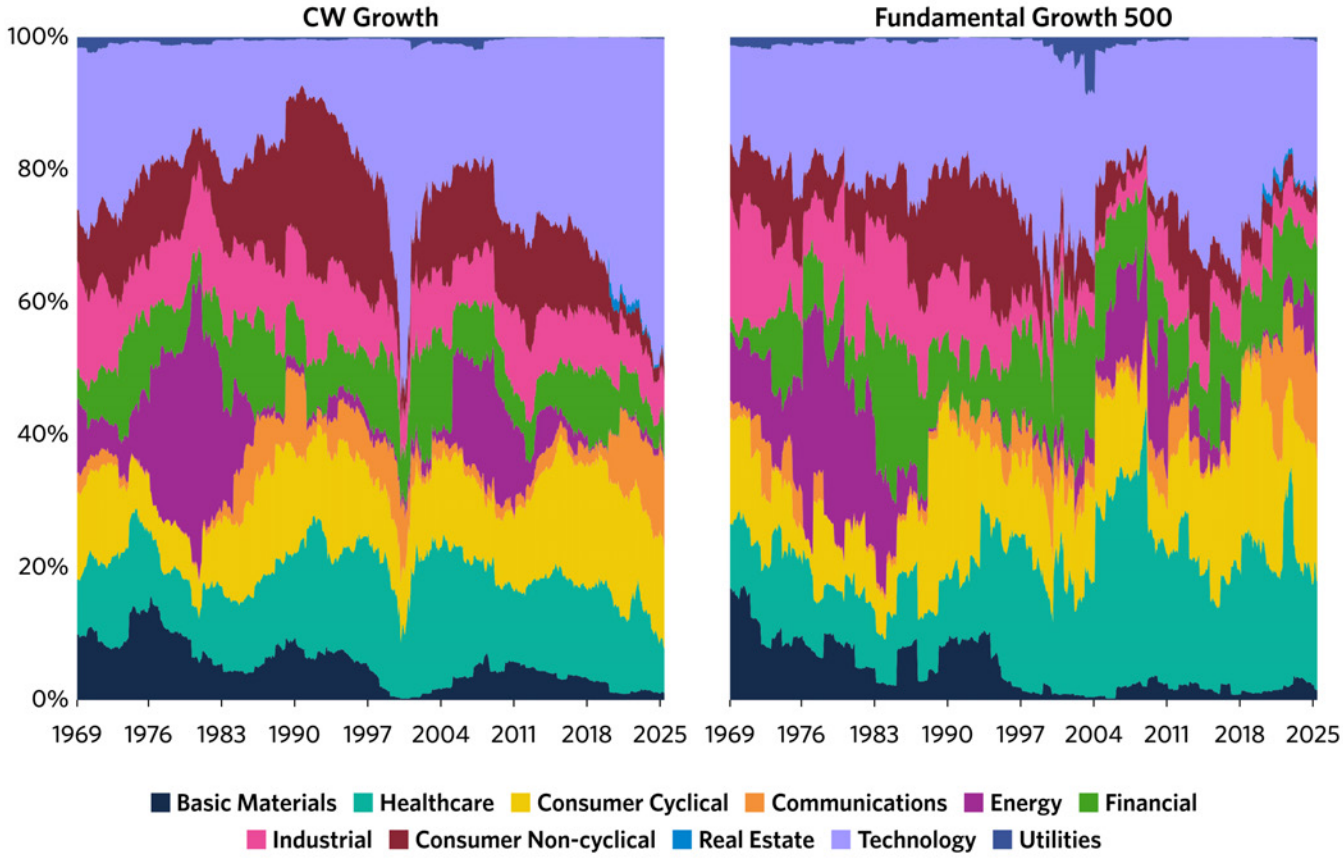
Source: Research Affiliates and CRSP/Compustat. The portfolios presented herein represent performance based on simulated data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

The CW Growth portfolio delivers 0.9% faster earnings growth than the market but gives 0.8% of that back because of its lower dividend income. Across all Fundamental Growth specifications, stronger EPS growth drives excess returns. Multiple expansion plays no role. As excess returns increase with concentration, EPS growth's contribution rises monotonically.

Furthermore, stronger EPS growth rather than valuation expansion or dividends is responsible for the performance advantage of the growth-weighted portfolios over their cap-weighted counterparts. This confirms that the excess returns of the Fundamental Growth approach are rooted in real fundamentals-based growth rather than revaluation or payout effects.

This superior EPS growth was achieved with less sector concentration than the legacy indices. **Exhibit 7** shows the sector allocations of the FG 500 and CW Growth simulated portfolios. While CW Growth has experienced bouts of concentration in technology during the tech bubble of 1998 to 2000 and again over the past decade, FG 500 has maintained a more balanced exposure. While hype can stretch the valuations of certain sectors to extraordinary heights, almost any sector can see rapid sales or profit growth. This reduced sector concentration at market extremes leads to far more consistent performance across varied market cycles.

Exhibit 7. Sector Allocations (March 1969–June 2025)

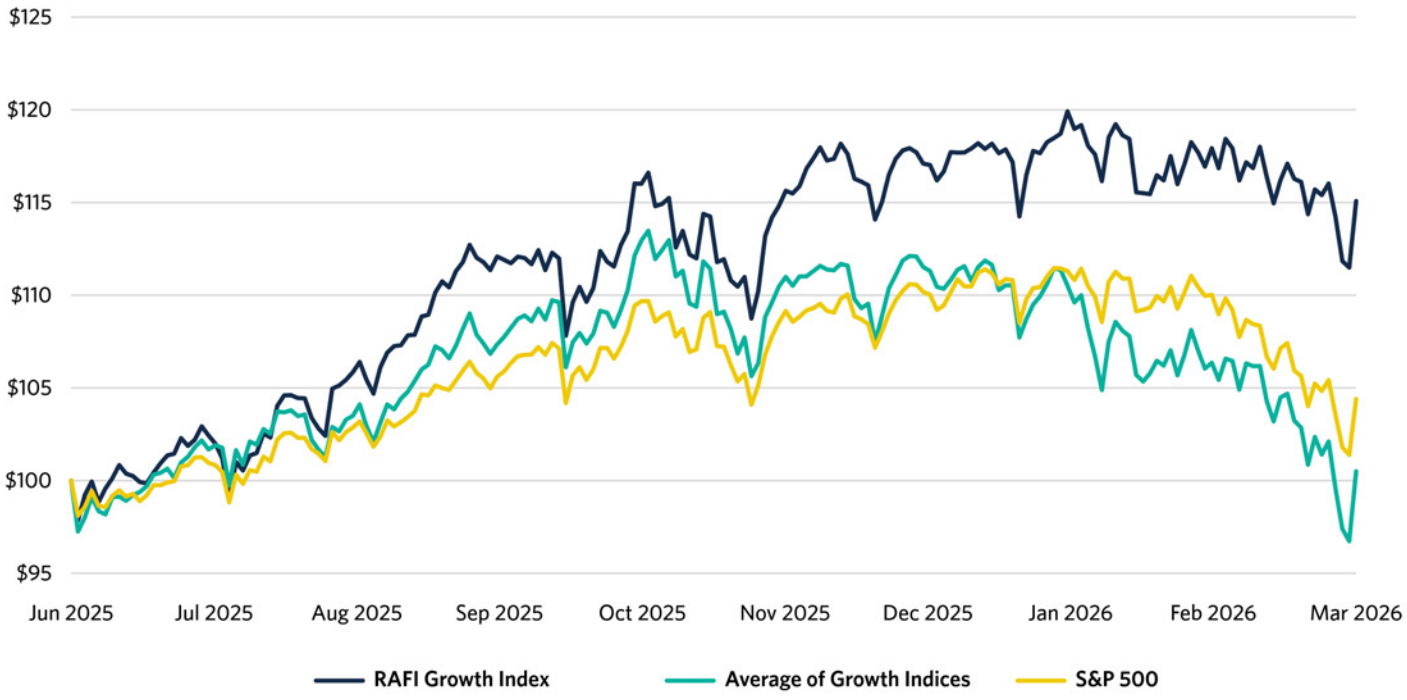


Source: Research Affiliates and CRSP/Compustat. The portfolios presented herein represent sector allocation based on simulated data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

RAFI Fundamental Growth US Index

Encouraged by our findings, we launched an index incorporating these principles in July 2025. The RAFI Fundamental Growth US Index incorporates additional robustness practices,[9] but the philosophy – to select and weight based on fundamental growth rather than price – remains the same. While the live track record is relatively short, it provides an out-of-sample test of our research. **Exhibit 8** shows how the RAFI Fundamental Growth US compares with the S&P 500 and an average of four growth indices from S&P, Russell, MSCI, and Bloomberg during this brief span.

Exhibit 8. RAFI Fundamental Growth US Index
Live Performance (Growth of $100)



Notes: Average of Growth Indices includes the S&P Growth, Russell 1000 Growth, MSCI USA Growth, and Bloomberg 1000 Growth indices. Daily returns are averaged and indexed to $100 at the start of the sample period, which runs from June 30, 2025 to March 31, 2026.

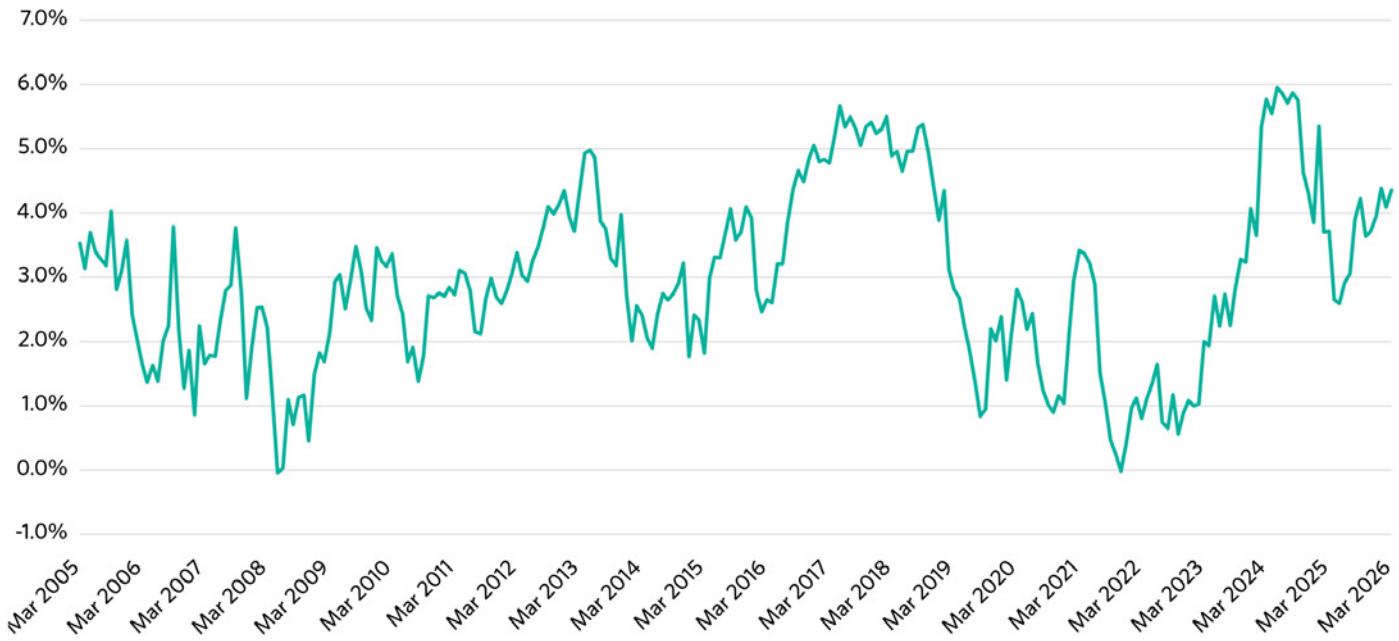
Source: Research Affiliates and Bloomberg.

During the initial live period, RAFI Fundamental Growth US delivered 10.7% and 14.5% higher returns than the S&P 500 and the blend of growth benchmarks, respectively. An attribution analysis versus the Russell 1000 Growth ETF (IWF) shows that security selection rather than sector allocation drove the bulk of the outperformance, reinforcing the importance of the selection and weighting framework.

The large outperformance in recent months, while exciting, is unlikely to be representative of long-run results. A backtested analysis of five-year rolling returns shows that RAFI Fundamental Growth US tends to outperform standard growth indices by 2% to 4% annualized. This has persisted in strong markets (2015 to 2019), bear markets (2007 to 2009), value-dominated markets (2005 to 2007), and growth-dominated markets (2021 to 2024). While the 1.000 batting average in relative five-year returns is impressive, what's more impressive is the 85% and 72% reliability, respectively, on rolling three-year and rolling one-year relative returns.

Exhibit 9. RAFI Fundamental Growth US Index vs. Average of Growth Indices[10]

Rolling 5-Year Relative Returns



Notes: Sample period is March 2000 to March 2026. Average of Growth Indices includes the S&P Growth, Russell 1000 Growth, MSCI USA Growth, and Bloomberg 1000 Growth indices. The rolling five-year analysis starts in 2000 to accommodate later inception dates for some underlying growth indices. Extending the U.S. analysis further back in time would have resulted in even greater excess returns for RAFI Fundamental Growth US.

Source: Research Affiliates and Bloomberg. All holdings prior to 7/17/2025 are simulated. Indexes are unmanaged and cannot be invested in directly. Please see important information at the end regarding simulated data.

The fundamental ratios and statistics in **Exhibit 10** also tell an interesting story. The RAFI Fundamental Growth US trades closer to core than traditional growth valuation multiples. By avoiding price in the selection and weighting process, RAFI Fundamental Growth US includes nicely growing companies if they are cheap. *Conventional growth indices will often exclude these companies simply because they are cheap!* Even in a market where a few stocks dominate the headlines and the cap-weighted indices, investors can still find growth without paying a hefty premium.

"By avoiding price in the selection and weighting process, RAFI Fundamental Growth US includes nicely growing companies if they are cheap. Conventional growth indices will often exclude these companies simply because they are cheap!"

Exhibit 10. RAFI Fundamental Growth Index Valuation Ratios

	RAFI Fundamental Growth Indices	S&P 500 Index	Average Growth Indices
Price-to-Book	4.8	5.1	9.6
Price-to-Sales	1.9	3.2	5.9
Price-to-Earnings	28.5	25.5	33.2
Dividend Yield	1.1	1.3	0.6

Notes: As of March 31, 2026. Average of Growth Indices include the S&P Growth, Russell 1000 Growth, MSCI USA Growth, and Bloomberg 1000 Growth indices. Price-to-book, price-to-sales, and price-to-earnings are averaged using harmonic means.
Source: Bloomberg and Research Affiliates.

Concluding Remarks

By embedding price directly into both selection and weighting, conventional growth indices can mistake expensive valuations for growth. This leads to a concentrated, valuation-sensitive portfolio that relies heavily on multiple expansion. We aim to avoid this mistake by not perpetuating the idea that growth and value indices must jointly define the market.[11] By selecting stocks based on fundamental growth in sales, profits, and innovation and weighting them according to their contribution to that growth rather than their market price, we target real, repeatable, and economically meaningful growth.

Fundamental Growth separates growth from glamour. It focuses on companies delivering tangible expansion in real growth metrics while seeking to reduce exposure to stocks whose "growth" image reflects frothy valuation multiples. In a market increasingly dominated by a narrow set of expensive names, getting growth right means focusing on actual growth. Fundamental Growth is designed to offer a clear, disciplined way to do exactly that.

"In a market increasingly dominated by a narrow set of expensive names, getting growth right means focusing on actual growth. Fundamental Growth is designed to offer a clear, disciplined way to do exactly that."

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Endnotes

1. See Shakernia, Omid, and Que Nguyen, 2025. "False Choices, Real Costs: Structural Flaws in the Growth-Value Duality." Research Affiliates.

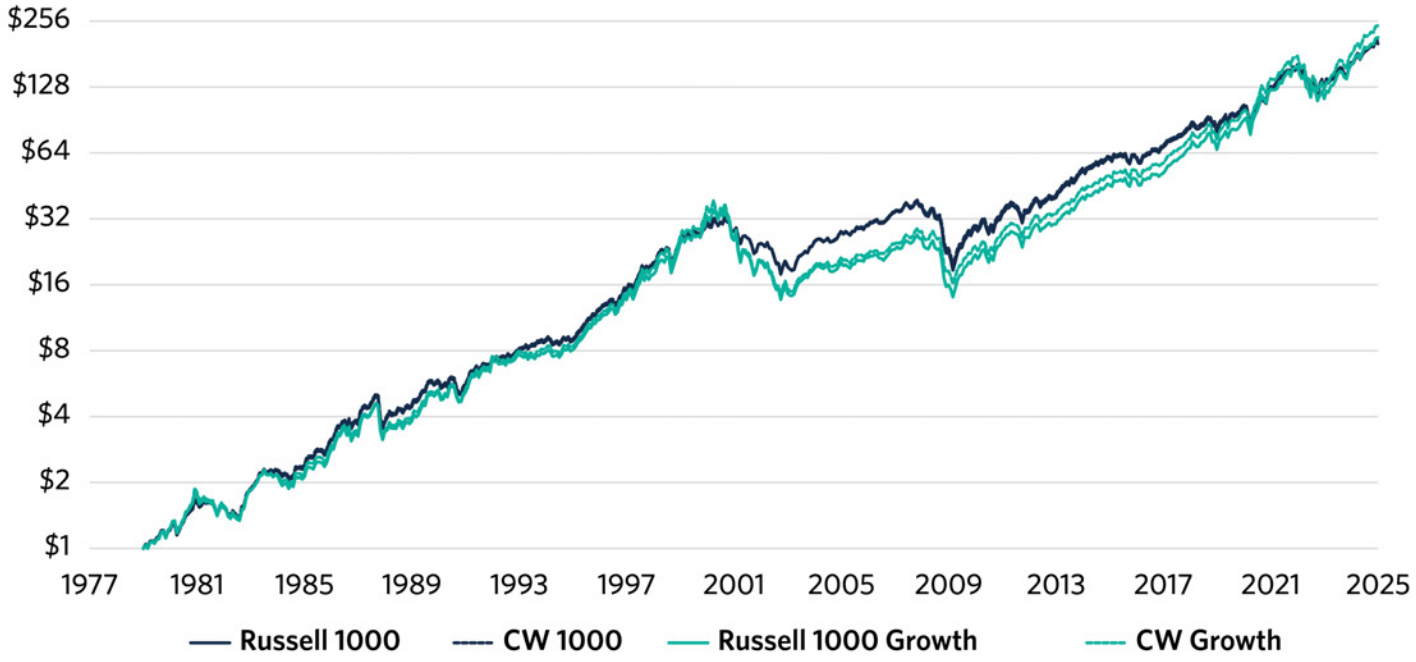
2. See Arnott, Robert D., Christopher Brightman, Campbell R. Harvey, Que Nguyen, and Omid Shakernia. 2026. "Fundamental Growth." *Financial Analysts Journal* 1–23. We evaluate additional growth metrics, including capex, net income, cash flow, asset, and dividend with buyback. In the interests of brevity, we exclude them from this discussion. For additional information on these additional measures, please refer to the article.

3. See Fama, Eugene F., and Kenneth R. French. 2015. "A Five-Factor Asset Pricing Model." *Journal of Financial Economics* 116 (1), 1–22.

4. Wonderful backtests are the proverbial "dime a dozen." The quantitative investment community is addicted to a particularly pernicious form of data mining, using backtests to improve the backtest. We studiously avoid this trap. Scientific method requires a hypothesis and then tests the hypothesis against empirical data. We began with a view that expensive is not the same as growth. We used historical data to test our prior hypothesis, not to tweak and enhance it in the quest for an ever-better backtest.

5. The Russell 1000 Growth Index's rulebook describes its methodology starting on page 22. Our simulation of the True Cap 1000 and CW Growth creates benchmarks with returns that closely track that of the Russell 1000 and Russell 1000 Growth indices, respectively. The chart below displays the simulated growth of $1 from December 1978 to December 2024 for four indices. We compare the Russell 1000 (in red) to our simulated True Cap 1000 (dashed red) and Russell 1000 Growth (green) to our simulated CW Growth (dashed green). The close alignment in cumulative return paths demonstrates that our simulated benchmarks mirror the behavior of the established Russell benchmarks.

Exhibit 11. Cumulative Growth of $1 for Simulated Cap-Weighted Index vs. Russell Indices (December 1978-December 2024)



Source: Research Affiliates, CRSP/Compustat, and Bloomberg. CW 1000 and CW Growth represent performance based on simulated data. Past simulated performance is no guarantee of future performance and does not represent actual performance of an investment product; actual investment returns will differ. Please see important information at the end regarding simulated data.

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6. The Fundamental Growth methodology is proprietary and the subject of one or more pending patent applications.

7. A powerful rebalancing engine, similar to RAFI, is also at work here and further bolsters performance. If the price rises and the dollar magnitude of the growth doesn't validate the price increase, a fundamental growth strategy will take profits. The opposite happens if investor confidence wanes, leading to a lower price, and the fundamental growth holds strong.

8. This decomposition is described in Brightman, Christopher, and Vitali Kalesnik. 2017. "A Smart Beta for Sustainable Growth." Research Affiliates.

9. Additional robustness measures include using multiple lookback windows of three, four, and five years. Diversifying across multiple time periods reduces the reliance on any one starting point. The severe dislocations some industries experienced during the onset of COVID-19 in 2020 highlight the benefit of this diversification. Airlines would exhibit substantial revenue growth if 2020 to 2025 served as the lone measurement, given the near collapse in travel in 2020. We also include additional sales, profits, and R&D measures. The complete methodology for the RAFI Fundamental Growth US Index can be found in this rulebook.

11. See Shakernia, Omid, and Que Nguyen. 2025. "False Choices, Real Costs: Structural Flaws in the Growth-Value Duality." Research Affiliates.

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