

Investing in wealth creation, not speculating

Wealth weighted indices aim to own a broad representation of the market, and to weight these securities by a measure of wealth creation rather than by market capitalisation. GWA has developed a measure of intrinsic company wealth that incorporates earnings, book value and cash flow. This is used in place of market capitalisation to weight securities in widely used indices.

Why wealth weight an index at all?

With around US\$5trn tracking market capitalisation indices globally, it is fair to ask, why would anyone want to construct an index without using stock prices? The answer is, in the short term, stock prices reflect the supply and demand dynamics of investor preferences. Rarely do they reflect a company's long term value. So if you want to invest in the equity market for the long term, it makes sense to allocate your capital to the stocks in your portfolio according to their underlying value rather than their market price.

It is important to note, however, that market capitalisation indices are a perfect construct. They represent investor preferences, second by second, as recorded objectively by stock exchanges around the globe. Investing in these indices provides broad coverage, transparency and liquidity at a very low cost. When investor preferences are diverse, tracking a market cap index is appropriate for most pension funds. Every now and again, however, these preferences all skew in one direction – what is often referred to as a 'bubble'. Bubbles distort the index, causing those tracking it to seriously misallocate their capital and translating into quite substantial financial losses.

Just how seriously these bubbles can

disturb markets was evident in 1988 when Japan rose to 42% of the world stock market – one third larger than the US. The technology sector exhibited similar behaviour in March 2000 when it grew to a quarter of the market, while today it stands at 9%. These bubbles always burst sharply and quickly as investors realise that the stock price has deviated sharply from what Adam Smith calls its 'natural price'. Since the prudent trustee is entrusted with caring for the well-being and happiness of their beneficiaries, it is rational to search for an alternative to this way of allocating equities while preserving the benefits that come with investing in an index.

One solution to this problem is to make

a distinction between market prices and market wealth. The relationship between these two entities is volatile in the short term, but very stable in the long run. By replacing the stock prices in any performance benchmark with company cash flow and net profit (two measures of income) and shareholders' equity (the wealth that accumulates the income) we can measure total market wealth.

Calculating each company's share of the total market wealth yields weights that are a proxy for the natural weights towards which the market is always moving. These wealth weights form a non-speculative, long term investment strategy. Offering this active strategy in the form of an index allows us to maintain the key advantages of index investing, namely broad coverage, transparency and low cost.

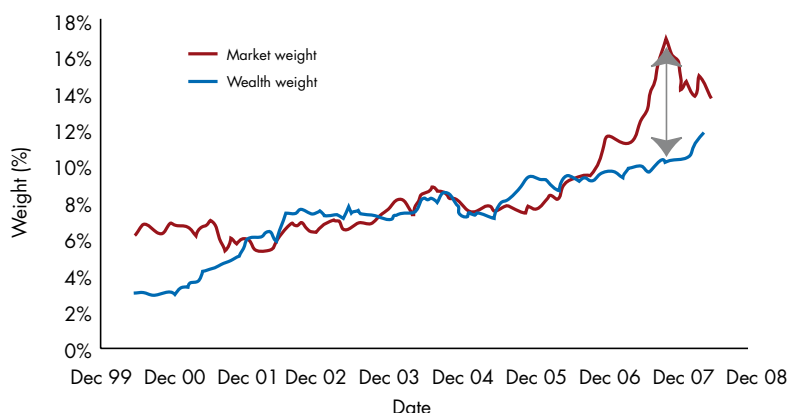
A wealth weighted All World index would have allocated Japan a weight of 17% at the height of the bubble, two and a half times less than the market weight. Similarly, the technology sector's wealth weight of 7% remained two thirds below the market weight of 23% at the peak of the dotcom bubble in 2000.

Diversifying core portfolios to include both market and wealth weighted index trackers is critical for the prudent trustee who needs to mitigate their fund's exposure to these market disruptions.

A wealth perspective, informing investors

Looking at the equity market through a wealth-tinted lens offers us many insights into what is occurring in the financial markets. For example, in 2007 comparing China's market and wealth weight in the Emerging Markets indicated a small bubble, which is now beginning to deflate (see Chart 1).

Chart 1: China bubble in 2007 – Wealth and market weights in emerging markets



Source: GWA, FTSE

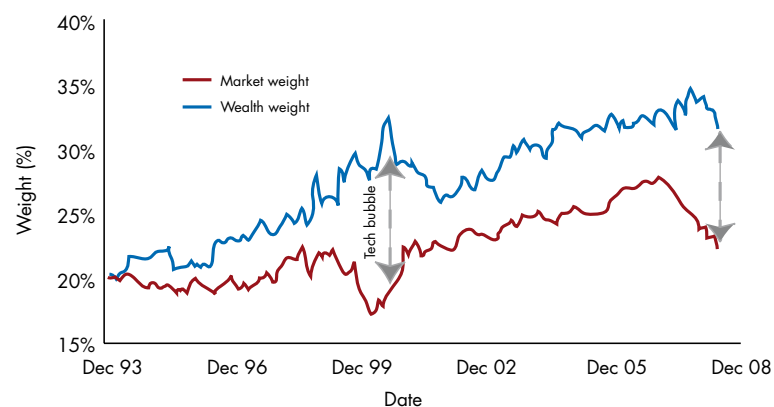
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Similarly, we can observe an 'inverse bubble' or 'anti-bubble' in the Financials sector in the last year. Comparing the market's plummeting weight in this sector with its relatively stable wealth weight implies the sector has been oversold (see Chart 2).

These observations are made entirely by looking at the wealth creation in the market. In contrast, day to day stock prices are often highly volatile, reflecting speculative opinion rather than the true economic value of these companies.

A wealth weighted strategy enables the investor to exploit this price volatility to extract excess returns over the long run. The portfolio systematically buys stocks whose wealth weights rise

Chart 2: Financials 'inverse' bubble in 2007 – Wealth and market weights in developed world



Source: GWA, FTSE

above their market weight, often referred to as 'buying low', and sells stocks whose wealth weights fall below their market weight, 'selling high'. Over the long run, this provides excess returns of between 1% p.a. and 4% p.a. depending on the mandate (see Chart 3).

Topix won a Five Star Morningstar Award in 2000, beating all other value managers at the time. The portfolio has now systematically rotated into a 'large cap growth at the right price' strategy, with a significant value premium.

Today there are US\$10bn tracking var-

Chart 3: Ten-year performance comparison

% per annum	Absolute Return	Relative Return
GWA Developed World (USD)	9.09	2.56
FTSE Developed World	6.36	
GWA Emerging* (USD)	28.16	3.70
MSCI Emerging Markets	23.58	
GWA US (USD)	6.44	2.15
S&P 500	4.21	
GWA UK (Sterling)	7.65	1.18
FTSE All Share	6.40	
GWA Japan (Yen)	5.49	2.91
TOPIX	2.50	
GWA Australia (AUD)	14.77	2.34
ASX / S&P 200	12.15	

*Historical simulations for the FTSE GWA Emerging Markets index only go back seven years

Source: GWA, Datastream

Investing for the long run

It is just as critical today as it was 80 years ago in the Great Crash of 1929, and again in 2000 during the dotcom bubble, to diversify core portfolios with a wealth weighted index. Ten years ago, the risk lay in the significantly inflated price of the technology sector; today the risk lies in the deflated price of the financials sector.

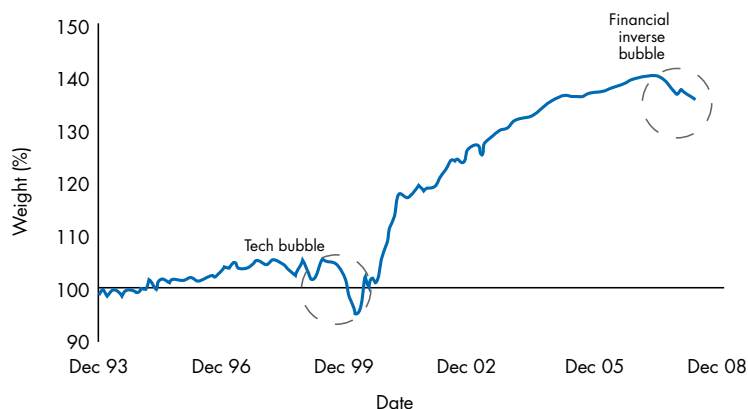
When these bubbles burst, the recovery for portfolios positioned closely to the equilibrium value of these sectors can be sharp and fast (see Chart 4).

In retrospect, a small cap value strategy would have been the ideal investment during the tech bubble, and this is just what our wealth weighted portfolio looked like. For this reason, the wealth weighted

indices in the US, the UK, Japan, Sweden and Australia, implemented by world class fund managers such as Legal & General, State Street, Mitsubishi UFJ, Sumitomo Trust and others. Investing in this strategy is a long term proposition based on robust economic principles. It is transparent, offers broad coverage equal to that of the market, and is both low cost and low governance.



Chart 4: FTSE GWA Developed World relative performance – Cumulative total return index versus FTSE Developed World (1993-2008)



Source: GWA, FTSE