EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

An update of performance, trends, research, & topics for long-term investors

July 2009

Asset Class Returns

June 30, 2009 (YTD)

	2006	2007	2008	Last 10 yrs.*	YTD 2009
Bonds (%)					
One-year	4.8	5.2	4.0	3.9	1.3
Five-Year	3.9	5.2	4.0	4.5	1.5
Intermediate	3.6	9.5	12.9	6.7	-2.4
Long-term	1.7	9.2	22.5	7.8	-11.2
U.S. stocks (%)					
Large Market	15.7	5.4	-37.0	-3.1	3.3
Large Value	20.2	-2.8	-40.8	0.0	2.8
Small Market	16.6	-3.1	-36.0	4.2	8.6
Small Micro	16.2	-5.2	-36.7	5.5	4.6
Small Value	21.5	-10.8	-36.8	6.2	2.4
Real Estate	35.3	-18.7	-37.4	3.7	-12.1
International stocks (%)					
Large Market	24.9	12.5	-41.4	-0.4	7.6
Large Value	34.1	10.2	-46.3	2.8	12.3
Small Market	24.9	5.6	-43.9	5.8	17.4
Small Value	28.4	3.0	-41.7	7.7	14.4
Emerg. Mkts.	29.2	36.0	-49.2	8.6	31.5

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Five-Year bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term U.S.Treas.
U.S. Large Market	DFA US Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US Micro Cap fund
U.S. Small Market	DFA US Small Cap fund
U.S. Small Value	DFA US Small Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Large Cap Int'l fund
Int'l Large Value	DFA Int'l Value fund
Int'l Small Market	DFA Int'l Small Company fund
Int'l Small Value	DFA Int'l Small Cap Value fund
Emerging Markets	DFA Emerging Markets fund

"Last 10 yrs." returns are ended 12/31/08.

Equius Partners, Inc.
4 Hamilton Landing, Suite 205
Novato, CA 94949
Phone: 415-382-2500
Fax: 415-382-2005

Editor: Jeffrey C. Troutner
jeff@equiuspartners.com

Critical Thinking is Essential

Jeff Troutner, Equius Partners

We try to impress on our clients from day one that knowledge is the key to their investment success and gleaning the *right* knowledge from an industry built on the profitability of misinformation is absolutely essential. It is not enough to listen to a good "story," either from us, another advisor, or the financial media. You must invest the time to *think critically* about what you are told or what you read if you are going to make the right decisions around your money. Knowledge gained from critical thinking leads to confidence in a long-range investment plan. This confidence, in turn, leads to the discipline necessary to weather investment storms and the constant onslaught of misinformation channeled through the media by the investment industry.

Unfortunately, crises, like the one we are working through today, create opportunities for powerful forces to promote their agendas and control the "debate"—enthusiastically aided by a perpetually news-starved media that is clearly devoid of critical-thinking journalists. In the area of finance and investments, this is particularly frustrating given that both are built on a scientific foundation of mathematics and statistics. But numbers are boring and they tend to lead to *conclusions*. For example, Bill Sharpe, the 1990 Nobel Prize winner in Economic Sciences, wrote the concise and to-the-point "The Arithmetic of Active Management" in 1991, quantifying the wealth-draining costs of active management, yet the value-added of stock pickers and market timers continues to be debated. It's like 2 + 2 might or might not = 4.

What is Critical Thinking?

Critical thinking can be defined as the skilled, active, interpretation and evaluation of observations, communications, information, and argumentation.[1] Or, alternatively, the careful, deliberate determination of whether one should accept, reject, or suspend judgment about a claim and the degree of confidence with which one accepts or rejects it.[2]

At Equius, critical thinking is essential to everything we do. We simply refuse to accept anything our industry puts forth as "truth" or "convention" until we have done our own research and used our own skills, logic, common sense, and experience to either accept or reject the issue at hand. We're *able* to do this because of our independence, but we're *determined* to do so because of our values. We believe that as long as a client pays us a fee, we should be doing things that are clearly in their best interests. We also respect our clients' intelligence and know that *long-term* relationships must be built on transparency and shared knowledge.

We Can Only Do So Much

Many investors fail to take responsibility for their investments decisions, deciding instead to delegate to those they believe are the investment experts. But who are

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these experts? For those who allow a compliant, self-serving, critically-challenged media to decide, the experts are major Wall Street firms, massive mutual fund complexes, (in)famous hedge fund managers and others who clearly exploit investor ignorance for their own gain. Their goal is to keep money moving; keep it in play. Whoever produces and distributes the most powerful marketing story—targeting the emotion of the day most effectively—wins the assets. Facts, principles, and values be damned.

Your only defense from being played by these forces is knowledge gained through critical thinking. We try to provide this to you every month via *Asset Class*. The recent articles on TIPS, gold and commodities (and this month, ETFs) are a good example. Our team reads all these articles with a very critical eye, making sure that they address the issues vital to the argument and that facts, principles, and conclusions are communicated in a way that non-professionals can understand.

We also strongly encourage our clients to read other sources of information that, at least from a wider perspective, support the principles we believe in. These include books such as Bill Bernstein's *The Intelligent Asset Allocator* and Charles Ellis's *Winning the Loser's Game*. For those so inclined, we also provide copies of some of the best academic research published to date on many of the issues we cover.

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Reader Beware

For contrast, I encourage you to read the article, "Buy and Hope," as an example of the quality of financial journalism today.[3] That it was published in a trade magazine, *Financial Planning*, makes an even more powerful statement about the level of intelligence and critical thinking skills of many in our industry, or possibly the lack of respect publications like that have for those of us who take our responsibilities seriously.

When I saw the title, I immediately thought the article would be about the foolishness of buying into a strategy based on little information, good recent performance, or a slick marketing angle. Instead, I read that "buy-and-hold" is dead and enlightened advisors were searching for another holy grail. In this case, the holy grail is, predictably, market timing.

To defend his shift to market timing, one advisor concluded after a market decline that buy-and-hold "was not a guaranteed strategy." (Brilliant.) Another advisor stated he *had* been a devoted buyer and holder because it was "so simple for clients to grasp." (Wow, lack of respect *and* critical thinking skills.) This advisor now uses forecasting software to make his investment decisions. The last two advisors interviewed shifted to "tactical asset allocation" in order to make changes based on "shifting views on valuations, economic conditions and technical analysis." Nowhere in the article was mention of market timing not being a "guaranteed strategy." How about well-defined principles and methodology; a documented track record; academic research support; expected risk/return characteristics? Nada.

Within days of reading this article, I received a call from a client, whose trust accounts we had managed since 2006, informing me that he was leaving us in order to place his money with another advisor (Phil referenced this in last month's *Asset Class*). After I expressed disbelief that he would leave us for a market timer, the client corrected me by stating that, no, they aren't market timers, they're actually *tactical asset allocators*. You can imagine my relief (!), since one of the things that drove me to the buy-and-hold philosophy of asset class investing in 1992 was a miserable two-year stint with a market timer (er, I mean tactical asset allocator).

Personal Responsibility

My guess is that this former client never took the time to really understand what we do and why. I suspect he never read the three years of *Asset Class* we sent him, or if he did, he never stopped to think about what was written in the context of his own situation. Based on what he told me, his new advisor's alleged move out of the market sixteen months ago was all he needed to know: not how the decision was made; how other decisions in the past worked out; why he believes the advisor's "system" will work in the future; what the long-term returns and risk of the strategy have been in the past; what research can be provided to back up the advisor's claims, etc. In fact, it turns out that the advisor actually offers six different strategies from which the client may *choose*, depending, I'm sure, on how the client *feels* at any given time.

Thinking around investments is often casual or routine, rather than truly critical. The investment industry and most advisors count on this. Casual thinking keeps investors on the merry-go-round of active management, where they routinely jump from one pretty horse to another every two or three years. In the case of our former client, his new advisor was savvy enough to build his own merry-go-round. Normally, I would give an investor like this less than three years with his new advisor. But with six different strategies, there's enough pretty horses to keep him snookered for some time.

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[1] Fisher & Scriven, *Critical Thinking. Its Definition and Assessment*
[2] Parker & Moore, *Critical Thinking*
[3] *Financial Planning*, "Buy and Hope" June, 2009, *www.financial-planning.com*

In Pursuit of Product (Profit)

The misuse and bastardization of Exchange-Traded Funds

Jeff Troutner, Equius Partners

As its label explicitly states, the financial services industry is a *service* business. On the retail (individual investor) side of the equation, you would think this service would entail helping investors meet their (mostly) long-term financial goals. Eighty years of financial markets data in the U.S., combined with extensive academic scrutiny of the data would suggest that building highly diversified portfolios of stocks, tempered by high-quality short-term bonds to control risks, would be more than sufficient for most investors. As long as risks are properly assessed and expectations are properly communicated (all part of "service," one would think) the result should be fairly boring but very stable investment strategies that meet investors' well-understood objectives.

Alas, Wall Street cannot survive *and* make big profits on boring and stable. They *must* keep money moving in order to generate transactions. A 1% fee to provide prudent, professional consultative advice just doesn't cut it. So what do we get instead? *Product*. Not iPhones, automobiles, or solar panels, mind you, but limited partnerships (1980's), equity-indexed annuities, auction-rate securities, and securitized mortgages (today)—all things that can be *sold* with a glossy brochure by legions of commission-based stock brokers and insurance agents.

But are all investment "products" bad? Of course not. Open-end mutuals funds have allowed smaller investors to invest in hundreds of stocks with one purchase. Index funds, which are simply a variety of open-end mutual funds, allow small and large investors alike to invest in *thousands* of stocks across multiple market and asset classes. They also have greatly reduced management fees and other costs due mostly to the fact that they are not reliant on highly-compensated "gurus" to make stock picks. They are also very tax-efficient for the same reason (gurus tend to trade a lot, taxes be damned). Pretty good product, right?

Well, evidently not good enough for Wall Street. Enter "exchange-traded funds" (ETFs) with all the advantages of index funds but with one important new element—they can be traded like stocks during the day. This allows day traders and market timers the ability to jump in and out of asset classes and even individual sectors or industries at the push of a button any time during normal market hours. In essence, Wall Street took the tried and true benefits of indexing and packaged them into a product that *keeps money moving*. Brilliant!

That was ETF 1.0. Since last year, that wonderful government regulatory body created to protect investors, the Securities and Exchange Commission (SEC), decided in its infinite wisdom to allow ETFs of *actively-managed* portfolios, not just index funds. This allows investors who tire of lousy investment results to fire their gurus after a day or two, instead of the normal two or three years. And they get to pay their Merrill Lynch, I mean Bank of America, broker a nice commission on *both* ends of the trade while continuing to pay the much higher annual management fees of active management. Brilliant! Call this ETF 2.0.

But it's not just crazy day-traders and market timing investors pouring money into ETFs. It's also serious indexers and their advisors who believe that ETF index funds are superior to open-end funds. Are they? Well, if you only listen to the Wall Street marketers and financial advisors who gain a marketing advantage perpetuating certain beliefs, they are. A more critical analysis reveals a different story.

The features of ETF's that were initially touted by their creators as superior to open-end mutual funds were their: 1) lower expense ratios and 2) greater tax efficiency. Both of these are important considerations with any investment option you review and, out the gate, ETFs delivered.

However, open-end index funds have met the cost competition by reducing expense ratios significantly, and they have always been very tax-efficient given their much lower portfolio turnover (trading of stocks within the fund). The introduction of "tax-managed" index funds for the less tax-efficient small cap and value stock asset classes have reduced taxable distributions even further.

The net result is that there is virtually no cost or tax efficiency differences between standard open-end index funds and comparably-managed ETFs, looking at either the averages for each asset class category or each category's "best of breed" (limited to ETFs with at least $100 million in assets).

Capturing Asset Class Returns

The biggest flaw we have always found with ETFs (one that overwhelms any *potential* cost or tax-efficiency advantage ETFs might possess) is the underlying index on which each fund is based. This is seldom discussed in articles touting ETFs because this is a flaw of open-end index funds as well. But we are not limited to either ETFs or open-end index funds based on standard, public indexes to build client portfolios since we have access to the institutional-level asset class funds of Dimensional Fund Advisors (DFA).

ETFs based on a wide range of indexes have proliferated over the past several years, so to do a meaningful comparison, we've decided to focus on those with the majority (48%) of market share—the iShares ETFs from Barclays Global

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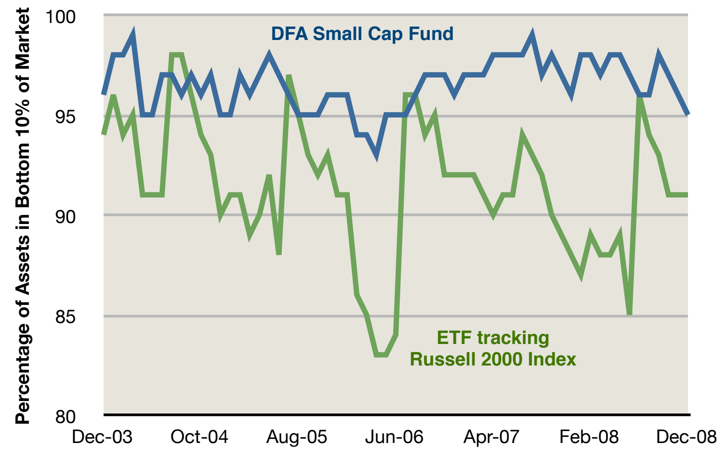
Investors. We should mention, however, that Equius continually monitors investment results in view of underlying index methodology and trading execution for *all* ETFs just in case someone comes up with a better mousetrap.

There are a number of different ETFs available in each asset class from iShares, but the domestic ETFs based on the Russell indexes and the international ETFs tied to MSCIs indexes have proved most popular as measured by assets under management. The Russell and MSCI indexes have the added benefit of returns data going back to the 1970's, allowing us to observe longer-term performance. We could have used iShares or Vanguard ETFs based on S&P, MSCI, or Morningstar domestic indexes instead, but the returns data is much shorter for these indexes and the conclusion is the same regardless.

Table 2: ETFs and Style Drift



Source: Dimensional Fund Advisors

The table below shows a comparison of the performance of the indexes underlying DFA's asset class funds to the Russell and MSCI indexes. We've excluded the U.S. large growth asset class (since there's no meaningful difference in returns for S&P 500-based funds looking at DFA, Vanguard, or the ETFs) and international small value stocks (since ETFs are still unavailable in that asset class).

Table 1: Index Structure Matters

1979-2008	Return	Advantage
DFA U.S. Large Value Index	13.0%	1.2%
Russell 1000 Value Index	11.8%	-
DFA Marketwide Value Index	13.5%	1.6%
Russell 3000 Value Index	11.9%	-
DFA Targeted Value Index	14.9%	1.8%
DFA U.S. Small Value Index	14.9%	-
Russell 2000 Value Index	13.1%	
DFA Int'l Large Value Index (94-08)	7.6%	2.1%
MSCI EAFE Value Index (94-08)	5.5%	
DFA Emerging Mkts. Index (88-08)	14.4%	3.0%
MSCI Emerging Mkts. Index (88-08)	11.4%	

Past performance is not a guarantee of future returns. Indices are not available for direct investment. Investors should read fund prospectuses carefully before investing.

Why have the DFA indexes outperformed? The most obvious answer for those of us who study index methodology is that DFA's proprietary indexes are structured to own smaller and less pricey (more "valuey") stocks than the Russell and MSCI indexes. These latter public indexes (along with the Standard & Poors and other indexes) were never designed to be used as investment vehicles, but instead were created in order to judge the talents of active managers. This has changed somewhat with the introduction of new indexes to "juice" returns of retail index funds. But so far the results are mixed at best. DFA also screens out REITs and regulated utilities in their funds since these stocks act very different from large, small, value, and growth stocks in general.

Besides the basic index structure that appears to capture more of an asset class's return characteristics, DFA also manages their index funds extremely well. Since their indexes are private, they can institute a "patient trading" methodology that results in better execution, especially in the very small stock area where liquidity is a factor. This allows them to buy a certain percentage of stocks in blocks below the posted market price. Since DFA institutes their patient trading continually throughout the year, their asset class funds stay consistently true to their indexes.

ETFs, on the other hand, tend to rebalance their portfolios only once or twice a year, causing their asset class exposure to drift over time, leading to a less precise focus and lower returns (see Table 2). Furthermore, ETFs buy and sell all of their stocks during this rebalancing period at the same time, negatively impacting share prices. Hedge fund managers are notorious for exploiting these flaws in standard-issue index funds at the expense of ETF shareholders.

Our conclusion on ETFs in general is that they improve very little, if at all, on standard open-end index funds and are inferior, due to their underlying indexes, to what we have access to through DFA.

ETFs will be increasingly marketed as a "valuable" tool for active managers, market timers, and other speculators who have *always* shunned a buy-and-hold approach. That's fine in our book. Sadly, however, they will also be sold to individual investors so traumatized by last year's decline that they'll buy into any "this time is different" story in search of The Holy Grail. Gotta keep that money moving!

Thanks to Eric Nelson for his good research on this topic.