

## Asset Class Returns

October 30, 2009 (YTD)

	2006	2007	2008	Last 10 yrs.*	YTD 2009
<b>Bonds (%)</b>					
One-year	4.8	5.2	4.0	3.9	2.0
Five-Year	3.9	5.2	4.0	4.5	4.5
Intermediate	3.6	9.5	12.9	6.7	0.2
Long-term	1.7	9.2	22.5	7.8	-8.5
<b>U.S. stocks (%)</b>					
Large Market	15.7	5.4	-37.0	-3.1	17.2
Large Value	20.2	-2.8	-40.8	0.0	20.0
Small Market	16.6	-3.1	-36.0	4.2	22.8
Small Micro	16.2	-5.2	-36.7	5.5	15.8
Small Value	21.5	-10.8	-36.8	6.2	20.1
Real Estate	35.3	-18.7	-37.4	3.7	12.2
<b>International stocks (%)</b>					
Large Market	24.9	12.5	-41.4	-0.4	24.5
Large Value	34.1	10.2	-46.3	2.8	33.9
Small Market	24.9	5.6	-43.9	5.8	38.7
Small Value	28.4	3.0	-41.7	7.7	37.2
Emerg. Mkts.	29.2	36.0	-49.2	8.6	56.5

### 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.

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## A Productive Partnership

*Jeff Troutner, Equius Partners*

As we contemplate what we're thankful for this Thanksgiving, I'm reminded again of how fortunate we are to have Dimensional Fund Advisors (DFA) as a partner in our efforts to meet our clients' long-term investment objectives. DFA provides the tools (mutual funds) we use to build the most efficient asset class portfolios possible. We were one of the very first advisors approved to use the DFA funds and we and our clients have prospered as a result ever since.

At this point, a different kind of advisor might tout the performance of DFA's mutual funds as the source of his/her gratitude. Not us. While performance has been what we've expected through the years (amazingly, we're entering our 18<sup>th</sup> year with DFA), it's DFA's consistent culture of evidence-based investing and unwavering discipline in the face of some pretty nasty markets for which we are most grateful.

### The Birth of a Great Idea

As independent advisors (who are paid only by our clients), Equius is able to choose among hundreds of established mutual funds companies and thousands of individual funds with which to build client portfolios. So what makes DFA special?

First, when Dan Wheeler, the former head of DFA's Global Financial Advisor Services, agreed to meet with Phil and me (then on separate advisory tracks) in the early 90's, he made it clear what his expectations were: since the DFA funds had previously been restricted to very large institutional investors with long-term time horizons, we could not, in any way, use their funds for market timing. Having just left an advisory firm that lost almost \$500 million dollars in client assets over two years as a result of bad market timing, I needed no further convincing.

Second, DFA has been fully committed to involving us in their investment process. In their words, we would be "well educated in financial market theory, articulate in describing the tenets of investing, and steadfast in focusing [our clients'] attention on the benefits of long-term investing. Most importantly, [we] would be able to control the emotions that often get in the way of seeking a successful investment experience."

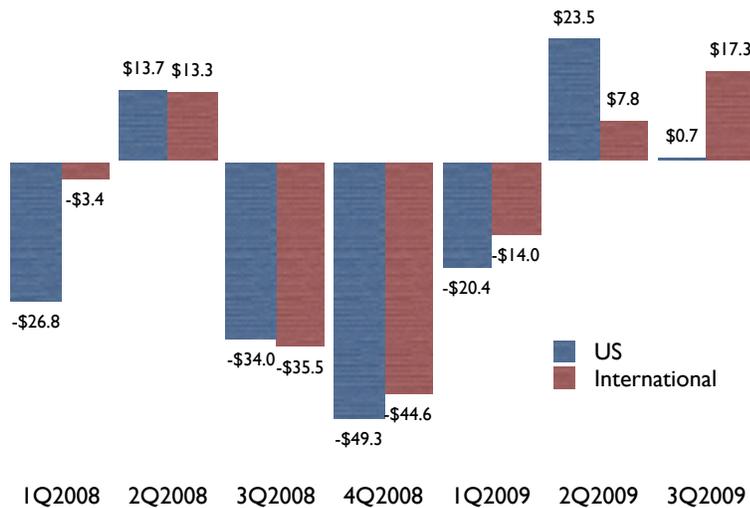
Third, the DFA funds have always had very low expense ratios compared to other fund choices and they have maintained a style purity and consistency that is second to none in the industry. Innovation around their core asset class strategies has never stopped and they continue to add value in their high-quality trading capabilities, securities lending, and other areas.

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## The Results: Stability in Unstable Times

DFA routinely studies mutual fund industry cash flows compared to flows into or out of their own funds. This gives them a good idea of how their approved advisors have directed the client experience—in contrast to retail investors who, either on their own or as clients of less-disciplined advisors, tend to make bad decisions during difficult market environments. As shown in Chart 1, industry cash flows were volatile and driven by emotion (mostly fear) over the past year and three quarters.

**Chart 1: Estimated Industry Flows Into and Out of Stocks**  
(January 2008 - September 2009; In \$US billions)



Returns for the S&P 500 and the Morgan Stanley EAFE index for the last quarter of 2007 and first quarter of 2008 were -12.5% and -8.4%, respectively. It's not surprising then that 1Q2008 industry cash flows were negative. Cash flows turned slightly positive 2Q2008 as the U.S. market dropped "only" an additional 2.7% and international stocks were flat.

But the movement out of stocks commenced with a vengeance during the third and fourth quarters of 2008 and first quarter of 2009 as stock prices plunged across the globe. After markets started to recover in the second quarter of this year and the financial media began hyping the decline of Western-style capitalism and the "certain" ascension of emerging markets to world dominance, assets shifted dramatically to foreign stocks.

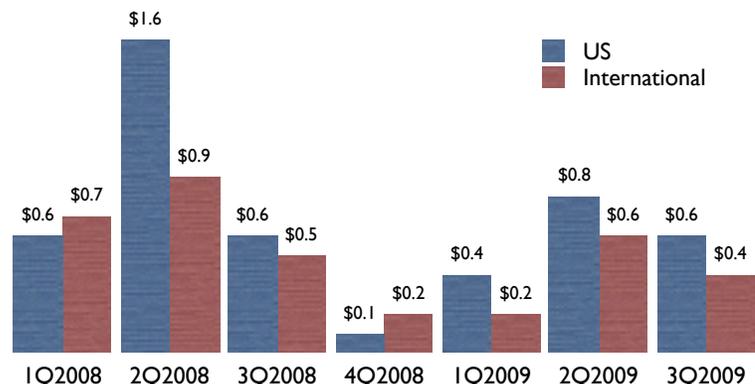
In contrast, Chart 2 shows positive cash flows into the DFA stock funds over this entire period and the U.S. to foreign mix was fairly consistent throughout—the differences owing more likely to rebalancing than anything else. For example, international stock prices fell over twice as much as U.S. stocks during the third quarter of 2008, leading to twice as much inflow to international stocks during the fourth quarter.

When markets turned around dramatically starting in mid-March of this year, clients of DFA advisors were poised to benefit. As we all know, these "unexpected" market recoveries are what drive long-term returns. It appears that many retail investors had substantial money in the market during the decline and were out of the market during the steepest part of the recovery. I suspect that we'll see substantial inflows during the fourth quarter *after* markets reached current levels. As David Booth, one of the founders of DFA, often says, "Most investors take the risk, but don't stick around for the return." Indeed.

It's interesting to note that of the DFA stock funds we use in client portfolios, every one experienced top-5 best and worst months since inception over this period. We know from experience and numerous studies (including those from Morningstar and DALBAR) that controlling client (and advisor) emotions over such volatile periods is *the* most crucial challenge we face. We're grateful for the

support DFA provides to us in this regard and for the confidence our clients continue to show in our long-term asset class strategies.

**Chart 2: Advisor-Driven Cash Flows to DFA Stock Funds**  
(January 2008 - September 2009; In \$US billions)



Source of data for both charts is Morningstar's Estimated Net Mutual Fund Flows net of Money Market Funds and Fund of Funds.



## Anchors “Away”

Phil Jonckheer, Equius Partners

Building on Jeff’s Thanksgiving theme, I think it’s appropriate to thank the investment gods for the very powerful stock market recovery that has occurred since this year’s March lows. We should note, however, that all of the stock asset classes we use to build long-term portfolios (including emerging markets, which we recently removed from most portfolios) are still down between 26%-34% since the October 2007 high. This probably explains the distinct shadow of unease we sense as we survey the landscape of current investor emotions. I’m sure it also explains the net outflows from stock mutual funds, as Jeff’s article points out.<sup>1</sup>

A question we should ask ourselves is: Why is the October 2007 high so important? After all, as we show in Table 1, since January 2000 (remember those heady days of almost ten years ago?) returns for all asset classes but U.S. large stocks have been reasonable and in line with what we would expect.

Table 1: A Longer View of Reality (Jan 2000 - Oct 2009)

Asset Class	Annual Return Since January 2000	Total Return Since January 2000
Five-Year Treasury Bond Index	6.4%	83.1%
S&P 500 Index	-1.7%	-15.9%
DFA U.S. Large Value Index	1.7%	17.9%
DFA U.S. Small Value Index	10.2%	160.3%
DFA Int’l Large Value Index	6.5%	85.3%
DFA Int’l Small Value Index	12.0%	204.3%
DFA Emerging Markets Index	9.5%	144.9%

Past performance is not a guarantee of future returns. Indices are not available for direct investment.

One explanation for this tendency to focus exclusively on *recent* highs (or recent returns in general) lies in the human behavior called “anchoring.” Anchoring serves to justify a faulty decision making process and attendant conclusions. Awareness of this behavior is especially relevant and extremely important to those investors who are near or already in their retirement years. In this case, retirement spending plans were too often anchored on the highs of October 2007 without consideration for potential setbacks.

As investment advisors, we cannot ignore either the market volatility or the very normal mental gymnastics that continuously play out in our clients’ minds. In light of those dynamics, we feel we must explore new ways of dealing with these challenges.

Since we can’t control the market’s ups and downs, perhaps we can work with our clients’ minds (expectations) in a more productive way. This is a topic we’re exploring with DFA and others and one Jeff will cover in more detail in the December issue of *Asset Class*. For now, let’s review some of the tricks our minds play and how we might begin using them to our advantage rather than our detriment.

### Neuroplasticity: Taking Your Brain to the Gym

When general stress and concern cause people’s imaginations to spiral (mirroring the market itself), that behavior is called “catastrophizing.” Such thinking magnifies anxiety and develops to the point where disaster is expected. Part of the reason that catastrophizing spirals out of control is explained by the fact that our brains are not static chunks of matter. As mentioned in a previous *Asset Class* article, the science of neuroplasticity has demonstrated that we can change the structure of our brains based on the thoughts we choose to process. The more we participate in and reflect on certain activities, the more the parts of our brain devoted to those activities expand.

So worrying begets worrying, and contentment breeds contentment. In other words, each time a person becomes anxious, the neuropathways or routes in our brain that deal with worrying are reinforced and grow physically larger. If you think of your brain as a topographical map, the decline in markets often fueled by the fear-inducing media will cause the route associated with worrying to become an ever-larger and more influential superhighway. What steps can we take to create an alternative route of contentment in our “brain maps” despite the unavoidable ups and downs of the market?

### Mental Accounting: We Can Get Satisfaction

Part of our quest to develop more satisfying routes in our brain maps lies in research on behavior called mental accounting which studies how people organize, evaluate and track their financial activities.

Regular financial accounting used by companies is very explicit, with numerous rules about how to record transactions and track cash flows with the intention of controlling expenditures. The mental accounting done by individuals, on the other hand, is not that clear cut or rational. Individuals are more inclined to relate to

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their wealth not as a whole unit but rather in discrete sub-accounts. Those sub-accounts are meant to finance different functions such as vacations, debt repayment, philanthropy and education. Although money in one account ought to be interchangeable with another account, people mentally build barriers between sub-accounts that discourage substitutions. For example, money in a vacation account would not be used to pay off expensive credit card debt even though it would be in the person's best financial interest to reduce that debt.

The tendency to segregate wealth into different compartments (a quirk of mental accounting) is illustrated in an experiment that dealt with people's separate cash and entertainment accounts. One set of individuals was asked to imagine going to a movie with a ticket they bought in advance. As they entered the theater they discovered they've lost the ticket. Those people were asked whether they would buy another \$10 ticket. Only 46% said they would. A different set of people was asked to imagine going to a movie except this group had to buy a ticket at the theater. As they stood in line they discovered they lost a \$10 bill, yet 88% of those people were still willing to buy a ticket. What this study shows is that even though the \$10 values were identical, people in the second group *who did not mentally create an entertainment account* were more inclined to use their cash account to buy the ticket since their entertainment account had not been depleted.

People also treat money differently depending on its source: Whether it was "found" money from tax-returns, gifts, and bonuses or whether it was "expected" money from a paycheck. Again, even though the values are identical, people are more willing to spend a lot more of their "found" money than money sourced from their paychecks.

When it comes to investing, research indicates that people are more inclined to consider their overall portfolios as a collection of sub-portfolios where each sub-portfolio is aligned with a goal. Those goals might include a vacation home, children's or grandchildren's education, retirement, or charitable giving. If that is true, then risk becomes less a function of total portfolio volatility and more the probability of failing to reach each sub-portfolio's objective. Perhaps the angst of investing could be reduced if advisors address more precisely the

goals that investors assign to each of their sub-portfolios.

### The Next Step

Whether the answer to addressing investors' proclivity to mental accounting and counseling them to increase the odds of attaining their objectives lies in building "virtual" sub-accounts or actual sub-accounts (or "buckets," as some in the industry are calling them) remains to be seen. Our balanced strategies already assign portfolios to what could be viewed as sub-accounts but what we have called asset classes. As we've discussed ad infinitum, each asset class has its own risk and return characteristics. Our disciplined process of rebalancing deals fairly effectively with the market's ups and downs. This form of virtual sub-accounting has served our clients well when combined with our investment counseling.

These thoughts have led us to begin working with DFA and others to explore alternatives for our clients who are near or in a "decumulation" phase of their lives. Next month's *Asset Class* will expand on this.

In the meantime, we hope you are enjoying your Thanksgiving holiday and your time with family and friends.

<sup>1</sup> To add a slightly different perspective to the mutual fund flows numbers in Jeff's article, here's a chart from Morningstar illustrating stock fund flows since 1990. It clearly shows fund flows topping out at the *top* of the market in 2000 and bottoming out at the *bottom* of the market in 2002-2003. If retail investors were wise, the opposite would be the case (you know, that old "buy low, sell high thing").

