

Asset Class Returns

December 31, 2009 (YTD)

	2009	2008	2007	2006	Last 10 yrs.*
Bonds (%)					
One-year	1.9	4.0	5.2	4.8	3.7
Five-Year	4.2	4.0	5.2	3.9	4.8
Intermediate	-0.7	12.9	9.5	3.6	6.9
Long-term	-12.1	22.5	9.2	1.7	7.4

U.S. stocks (%)

Large Market	26.5	-37.0	5.4	15.7	-1.0
Large Value	30.2	-40.8	-2.8	20.2	4.4
Small Market	36.3	-36.0	-3.1	16.6	5.7
Small Micro	28.1	-36.7	-5.2	16.2	6.3
Small Value	33.6	-36.8	-10.8	21.5	9.1
Real Estate	28.2	-37.4	-18.7	35.3	10.5

International stocks (%)

Large Market	30.6	-41.4	12.5	24.9	1.4
Large Value	39.5	-46.3	10.2	34.1	6.7
Small Market	42.0	-43.9	5.6	24.9	8.7
Small Value	39.5	-41.7	3.0	28.4	11.3
Emerg. Mkts.	71.8	-49.2	36.0	29.2	9.5

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 U.S. Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA U.S. Micro Cap fund
U.S. Small Market	DFA U.S. Small Cap fund
U.S. Small Value	DFA U.S. 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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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

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Balance Is No Gimmick

Jeff Troutner, Equius Partners

The volatile markets of 2008-2009 were hard to take, especially for those of you in or near retirement. You did all the right things and still saw your portfolio drop precipitously for many months:

- You took the time to understand the history of the financial markets and the sources of risk and return.
- You diversified broadly within and among the primary asset classes based on rational objectives using the best index funds available.
- You allowed us to rebalance your allocation to targets when most other investors and advisors were doing nothing or the opposite.
- You were patient and confident through all the ups and downs...

...and yet you still suffered through a pretty severe decline. So, do we now give up on balanced asset class portfolios? Should we continually shift your asset allocation in reaction to or anticipation of market movements? Should we add or delete different asset classes at different times? Should we use psychological "tricks" to make a certain balance look less risky than it really is? Our answer to all of these is a definite no. And, as usual, we seem to be in the minority of money managers and investors.

The herd has made *its* decision. Money has flooded out of U.S. stock funds by the billions and into bond funds, international stock funds (especially emerging markets), and assumed inflation hedges such as gold and commodity funds. With interest rates so low, we're also seeing a huge demand for junk bonds and other riskier fixed-income investments as investors reach for higher yields. This is, of course, the pattern we see in various forms and degrees after every significant down period for stocks. It's a pattern of foolishness and desperation that ends up costing investors many billions of dollars over time. We're also reading every day about advisors who reject market timing as a viable strategy, yet are recommending "permanent" reductions in their clients' stock allocations.

It appears that balance, discipline, and patience are forgotten virtues among today's investors and advisors. After investors shifted increasingly to stocks in the late 90's, only to ride these concentrated portfolios into the ground in 2001-2002, Peter Bernstein wrote one of my all-time favorite investment articles (reprinted in this issue of *Asset Class*). We had consistently warned against herd following during that period, culminating in an *Asset Class* article in January 2000 titled, *Should We Fear a Total U.S. Market Collapse, Or Is a Gradual Rotation Among Asset Classes More Likely?* (a link to the article is on our website). So how has our advice and Mr. Bernstein's fared since then?

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The First Stock Market Debacle

Table 1 shows what we were faced with in 2000. U.S. large growth stocks were all the rage then, driving the S&P 500 up 248% for the period. A more balanced all-stock allocation (which includes higher percentages of small cap and value stocks) lagged that return by 100 percentage points, while a balanced stock/bond mix did even worse (despite a 15.6% annual return!). Then things changed dramatically.

From the beginning of 2000 to the end of the first quarter of 2003, large growth stocks (the S&P 500) fell 40% compared to a decline of 15% for a balanced stock portfolio and an increase of 2% for the balanced stock/bond portfolio. Things really changed in the subsequent recovery period from April 2003 to May 2007. The balanced stock portfolio doubled the S&P 500 return. Even the balanced stock/bond portfolio beat the return of large growth stocks. When you combine all three periods— up, down, up— we find that balance wins out (blue column).

Table 1: 1995 to May 2007

Asset Mix	Total Return (Annualized)			
	1995-1999	2000-3/2003	4/2003-5/2007	1995-5/2007
S&P 500 (large growth stocks)	248% (28.3%)	-40% (-14.5%)	94% (17.2%)	305% (11.9%)
Balanced All-Stock ¹	151% (20.2%)	-15% (-4.9%)	197% (29.8%)	534% (16.0%)
Balanced 65% Stock, 35% Bond ²	106% (15.6%)	2% (0.5%)	116% (20.3%)	352% (12.9%)

See footnotes for index descriptions and allocations. Past performance is not a guarantee of future returns. Indices are not available for direct investment.

Many investors missed the April 2003 to May 2007 stock market rise because they either got out of stocks altogether or they shifted allocations to “alternative” investments, including real estate (oops!).

The Second Stock Market Debacle

As Table 2 illustrates, the S&P 500 fell 50% from June 2007 through February 2009. The balanced stock mix fell even more, due to the bigger declines in small cap and value stocks. Even the balanced stock/bond mix fell 37%.

Since March of last year, returns have recovered dramatically, with the S&P 500 up 54% compared to 86% for the

balanced all-stock and 51% for the balanced stock/bond mix. However, combining these periods, we find the S&P 500 is still down 22%, while the balanced all-stock and balanced stock/bond portfolios are down 26% and 5%, respectively. These numbers aren't going to make anyone feel warm and fuzzy about stocks. But 2½ years of lousy returns should not be an indictment against stocks, nor should it be a surprise. The market's had similar periods in the past.

If we consider the total 15-year period of the two tables (1995-2009), we find that *balance* wins out. The S&P 500, which is considered a “market” index even though it's dominated by large growth stocks, gained 214% compared to 371% for the balanced all-stock mix and 328% for the balanced stock/bond mix (blue column in Table 2).

Now What?

We can't know how long this market recovery will last or the degree of the rise. What we *do* know is that continually jumping in and out of stocks, shifting allocations, adding or deleting asset classes based on short-term trends, or tricking your mind into believing you're taking less risk by segregating assets into “buckets” are not the answers. Balance is the answer. For retired investors, the past 15 years also shows that it's possible to maintain a large percentage of high-quality, short-term bonds (35%, in this case) in the portfolio to reduce risk (and to draw from during the difficult markets) and still achieve excellent returns over time.

If you are in or near retirement, you must take the time to review your cost of living, establish an asset allocation and withdrawal rate that offers a high probability that you will not outlive your money, withdraw money from bonds when stocks are down and from stocks when they are up, and maintain a cash reserve that covers at least one year's expenses. Review your *total* financial picture with your advisor regularly. And stay optimistic. Our best days are ahead.

¹Balanced All-Stock is 21% S&P 500 Index, 21% Dimensional US Large Cap Value Index, 28% Dimensional US Small Cap Value Index, 18% Dimensional Int'l Large Value Index, 6% Dimensional International Small Cap Value Index, and 6% DFA Equally Weighted Emerging Markets Index.
²Balanced Stock/Bond is 35% Five-Year Treasury Notes, 13.5% S&P 500 Index, 13.5% Dimensional US Large Cap Value Index, 18% Dimensional US Small Cap Value Index, 12% Dimensional Int'l Large Value Index, 4% Dimensional International Small Cap Value Index, and 4% DFA Equally Weighted Emerging Markets Index.

Table 2: June 2007 to Dec. 2009 (with Total of 1995-2009)

Asset Mix	Total Return (Annualized)			
	6/2007-2/2009	3/2009-12/2009	Down + Up	1995-12/2009
S&P 500 (large growth stocks)	-50% (-32.5%)	54%	-22% (-9.4%)	214% (7.9%)
Balanced All-Stock ¹	-60% (-40.7%)	86%	-26% (-10.8%)	371% (10.9%)
Balanced 65% Stock, 35% Bond ²	-37% (-23.4%)	51%	-5% (-2.1)	328% (10.2%)

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The 60/40 Solution

Peter L. Bernstein

The following article appeared in Bloomberg Personal Finance (discontinued in 2003) in January/February 2002.

The derivation of the word “risk” reaches back to the early Italian *risicare*, which translates as “to dare.” Risk looked at from this viewpoint is a choice rather than a fate. For a true long-term investor, the choice, by definition, must be survival, or you can forget that long-term stuff. Survival as an investment objective has been proven essential over the past 21 months, as the dangers of seeking maximum return have been demonstrated once again.

Once upon a time—that is, for many years before the great bull market of the '90s—the most popular benchmark for portfolio asset allocation aimed at this goal was about 60 percent in stocks and 40 percent in fixed-income investments. After 1990, this seemingly stodgy arrangement largely went by the boards as stocks roared ahead, encouraging institutional and individual investors to become increasingly aggressive in their search for higher returns. But now the high-tech bubble has burst, the economy has weakened, and the war on terrorism has landed at our front door.

Does this fundamental transformation in the environment mandate a return to 60/40? In a more general sense, should investors consider shifting—on a permanent basis—to a conservative stance, where the allocation to stocks is smaller than it might have been in the recent past?

The short answer to this question is “Yes!”—but not for the reasons you might imagine. I don't recommend cutting back because the bad economic news and the war on terrorism are promoting a bearish view of the market. I'd say the same thing whether I were bearish or bullish. This is not a question of market timing. If it were, you could stop reading now, because market timing recommendations have an impressive track record of being harmful to an investor's financial health. The issues involved are more basic, even philosophical, and quite unrelated to where I happen to think the equity market is headed.

Before I get into those matters, however, let's stop to consider why the 60/40 formula was so popular in the era before the bull market of the '90s. Stocks, after all, are riskier than bonds, which are contracts to pay interest and to redeem the principal when it falls due, while stocks have no maturity date and often yield less income to their owners. Then why not 50/50, or even 40/60? The answer is in how markets work. Rational investors buy stocks only when they can expect to make enough extra in the stock market to compensate for the greater risks involved in owning stocks. This dynamic process of pricing stocks relative to less risky assets explains why, over the long run, stocks have returned

more than bonds and why, therefore, more stocks than bonds makes good sense.

As experience teaches, however, reading the future is never easy. Unexpected events often defy the forecasts of even the keenest investors. As investors search for the appropriate price for equities, a steady stream of surprises makes stocks highly volatile in the short run. You can make a killing in one year and give it all back and more in another. Bonds have also had their moments of high volatility, based in large part on fluctuating expectations about the outlook for inflation, but those moments have been relatively brief and less intense than the swings in equity markets. In many instances, furthermore, bond prices have offset equity volatility by moving in the opposite direction from stock prices. Hence, 60/40 seemed like a good compromise for the long-run average balance between maximizing return and minimizing risk.

The arithmetic is interesting. Over the long 75-year span from the end of 1925 to the end of 2000, a portfolio of \$100 fully invested in stocks would have generated a compound return of 11 percent a year compared with 9.3 percent a year for a 60/40 portfolio—assuming no taxes and full reinvestment of dividends. This spread of less than 2 percentage points looks modest, but it is far from chicken feed when compounded over 75 years: The \$100 in the 100 percent stock portfolio would have blossomed into \$259,000, whereas the 60/40 portfolio would have grown to only \$76,000.

But consider the following. Equity performance was all over the place. The annual return on stocks ranged between a glorious 54 percent rise and a horrible 43 percent swoon; on eight occasions, losses were greater than 10 percent. Although the 60/40 portfolio was inevitably affected by the high stock volatility, the 40 percent in bonds helped the balanced portfolio come through with a more comfortable spread, ranging from a 40 percent gain to a 9 percent drop. **[Note: Mr. Bernstein mistakenly included the range of returns for 100% Long-Term Government Bonds over the period. The range of returns for the 60/40 portfolio was actually a 35% gain to a 28% drop.]**

These statistics contain important information for decision making in any kind of environment, not just today's. The results were manufactured by millions of investors making bets on the future, financing businesses, and raising cash every minute over some 20,000 business days. While some were acting each day, a much larger number were reacting and making decisions on how to respond to the changing conditions on the next day, or days. How can anyone foresee how something as complex as that is going to work out?

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That's why this kind of historical analysis is so valuable; it defines the parameters of unpredictability.

Many aspects of investing are fun, but your future wealth isn't a game. You should manage it in the most cold-blooded fashion. Emotion, pride, ego, dreams, and nightmares have nothing to do with the process, although some investors rely on little else. It is in this sense that volatility really matters.

Many people pride themselves on being "long-term investors," but acting deliberately when prices are bouncing around is not so easy. When stocks are blasting skyward, even the most steadfast can be sucked into the updraft. When they are cascading downward, keeping one's cool is almost impossible. Volatility provokes the constant dread that some investors know more than we do, making us fearful of ignoring such powerful price movements.

But remember: That \$259,000 earned since 1925 from a 100 percent stock portfolio assumed an investor who bought and held over a period of 75 years and also paid no taxes and fully reinvested the dividends. Those are unrealistic assumptions, to say the least. Even if we could imagine a person blessed with sufficient longevity to have been active in the market ever since 1925, how likely would it be that even the most experienced and sophisticated investor would have the self-control to stay 100 percent in stocks, without trading in and out as the market rode up and down its roller coaster? I know I could not have been so calm through depressions, inflations, banking and currency crises, wars, and political disruptions.

I emphasize this psychological aspect of the matter, because those wonderful statistics on long-term returns are what the market did, not what any single individual or fund did, or would do, if history replayed itself. In my real-world experience, investors with smaller allocations to stocks and with some anchors to windward have been the ones most likely to be the winners over the long haul. The crucial element of success is the ability to make decisions without freezing up or slamming the panic button. In bear markets, the muted volatility and the contractual safety of bonds provide the most congenial environment for arriving at rational decisions about stocks. In bull markets, the balanced portfolio may not make for lively cocktail-party conversation, but with 60 percent in stocks, your wealth will still be participating and growing.

I cannot overemphasize the importance of this last point. Few decisions in life motivated by greed ever have happy outcomes. Unless you are that rarest of birds, someone who is cool under the rapid-fire, high-pressure decision making required to maximize your returns, let others take such risks, and allow your portfolio to plug along at a slower speed. In investing, tortoises tend to win far more often than hares over the turns of the market cycle (and, as

we have recently been reminded, markets still do have cycles).

Here is another way to look at the situation. The constant lesson of history is the dominant role played by surprise. Just when we are most comfortable with an environment and come to believe we finally understand it, the ground shifts under our feet. Surprise is the rule, not the exception. That's a fancy way of saying we don't know what the future holds.

Even the most serious efforts to make predictions can end up so far from the mark as to be more dangerous than useless.

Consider the following analysis conducted by Jeremy Siegel of the Wharton School of the University of Pennsylvania, who studied long-range forecasts prepared in 1975 by Roger Ibbotson and Rex Sinquefeld, with strong theoretical support, for the quarter century 1976–2000. Siegel describes this work as "state of the art...with 50 years of financial returns available" to support the process. Here are the 1975 forecasts for 1976–2000, in percent per annum, with the actual results in parentheses: stocks, 7.6 percent (14.6 percent); bonds, 1.8 percent (9.9 percent); Treasury bills, 0.0 percent (2.9 percent); and inflation, 12.8 percent (3.3 percent).

All of history and all of life is stuffed full of the unexpected and the unthinkable. Survival as an investor over that famous long course depends from the very first on recognition that we do not know what is going to happen. We can speculate or calculate or estimate, but we can never be certain. Something very simple but very penetrating stems from this observation. If we never know what the future holds, we can never be right all the time. Being wrong on occasion is inescapable. As the great English economist John Maynard Keynes expressed it some 80 years ago, "A proposition is not probable because we think it so." The most important lesson an investor can learn is to be dispassionate when confronted by unexpected and unfavorable outcomes.

Investment management provides only one dependable way to survive through the uncertainty of the future: diversification. Diversification means owning assets that do not move up and down together—a portfolio designed to subdue volatility rather than to maximize returns, while still exposing you to the widest possible range of positive opportunities. (A colleague once suggested you are never adequately diversified unless you have some holdings that make you uncomfortable.) Placing large bets on an unknown future is worse than gambling, because at least in gambling you know the odds. This is why I propose restoring 60/40 to its rightful place as the center of gravity of asset allocation for long-term investors.