

Asset Class Returns

June 30, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
Bonds (%)					
One-year	1.9	4.0	5.2	3.7	0.7
Five-year	4.2	4.0	5.2	4.8	3.9
Intermediate	-0.7	12.9	9.5	6.9	6.3
Long-term	-12.1	22.5	9.2	7.4	13.1
U.S. stocks (%)					
Large Market	26.5	-37.0	5.4	-1.0	-6.7
Large Value	30.2	-40.8	-2.8	4.4	-4.2
Small Market	36.3	-36.0	-3.1	5.7	-0.3
Small Micro	28.1	-36.7	-5.2	6.3	0.9
Small Value	33.6	-36.8	-10.8	9.1	-2.1
Real Estate	28.2	-37.4	-18.7	10.5	5.8
International stocks (%)					
Large Market	30.6	-41.4	12.5	1.4	-12.8
Large Value	39.5	-46.3	10.2	6.7	-13.1
Small Market	42.0	-43.9	5.6	8.7	-5.9
Small Value	39.5	-41.7	3.0	11.3	-9.8
Emerg. Mkts.	71.8	-49.2	36.0	9.5	-5.4

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 12/31/09.

Equius Partners is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of any mutual fund and read the prospectus carefully before investing. **Past performance is not a guarantee of future results.**

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Valuable Roots

Jeff Troutner, Equius Partners

I have been in the investment industry for thirty years and have not personally experienced the depth of pessimism, the general lack of direction and confidence, and the overall fear of stock investing that is prevalent today. I've read extensively about prior periods like this—the years around the Great Depression of the 1930s and inflation-impacted years of the 1970s—but it's not the same as living it, as I'm sure anyone reading this would agree.

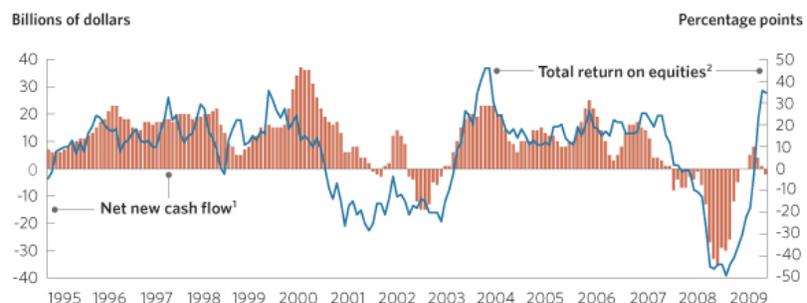
The question on everyone's mind today is, how should I react to all the political, economic, and market volatility and turmoil? Our answer, as always, is to stay the course—stay broadly diversified in stocks and bonds only (maximum liquidity, proven track record), make sure asset allocations meet your long-term objectives, and be patient. If you're already in retirement, consider reducing spending until markets recover.

We're extremely confident in this approach since our roots are firmly set in sound and timeless *investing principles* and *value-investing strategies*. I'll outline the source of these roots in a moment (hint: their practical origin was in the 1930s, they've produced superior results ever since, they're followed by the greatest investor of all time, and they are decidedly contrarian in nature). But before that, let's look at how the herd invests.

Insanity Defined

A quick look at mutual fund flows over the past fifteen years shows us how investors in general have *always* reacted to market volatility: they buy high and sell low. And naturally, they engage in more of this insane behavior during the extreme market cycles (the middle and right side of the chart) when the cost to long-term returns is the highest.

Net Flows to Equity Funds Related to Global Stock Price Performance (1995-2009)



¹Net new cash flow to equity funds is plotted as a six-month moving average

²The total return on equities is measured as the year-over-year change in the MSCI All Country World Total Return Stock Index.

Sources: Investment Company Institute and Morgan Stanley Capital International

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What this chart doesn't show is where the money goes when it leaves stocks. Most of the money today is going into bonds. And with yields at historically low levels, it doesn't take a rocket scientist to conclude that investors are taking extraordinary risks in this asset class—much more than they normally would.

After the 2000–2002 stock market decline, much of the money leaving stocks also went to “alternative investments”—real estate, commodities, hedge funds, etc. We all know how that has worked out. Yet this “investment stew” methodology (also known as “the endowment approach”) is still prevalent today.

Rather than believing that these alternatives will provide higher risk-adjusted returns than stocks in general, I'm convinced most advisors recommending the investment stew approach today are doing it because they and their clients have simply lost their way. It would be like a physician knowing that a certain drug will have long-term benefits for the patient, but because the patient isn't seeing the short-term results he or she wants, the physician prescribes five more drugs with no proven value (or even with bad side effects). The physician wants to *look* like he or she is doing something positive. Would you go to that kind of doctor for treatment of a serious illness? Why do investors go to advisors who do the same thing with their serious retirement money?

There's a much better way to get through these troubling times. The most respected investor of all time (Ben Graham) gave us the roadmap in 1934 after witnessing similar insanity in his time. His prodigy (Warren Buffett) followed his advice during the next debacle, the 1970s. It's interesting to read their words during these periods, recognize the soundness and consistency of the principles they follow(ed), and acknowledge the outstanding returns investors who embraced their principles have realized over the past eighty years as a result.

Our Roots

I was very fortunate to have written a paper for a college finance course on low P/E (value) investing. That led me very quickly to Warren Buffett and then to his mentor, Benjamin Graham. Graham and David Dodd wrote the investing classic *Security Analysis* in 1934, and Graham followed up with the classic best-seller *The Intelligent Investor* in 1949. These books are considered the bible of investing, for good reason.

Graham introduced sound and timeless investing principles at a time when capitalism was teetering on the brink. He put structure and discipline around investing, turning it into more science than art. And he gave the world “value investing.” These features of Graham's work are an enduring legacy that has added

significantly to the general wealth and standard of living in this country (and elsewhere) and serve as the firm foundation of the Equius approach to investing. We couldn't agree more with the following description of *Security Analysis* (from a 1996 edition) and strive for the same qualities in our work at Equius:

...the mesmerizing qualities of rigorous honesty and diligent scrutiny...of disciplined thought and determined logic...

Much of the value of *Security Analysis* today can be found in the Preface and Introduction to the first edition. It's not necessary to read all 700+ pages because advancements in markets, technology, financial science, and mutual fund management since 1934 render them mostly irrelevant—unless one aspires to be the next Warren Buffett. Time would be better spent reading the entirety of Graham's 1949 classic, *The Intelligent Investor*. This is *the* bible on “old school” value investing and serves as the inspiration for the Equius “new school” style of value investing today. More on that later. In the meantime, here are some timeless and extremely valuable perspectives from Graham.

On Speculation (1934)

That enormous profits should have turned into still more colossal losses, that new theories should have been developed and later discredited, that unlimited optimism should have been succeeded by the deepest despair *are all in strict accord with age-old tradition* [my emphasis].

...we seem to be on firm ground in repeating the old aphorisms that in speculation *when* to buy—and sell—is more important than *what* to buy, and also that almost by mathematical law more speculators must lose than can profit.

Graham was describing a market firmly in the hands of speculators. The first two years of the ten-year period starting in 1927 saw average *gains* of 40.5% per year for the S&P 500. This was followed by four years when the average *loss* was 21.2% per year. In 1933, stocks were up a whopping 54%, followed by a see-saw 1934 that ended relatively flat (-1.4%). The last two years, 1935–1936, ended the way the period started with average *gains* of 40.8% per year.

Investors who owned stocks at the start of 1927 and held them through 1936 realized a real ten-year annual return of 10.1% per year (S&P 500 return of 7.8% and inflation of -2.3%). **Now I ask you, who was smarter over this period, the buy-and-hold investor or the market timer?** Graham knew the answer then and we know it today.

As a footnote, the S&P 500 generated a 0% real annual return over the next ten years (1937–1946) and 7.7% over the twenty-year period (1937–1956). Large and small

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value stocks had real annual returns of 1.7% and 7.1% for the next ten years, respectively, and 8.2% and 10.3% for the twenty years. Clearly, Graham's buy-and-hold principles and his recognition of the superiority of value stocks were *both* well-founded.¹

In words that could easily apply to the 1998–1999 period, Graham recognized “speculation masquerading as investment”:

In previous bull markets the rise in stock prices remained in fairly close relationship with the improvement in business during the greater part of the cycle; it was only in its invariably short-lived culminating phase that quotations were forced to disproportionate heights by the unbridled optimism of the speculative contingent. But in the 1921–1933 cycle this “culminating phase” lasted for years instead of months, and it drew its support not from a group of speculators but from the entire financial community. The “new era” doctrine—that “good” stocks (or “blue chips”) were sound investments regardless of how high the price paid for them—was at bottom only a means of rationalizing under the title of “investment” the well-nigh universal capitulation to the gambling fever.

Apropos of the chart on mutual fund flows, Graham mentions how high prices attract “investors”:

But here again we must recognize that the psychology of the speculator militates strongly against his success. For, by relation of cause and effect, *he is most optimistic when prices are highest and most despondent when they are at bottom* [my emphasis]. Hence, in the nature of things, only the exceptional speculator can prove consistently successful, and no one has the logical right to believe that he will succeed where most of his companions have failed. For this reason, training in speculation, however intelligent and thorough, is likely to prove a misfortune to the individual, since it may lead him into market activities which, starting in most cases with small successes, almost invariably end in major disaster.

Hedge funds anyone?

On Investor Behavior (1934)

Graham also knew something about investor behavior:

While we were writing, we had to combat a widespread conviction that financial debacle was to be the permanent order; as we publish, we already see resurgent the age-old frailty of the investor—that his money burns a hole in his pocket.

He goes on to say that he and Dodd:

...have striven throughout to guard against overemphasis upon the superficial and the temporary...this overemphasis is at once the delusion and the nemesis of the world of finance.

In the midst of market despair, Graham notes that “the doctrine of common stocks as the best long-term investments [is] in eclipse” and cites as an example Lawrence Chamberlain’s (a prominent banker of the time) pronouncement that all stocks are speculative. Graham then speaks of the “common-stock insanity” that occurred prior to the 1929 Crash as:

...*sound* principle grievously misapplied. Its history teaches us more about the nature of human beings than the nature of common stocks. Long before the “new era” gospel was being preached, there were principles guiding the selection of common stocks for investments as distinguished from speculation.

Sound familiar? Consistent with our views at Equius, Graham also mentions lack of investor discipline when he states:

...fact remains that the common-stock investor, proceeding along old-time conservative lines, had opportunities of profit commensurate with any risks he ran... The chief weakness of these investment principles was the difficulty of *adhering firmly* to them in the speculative contagion of 1928 and 1929. (My emphasis.)

Again, one can easily substitute 1998 and 1999 for 1928 and 1929 and the words have perfect relevance to today.

On Wall Street Ethics (1934)

Something else we have in common with Graham was his view of what “Wall Street” had become:

In previous years, when houses of issue had their choice between selling good bonds or poor ones, they habitually chose the good securities, even at some sacrifice of underwriting profit. But now they had to choose between selling poor investments or none at all—between making large profits or shutting up shop—and it was too much to expect from human nature that under such circumstance they would adequately protect their clients’ interests.

Graham also understood the limits of regulation (the Securities Act of 1933 had just been passed, requiring “the submission of elaborate data” on securities issues and extending liability to bankers, directors, etc.) and the importance of advisors like Equius when he wrote:

...we conclude that there is greater need than before of either thorough knowledge of investment principles on the part of the individual bond [or stock] buyer or else of recourse by him to advice which is both expert and disinterested.

Value Investing 2.0

Ben Graham is best known as the father of “value investing,” and his second book, *The Intelligent Investor*, is considered the bible of this style of investing. The dust jacket of the fourth edition (1973) of the book states it well:

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...Benjamin Graham's book has remained the most respected guide to investing, due to his timeless philosophy of "value investing," which helps protect investors against the areas of possible substantial error and teaches them to develop long-term strategies with which they will be comfortable down the road.

Graham was a stock picker, at a time when there was no real alternative if you wanted to build a long-term portfolio with performance that matched or exceeded the rate of growth in corporate earnings. There were no index funds, and mutual funds in general were in their infancy. There were no high-speed computers and information traveled a lot slower and more selectively among mostly rich people, their Wall Street connections, and the few institutional-type investors around at the time. In other words, stock picking had a chance.

Times have changed. As financial progressives, we at Equius recognize that significant changes have occurred in markets, technology, financial science, and the study of human behavior since 1934 that render stock picking virtually obsolete for anyone but the speculator. Equius has refined value investing in ways that exploit these changes for the benefit of our clients, while adhering firmly to Graham's timeless principles.

John Bogle, the former chairman of The Vanguard Group, notes in the forward to a recent edition of *The Intelligent Investor*, that Ben Graham's name is synonymous with "value investing." Bogle goes on to cite a favorite quote of indexers taken from an interview with Graham in 1976 (coincidentally, the same year Vanguard launched its S&P 500 index fund):

Graham: "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, forty years ago, but the situation has changed a great deal since then. In the old days, any well-trained security analyst could do a professional job of selecting undervalued issues through detailed studies; but in the light of the enormous amount of research now being carried on, I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their costs. To that very limited extent, I'm on the side of the 'efficient market' school of thought..."

For Bogle and Vanguard these words were like a big sign that said "Mission Accomplished." From 1976 until today, Bogle has preached a "large growth stock" sermon by emphasizing almost exclusively the superiority of S&P 500 or Total Stock Market indexing over stock picking (active management). So investors who embraced indexing on Bogle's explicit advice and Graham's measured endorsement essentially gave up on value investing as the S&P 500 and every other cap-weighted *market* index is dominated by the largest, priciest "glamour" stocks.

In the interim, Eugene Fama Sr. and Ken French were at the University of Chicago using new computers, a power-

ful new database of stock fundamentals (CSRP), and a bevy of eager graduate students to unlock the secrets of value investing in the modern era.

Since Bogle declared victory in 1976, U.S. large value stocks have outperformed the S&P 500 index by almost 2.5% per year and U.S. small value stocks have returned almost 6.5% more per year! During the recent "lost decade" (2000–2009) when the S&P 500 produced an annual loss of 1% per year, the value return "premiums" have been even higher (3.3% and 12.3% annually for large and small stocks, respectively)—and extend to the non-U.S. markets as well.

Far from killing value investing, indexing offered a new, modern way for investors to realize the superior returns of the strategy—without relying on the speculative methods of active managers. But it took progressive firms like Dimensional Fund Advisors (DFA) and Equius Partners to help investors realize that potential. DFA embraced the Fama/French research and created new indexes and mutual funds based on those indexes that allow us and our clients to benefit from value investing today.

Recommended reading: Besides the preface and introduction to *Security Analysis* (available via the "Look Inside!" feature on Amazon) and the entirety of *The Intelligent Investor*, readers should google "The Death of Equities" to read an August 1979 perspective on the market of the 1970s and "You Pay A Very High Price In The Stock Market For A Cheery Consensus" to get Warren Buffett's view of the same market. Both are fascinating reads.

¹Large and small value stocks returns in this article are the DFA US Large Value and DFA US Small Value indexes. Source: Dimensional Returns program.

The Bottom Line...

- Graham's investment principles have been the best guide for investors for eighty years. He introduced value investing to the world, and despite a much more efficient market it remains a superior strategy today (using an asset class approach).
- Graham understood investor behavior and the importance of discipline to a successful value approach.
- Traditional indexers, such as John Bogle and Vanguard, favor market weightings that overemphasize large growth stocks over value stocks.
- Equius Partners recognized the changes in markets, technology, and financial science since Graham's days and embraced the research of Fama/French to exploit the benefits of value investing for our clients.
- Equius Partners' roots are firmly established in Graham's general investment principles and his advocacy of value investing.