

## Asset Class Returns

July 31, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
<b>Bonds (%)</b>					
One-year	1.9	4.0	5.2	3.7	0.9
Five-year	4.2	4.0	5.2	4.8	5.4
Intermediate	-0.7	12.9	9.5	6.9	7.4
Long-term	-12.1	22.5	9.2	7.4	13.0
<b>U.S. stocks (%)</b>					
Large Market	26.5	-37.0	5.4	-1.0	-0.1
Large Value	30.2	-40.8	-2.8	4.4	3.3
Small Market	36.3	-36.0	-3.1	5.7	6.9
Small Micro	28.1	-36.7	-5.2	6.3	8.1
Small Value	33.6	-36.8	-10.8	9.1	6.5
Real Estate	28.2	-37.4	-18.7	10.5	16.3
<b>International stocks (%)</b>					
Large Market	30.6	-41.4	12.5	1.4	-3.8
Large Value	39.5	-46.3	10.2	6.7	-2.2
Small Market	42.0	-43.9	5.6	8.7	2.7
Small Value	39.5	-41.7	3.0	11.3	-1.0
Emerg. Mkts.	71.8	-49.2	36.0	9.5	3.0

## 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. Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results.

Equius Partners, Inc.  
3 Hamilton Landing, Suite 130  
Novato, CA 94949  
Phone: 415-382-2500  
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## Value Investing 2.0

Jeff Troutner, Equius Partners

As we pointed out last month, Benjamin Graham's core investment principles have been the best guide for investors for the past eighty years. He taught millions of serious investors how to avoid speculation by putting more science and discipline around the process of managing portfolios for retirement and other long-term goals. He introduced value investing to the world in 1934, and despite today's comparatively more efficient market, value investing remains a superior strategy—provided that investors and advisors recognize how markets, technology, and financial science have changed since Graham's days and adjust their thinking and strategies accordingly. This month, I'll go into greater depth on what I call "Value Investing 2.0" which is the modern way of capturing the value stock return premium without all the downsides of stock picking. But first, let's learn more from Ben Graham.

## The Goal of Value Investing

Graham believed that value investing provided higher returns with less risk. He came to this conclusion based on a rational belief at the time that sophisticated security analysis techniques could uncover stocks with "intrinsic" values higher than their market prices. When combined with a long-term view of investing and sufficient discipline during difficult periods, this approach made sense and rewarded those who followed it diligently.

Recall, however, the 1976 Graham quotation in last month's *Asset Class* (condensed here): "I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. ... I doubt whether in most cases such extensive efforts will generate sufficiently superior selections to justify their costs."<sup>1</sup> Graham anticipated this to some degree when he and David Dodd wrote *Security Analysis* in 1934. In discussing intrinsic value and the risk investors face that the market price might be slow to rise (or never rise) to that intrinsic value, Graham said, "Experience affirms that the price and the independently ascertained value do tend to converge over time." In other words, the market was efficient in 1934—just not *that* efficient.

But he failed to anticipate (understandably!) a number of factors: how much the investment industry would grow over the next forty years, his immense influence on security analysis, the numerous and diverse ways analysts and investors in general determine value, the broad ownership of stocks beyond large institutions and the very wealthy, and the immense power and widespread use of computing technology.

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What it comes down to is that the degree and timing of that convergence of intrinsic value and market price are something millions of speculators—whether dressed in expensive Italian suits in walnut-paneled offices or sitting in their underwear in their kitchens—watch for continuously on their Bloomberg-splattered computer screens. Their activities today create a truly efficient market.

But take heed, mainstream media followers: efficient market theory does not claim that investors always and everywhere are rational or collectively able to guess where markets, individual security prices, economic growth, interest rates, or any other *unknowns* will be in the near future. In the most practical interpretation, efficient market theory simply explains why something like 75% of active stock pickers and market timers fail to beat the market over time.

With those odds, I'm pretty certain that if Ben Graham were alive today, he would consider almost all active management (or at least how the average investor *uses* active management) pure speculation. He states in *Security Analysis*, "It is only where chance plays a *subordinate role* that the analyst [advisor] can properly speak in an authoritative voice and accept responsibility for the results of his judgments." (emphasis added)<sup>2</sup> Certainly asset class investing—at the very least when compared to active management—places chance in a subordinate role. And I say that with authority.

So it's appropriate to put active stock picking *today*—whether value-oriented or not—in its proper perspective. One of my favorite Graham quotes works well in this context: "It is as though the analyst and Dame Fortune were playing a duet on the speculative piano, with the fickle goddess calling all the tunes." He goes on to say, "His [the analyst's] 'analysis' will enable him to win a little more if he is lucky; it will be of no value when luck is against him."<sup>3</sup> Doesn't this describe active management today? Well, let's see.

### The Brandes Example

One of Graham's most passionate disciples is Charles Brandes, whom I've known since I placed client assets with him during my "dark side" days at Shearson Lehman Brothers. Of the hundreds of active managers I evaluated in those days and the thousands I've gotten to know indirectly through other research, he's one whom I've always respected and admired. Brandes has applied Graham's value investing principles to global investing for decades, and he manages an astounding \$34 billion in assets today. How has he done the past ten years?

Well, consider first that Brandes managed over \$100 billion in 2005. It is difficult to ascertain from his performance materials how much of that decline in assets

under management is due to market loss or client loss, but my best guess is that it's a lot of both. Brandes was popular in the broker "wrap" programs, and anything broker-driven is generally "hot" money. At any rate, let's look at Brandes's track record over the ten years ended June 2010.

Table 1 shows the ten-year annual returns for the Brandes U.S. Value and Small Value strategies over the last ten years versus the Russell and DFA indexes. Though this period generally favored small and value stocks, Brandes failed to match these unmanaged indexes for the total period.

**Table 1: Stock picking vs. Indexes**

Investment	Annual Return 7/2000 - 6/2010	Index Advantage
Brandes U.S. Value	1.5%	-
Russell 1000 Value Index	2.4%	0.9%
DFA U.S. Large Value Index	2.5%	1.0%
Brandes U.S. Small Value	4.4%	-
Russell 2000 Value Index	7.5%	3.1%
DFA U.S. Small Value Index	11.2%	6.8%

Source: [www.brandes.com](http://www.brandes.com) and Dimensional Fund Advisors. **Past performance is not a guarantee of future results.**

As Table 2 shows, Brandes's value stock picks performed horribly in the 2007-2008 market cycle. The DFA U.S. Large Value and Small Value indexes were down more than the Russell indexes, due to their heavier tilts toward value and small cap stocks. But those tilts helped returns over the total period.

**Table 2: The Downside of Individual Stocks**

Investment	Total Return 2007 - 2008	Index Advantage
Brandes U.S. Value	<b>-62.2%</b>	-
Russell 1000 Value Index	-37.0%	25.2%
DFA U.S. Large Value Index	-47.3%	14.9%
Brandes U.S. Small Value	<b>-69.4%</b>	-
Russell 2000 Value Index	-35.9%	33.5%
DFA U.S. Small Value Index	-49.8%	19.6%

Source: [www.brandes.com](http://www.brandes.com) and Dimensional Fund Advisors. **Past performance is not a guarantee of future results.**

To his credit, Brandes beat the indexes and DFA funds by good margins in 2009 (their U.S. Small Value strategy was up over 72.5% versus 58.8% for the DFA U.S. Small Value index). But that's little consolation if you can't keep your clients in the game or if the bad years pull down your long-term performance so dramatically.

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Let's face it. Active management's only reason for existing is to beat the market. The evidence shows that you can do that with a small cap and value tilt to your portfolio *if* you are patient and diversified.

Active value investing's only reason to exist is to beat the value stock indexes. Otherwise what's the point? Value index funds are much more diversified, incur much lower costs to investors, and their returns are much more predictable—on a relative basis—over time. So if one of the most dedicated, smart, and disciplined Graham disciples can't even beat the indexes, then who can? And even if Brandes *did* beat the value indexes by a margin worth the extra risk of low diversification and human error (say, 2% per year after costs), it's clear that keeping investors in the strategy long enough to reap the benefits is an enormous and often losing proposition for active managers.

### Value Investing Is Contrarian

Value investing is decidedly contrarian in nature. Most investors (and the S&P 500 investment committee) prefer sexy, large, expensive growth stocks like Google and Apple. The higher the price, the more confident the herd is that the stock's a winner. This same behavior shows up in mutual fund cash flows. The higher the most recent performance, the more money flows into those "winning" funds.

So to be a successful value investor requires patience and confidence, a willingness to run counter to the herd, an understanding of the relationship between current price and *future* returns, and, often, a relationship with a disciplined advisor to counsel you effectively through the tough times. For these reasons, most investors, investment advisors, and mutual fund managers simply opt for more market-like (large- and growth-tilted) portfolios.

Chart 1 shows the tilts (degree of exposure to small and value stocks) for the Morningstar universe of small and large value funds for 2000-2009 compared with the same period for the Russell and DFA indexes. Higher on the chart indicates a greater tilt to small stocks and more to the right indicates more value tilt. These charts demonstrate two facts: a) the DFA indexes have much more pronounced exposure to small and value stocks, and b) the active funds are all over the place with their tilts. What

this chart doesn't show is that the active funds tend to drift around the chart when the tilts are measured over different periods and that the indexes remain fairly consistent throughout. This is just another indication of the unpredictability and increased risk of active management.

### Keep It Simple

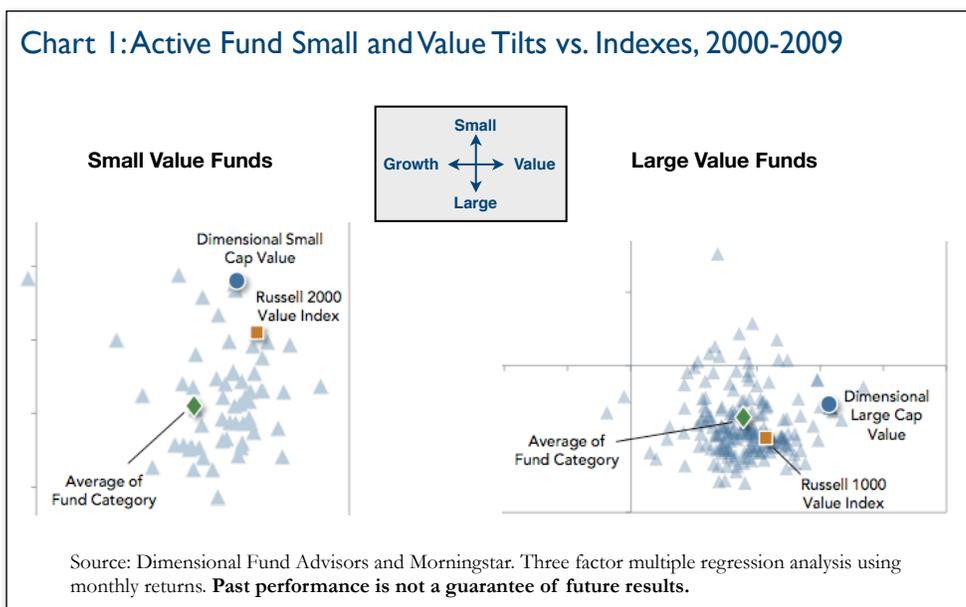
Back to Brandes for a moment. The fact that just one (Global Balanced) of the thirteen distinct investment strategies he offers is balanced makes it a challenge to keep clients. Brokers (and maybe Brandes's advisors themselves) no doubt sell the strategies as "products" based on recent past performance. That would be like Equius offering a "small value portfolio" rather than including small value as part of a balanced, diversified portfolio. Or like DFA selling its mutual funds to the general public with no advisor assistance. Can you imagine the cash flow shifts to hot asset classes like emerging markets or bonds today, or shifts away from DFA when an active alternative significantly outperforms one of its index funds if these decisions weren't advisor-controlled?

This is one of the reasons why Equius offers only one strategy: a diversified asset class portfolio, with the asset classes limited to those that have shown the greatest risk/return benefits over time. What varies is the mix of the asset classes based on individual client objectives. Furthermore, the criteria DFA uses to screen stocks for its asset class funds are limited to company size (market capitalization) and book value per share.

Once again, we can look to Ben Graham for confirmation that this is a wise policy. In the interview for the *Financial Analysts Journal* in 1976, we read this exchange:

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**Chart 1: Active Fund Small and Value Tilts vs. Indexes, 2000-2009**



**FAJ:** What general approach to portfolio formation do you advocate?

**Graham:** Essentially, a highly simplified one that applies a single criteria or perhaps two criteria to the price to assure that full value is present and that relies for its results on the performance of the portfolio as a whole—i.e., on the group results—rather than on the expectations for individual issues.

### Keep it Structured

Another advantage of a diversified, indexed value approach is the automatic sell discipline on both the fund and portfolio levels. On the fund end, DFA selects stocks based first on size and then on price-to-book ratios. This ensures that its small cap and value funds don't become roach motels where stocks check in but never check out. Instead, stocks enter with low prices and are shown the exit when their price rises to a level that disqualifies them as either a small stock or a value stock.

This two-criteria fund-level buy/sell discipline tends to keep a lid on insanity. Compare price-to-book ratios of the S&P 500 and MSCI EAFE indexes (where stocks tend to check in *after* good things happen and check out *after* bad things happen) and the DFA value strategies (where stocks check in *before* good things happen and check out *after* good things happen) for the 2000-2002 period and today (Table 3).

they've become dinosaurs (think value stocks in general). Remember Apple? It was once on the endangered species list. It's now in the S&P 500 index. I'm sure the value index funds enjoyed the Apple ride while it lasted.

On the portfolio level, Equius rebalances among asset classes when market cycles drive them beyond acceptable, client-specific targets. When value stocks took a big hit in 2008 and 2009, we sold asset classes that performed better, meaning we bought the value stocks much cheaper and in line with established allocation targets.

### Dame Fortune

I'll close this article with a few more statistics to help you decide whether value *indexing* is superior to active management of any style. Since the publication of Graham & Dodd's *Security Analysis* in 1934, a 60/40 mix of the DFA U.S. large value and DFA small value indexes beat the market (the average investor) during 62% of the rolling twelve-month periods. In other words, starting any month since 1934 and holding the index mix for one year would have produced a higher return than the S&P 500 62% of the time. If the holding period is extended to five years, the percentage increases to 69%. Extending the period to a full ten years increases the winning percentage to 84%.

Now consider that about only 25% of active managers consistently beat the S&P 500 (and you have no reliable way of identifying those managers in advance), and you can see why we favor value stocks within the structure of well-managed index funds for long-term portfolios.

Dame Fortune's not calling *all* the tunes.

**Table 3: Roach Motels Are Volatile**

Investment	Price-to-Book Ratios		Price-to-Book Ratio July 2010	Annualized Return Sept. 2000-Dec. 2002	Annualized Return Sept. Jan. 2003-July 2010
	Sept. 1 2000	Dec. 31 2002			
S&P 500 Index	4.8	2.4	1.9	-19.7%	5.1%
DFA U.S. Large Value	1.0	0.9	1.0	-2.0%	6.7%
DFA U.S. Small Value	0.9	0.9	0.9	+3.0%	10.3%
MSCI EAFE Index	3.0	1.6	1.5	-19.0%	8.7%
DFA Int'l Value	1.5	0.9	1.0	-9.7%	12.3%
DFA Int'l Small Value	0.8	0.5	0.8	-1.4%	15.3%

Source: Dimensional Fund Advisors, Matrix Book 2003; DFA Returns Program. **Past performance is not a guarantee of future results.**

Note a couple of things about all the numbers: 1) the volatility of the S&P 500 and EAFE price-to-book ratios compared with the value index funds—particularly the U.S. funds, and 2) the lower levels for those indexes today relative to the market bottom in 2002.

What we're seeing with market indexes like the S&P 500 is that stocks generally enter the index due to high prices, gigantic size, and broad popularity (think Google and Berkshire Hathaway) and leave only after

<sup>1</sup> *Financial Analysts Journal*, 1976

<sup>2</sup> *Security Analysis*, The Classic 1951 Edition

<sup>3</sup> *Ibid*