

February 2011

Asset Class Returns

January 31, 2011 (YTD)

	YTD 2011	Last 10 yrs.*	2010	2009	2008
Bonds (%)					
One-year	0.1	3.1	1.2	1.9	4.0
Five-year	0.3	4.6	5.3	4.2	4.0
Intermediate	0.0	6.3	6.9	-0.7	12.9
Long-term	-2.4	7.1	8.9	-12.1	22.5
U.S. stocks (%)					
Large Market	2.4	1.3	14.9	26.5	-37.0
Large Value	3.2	5.3	20.2	30.2	-40.8
Small Market	0.1	8.3	30.7	36.3	-36.0
Small Micro	-1.1	9.6	31.3	28.1	-36.7
Small Value	0.3	11.1	30.9	33.6	-36.8
Real Estate	3.5	10.5	28.7	28.2	-37.4
International stocks (%)					
Large Market	2.3	3.9	9.3	30.6	-41.4
Large Value	4.2	7.8	10.6	39.5	-46.3
Small Market	1.2	11.7	23.9	42.0	-43.9
Small Value	2.1	13.5	18.1	39.5	-41.7
Emerg. Mkts.	-2.6	15.6	21.8	71.8	-49.2

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 12/31/10.

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.

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What's "New" about a New Normal?

Eric Nelson, Equius Partners

The 2008 global market crisis and the struggling economy have left many investors fatigued. Despite two years of strong equity returns, some investors have been slow to regain market confidence. Many are accepting the talk about a "new normal" in which stocks offer lower returns in the future.¹

The concept of a new normal is anything but new. Throughout modern history, periods of economic upheaval and market volatility have led people to assume that life had changed and that new economic rules or an expanding government would limit growth. What they could not see was how markets naturally adapt to major social and economic shifts, leading to new wealth creation.

Let's look at other periods when investors had strong reasons to give up on stocks, and consider the parallels to today. In each case, we present the subsequent returns for the total U.S. stock market and a mix of U.S. asset classes with a small cap and value tilt.²

1932: The U.S. stock market had experienced four consecutive years of negative returns. A 1929 dollar invested in stocks was worth only 31 cents by the end of 1932. Hope sank during the Great Depression, and many people felt the economy had permanently changed. Many investors left the market, and some would not return for a generation. Yet amidst what is considered the roughest economic time in U.S. history, the markets looked ahead to recovery.

Asset Class Performance after 1932

Index	5 Years	10 Years	20 Years
Total Stock Market	15.4%	10.1%	13.2%
Asset Class Mix	18.1%	12.1%	16.6%

1941: World War II was raging, and the U.S. had just entered the conflict. The U.S. stock market had experienced two consecutive years of negative performance, and the economy had shown signs of sliding back into depression. Although conversion to a wartime economy would revive industrial production and boost employment, investors struggled to see beyond the conflict. Many expected rationing, price controls, directed production, and other government measures to limit private sector performance, yet (once again) the markets looked ahead to recovery.

Asset Class Performance after 1941

Index	5 Years	10 Years	20 Years
Total Stock Market	18.6%	16.7%	16.3%
Asset Class Mix	28.3%	22.5%	18.8%

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1974: Investors had just experienced the worst two-year market decline since the early 1930s and the economy was entering its second year of recession. The Middle East war had triggered the Arab oil embargo in late 1973, which drove crude oil prices to record levels and resulted in price controls and gas lines. Consumers feared other shortages. President Nixon had resigned from office in August over the Watergate scandal. Annual inflation in 1974 averaged 11%, and with mortgage rates at 10%, the housing market was experiencing its worst slump in decades. With prices and unemployment rising, consumer confidence was weak and many economists were predicting another depression. The market, however, painted a very different picture.

Asset Class Performance after 1974			
Index	5 Years	10 Years	20 Years
Total Stock Market	17.3%	15.9%	14.9%
Asset Class Mix	27.2%	23.7%	19.1%

1981: The stock market had delivered strong positive returns in five of the last seven years and the two negative years (1977 and 1981) were only moderately negative. Yet investors were weary from “stagflation” (high inflation, anemic GDP growth, and high unemployment) and from fears of another economic downturn. In late 1980, gold climbed to a record \$873 per ounce—or \$2,457 in 2010 dollars. (By comparison, gold reached \$1,256 per ounce in 2010.) Memories of the 1973-74 bear market lingered. A 1979 *BusinessWeek* cover story titled “The Death of Equities” claimed inflation was destroying the stock market and that stocks were no longer a good long-term investment. Once again, the pundits were wrong.

Asset Class Performance after 1981			
Index	5 Years	10 Years	20 Years
Total Stock Market	18.8%	16.6%	14.5%
Asset Class Mix	22.0%	16.9%	17.2%

1987: On “Black Monday” (October 19, 1987), the Dow Jones Industrial Average plummeted 508 points, or 22%, during the worst single day in market history. The plunge ended a five-year bull market. But in the wake of the crash, the market began a relatively steady climb and recovered within two years. The effects of the crash were mostly limited to the financial sector, but the event shook investor confidence and raised concerns that destabilized markets would increase the odds of recession.

Asset Class Performance after 1987			
Index	5 Years	10 Years	20 Years
Total Stock Market	16.2%	17.8%	11.9%
Asset Class Mix	16.4%	19.7%	14.8%

2002: By the end of 2002, investors had experienced the stress of the dot-com crash in March 2000, the shock of the 9-11 attacks, and the early stages of wars in Afghanistan and Iraq. Although October 9, 2002, would mark the market’s low point, investors had endured three years of negative performance and an estimated \$5 trillion in lost market value. A younger generation of investors had experienced its first taste of old-world risk in the “new economy.”

Asset Class Performance after 2002			
Index	5 Years	10 Years	20 Years
Total Stock Market	13.8%	-	-
Asset Class Mix	16.8%	-	-

2008–Today: The market slide that began in 2008 reversed in February 2009—gaining 83.3% from March 2009 through 2010. Despite two years of strong stock market returns, memories of the 2008 bear market and talk of the “lost decade” have led many investors to question stocks as a long-term investment. But earlier generations of investors faced similar worries—and today’s headlines echo past stories about government spending, surging inflation, deflationary threats, rising oil prices, economic stagnation, high unemployment, and market volatility.

Of course, no one knows what the future holds, which brings the concept of “normal” into question. What exactly is the status quo in the markets?

Since 1926, there have been four periods when the stock market had two or more consecutive years of negative returns. In addition, annual returns are rarely in line with the market’s 9.7% long-term average (annualized). The most obvious normal may be that, over time, stocks offer expected returns reflecting the uncertainty and risk that investors must bear.

What’s new about that?

¹Adam Shell, “New Normal? Argues for Investor Caution,” *USA Today*, August 16, 2010. The term “new normal” originally referred to a post-global financial crisis environment characterized by several years of sluggish economic growth, below-average equity returns in developed markets, high market volatility and risk, high unemployment, and a world in which the range of possible financial outcomes is wider than normal and wealth dynamics are moving from developed to emerging economies.

²Returns for all periods are annualized. “Total Stock Market” = CRSP 1-10 Index. “Asset Class Mix” = 30% S&P 500 Index, 30% DFA US Large Value Index, and 40% DFA US Small Value Index.

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Three Factor Vindication

Jeff Troutner, Equius Partners

In June 1992, the *Journal of Finance* published a study by two academics at the University of Chicago, Eugene Fama and Ken French, titled “The Cross-Section of Expected Stock Returns.” Their research, which has been the cornerstone of our investment philosophy ever since, showed that only three distinct “risk factors” explain almost all the results we observe from a diversified portfolio. William Bernstein (the author of *The Intelligent Asset Allocator*) described this in plain English years ago: “Show me the returns series of any U.S. diversified portfolio and, in almost every case, I can explain nearly all its performance based on these three factors; the precise securities are irrelevant.”¹

The original research covered the period 1963-1989 and was met with skepticism and data-mining accusations by academics and industry practitioners alike. So Fama and French extended their research back to the 1920s in the U.S. and to non-U.S. stocks, including emerging markets, as far back as the data allowed.

The results were the same: Stocks outperformed bonds (the “market” factor), small stocks outperformed large stocks (the “size” factor), and low-priced value stocks outperformed high-priced growth stocks (the “value” factor) because in each case the first asset class is riskier than the second. In other words, solid academic research performed by two highly regarded financial economists in markets worldwide confirmed what we should all know from using basic common sense—risk and return are related.

We now have over twenty years of asset class returns and actual Equius Partners investment experience to consider since the original Fama/French research. And guess what: risk and return are *still* related. Table 1 shows the returns and “risk premiums” for the period 1928-1989 and for the twenty-one years since (1990-2010).

All three factors were positive and very similar in both periods. *Risk taking was rewarded.* The stock risk premium over bonds dropped by 0.8% per year in the second period, but the size premium was about the same and the value premium was larger by 3% per year.

If we look a bit closer at the data, we find that asset class

returns were also very close for both periods. The exception was large growth stocks (which dominate the S&P 500 and all “total market” indexes). Their annualized return was 2.6% *less* over the more recent period. Value stock returns were incredibly consistent over the two periods (12.1% versus 12.5% annually).

The major point of this post-research data is hard to miss: the Fama/French Three Factor risk premiums have persisted out of sample and largely in line with the previous period of study. This is compelling evidence that the research results of Fama/French are not an artifact of data-mining but instead present a robust model of risk and return that can be used as the primary consideration for asset allocation decisions.

Dow 36,000 Revisited

The consistency of the annual asset class returns and risk premiums shown in Table 1 can drive some people crazy. In fact, as Jason Zweig points out in a recent article,³ a similar analysis conducted around the peak of stock prices in 1999 drove James Glassman and Kevin Hassett to write the infamous book *Dow 36,000*. They were looking just at stocks versus bonds (no one cared about small company or value stocks in 1999!) and concluded that since stocks have generated a positive return over the long term, they really aren’t that risky.

In the same article, Zweig quotes the chairman of Oaktree Capital Management, Howard Marks, stating that riskier assets don’t necessarily offer higher returns—they just *appear* to do so. “It’s really simple,” he says. “If risky investments could be counted on for higher returns, then they wouldn’t be risky. And if investments weren’t risky, then they probably wouldn’t appear to promise higher returns.”

Huh?

This is the kind of logic investors are subjected to every day to justify active management. But what should we expect from an industry centered on the basic premise that things as volatile as earnings of individual companies, industry earnings, interest rates, inflation rates, economic growth rates, commodity prices, and political winds can be accurately predicted year to year? Most money “invested” in this country is in the hands of people who promise or believe in better-than-market returns *with less risk.*

Table 1

Indexes ²	1928-1989	1990-2010
All Stocks	9.6%	8.9%
1 Month U.S. T-Bills	3.6%	3.7%
Stock Premium	6.0%	5.2%
Small Stocks	11.5%	10.9%
Large Stocks	9.5%	8.7%
Size Premium	2.0%	2.2%
Value Stocks	12.1%	12.5%
Growth Stocks	8.6%	6.0%
Value Premium	3.5%	6.5%

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So, Mr. Marks, here's a lesson on risk—one that Equus clients are familiar with after our first meeting with them. It's a lesson that carried them through the gaga years of large growth stocks in the 1990s, when all the experts were blowing their "new era" horns, and helped them weather the market storms of the past ten years. Let's take a look at those two periods.

Asset Class Returns Are Volatile!

If the Fama/French *Journal of Finance* article had been written at the end of 1989, instead of June 1992, it would have been met with even more skepticism in our industry than it was. Why?

As we see in Table 2, the first two years of the 1990s saw large growth stocks gain an average of almost 33% per year compared to 4.4% per year for a mix of 50/50 large and small value stocks. Someone who doesn't understand risk or who does not have a coherent theory to explain asset class return expectations might have concluded from those results that the Fama/French research is garbage science.

This was followed by two phenomenal years for value stocks and then four years when the returns were nearly identical. For six years then (1992-1997), value stock investors were feeling pretty smug—only to be kicked in the gut with two more years of spectacular returns for large growth stocks. This left the decade solidly in the hands of the "new era" growth stock prophets.

Table 2

Year	Large Growth Stocks	Value Stocks
1990	8.5%	-21.6%
1991	62.8%	39.2%
1992	-4.6%	25.7%
1993	-3.1%	27.3%
1994	2.4%	1.8%
1995	36.0%	36.2%
1996	25.5%	24.2%
1997	31.1%	35.5%
1998	54.2%	3.8%
1999	50.0%	11.3%
Annual	24.1%	16.8%

Now let's look at the second period, in Table 3. Investors who still believed that risk and return are related saw the risk premiums of small and value stocks reappear with a vengeance in the 2000s. However, they still had to endure a brutal 2007-2008 to be rewarded with extraordinary returns over the past two years.

Table 3

Year	Large Growth Stocks	Value Stocks
2000	-37.9%	13.3%
2001	-41.6%	14.3%
2002	-25.0%	-15.4%
2003	18.7%	55.6%
2004	7.4%	20.7%
2005	3.5%	6.9%
2006	7.1%	23.0%
2007	16.5%	-7.8%
2008	-40.1%	-44.0%
2009	42.2%	42.3%
2010	18.2%	26.1%
Annual	-7.0%	8.7%

So yes, Mr. Marks, riskier investments *can* be counted on for higher returns *if* unsystematic (active) risk is taken out of the equation, common sense and first-class research are introduced, and investors accept that there are no guarantees. Investors must also accept extreme volatility in yearly returns, long stretches of negative asset class risk premiums, and some extreme market declines in order to be rewarded. They must also ignore almost everything coming out of the investment industry and the media that supports it, since both are dominated by short-term thinkers, prognosticators, charlatans, and professional dart-throwers who clearly don't understand risk.

¹ "The Cross-Section of Expected Stock Returns: A Tenth Anniversary Reflection," William Bernstein, www.efficientfrontier.com

² "All Stocks" = CRSP 1-10 total market index, "Small Stocks" = DFA US Small Cap index, "Large Stocks" = DFA US Large Cap index, "Large Growth Stocks" = DFA US Large Growth Index, "Value Stocks" = 50/50 blend of DFA US Large Cap Value and DFA US Small Cap Value indexes (rebalanced annually), and "Growth Stocks" = 50/50 blend of DFA US Large Cap Growth and DFA US Small Cap Growth indexes (rebalanced annually).

³ "How Now, 36,000 Dow? The Ominous Undertone of Rallies," Jason Zweig, *The Wall Street Journal*, 2/12/11.

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