EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

An update of performance, trends, research & topics for long-term investors

Asset Class Returns

February 28, 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	0.2	4.6	5.3	4.2	4.0
Intermediate	0.0	6.3	6.9	-0.7	12.9
Long-term	-1.2	7.1	8.9	-12.1	22.5
U.S. stocks (%)					
Large Market	5.9	1.3	14.9	26.5	-37.0
Large Value	8.8	5.3	20.2	30.2	-40.8
Small Market	5.7	8.3	30.7	36.3	-36.0
Small Micro	4.7	9.6	31.3	28.1	-36.7
Small Value	6.6	11.1	30.9	33.6	-36.8
Real Estate	8.2	10.5	28.7	28.2	-37.4
International stocks (%)					
Large Market	6.3	3.9	9.3	30.6	-41.4
Large Value	7.7	7.8	10.6	39.5	-46.3
Small Market	4.3	11.7	23.9	42.0	-43.9
Small Value	5.1	13.5	18.1	39.5	-41.7
Emerg. Mkts.	-3.3	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.**

Equius Partners, Inc.
3 Hamilton Landing, Suite 130
Novato, CA 94949
Phone: 415-382-2500
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In Appreciation of Open-Minded Clients

Jeff Troutner, Equius Partners

The Equius team recently hosted an open house for our new headquarters in the Hamilton Landing complex (the former Hamilton Air Force Base) in Novato. Along with the opportunity to connect with clients and friends in an informal setting, the event allowed us to introduce the Equius Gallery: a central location in our office designed for group events and to display the great work of some of Marin County's most accomplished artists.

As part of the open house program, we presented a short history of Equius Partners initially titled "The Evolution of an Investment Philosophy & Firm." The presentation was divided into two parts, the first of which dealt with the philosophical and industry challenges we faced in introducing our services to potential clients over the years, and the second of which looked at those challenges from a performance perspective.

After compiling the information, however, we decided to title the presentation "In Appreciation of Open-Minded Clients," since it became clear that embracing asset class investing principles was significantly more difficult for our clients than it was for us. Our team, after all, has extensive experience in the investment industry, as well as undergraduate and graduate degrees in business and finance and certifications in securities analysis. Embracing modern portfolio theory while rejecting the false promises of active management in an age of highly efficient markets was pretty easy for us. We study this stuff constantly. We know our industry inside and out. We made the same mistakes with our own money in the past that our clients have made with theirs. Some of us, early in our careers, also helped facilitate bad decisions and bad behavior for clients before we realized the folly (and high costs) associated with that model.

Like Sheep to Be Sheared

Our clients, on the other hand, have only their own singular experience to guide them. Most were not aware, before meeting with us, that stockbrokers are not legal fiduciaries and therefore have primary loyalty to their *firms*, not their "customers." This is why most of what comes out of brokerage firms is *product sales* with either an obvious commission attached or (in too many cases) a large commission or ongoing fee buried within a product contract or prospectus. Brokers are trained and managed to focus on their monthly sales production and to compete with one another on that basis. This often leads to a focus on what's hot and currently in demand rather than what's in their customers' best interest over time. Evidence of this is the fact that it's extremely rare for a broker to provide a total portfo-

Continued on page 2

lio performance report on his or her recommendations. Instead, whatever poses as a "performance review" with a customer is most often a discussion of a few recent winners and excusing or ignoring the more prevalent losers in their brokerage account (seldom referred to as a *portfolio*).

But even investors who have moved on from the old-school brokerage relationships are faced with a fee-based, fiduciary advisor world dominated by old-school active management philosophies that fail consistently and predictably. As I outlined in several *Asset Class* articles last year, these advisors continue to embrace techniques made popular eighty years ago—before high-speed computers, Bloomberg and the Internet, the dominance of professional institutional investors in the financial markets, and the high-quality academic research that confirms market efficiency. Trying to out-guess other investors, politicians, corporate managers, and even God (in the case of natural disasters) is the cocaine of active managers and naïve investors seeking quick gains simply feed their habit.

Active management and its (false) promises are far sexier and appealing than indexing and asset class investing. Markets are volatile and constantly changing. Economic growth, interest rates, and inflation constantly rise and fall. Wars and natural disasters create havoc and uncertainty. Someone *has* to make sense of it all, right?

For an oft-quoted total cost of 2% of your money, active managers will help you move your assets around, chasing trends and predictions (another 3% or more of "behavioral" cost), with the confidence that once you realize the folly in this approach, two or three other suckers will be lined up to take your place. Keep thinking short term, keep speculating, keep chasing your tail. It's the classic tortoise versus hare story. In America, it seems most people want to be the hare.

Evolution: Experience, Ellis & Indexing

So, we're very fortunate to have clients who have "seen the light" and have endured the consistent onslaught of powerful Wall Street marketing *and* very volatile markets to embrace asset class investing with us. Now, let's review what we've gone through together.

My predecessor firm to Equius, TAM Asset Management, was founded in October 1992 with an indexing approach to long-term portfolio management. Phil's firm, Dynamic Funds Management, had started its transition to indexing a year before that. The initial catalyst for founding TAM on *indexing* principles was my personal experience in the brokerage business, recommending active managers and subsequently joining the one that brought me to San Francisco. All eventually failed in their "beat the market" mission. But the big push out of the active world for me came from reading Charlie Ellis's book *Investment Policy: How to Win the Loser's Game*.

Mr. Ellis was a widely respected consultant to large institutional investors as chairman of Greenwich Associates and a longtime advocate of active management. My first experience with his views on investing was in 1989 with his book *Classics: An Investor's Anthology*—a compilation of articles written by the best active managers of all time—people like Ben Graham, T. Rowe Price, Warren Buffett, Philip Fisher, and many others. He wrote *Classics II* in 1991.

So the fact that in 1992 Ellis endowed us with this incredible little book, *Investment Policy*, refuting the principles and promises of active management and extolling the virtues of indexing, was enormously influential to me. That it was packed with verifiable facts on the failures of active management as a whole and not just one man's anecdotal evidence from his Greenwich experience was also hugely important. Every new TAM client received a copy of *Investment Policy* and, for good measure, I received from Mr. Ellis and his publisher permission to reprint the book in its entirety over the first two years of monthly *Asset Class* newsletters.

Fama/French, DFA & Asset Class Investing

The Fama/French article in the *Journal of Finance* [1] that became the catalyst for our *asset class* investing approach was published in June 1992. So from 1993 to about mid-1996, we gradually shifted our market-weighted indexed portfolios toward greater balance among the Fama/French Three Factors (market, size, and value) as DFA developed highly structured mutual funds for that purpose. By January 1995, DFA had launched its International Small Value fund, and we had all the tools we needed to build fully diversified asset class portfolios. We were on our way to asset class nirvana. Or so we thought.

For the next five years, we found ourselves paddling our strange little asset class kayaks, laden with small cap and value stocks, against the strongest winds and tides we could have imagined: the rise of Internet technology and investor obsession with the large, high-priced stocks that fueled its growth. Understandably, most investors who decided to listen to our "indexing with a small cap and value tilt" story looked at us like we had two heads, neither of which had the brains to realize we were in a New Era.

The table on the next page illustrates the evolution of the Equius investment approach with asset class and simulated portfolio performance starting in 1995.

Continued on page 3

This was a period marked by both euphoric and fear-driven financial markets. As we reflect on these periods, we're struck by the confidence in asset class investing principles that both we and our clients (new and existing) displayed in the face of these challenges *and* the discipline both groups exhibited as we continued to structure and rebalance portfolio allocations.

Our Philosophical Evolution	Asset Class (AC) Total Returns		
1995-March 2000	**5 ¼ Years**		
Shifted portfolios to a more balanced asset class approach based on Fama/French research, emphasizing global small cap and value stocks.	Five-Year Bonds	59%	
Challenge: Indexing? Small cap and value stocks? Are you nuts?	S&P 500	259%	←
Result: "Bubble" in large growth, patience & confidence required.	Large Value	142%	
	Small Value	136%	
	Int'l Large Value	48%	
	Int'l Small Value	-1%	←
	Emerging Mkts.	38%	
	AC Stock Mix*	127%	
	AC 65/35 Mix*	101%	
April 2000-Sept. 2002	**2 ½ Years**		
Maintained asset class approach with disciplined rebalancing.	Five-Year Bonds	22%	
Challenge: Stocks? Are you nuts?	S&P 500	-44%	
Result: Tough market, patience & confidence rewarded.	Large Value	-5%	←
	Small Value	5%	←
	Int'l Large Value	-23%	
	Int'l Small Value	-4%	←
	Emerging Mkts.	-42%	
	AC Stock Mix	-17%	
	AC 65/35 Mix	-3%	
Oct. 2002-Oct. 2007	**5 Years, 1 Mo.**		
Maintained asset class approach with disciplined rebalancing.	Five-Year Bonds	18%	
Challenge: What, no real estate, hedge funds, commodities, or other "alternatives"?	S&P 500	108%	
Result: Risk, patience & confidence rewarded.	Large Value	131%	
	Small Value	176%	
	Int'l Large Value	281%	
	Int'l Small Value	321%	
	Emerging Mkts.	448%	
	AC Stock Mix	187%	
	AC 65/35 Mix	115%	
Nov. 2007-Feb.2009	**16 Mos.**		
Maintained asset class approach with disciplined rebalancing.	Five-Year Bonds	8%	
Challenge: Diversification and buy-and-hold are dead. Fear and panic everywhere. Buy gold!	S&P 500	-51%	
Result: No place to hide, patience & confidence required.	Large Value	-58%	
	Small Value	-57%	
	Int'l Large Value	-63%	
	Int'l Small Value	-58%	
	Emerging Mkts.	-59%	
	AC Stock Mix	-57%	
	AC 65/35 Mix	-38%	
March 2009-Dec. 2010	**22 Mos.**		
Maintained asset class approach with disciplined rebalancing.	Five-Year Bonds	10%	
Challenge: Gold, commodities, and emerging markets are all the rage.	S&P 500	78%	
Result: One of the shortest and steepest recoveries for stocks in history. Patience & confidence rewarded.	Large Value	107%	
	Small Value	134%	
	Int'l Large Value	104%	
	Int'l Small Value	102%	
	Emerging Mkts.	143%	
	AC Stock Mix	110%	
	AC 65/35 Mix	72%	

We attribute this to our personal experiences on "the dark side," the incredible knowledge base we draw from today (including the best academic research, wisdom and insights from people like Ellis, and the first-class fund design and management of firms like DFA), and our commitment to establishing realistic and rational expectations with clients from the very first meeting.

The intended results—illustrated in the table below covering the full 16 years—are portfolios rewarded for the market, size, and value risk systematically assumed over multiple market cycles. International stocks lagged their U.S. counterparts over this period, but the small cap and value risk premiums are still evident in the numbers.

1995-2010 (The tortoise wins again!)		
Asset Class	**Total Return**	**Annual Return**
Five-Year Bonds	162%	**6.2%**
S&P 500	267%	**8.5%**
Large Value	362%	**10.0%**
Small Value	579%	**12.7%**
MSCI EAFE	*121%*	***5.1%***
Int'l Large Value	228%	**7.7%**
Int'l Small Value	240%	**7.9%**
Emerging Mkts.	333%	**9.6%**
AC Stock Mix	**388%**	**10.4%**
S&P 500/EAFE Mix*	**223%**	**7.6%**
AC 65/35 Mix	**324%**	**9.5%**

Knowledge, confidence, and discipline. Those words are now inscribed on the walls of the Equius Gallery and firmly imbedded in the Equius philosophy. They've served our clients well in the past, and we're confident they are the best guide for an uncertain future.

*The "AC Stock Mix" is 21% S&P 500 index, 21% DFA US Large Value fund, 28% DFA US Small Value fund, 18% DFA International Value fund, 6% DFA International Small Value Fund, and 6% DFA Emerging Markets fund. The "AC 65/35 Mix" is 35% DFA Five-Year Global Fixed fund, 13.5% S&P 500 index, 13.5% DFA US Large Value fund, 18% DFA US Small Value fund, 12% DFA International Value fund, 4% DFA International Small Value Fund, and 4% DFA Emerging Markets fund. The "S&P 500/EAFE Mix" is 70% S&P 500 index, 30% MSCI EAFE index. All asset class returns are represented by the corresponding DFA funds noted above.

The returns and performance data are for illustration purposes only and do not represent actual Equius client performance. There are limitations inherent in model allocations. In particular, model performance may not reflect the impact that economic and market factors may have had on the advisor's decision making if the advisor were actually managing the client money. Mutual fund and portfolio mixes are net of mutual fund fees and expenses, but are not net of Equius investment advisory fees. Past performance is no guarantee of future results.

[1] "The Cross-Section of Expected Stock Returns," Eugene F. Fama; Kenneth R. French, *The Journal of Finance*, Vol. 47, No. 2. (June 1992)

The Tortured 'Logic' of Active Managers

Jeff Troutner, Equius Partners

In an article titled, Value Investing: Human Nature and the Last Great Anomaly, Charles Lahr, a global portfolio manager for the bond fund giant PIMCO, is making the case for PIMCO's foray into stock mutual fund management. Any average person reading this article would probably agree that value investing makes a lot of sense *if* the investor can overcome the typical behavioral challenges. After all, as Lahr points out early in the article:

> ...the value premium is one of the most persistent sources of return found in equity markets. Studies going back to 1926 in the U.S., 1900 in the UK, and different periods worldwide have shown that the value premium averages about 3% on an annualized basis. The key takeaway here is that a long-term focus on value investing and unwavering discipline has worked in the past, and did so without taking the forecast risk of trying to predict when value would be out of favor.

Unfortunately, Lahr spends the rest of the article trying to make the case for hiring an active stock picker to exploit the value premium. He does this by implying that we're all dumb and he's not.

Lahr describes value investing in his title as the "last great anomaly." In other words, we have an active money manager admitting that markets are efficient—except when it comes to value stocks. Lahr would have you believe that investors have been collectively ignorant or blind *for eighty-five years* because the value "anomaly" still lives!

So what does he use to prove his point? A highly diversified, highly structured, and *unmanaged index* going back to 1926. That's right, eighty-five years of outstanding, superior performance from an index.

Naturally, he goes on to describe how difficult and complex analyzing "intrinsic value" and deciding when to buy and sell individual value stocks are for the average investor. Nowhere does he point out that large and small value stock index funds exist—whether of the Vanguard and ETF retail variety or the DFA institutional proprietary kind—that are more or less designed to capture the value premium he readily acknowledges.

But never fear, Lahr and PIMCO will come to your rescue. Under "Investment Conclusions," he states that "the process of searching for undervalued and neglected equities is one that can be tedious, trying and challenging. … And now, if you'll excuse me, I have to go back to getting my hands dirty looking under rocks."

Memo to Mr. Lahr: "value" is a risk factor, not an anomaly. *See "Fama, Eugene, Sr., and French, Ken."* Also, some of your competitors offer index funds designed to capture the value risk premium without the dirty job of stock-picking. *See "Dimensional Fund Advisors."*

I'm picking on Mr. Lahr here, but even advisors I've respected for decades present the same kind of twisted logic in their marketing pieces. In an April 2009 publication titled Value Investing: A Brief History, Key Principles, and Historical Performance, Charles Brandes outlines Ben Graham's security analysis techniques from the 1930s for picking undervalued stocks. Brandes is an active money manager and longtime follower of Graham. Yet at the end of the paper he illustrates the return advantage of value stocks using the Fama/French *index* data.

Brandes did much the same in a presentation titled Investing in Emerging Markets with Confidence. To make the case for investing in those markets, he shows the MSCI Emerging Markets *index* returning 16.2% over the last ten years and then shows his much less diversified and higher-risk active stock-picking techniques producing the *exact same return* after fees.

Over the remaining thirty slides we find a mind-numbing amount of fundamental data on emerging markets stocks compiled by at least six CFAs on his staff—all designed to impress us.

What we didn't find was that this famous value stock picker *underperformed* the MSCI Emerging Markets *Value* index by 2.2% per year over the last ten years.

Why do smart people like Lahr and Brandes see the risk/return, diversification, and portfolio construction advantages of indexing and then spend so much energy doing things that are destined to underperform and expose their clients to much greater risks and costs?

Because they're trying to protect their old-school sizzle before you find the indexing steak. The lesson is clear: to avoid being exploited by active managers and product peddlers, you must read these kinds of articles with a very critical eye.

Note: For more perspective on how the 3% value premium that Lahr cites relates to active management performance the last fifteen years, visit the Equius Blog at www.equiuspartners.com/blog.