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ASSET CLASS SM

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

Asset Class Returns

August 31, 2011 (YTD)

	YTD 2011	Last 10 yrs.*	2010	2009	2008
Bonds (%)					
One-year	0.7	3.1	1.2	1.9	4.0
Five-year	5.2	4.6	5.3	4.2	4.0
Intermediate	7.0	6.3	6.9	-0.7	12.9
Long-term	15.6	7.1	8.9	-12.1	22.5
U.S. stocks (%)					
Large Market	-1.9	1.3	14.9	26.5	-37.0
Large Value	-5.3	5.3	20.2	30.2	-40.8
Small Market	-5.7	8.3	30.7	36.3	-36.0
Small Micro	-6.5	9.6	31.3	28.1	-36.7
Small Value	-9.0	11.1	30.9	33.6	-36.8
Real Estate	6.3	10.5	28.7	28.2	-37.4
International stocks (%)					
Large Market	-5.6	3.9	9.3	30.6	-41.4
Large Value	-9.5	7.8	10.6	39.5	-46.3
Small Market	-5.2	11.7	23.9	42.0	-43.9
Small Value	-7.7	13.5	18.1	39.5	-41.7
Emerg. Mkts.	-7.6	15.6	21.8	71.8	-49.2

Descriptions of Indexes

One-Year 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 Market	DFA U.S. Small Cap fund
U.S. Small Micro	DFA U.S. Micro 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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Uncertainty is Our Friend

Jeff Troutner, Equius Partners

As I wrote last month's *Asset Class* article "America Is a Value Stock," I recalled an article I had read many years ago. Writing about the excuses professional investment managers make to avoid stocks during market environments similar to today's, a wise man once wrote:

> A second argument is made that there are just too many question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: "Maintain buying reserves until current uncertainties are resolved," etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.

Fans of Warren Buffett will recognize this passage from an article he wrote for *Forbes* magazine 32 years ago, titled "You Pay a Very High Price in the Stock Market for a Cheery Consensus." In his folksy, sarcastic style throughout the article Buffett skewers professional investment experts for their "schizophrenia," "Pavlovian response," and "puzzling behavior" of buying high and selling low. He starts out with this observation:

> Pension-fund managers continue to make investment decisions with their eyes firmly fixed on the rearview mirror. This generals-fighting-the-last-war approach has proven costly in the past and will likely prove equally costly this time around.
>
> Stocks now sell at levels that should produce long-term returns far superior to bonds. Yet pensions managers, usually encouraged by corporate sponsors they must necessarily please ("whose bread I eat, his song I sing"), are pouring funds in record proportions into bonds.

I've written about this behavior in previous *Asset Class* articles as being particularly puzzling when displayed by investment advisors who should know better. They market their value proposition as being the strong, disciplined tree that won't be swayed by short-term market winds—until a client gets wobbly during a falling market. The advisor then turns into a weeping willow, not only refusing to rebalance back to the portfolio target for equities but compounding the mistake by reducing long-term stock allocations "at the client's request." This is how fee-only, full-discretionary investment advisors become order-taking stockbrokers in a flash.

Thirty-two years after Buffett's brilliant article, we continue to see the same behavior from advisors and their clients. The chart below shows the flow of assets out of stock mutual funds since 2008. Note how the outflows (orange line) coincide with a decline in the S&P 500 market index (gray area). When stocks exploded (unexpectedly*) starting in early March 2009, we see barely a blip in positive stock fund flows before investors and

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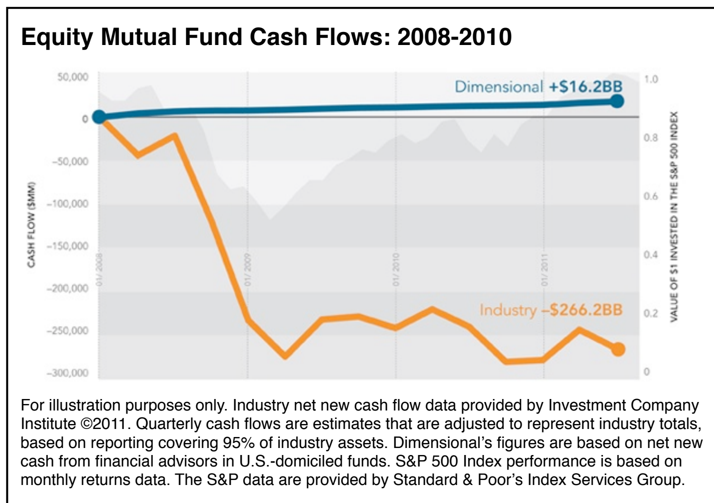
advisors got wobbly again and moved out of stocks. Although we don't show it here, much of this money found its way into bond and money market funds—despite close to 0% yields. In contrast, assets devoted to a disciplined asset class strategy using the DFA funds steadily rose over the period (blue line).

Equity Mutual Fund Cash Flows: 2008-2010



For illustration purposes only. Industry net new cash flow data provided by Investment Company Institute ©2011. Quarterly cash flows are estimates that are adjusted to represent industry totals, based on reporting covering 95% of industry assets. Dimensional's figures are based on net new cash from financial advisors in U.S.-domiciled funds. S&P 500 Index performance is based on monthly returns data. The S&P data are provided by Standard & Poor's Index Services Group.

Buffett's comments in 1979 were directed at decision makers at pension plans. These included the corporate executives who hired the professional consultants who recommended the professional money managers—all seemingly highly intelligent, highly experienced and certainly, highly paid experts. Clearly these professionals were no smarter or better behaved than the mere mortals whose retirement money they were entrusted with protecting and growing.

Wisdom and Patience Win Out

In the August 1979 *Forbes* article, Buffett asks the question "Can better results be obtained over, say, 20 years from a group of 9 1/2% bonds of leading American companies maturing in 1999 than from a group of Dow-type equities purchased, in aggregate, at around book value and likely to earn, in aggregate, around 13% on that book value?" Good question. Here's the answer (in terms of investment return):

Table 1: 1980-1999	Annual Return
S&P 500 index	17.9%
5-Year Treasury Notes	9.5%
Long-term Treasury Bonds	10.8%

Of course, even the great Buffett had no idea that stocks would do as well as they did over that period and essentially peak at the end of 1999. He was simply using "20 years" as a reasonable long-term time period to match the long-term investment horizon of pension plans. So let's be more realistic by including the last 11 tumultuous years (and add large and small value stocks to honor Buffett's and our value preference):

Table 2: 1980-2010	Annual Return
S&P 500 index	11.4%
DFA US Large Value index	**13.2%**
DFA US Small Value index	15.9%
5-Year Treasury Notes	8.3%
Long-term Treasury Bonds	**9.7%**

Kind of scary how clear thinking, independence from Wall Street, and a disciplined adherence to sound principles pays off, right?

Then and Now

The market environment that influenced Buffett's article was very similar to what we're experiencing today. Buffett went through a severe bear market (1/73-9/74, S&P 500 down 42.6%), followed by a steep recovery over a short period of time (up 55.1% in nine months). The market bounced along after that, providing a meager 2.5% annual return from the beginning of 1973 until Buffett wrote his article. After another short, steep climb in 1980, the market fell again until the big bull market started in earnest in late 1982.

From 11/07 to 2/09 the market fell 50.9% and then returned 65.5% over the next 14 months (through April 2010). Since then, the market's bounced around, with volatility increasing significantly of late as economic uncertainty in the U.S. and Europe has increased.

The seven years before Buffett's article and the two years afterward offered exceptional opportunities to buy stocks cheap. There should be no question that our own "lost decade" and these current uncertain times are creating similar opportunities to buy stocks at exceptionally high expected returns—especially compared to what we can get from bonds.

It's appropriate then to close this article with Buffett's last words thirty-two years ago:

> Managers [investors] currently opting for lower equity ratios either have a highly negative opinion of future American business results or expect to be nimble enough to dance back into stocks at even lower levels. There may well be some period in the near future when financial markets are demoralized and much better buys are available in equities; that possibility exists at all times. But you can be sure that at such a time the future will seem neither predictable nor pleasant. Those now awaiting a "better time" for equity investing are highly likely to maintain that posture until well into the next bull market.

Amen. Now, Mr. Buffett, that thing about raising taxes during a recession...

* Unexpectedly for some, not Equius Partners. See our February 2009 *Asset Class* article "Past Declines & Their Recoveries."