

August 2012

## Asset Class Returns

July 31, 2012 (YTD)

	YTD 2012	Last 10 yrs.*	2011	2010	2009
<b>Bonds (%)</b>					
One-Year	0.8	2.6	0.6	1.2	1.9
Five-Year	3.8	4.5	4.5	5.3	4.2
Intermediate	3.2	6.4	9.4	6.9	-0.7
Long-Term	8.0	8.7	29.3	8.9	-12.1
<b>U.S. stocks (%)</b>					
Large Market	10.9	2.8	2.1	14.9	26.5
Large Value	9.4	4.6	-3.1	20.2	30.2
Small Market	7.4	6.7	-3.2	30.7	36.3
Small Micro	7.2	7.1	-3.3	31.3	28.1
Small Value	7.9	8.1	-7.6	30.9	33.6
Real Estate	17.0	10.1	9.0	28.7	28.2
<b>International stocks (%)</b>					
Large Market	3.5	4.9	-12.3	9.3	30.6
Large Value	0.3	7.6	-16.9	10.6	39.5
Small Market	3.5	11.0	-15.4	23.9	42.0
Small Value	3.6	11.9	-17.5	18.1	39.5
Emerg. Mkts.	5.3	14.2	-17.4	21.8	71.8

## 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 12/31/11.

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## Other Voices



## Knightmare on Wall Street

Weston Wellington, Dimensional Fund Advisors

*Question: Which of the following statements applies to the stock market's behavior the first week of August?*

- Computer errors at a major trading firm generated millions of faulty trades, causing dramatic and puzzling price swings in dozens of stocks Wednesday morning.
- A New York Times columnist fumed that "Wall Street has created its own Frankenstein. The machines are now in charge."
- Stocks on the fifty-two-week new low list included Dell, Facebook, Ford Motor, Hewlett-Packard, and Office Depot.
- Stocks on the fifty-two-week new high list included AT&T, Abbott Laboratories, Allstate, Berkshire Hathaway, Coca-Cola, Colgate-Palmolive, Consolidated Edison, Gap, Heinz, Johnson & Johnson, Kimberly-Clark, Monsanto, PepsiCo, Pfizer, Philip Morris International, SprintNextel, Target, Time Warner, Union Pacific, Verizon, WalMart, and Wells Fargo.
- The S&P 500 Index rose 0.16% for the week, reaching its highest level in three months on Friday, August 3.

*Answer: All of the above.*

The first trading session of the month was marked by unusual activity in 148 stocks listed on the New York Stock Exchange, many of which swung sharply in the first hour of trading due to an apparent error in a newly installed software program developed by seventeen-year-old Knight Capital Group Inc., one of the country's largest market-making and trading firms. The NYSE canceled trading in six stocks, including podcasting company Wizzard Software (WZE), and oil and gas company Quicksilver Resources (KWK).

For some, the incident was an unwelcome reminder of the so-called "flash crash" on May 6, 2010, which saw the Dow Jones Industrial Average plunge over 700 points in fifteen minutes. Wall Street Journal columnist Jason Zweig sounded out a number of individual investors for their thoughts on Wednesday's market gyrations and got an earful. One college professor, dismayed by the unusual volatility, fretted about the possibility of investing for many years only to see "everything you have built up disappear in five minutes." A New York lawyer observed that the investors he talks to are convinced "the game is stacked against them" and that earning a pittance in safe fixed income investments was preferable to "losing it all on a roulette-wheel stock market."

*Continued on page 2*

Cash flows for equity mutual funds have been generally negative over the past two years, and incidents such as the “flash crash” are often cited as a contributing factor to investor skepticism of equity investing. A recent article by Ron Lieber appearing in the New York Times suggests this anxiety is becoming more widespread. Responding to the desire by some readers to avoid traditional financial service companies, he explores a range of alternatives, including credit unions, direct ownership of rental real estate, and so-called peer-to-peer programs that facilitate direct lending to individuals. He finds possibilities but no easy answers, and cautions those who intend to pursue this alternative approach to consider the chance that they will have to “save even more, spend less, and work several years longer to make up for any shortfall in returns.”

One can sympathize with investors who fear that the investment industry machinery somehow places them at a disadvantage, but we think such concerns should be placed in a proper context. We live in a complicated world, and it’s unrealistic to expect power plants, airlines, or stock exchanges to work perfectly 100% of the time. The lights go out, flights are canceled on short notice, and computers freeze up just when we need to print that important document. These malfunctions serve to remind us that technology is a mixed blessing, but few of us would prefer a permanent return to the era of spinning wheels and candlelight.

Electronic trading has received a well-deserved black eye due to Wednesday’s fiasco, but before we throw out all the computers in angry frustration, we should consider what transaction costs might look like in their absence. Some of us are old enough to remember the commission schedule at NYSE-member firms in the days before negotiated commission rates and high-speed trading algorithms. A 100-share order of IBM or Procter & Gamble cost \$80.73 at Bache & Company, E.F. Hutton, Kidder Peabody, or anywhere else. These days, a Wells Fargo customer with a meaningful checking account balance can execute one hundred trades a year for free. How many of us would vote to bring back the old system? More traders and more trading paves the way to greater liquidity and lower transaction costs. If we banished all short-term traders, who would be there to take the opposite side of our order when it’s time to sell some shares to pay a college tuition bill?

Although some journalists were quick to accuse Wall Street insiders of using their trading tactics to fleece small investors, it seems the reverse was more plausible in this case. Knight Capital—the epitome of the wired-in New York trading firm—suffered over \$400 million in trading losses from Wednesday’s errant trades and appeared at one point to be in danger of failing. There are two sides

to every transaction, and if some market participants—whether man or machine—demand instant liquidity regardless of price, we should not be surprised if the price of that liquidity occasionally becomes very steep. Knight Capital’s loss is someone else’s gain, and it appears that floor traders and other market participants responded quickly to the peculiar price patterns and took the opposite side of Knight’s trades to their advantage.

What about the buy-and-hold investor? Zweig’s column cited four widely held stocks affected by the trading glitch. We note that the spread between high and low prices on August 1 ranged from 1.96% (Berkshire Hathaway) to 14.64% (Harley-Davidson). While the intraday swing was unusual, the net change for the day was considerably smaller (–1.85%, on average), and smaller still for a diversified S&P 500 strategy (–0.29%). Investors who are traumatized by this degree of volatility are probably not good candidates for equity investing under any circumstances.

**Trading Results for Wednesday, August 1, 2012**

Company	Open	High	Low	Close	High/Low Spread	Daily Change
American Express (AXP)	\$57.52	\$57.86	\$56.75	\$56.80	1.96%	–1.57%
Berkshire Hathaway B (BRK.B)	\$85.04	\$85.31	\$82.12	\$84.62	3.88%	–0.26%
Harley-Davidson (HOG)	\$43.34	\$43.38	\$37.84	\$41.67	14.64%	–3.61%
Nordstrom (JWN)	\$54.44	\$54.44	\$51.50	\$53.08	5.71%	–1.96%
S&P 500 Index	1379.3	1385	1373.4	1375.3	0.85%	–0.29%

We also wonder how many investors were even aware of the trading gyrations as they were taking place last Wednesday. We suspect those expressing the greatest alarm were accustomed to watching market developments minute-by-minute on financial websites or television programs. Here again, advances in technology can be both a blessing and a curse.

In this regard, we cannot improve on Jason Zweig’s observation, so we’ll quote him directly: “It’s harder than ever for long-term investors to ignore the trading madness of Mr. Market. But ignoring it remains the very essence of what it means to be an investor.”

#### References

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