

Asset Class Returns

April 30, 2008 (YTD)

	2005	2006	2007	Last 10 yrs. SM	YTD 2008
Bonds (%)					
One-year	2.3	4.8	5.2	4.1	1.0
Five-Year	1.7	3.9	5.2	5.1	0.3
Intermediate	1.6	3.6	9.5	6.4	2.8
Long-term	6.6	1.7	9.2	7.0	2.1

U.S. stocks (%)

Large Market	4.9	15.7	5.4	5.8	-5.1
Large Value	10.2	20.2	-2.8	8.9	-1.9
Small Market	6.1	16.6	-3.1	9.0	-6.7
Small Micro	5.7	16.2	-5.2	10.6	-8.4
Small Value	7.8	21.5	-10.8	11.5	-4.3
Real Estate	13.2	35.3	-18.7	10.8	8.3

International stocks (%)

Large Market	13.5	24.9	12.5	8.6	-3.1
Large Value	15.3	34.1	10.2	13.0	-4.1
Small Market	22.0	24.9	5.6	14.3	-3.1
Small Value	23.2	28.4	3.0	16.2	-2.0
Emerg. Mkts.	29.9	29.2	36.0	16.0	-2.3

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 US Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US Micro Cap fund
U.S. Small Market	DFA US Small Cap fund
U.S. Small Value	DFA US 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 12/31/07.

Equius Partners, Inc. 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. **Past performance is no guarantee of future results.**

Equius Partners, Inc.
4 Hamilton Landing, Suite 205
Novato, CA 94949
Phone: 415-382-2500
Fax: 415-382-2005

Editor: Jeffrey C. Troutner
jeff@equiustpartners.com

© 2008 Equius Partners, Inc.

Getting Satisfaction

Phil Jonckheer, Equius Partners

The art of resting the mind and the power of dismissing from it all care and worry is one of the secrets of energy [...].

Captain J.A. Hadfield

The barrage of bad news seems determined to compromise investors' rationality. It takes every bit of discipline to avoid being engulfed by that avalanche and affected by the mood swings that naturally result from tracking short-term market volatility—particularly if the direction is negative. What we are learning from studying human behavior is that those gyrations exacerbate a natural human tendency to make illogical decisions in our uncertain world. That does not give anyone the excuse to dismantle a carefully constructed investment strategy. It does, however, suggest that a level of awareness is needed to understand how people are wired for worrying and how we might more consciously put ourselves in positions of stressing less and getting more satisfaction.

What Happened to Logic?

For insight into humans' proclivity to decide matters illogically, we turn to Professor Daniel Kahneman, a 2002 Nobel Laureate in Economic Sciences. His research suggests that people exhibit risk-averse behavior when deciding on choices that involve sure gains but appear to be risk seekers when making decisions that involve sure losses.

For example, when given a choice between receiving \$1000 with certainty or a 50% chance of winning \$2500 and a 50% chance of getting nothing, people prefer the certain \$1000 – even though the probability adjusted outcome of the uncertain option is \$1250. Conversely, Kahneman found that when given a choice of a certain loss of \$1000 versus a 50% chance of no loss or a 50% chance of a \$2500 loss, the same people favored the risky alternative, i.e., taking a chance of a risk-adjusted loss of \$1250. Thus people are somewhat illogically disposed to embracing more risk when confronted with a sure loss, but then shift to embracing less risk when confronted with a sure gain.

Dr. Kahneman further elaborates on how humans make decisions and the challenges people face in controlling emotions.¹ He explains, "There are two mental processes. System One is intuitive, rapid, uncontrolled, and automatic thinking. System Two is the rule-governed approach that helps you complete your income tax form, compute 17 times 24, or read a map. Most of the time we run on the software of System One.

"You can be aware of your mistakes, but it's very difficult to learn to avoid them, because System One operates automatically. Occasionally when a decision is very important, you can stop to think, and you have to recognize that you can stop to think. But then there is the very painful and difficult stage, where even if your analysis tells you to do something, you



don't want to do it. It's very difficult to impose the rationality of discipline on yourself. And the more emotional the event, the less sensible people are." So people's emotions influence their decision-making process and overcome their sense of logic.

In addition to the influence of emotions on decision-making, recent research reveals that behavior and emotions can actually create neurological changes. The more people worry, the more they change the structure and size of parts of the brain, hardwiring them to worry even more. An insidious cycle can develop that places people on what we call the Worry Treadmill. The following summarizes research on this phenomenon.

Emotions: Problem or Solution?

Dr. Richard Davidson of the University of Wisconsin has studied the relationship between our moods and our brains. His research suggests that the activity in various parts of our brain predicts our moods fairly accurately.

Dr. Jon Kabat-Zinn, founder of the Mindfulness-Based Stress Reduction Clinic at the University of Massachusetts Medical School in Worcester, conducted an experiment on workers in a high-pressure business who complained of feeling highly stressed (no, he was not studying us). After Dr. Kabat-Zinn's two months of mindfulness training, brain scans demonstrated that the workers' emotions had shifted activity to parts of the brain that caused their moods to improve. As a result they felt more engaged in their work, and were less anxious.

At the University of Toronto, neuroscientists Helen Mayberg and Zindel Segal used imaging to measure activity in the brains of depressed adults. One set of patients received an antidepressant. Another set was subjected to cognitive-behavioral therapy in which they learned not to treat every setback as a disaster. All patients' depression lifted indicating that although moods are biologically influenced, the amount of pleasure and stress attained also can be affected by the thought patterns we learn and choose to practice.

Altering the Brain

In a stunning 1983 experiment underscoring the relationship between emotions and the brain, Dr. Michael Merzenich and a team of scientists at the University of California, San Francisco demonstrated that what a subject chooses to focus on can alter the physiology of the brain.² Their experiment subjected two sets of monkeys to identical physical and auditory stimulations. One set of monkeys was rewarded when the physical stimulation changed. The other set was rewarded when the auditory stimulation changed. After six weeks, the scientists compared the monkeys' brains. Those that paid attention to the physical taps expanded the part of their brain that processes touch by as much as three times. In the brains of the monkeys that paid attention to the sounds, however, the region that expanded was that area that processes sound.

Dr. Merzenich concluded, "Through attention, we choose and sculpt how our ever-changing minds will work: we choose who we will be in the next moment in a very real sense, and these choices are left embossed in physical form on our material selves." This experiment has striking implications for how we relate to money.

Treadmill or Escalator: The Choice is Yours

As we decide on which paths to take in our pursuit of satisfaction and happiness, we need to be mindful that our journeys can be sabotaged not just by our thoughts and how we process them but also by the impact of our thoughts on our brains which can add a physiological dimension to the Worry Treadmill. There lurks another treadmill identified in financial terms by researchers Philip Brickman and Donald Campbell. They call it the Hedonic Treadmill and explain, "As we rise in accomplishments and possessions, our expectations also rise. Soon we get used to the new level and it no longer makes us happy."³ It's not unlike being trapped in the question, "How much money is enough?" The answer: Just a little bit more...

How can mere mortals break out of the treadmills of worry and hedonism as we relate to our money and possessions? By making choices that remove us from those treadmills and place us on escalators that take us to new heights of satisfaction. One such choice is an investment strategy like ours that does not rely on the anxiety-producing gyrations of the market nor on the vagaries of individual stocks but rather on knowledge of capital market behavior and on managing risk. The brain research cited here suggests our investment strategy may promote your satisfaction since it can reduce stress by freeing you from having to focus on short-term market volatility and how much money you made or lost today.

Our strategy does not ask you to stress about the market, so you are free to focus on aspects of your life that bring you pleasure. Since money or possessions (beyond a certain basic and relatively low amount) won't buy happiness, what does bring you happiness? Is it spending more time with friends, family? Volunteering for charities? Enjoying the comfort of your home? Reflecting on the wealth we are blessed with?

The choices you make can hardwire your brain for elevated levels of satisfaction, happiness and enthusiasm. If you find yourself on the Worry Treadmill or if you want to build on your sense of satisfaction by reviewing the positive experiences you've been having lately, please give us a call.

¹ *Conversations with History* (Daniel Kahneman); Institute of International Studies, UC Berkeley February 7, 2007

² *How Thinking Can Change the Brain*, January 19, 2007; Page B1, Common Ground Common Sense

³ Brickman, P., & Campbell, D. T. (1971). *Hedonic relativism and planning the good society*. In M. H. Appley (Ed.), *Adaptation-level theory: A symposium* (pp. 287-302). New York: Academic Press.