

July 2008

Asset Class Returns

June 30, 2008 (YTD)

	2005	2006	2007	Last 10 yrs.	YTD 2008
Bonds (%)					
One-year	2.3	4.8	5.2	4.1	1.5
Five-Year	1.7	3.9	5.2	5.1	0.3
Intermediate	1.6	3.6	9.5	6.4	1.7
Long-term	6.6	1.7	9.2	7.0	-0.3
U.S. stocks (%)					
Large Market	4.9	15.7	5.4	5.8	-11.9
Large Value	10.2	20.2	-2.8	8.9	-10.6
Small Market	6.1	16.6	-3.1	9.0	-11.0
Small Micro	5.7	16.2	-5.2	10.6	-13.4
Small Value	7.8	21.5	-10.8	11.5	-10.4
Real Estate	13.2	35.3	-18.7	10.8	-3.4
International stocks (%)					
Large Market	13.5	24.9	12.5	8.6	-9.0
Large Value	15.3	34.1	10.2	13.0	-13.6
Small Market	22.0	24.9	5.6	14.3	-7.9
Small Value	23.2	28.4	3.0	16.2	-8.6
Emerg. Mkts.	29.9	29.2	36.0	16.0	-11.8

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.

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

Editor: Jeffrey C. Troutner
jeff@equiuspartners.com

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A Broken Record Can Play Sweet Music

Jeff Troutner, Equius Partners

Long-time readers of *Asset Class* might have noticed a shift in the content of our articles recently from fairly detailed explanations of the science behind what we do to more of the behavioral challenges we face with clients. There are a few reasons for this. First, Phil Jonckheer, the other Managing Director of Equius, is more of a right-brain guy than I am and I've encouraged him to write more so I can play more. Second, it seems to us that investor behavior has become more extreme over the past ten years or so and this is causing much of the volatility we've experienced—first with the growth stock bubble of the late 90's and now with the real estate derived problems in our debt markets that have spilled over to the economy and markets in general. Finally, the shift represents a formal recognition on our part that successful investing is 10% science and 90% behavior.

So, it was no surprise to us that a psychology professor who never took a course in economics could receive the Nobel Prize in Economics (Daniel Kahneman, 2002). Successful investing, quite simply, is about *successful behavior*. And in our world, *less behavior is better*. It's true of the science of our approach, which eschews active stock picking, sector bets, and country bets. It's also true on the behavioral side of our approach, which rejects market timing in any form and looks optimistically and unemotionally for "challenging" markets to return to normal and compensate our clients for taking appropriate systematic risks.*

We believe our intense focus on investor behavior is why Equius Partners is enjoying greater growth today, both qualitative and quantitative, than at any time in our history. Investors are looking for a more stable, predictable, and balanced investment experience. They're sick of hearing "this time is different" while being sucked into the investment du jour by a big Wall Street brokerage firm.

They're also increasingly aware of the lack of substance most advisory firms represent—habitual and unrepentant trend following that seems to take its direction from the mass media, while leading investors over the next financial cliff. In a macabre sort of way, it's nice to see the trend sellers finally taking massive financial (and, in not enough cases, criminal) hits for overindulgence in the silly games they were promoting. Unfortunately, a lot of good people were taken down with them.

Why Try to Outguess the Market?

There are a lot of very smart people in top universities using really good computers to analyze exceptionally well scrubbed financial data on the U.S. and foreign markets. And the state-of-the-art of this body of research concludes that there are only a few systematic risks that reward investors over time. Systematic risks are those that cannot be diversified away and they are limited to market risk (the risk of stocks in general), small company risk, and price risk (the difference between high priced growth stocks and low priced "value" stocks). All other risks can be diversified away and have been shown to add no value to investors in the aggregate over time.

Yet it is *unsystematic* risks that are sold to and bought by the vast majority of investors. Why? They're appealing—emotionally (they elicit varying degrees of fear

and greed), intellectually (only on the surface), and comfortably (everybody seems to be doing it). We witnessed this in the late 90's with the promotion of technology and Internet stocks; in the following years with real estate investments (both real property speculation and securities); and more recently with hedge funds and commodities. The latest developing trend appears to be away from U.S. stocks and toward foreign stocks, especially emerging markets—not as a compliment to a well structured and well diversified portfolio, but as a core, long-term (ha, ha) strategy.

So What's the Alternative?

It's boring, I know, but the answer to the tough times we're going through and the lure of the emotional appeals to change your strategy is...do nothing. Well, almost nothing. Rebalance your core asset class portfolio if necessary, be patient, and let the markets work for you. Remember, you're invested in the highest quality short-term bonds without "yield enhancing" gimmicks and you are broadly diversified among the core asset classes in a way that ensures you will participate in global economic growth over time. Companies will continue to grow earnings. People will continue to work hard to improve their lives. They innovate. They create. They become more productive. *They move forward.*

The challenges we face today are real and we're not immune at Equius to some of the same feelings of concern as our clients. We, however, have a couple of advantages. First, we read the financial news or listen to the talking heads on radio and television *for entertainment purposes only* and to get a sense of what some of our clients might be hearing. Second, we have lots of good data to review and analyze. It's the underlying theories and logic supporting the data that are the sources of our optimism.

Here's some data to consider. The table on the right shows all the negative 12-month real returns for a portfolio of 30% U.S. large, 30% U.S. large value, 20% U.S. small, and 20% U.S. small value stocks since 1945 (June ended).** These returns are followed by the annual return for the next 5 years, 10 years, and for a total 11-year period (the negative year + the next 10).

With the exception of the 1969-1970 period, markets provided very good to exceptional real returns for the years following and including the bad year.

The verdict is out, of course, on whether the recent 2002 and current 2008 declines produce subsequent returns similar to the majority of these past periods or whether we experience another 1969-1970 cycle.

For those in retirement who have met their goal for accumulated wealth and have a margin of safety built in for inflation and increased living expenses, the risk of further declines might not be worth it. In those cases, a portfolio of very high quality short-term bonds would be appropri-

ate. Those investors who are still accumulating wealth and have longer time horizons to recover from market declines should continue to invest in a structured and disciplined way and avoid the temptation of market timing.

Balanced U.S. Stock-Only Portfolio Real Returns (after inflation)				
Year Ended June	1 Year	Next 5 Years (Annual)	Next 10 Years (Annual)	Total 11 Years (Annual)
1947	-32.8%	14.0%	15.0%	9.5%
1949	-16.7%	19.6%	19.3%	15.4%
1958	-2.8%	12.1%	13.9%	12.3%
1960	-6.3%	11.4%	6.0%	4.8%
1962	-14.0%	17.2%	9.8%	7.4%
1969	-3.5%	-7.5%	1.4%	0.9%
1970	-33.9%	3.9%	5.7%	1.3%
1973	-15.2%	5.3%	9.5%	7.0%
1974	-17.9%	11.1%	10.9%	7.9%
1982	-17.4%	24.7%	13.9%	10.6%
1984	-6.6%	14.2%	10.6%	8.9%
1988	-7.9%	9.1%	14.2%	12.0%
2002	-9.8%	11.8%	?	?
2008	-26.1%	?	?	?

We did not include foreign stocks in the simulated portfolio due to their shorter returns history (early 70's for MSCI EAFE and early to late 80's for foreign small and emerging markets). The diversification benefits of global diversification tend to limit downside and volatility risk and enhance long-term returns. An allocation to short-term fixed income securities would reduce overall portfolio risk as well.

It is often said that while capitalism is not perfect, it is better than the alternative. This is certainly true of asset class investing. We'll continue to sound like a broken record—one that keeps playing sweet music, not seductive siren calls—and that's *much* better than the alternative.

*In case you're wondering, optimism is generally not considered an emotion, but rather primarily a cognitive activity based on logical, rational facts.

** U.S. large = S&P 500 index; U.S. large value = Dimensional US Large Cap Value Index; U.S. small = Dimensional US Small Cap Index; U.S. small value = Dimensional US Small Cap Value Index. **Past performance is not a guarantee of future results. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.**