

## Asset Class Returns

November 30, 2008 (YTD)

	2005	2006	2007	Last 10 yrs.	YTD 2008
<b>Bonds (%)</b>					
One-year	2.3	4.8	5.2	4.1	3.0
Five-Year	1.7	3.9	5.2	5.1	2.4
Intermediate	1.6	3.6	9.5	6.4	8.0
Long-term	6.6	1.7	9.2	7.0	12.5
<b>U.S. stocks (%)</b>					
Large Market	4.9	15.7	5.4	5.8	-37.5
Large Value	10.2	20.2	-2.8	8.9	-42.7
Small Market	6.1	16.6	-3.1	9.0	-39.0
Small Micro	5.7	16.2	-5.2	10.6	-40.1
Small Value	7.8	21.5	-10.8	11.5	-39.9
Real Estate	13.2	35.3	-18.7	10.8	-46.5
<b>International stocks (%)</b>					
Large Market	13.5	24.9	12.5	8.6	-45.3
Large Value	15.3	34.1	10.2	13.0	-50.1
Small Market	22.0	24.9	5.6	14.3	-48.1
Small Value	23.2	28.4	3.0	16.2	-46.5
Emerg. Mkts.	29.9	29.2	36.0	16.0	-52.9
<b>Descriptions of Indexes</b>					
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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## Who Can We Trust?

*Jeff Troutner, Equius Partners*

The hits just keep on coming...

Sadly, I'm not talking about Top 40 radio hits. Since my article last month on the culpability of our federal politicians and their appointees in the current economic crisis, we have now witnessed the Illinois governor apparently attempting to sell President-Elect Obama's vacant Senate seat and a prominent investment advisor pulling off the world's largest Ponzi scheme (that is, if we don't count Social Security).

I'm starting to feel like I'm in a Twilight Zone episode. Is this really happening? Have our politicians all become so intoxicated with power to the point where they're all corrupt? Has so much money and so much prosperity been pumped into the global economy that greed has completely taken over—from mom and pops flipping condos to the rich and supposedly-smart putting money into a "too-good-to-be-true" scheme with no questions asked? What the heck is going on around here? What we are witnessing is a level of greed and political corruption that, in monetary terms, is almost beyond belief.

### Politicians

To get an idea of what the culture in Washington is like today, consider this recent quote from a prominent Congressman:

***"The problem in politics is this: you don't get any credit for disaster averted."***

Rep. Barney Frank's comment on "60 Minutes" 12/14/2008

I think that pretty much sums up the current financial crisis and our politicians' role in not helping to avert it. Frank was a major player in allowing Fannie Mae and Freddie Mac to grow to ridiculous proportions, lower their credit standards, and engage in accounting fraud. Now, true to his words, he is all over the airwaves denying responsibility for his role in the disaster and trying hard to take credit for the cleanup. Is "pitiful" a strong enough word to describe this?

***"If something were really wrong, wouldn't someone in the government do something?"***

Fannie Mae CEO Franklin Raines, 2002

Apparently not. And multi-billion dollar accounting fraud isn't enough to land you in jail if the company for which you are the CEO is effectively controlled by politicians that you, in turn, control through massive lobbying. Is "madness" a strong enough word to describe this?

The sad fact is, Fannie Mae and Freddie Mac were (are?) places "where former government officials went to get wealthy and to wait for new federal appointments."<sup>1</sup> And we're appalled by Illinois governor Rod Blagojevich's apparent attempt to sell President-Elect Obama's vacant Senate seat?

Greed is not the sole province of Wall Street bankers or corporate CEO's. Greed is arguably a much, much larger problem and a much more pervasive trait of our political class. I strongly encourage anyone who doubts this to read the articles posted on our web site. Click on the "Credit Crisis Reading List" box. You'll find articles from liberal, conservative, and non-partisan publications. To cut right to the greed of the matter, read the Slate article titled,

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[“Fannie Mae and the Vast Bipartisan Conspiracy, A list of villains in boldface.”](#) For a taste of how long politicians have ignored the 900-pound gorilla in the corner, read Slate’s [“A Medici With Your Money.”](#) This should not have happened.

### Bernie Madoff

I wrote an article for *Asset Class* in June 1995 titled, “Trust Me,” which highlighted the billion dollar fraud perpetrated by the New Era Foundation and John Bennett. I also wrote a follow-up article in March 2004 after a client dinner presentation that featured DFA’s Gordon Murray talking about the Wall Street culture at Goldman Sachs, Lehman Brothers, Merrill Lynch, and others. My point of that article was that “government regulators and Wall Street executives are not going to fix the problems of greed, fiduciary mismanagement, and self-dealing that are rampant in the industry. The solution lies with informed investors who reject the marketing facades, have self-educated themselves to some degree, and take control of their financial destinies.”

Unfortunately, some very rich, well-connected, and supposedly smart people trusted Bernie Madoff, a prominent broker and advisor in New York and have lost as much as \$50 billion as a result. Amazingly, at least two major consulting firms charged with screening advisors like Madoff for their clients and the SEC fell for this scam as well. None of these “professionals” understood how Madoff was producing his investment results and no one verified that client assets even existed. As the *Wall Street Journal*<sup>2</sup> has pointed out in a series of articles, the red flags were many. All, apparently, were ignored.

### Trust

In our initial discussions with prospective clients, we emphasize trust in an investment relationship. But we emphasize trust in the *investment process*, not a person or a track record—just the opposite of what we see in the Madoff case. Why? Because we know returns in any strategy related to the stock market are *variable*. And unless clients know where returns come from and begin to develop a certain level of confidence in the *process*, they will allow their emotions to take over in difficult times—they will lack the discipline to stay with the strategy.

This is why Madoff would always show very steady (although abnormally high) returns. His clients *bought the returns* and *trusted* that he, Madoff, would continue to produce them. I guess ignorance really is bliss, until the Ponzi scheme is revealed.

### Alternative Investments

In most cases, I’m sure, Madoff’s clients were pursuing an “alternative” investment. This has been the major trend since the Internet bubble burst in 2000. Hedge funds, private equity, venture capital, commodity funds, and other alternatives to boring stock and bond portfolios exploded in popularity. The trend also spawned an offshoot called a “fund of funds” in which a third party with special skills and insights (yea, right) picked the best investment advisors in various categories, packaged

them together, added another layer of fees and sold them to clients and other advisors.

Much of this demand was fueled by publicity surrounding well-connected endowments, such as Yale’s. In fact, many investment advisors (including some who allegedly believe in structured asset class investing using DFA funds) have adopted an “endowment” approach by adding many of these products to their client portfolios. I’m sure they and their clients are questioning the timing of such an approach, but therein lies the danger of putting marketing before tried and true investment principles.

These advisors often rely on third-party consultants to screen alternative investments. In the Madoff case, both Tremont Capital Management (a hedge fund subsidiary of Oppenheimer Funds) and Fairfield Greenwich Group failed to perform even the most basic due diligence on Madoff for their clients. And this despite the fact that Fairfield was paid \$160 million in fees relating to the Madoff investments in 2007!

### Lessons

If the Internet bubble offered investors a Masters-level education in prudent investing principles, the current environment should be thought of as a Doctorate-level degree—for those willing to learn. Here are a few things I would take away from this series of financial and political debacles:

1. Politicians on the whole are just as greedy as the Wall Street executives they pretend to loathe—but tragically they control much more money and are seldom held accountable.
2. Nothing substitutes for clarity and transparency in the investment business. Seek both, rather than abnormal returns.
3. Invest your time before you invest your money. Otherwise you have no one to blame but yourself.
4. Trust the investment strategy first, then...
  - Expect your advisor to *earn* your trust that he or she will execute it faithfully.
5. Don’t rely on social or religious affiliations, glowing testimonials, third-party referrals, or letters after a name to protect you.
6. Don’t rely on government agencies or “regulation” to protect you.
7. Avoid “one-stop-shops.” Hire a sound advisor with a sound strategy, maintain an independent accountant and attorney, and make sure a high quality and totally independent custodian holds your assets.
8. Stay optimistic. The vast majority of people are good, ethical, responsible, and caring of their fellow human beings. Let’s not allow the greedy fools to prevail.

<sup>1</sup> How Washington Failed to Rein in Fannie, Freddie, *Washington Post*, 9/14/2008

<sup>2</sup> <http://online.wsj.com/public/page/bernard-madoff.html>