

Asset Class Returns

September 30, 2009 (YTD)

	2006	2007	2008	Last 10 yrs.*	YTD 2009
Bonds (%)					
One-year	4.8	5.2	4.0	3.9	1.9
Five-Year	3.9	5.2	4.0	4.5	4.0
Intermediate	3.6	9.5	12.9	6.7	-0.1
Long-term	1.7	9.2	22.5	7.8	-7.2
U.S. stocks (%)					
Large Market	15.7	5.4	-37.0	-3.1	19.3
Large Value	20.2	-2.8	-40.8	0.0	25.4
Small Market	16.6	-3.1	-36.0	4.2	31.9
Small Micro	16.2	-5.2	-36.7	5.5	24.8
Small Value	21.5	-10.8	-36.8	6.2	29.9
Real Estate	35.3	-18.7	-37.4	3.7	17.6
International stocks (%)					
Large Market	24.9	12.5	-41.4	-0.4	27.8
Large Value	34.1	10.2	-46.3	2.8	39.6
Small Market	24.9	5.6	-43.9	5.8	41.3
Small Value	28.4	3.0	-41.7	7.7	42.3
Emerg. Mkts.	29.2	36.0	-49.2	8.6	59.9

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 12/31/08.

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Unconventionally Committed

Jeff Troutner, Equius Partners

Equius Partners has been swimming against the conventional Wall Street tide since our founding, and from what we're reading in the press these days, our job isn't about to get any easier. Depending on your source, Obama is a socialist, capitalism is dead, efficient market theory is a hoax, the earth will melt down within five years, everyone on Wall Street should be hung (okay, I'll buy that one), inflation is going to 20%, gold to \$2,000 an ounce, and the emerging markets are our only financial salvation. Gee, you might think we just went through the worst economic and market decline since the Great Depression!

It's gotten so crazy that Mr. Big Government/Anti-Wall Street himself, Paul Krugman, the economics writer for *The New York Times*, just penned the most pro-Wall Street article ever—without even knowing it. In his zeal to promote Keynesian economics in support of the current administration's stimulus policies, he attacks economists at the University of Chicago who have the audacity to believe in efficient markets.¹ In the process, he concludes that all investors are not perfectly rational; markets are not perfect or inherently stable; and efficient market believers can't predict future market trends (please hold your Duh! for just a moment).

Krugman's not the only one to fall for the "this time it really, really *is* different" affliction. But his article is important for its tone (personal attacks); its misunderstanding and rejection of the most highly-regarded financial theory of the past 50 years (efficient market theory); its hyperbole (he uses variations of "perfect" and "rational" 38 times in the article); its forum (*The New York Times*); and its conclusion: that economists "have to face up to the inconvenient reality that financial markets fall far short of perfection." As you let out that resounding Duh! now, let me point out that this is (sadly) the style of most of the financial articles published today.

Optimal, Not Perfect

Capitalism and free markets are not perfect, but they have consistently been shown throughout history to be better than the alternative. This is due to the fact that there is *wisdom* in crowds. In other words, the more people there are weighing in on a certain decision, the more optimal that decision tends to be. Not all participants in the decision need be experts, rational, or even very knowledgeable at all. They just need an opinion derived from *something*. That something could be fear, greed, ignorance, knowledge, self-interest, charity, or whatever. The more diverse the views, the better.

James Surowiecki does a masterful job of explaining all of this in his book, *The Wisdom of Crowds*. The essential message is that large groups of people

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are smarter than an elite few, no matter how brilliant—better at solving problems, fostering innovation, coming to wise decisions, even predicting the future.

From an investment point of view, those who do not believe in the wisdom of crowds argue that a relatively few really smart people would do a better job than “the crowd” (also known as “the market”) of allocating capital and scarce resources, setting compensation levels at firms, controlling financial markets, and just about everything else. Their assumption is that these elites have all the answers; are “perfectly” rational and moral; are not susceptible to greed and blind self-interest; and are devoid of the personal biases, bad behaviors, and other negative traits that the little people possess. This view is the very definition of hubris.

Accepting that markets are not perfect and investors are not all or always rational, we have essentially two investment paths we can take. One is to try to outsmart everyone else and exploit the imperfections and inefficiencies for above-average profit. The second is to allow all the supposedly smart people to compete with one another for these profits in a free and very active exchange, take advantage of the equilibrium in prices that develops as a result, and reap the *long-term* benefits through broad diversification and investment discipline.

“A foolish faith in authority is the worst enemy of truth.”²

We are grateful for the vast majority of investors and their advisor authorities (be they stock brokers, registered investment advisors, or mutual fund companies) who are fully engaged in trying to outsmart each other. The evidence is clear that they fail in the aggregate to *our* advantage. Most are involved in some sort of speculation, disguised as investment, and simply end up fueling the revenues of Merrill Lynch, UBS, Fidelity, AllianceBernstein, and all the others, while reliably underperforming simple market indexes.

This is the greatest crime on Wall Street—not the outsized salaries and bonuses that consume so much hot air and print. Wall Street is engaged in a conventional, established, institutionalized lie: that what they advocate is investing, rather than speculation.³ Nowhere is this more tragic than in the 401(k) market where participants rely on those in authority at their own companies, at the mutual fund companies, at third-party administrators, and at consulting firms to tell them the truth. Instead, they are being consistently lied to and manipulated. If you want to make a real difference, Mr. Krugman, put truth to that lie.

Keeping Our Heads as All Around Us Are Losing Theirs

Asset class investing is not perfect, if perfect means that investors expect all the upside of the strategy

without the risk of markets like last year. It can't happen. Yet we are seeing for the first time since we embraced this strategy in the early 90's that many of our asset class investing peers are either giving in to their own fears and the fears of their clients or “enhancing” their strategies based on marketing/business reasons instead of value-added ones.

This is quite different from being *sympathetic* to fears and concerns and effectively counseling clients through the tough periods or using better investment tools to positively alter the risk/return characteristics of a portfolio. The value-added of asset class investing is derived from both the sound science of efficient markets and by modifying investor behavior. We can't learn how to beat markets from behavioral finance. We can learn how to identify and deal with investor emotion and irrationality in a positive way.

Investing in ETFs that are based on inferior underlying indexes might earn you an ETF-marketing merit badge, but it doesn't add value for your clients, no matter how much you might discount your fee. Introducing a market timing overlay to your strategy might show that you are “prepared” for the next downturn, but it's more likely to cost your client significant money in the long-run. Changing a client's stock allocation *after* a significant decline and increasing it once the client *feels* better might help you keep the relationship (and it's arguably better than mood-altering drugs), but it comes with a very steep price to the client.

This is a tough business in good and bad times. We don't have all the answers and we don't always handle every client situation just right. When markets are as historically volatile as they've been lately, the client/advisor dynamic can be particularly challenging. But by sticking to sound principles, evidence-based strategies, and committing to doing the right thing for clients *first*, we've survived and thrived along with our clients using an unconventional investment approach. That it *is* unconventional, and likely to remain so, is sad indeed.

¹ Paul Krugman, “How Did Economists Get It So Wrong,” *The New York Times*, September 6, 2009. John Cochrane, University of Chicago, “How did Paul Krugman get it so Wrong?,” September 16, 2009. Links to both articles can be found on the Equius Blog at www.equiuspartners.com

² Albert Einstein

³ As I've written in previous *Asset Class* articles, I have no problem with speculation. Just call it what it is. Predicting that this stock will outperform that stock, or the market will go this way or that way, or that this fund will outperform that fund—in conventional Wall Street terms—is speculation, not investing.



A Dose of Stock Market Reality

Eric Nelson, Equius Partners

With two of the five most severe bear markets in the last 80 years occurring this decade, some investors are questioning the role of stocks in their portfolios. According to the Investment Company Institute, individual investors pulled more than \$205 billion from stock funds between September of 2008 and March of this year, and only \$56 billion has returned since April.

Stock Market Skeptics

This latest bout of stock phobia differs from previous episodes in that several professional investors and academics have come along for the ride, going so far as to question stocks as a viable long-term investment. Prominent investment managers Bill Gross and Rob Arnott have argued we are entering an era where stocks no longer are expected to outpace bonds, and successful investing today requires an emphasis on “tactical allocation” (aka market timing). Of course this is a convenient position for the largest bond fund manager in the country (Gross) and the manager of a market timing mutual fund (Arnott).

MIT professor Andrew Lo has publicly challenged the basic tenets of portfolio theory, arguing that we face a new investment paradigm requiring “tactical risk management” and “more sophisticated financial technologies.” If this sounds complicated, don’t worry. Lo has started a hedge fund to offer strategies on which these technologies are based. One of the most extreme anti-stock positions has been taken by Zvi Bodie at Boston University. Bodie believes that investors should basically have 100% of their money in Treasury Inflation Protected Securities and avoid stocks altogether. If you wonder how you might live on as little as a 1% inflation adjusted return, you’ll have to buy his book “Worry-Free Investing” for the answer.

A Dose of Reality

Because we believe a permanent commitment to a diversified equity portfolio for some portion of their wealth is essential for every one of our clients, it is worth the effort to inject some reality into this debate:

Reality #1: Asset class diversification is essential

Without fail, any research or commentary relating to the stock market is defined using only the S&P 500 Index. Despite holding 500 different companies, the index is market capitalization weighted and its return is

dominated by a relative handful of the largest and highest-priced companies. Like other asset classes, these stocks have gone through long periods of underperformance. The answer is not to avoid stocks entirely, but to diversify across stock asset classes.

Looking specifically at the two most challenging periods for stocks in the last half century (Table 1) we see the benefit of adding large and small value stocks to the S&P 500. During periods when the S&P 500 has failed to deliver positive returns in excess of inflation, a multi-asset class approach produced an improvement in returns of 5% to 6% per year. The long-term diversification benefits of asset class investing can often appear when needed most.

Table 1: Diversification Benefits Beyond the S&P 500

Period	Inflation	S&P 500 Index	Multi-Asset Class Portfolio*	Multi-Asset Class Advantage
1966-1982	6.8%	6.8%	12.0%	5.2%
2000-8/2009	2.6%	-2.0%	4.3%	6.3%

Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. *30% S&P 500, 30%, DFA US Large Value Index, 40% DFA US Small Value Index.

Reality #2: Bonds are riskier than you think

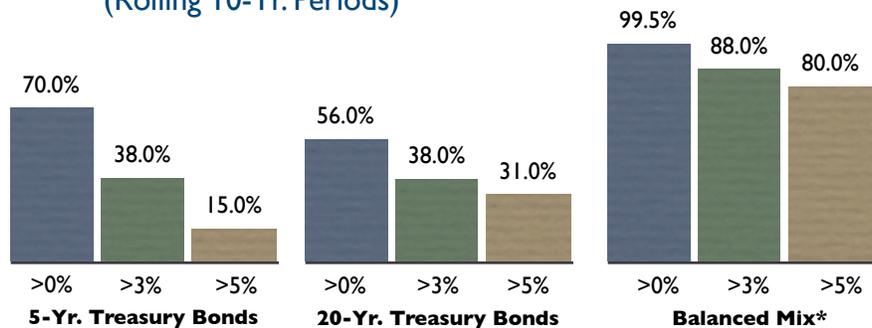
In an attempt to avoid the short term uncertainty and potential loss of stocks, some are considering bond-only alternatives. But this ignores an important element of risk. Investors aren’t just concerned with short-term losses, but also long-term growth in excess of inflation. In this regard, bonds are very risky indeed.

Chart 1 on the next page illustrates the inflation-beating potential of a balanced asset class portfolio compared to short-and long-term Treasuries.¹ An oft-quoted criticism of stocks is that they went through a 17-year period when they simply matched the rate of inflation (the S&P 500 index from 1966-1982). Yet, 20-year bonds have gone through a period of over 50 years when they generated no real return (1940-1990).

For the typical investor needing to grow their wealth at a reasonable 3% to 5% or more in excess of inflation, a much better alternative is a balanced asset class portfolio. A diversified mix of stocks and bonds does have greater risk of loss in the short term, but has histori-

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Chart 1: Chance of Beating Inflation by 0%, 3%, & 5% Per Year (Rolling 10-Yr. Periods)



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cally provided much more consistent and satisfactory inflation-adjusted growth.

Reality #3: Bear markets can't be avoided, but they can be managed

As difficult as bear market are to tolerate, they are always made worse by the reality that each downturn is caused by a completely new and unique set of circumstances, creating the feeling that “this time it’s different.” The Great Depression saw massive deflation caused by monetary contraction, coupled with dangerous trade protectionism and a failure of the banking system. Forty years later, the mid 70’s saw rampant stagflation with a quadrupling of oil prices. More recently, we experienced the bursting of the technology “bubble” and the 9/11 terrorist attacks that shook our financial system to its core.

But the uncertainty regarding future events and their market impact is not an excuse to avoid stocks. Instead it requires a process to avoid being unduly punished by their decline. For most of our clients, we include a healthy allocation to short-term high quality bonds. Bonds serve to dampen the losses associated with bear market declines. Furthermore, when bond allocations rise disproportionately (usually as a result of stock market declines), we are able to rebalance back into stocks at lower prices and higher expected returns. For

clients in retirement who need to withdraw funds, we are able to sell bond fund shares to meet cash flow needs as we wait patiently for the stock market to recover. This fixed-income safety cushion allows us to react to changing market environments without being forced to predict them ahead of time.

Reality #4: When prospects for stocks seem most dire, they have their highest expected returns

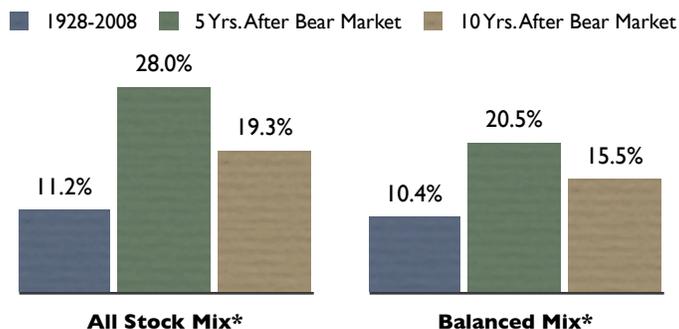
The greatest stock market skepticism tends to surface after significant declines when lower prices represent much higher expected future returns. Looking at 5- and 10-year periods after each of the last four serious bear markets (Chart 2), we see that asset class portfolios have tended to deliver much higher than average returns when the economic and market environment appears most uncertain. Investors who liquidate stocks and wait for things to improve run the substantial risk of missing much of the recovery in stock prices.

Even diversified asset class portfolios can test the will of the most patient and disciplined investor. *Stock market returns wouldn't be as generous if this weren't the case.* After sizable market declines, Monday-morning quarterbacks proliferate. But with a diversi-

fied portfolio and strict adherence to an asset class process, we believe investors will be supremely rewarded. We cannot predict the future, but we can be prepared—which includes tuning out irrational stock market skepticism.

¹Purposely excluded from this analysis were TIPS, which provide inflation protected income over the life of the bond. Currently, short term TIPS only offer yields of 0.7% in excess of inflation, while 30-year maturities only yield 2.1%. Consider that the *worst* 30-year inflation adjusted return for the balanced asset class portfolio was +5.2% per year.

Chart 2: Low Prices = Higher Expected Returns



Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. *All Stock Mix = 30% S&P 500, 30% DFA US Large Value Index, 40% DFA US Small Value Index. Balanced Mix = 35% 5-Yr. Treasury Index, 19.5% S&P 500, 19.5%, DFA US Large Value Index, 26% DFA US Small Value Index. A bear market is defined here as a drop in the S&P 500 index of 40% or more.