

**EQUIUS**

PARTNERS

Adding Balance to Wealth<sup>SM</sup>

# ASSET CLASS<sup>SM</sup>

An update of performance, trends, research, &amp; topics for long-term investors

**Asset Class Returns**

June 30, 2009 (YTD)

	2006	2007	2008	Last 10 yrs.*	YTD 2009
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**Bonds (%)**

One-year	4.8	5.2	4.0	3.9	1.3
Five-Year	3.9	5.2	4.0	4.5	1.5
Intermediate	3.6	9.5	12.9	6.7	-2.4
Long-term	1.7	9.2	22.5	7.8	-11.2

**U.S. stocks (%)**

Large Market	15.7	5.4	-37.0	-3.1	3.3
Large Value	20.2	-2.8	-40.8	0.0	2.8
Small Market	16.6	-3.1	-36.0	4.2	8.6
Small Micro	16.2	-5.2	-36.7	5.5	4.6
Small Value	21.5	-10.8	-36.8	6.2	2.4
Real Estate	35.3	-18.7	-37.4	3.7	-12.1

**International stocks (%)**

Large Market	24.9	12.5	-41.4	-0.4	7.6
Large Value	34.1	10.2	-46.3	2.8	12.3
Small Market	24.9	5.6	-43.9	5.8	17.4
Small Value	28.4	3.0	-41.7	7.7	14.4
Emerg. Mkts.	29.2	36.0	-49.2	8.6	31.5

**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.

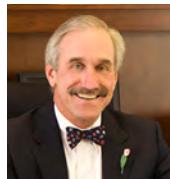
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**June 2009****Taking U Out of Anxiety***Phil Jonckheer, Equius Partners*

This past week I've witnessed Jeff face one of the deepest sadness that confronts us mortals: The loss of a dear friend. In this case, Daisy also was his first client. Daisy's passing really set in hard as Jeff bore her casket. It will take time and reflection to work through his grief so that Jeff can return to a more conscious place of peace in a world without Daisy. As I observe what Jeff is processing, what I appreciate more than ever is how important it is to honor the powerful emotion of sadness so that it does not turn into a more pervasive mood of depression.

As Jeff worked through his feelings, I've become more conscious of the powerful emotion of anxiety that our clients have experienced as the markets gyrate through their gut-wrenching cycles. I have witnessed all too often that in an anxious state it is virtually impossible to think rationally. In order to ensure that anxiety does not lead to behavior that encourages a loss-provoking investment decision about their portfolios, clients gripped with that feeling must pursue a path similar to that which Jeff consciously chose to deal with Daisy's passing: Taking the time to face the anxiety instead of denying that powerful feeling and trying to run away from it.

Psychological evidence indicates that the intensity of anxiety is U-shaped with respect to time, meaning that the initial threat and attendant anxiety is felt with great intensity. It is at that point that one is most vulnerable and needs to sit with that emotion. If it is not dealt with directly, the feeling of anxiety wanes over time but can return with a vengeance as the anticipation of the threatening event ignites the emotion again, creating the "U". Stock markets cycles are therefore perfect catalysts for this pattern.

There are plenty of investment options that offer an anxious person the opportunity to change an investment plan with the hope of finding solace. Keep in mind that the "professionals" offering those options are not only playing on clients' feelings, they also are projecting their own anxieties about what they are processing as humans. Most solutions set forth by those professionals might feel right but must be considered in light of the fact that they source from places of anxiety, fear and/or greed. (Eric speaks to some apparent "solutions" in the following piece). It is normal to seek relief from market declines. Running from anxiety, however, won't alleviate it longer-term. Facing anxiety is the only way to salve it.

If investors would spend the time and attention taking care of their anxiety the way they assiduously construct their investment plans, there would be much less damage done to those plans. In an anxious state what needs to be addressed is not the investment plan, it's the anxiety.

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We've also observed that this recent market swoon has upheld what we're labeling Investment Darwinism. Those who panicked, those who ignored the value of knowledge-based plans, those who let their emotions lead them most likely will find their portfolios and/or their businesses decimated by their decisions. We say businesses because this concept of how to ensure survival in the investment world applies not just to clients of advisory firms, it includes the firms as well. We're pleased to report that as a result of working through this market decline by fully embracing the knowledge that always has guided us and with full consciousness of the anxiety that naturally grips us as humans, our client base is stronger, our team is more committed than ever to our philosophy and therefore our firm is as fit as ever.

Lest we leave you with an impression of nirvana, let me reassure you that the path we've taken has not been an easy one. Any client lost is a blow to us and, sadly, we did just lose a client to a market timer. We consider this a shared failure in that although it is clear the couple did not invest the intellectual capital to comprehend fully the risks and cost of market timing, we feel a loss in that our efforts to educate them did not bear fruit. Our ex-clients will be forced to deal with the double "U" of anxiety as they now get to worry not just about exiting the markets but also about reentering them at the right moments.

The reason for our collective confidence is largely explained by universal truths that source from evidence-based research, not the feelings-based hunches triggered by powerful emotions. Those emotions can trick the mind into believing that whatever appears to salve the feeling du jour is the absolute truth, especially when that feeling wears the cloak of rationality. Our philosophy consistently has withstood the enormous pressure constantly placed on it by the various "different-this-time" scenarios.

From that variegated history what we confidently conclude, what in fact is irrefutable, is that risk and return are related. This is not a fact that we've concocted. This is not our opinion. This is a demonstrated, researched principle of how capital markets consistently value investment opportunities. We've seen how violently the downside of risk can affect returns. Upturns can be equally concentrated and vigorous. In the face of those dramatic yet understandable gyrations we remain confident that risk, if properly held, will be rewarded. The way to properly hold risk is through a structured asset class portfolio that methodically maintains a risk profile through disciplined rebalancing. Investors cannot run away from risk and still maintain any consistent semblance of returns needed to support their objectives.

We also understand that since the negative pang of pain is felt more intensely than the positive high of happiness, it's all too easy for people to believe that their investment

plans must change when pain is experienced. In that state, people will use any excuse to justify any change—even going as far as to embrace a totally unfounded opinion such as "the market will take decades to recover." The truth, however, is that no model, and certainly no human, can predict the markets' paths with certainty and consistency.

It now is much clearer to us that in periods of high anxiety where information is particularly uncertain and/or perplexing investors wage more than a battle between their knowledge base and their feelings. They engage in a war between their consciousness and their unconsciousness. In anxious states, convenient unfounded rules of thumbs (what psychologists call heuristics) begin surfacing with uncanny regularity. Unfortunately, those heuristics frequently fail to uphold their rules and can seriously compromise portfolio returns. Equally devastating to portfolios are the tendencies of anxious investors to base long-term decisions on short-term information such as buying into a strategy that has experienced recent short-term success. This is what psychologists call the law of small numbers. Unfortunately what results from this behavior are smaller portfolios.

I imagine that in varying degrees all of us are seduced by short-term, convenient, emotion-based "solutions" that appear to relieve our anxiety about the uncertainty that shadows all markets all the time. In the face of those sirens we offer this: honor your anxiety for the powerful emotion it is without feeling that you need to make a decision about it. That will allow you to respect the markets for what they are: unforgiving mechanisms that reward patient investors who have taken the time to build a base of knowledge founded on research, not opinions.

### By The Way...

In Jeff Troutner's article, "Past Declines & Their Recoveries," in the February 2009 issue of *Asset Class*, he wrote:

"...the market gods torture the market timers and challenge long-term investors by slamming stock prices over the last few months of the decline and then sending stocks skyward almost immediately."

Even *we* were amazed at how prescient this was as stock prices nosedived in March and have recovered so dramatically since. Here's how our core stock funds have performed since the low of March 9<sup>th</sup> (through June 26th):

DFA U.S. Large Company	+36.3%
DFA U.S. Large Value	+54.0%
DFA U.S. Small Value	+56.3%
DFA International Value	+62.0%
DFA International Small Value	+47.6%
DFA Emerging Markets	+55.6%

Of course, these gains have not fully recovered the losses in these funds since mid-2007 and they are no guarantee of future returns, but it's a start and we'll take it.



# Too Much of a Good Thing?

A Critical Look at Gold & Commodities

Eric Nelson, Equius Partners

In less than a decade, many investors and advisors burned by the tech stock collapse have transitioned from concentrated U.S. large growth stock portfolios to excessively diversified asset allocations including sizable commitments to alternative strategies. Equius has always been an advocate of broad-based diversification, and we've been consistent in our efforts over the years to develop asset class portfolios that include large, small, growth, and value stocks in the US and foreign equity markets. In most cases, we also use short term, high quality global bonds to control risk.

But is there such a thing as too much diversification? Most Wall Street marketing departments today would say no, but we disagree. It's not that we're opposed to adding new strategies where they make sense. But based on a rigorous ongoing analysis and an objective point of view, we don't see any value-added of including alternatives (hedge funds, private equity, etc.), and other securities such as REITs, gold, commodities, or TIPS (inflation-protected bonds) that are popular in so many investors' over-diversified asset allocations. We've covered our REIT-reluctance a number of times over the years, and last month's *Asset Class* highlighted our rationale for avoiding TIPS. Next up: gold and commodities.

## Gold

A long-term portfolio should consist of **core investments** from which a realistic expected return can be derived. Based on 80 years of financial markets experience in the U.S. and reams of academic research, we've determined that those core investments are 1) short-term, high-quality bonds and 2) a well-balanced, highly diversified basket of stocks.

Anything we add to the portfolio, like gold, has to result in a reduction in one or both of those two core investments, so we need solid evidence of value-added to make a change. And since *our* crystal ball tends to be as consistently fogged as a summer day in San Francisco, *speculation* has absolutely no place in our analysis.

So, to consider gold, let's look first at the effectiveness of our core investments as inflation hedges and use the modern era of 1970 to today as our guide. As Table 1 shows, the diversified stock portfolio outpaced inflation by over 7% per year, while short-term Treasuries and gold stayed ahead of inflation by around 4%. Since we emphasize short-term fixed income as the logical hedge against infla-

tion, let's leave stocks aside and give gold the slight advantage so far (0.3% per year over Treasuries).

Now let's look at volatility as a measure of risk. Running the standard deviation of the annual returns (how much the annual returns vary from their average over time), we see in Table 2 that gold is 4.5 times more volatile than 5-year Treasury Bonds! That's a pretty steep price to pay for 0.3% more return, don't you think?

**Table 1: Where's the Glitter?**

39 Years: 1970-2008	CPI	5-Year Treasuries	Gold	Stock Portfolio <sup>1</sup>
Annual Return	4.5%	8.3%	8.6%	11.8%

<sup>1</sup>30% S&P 500 index, 30% Dimensional US Large Value index, 20% Dimensional US Small Cap index, 20% Dimensional US Small Value index.

How about downside risk? Over the 39 years covered, gold had *sixteen* losing years to only two for the Treasuries. The worst calendar year for gold was -32.6% (1981) and the worst year for Treasuries was -5.1% (1994). That rare loss for the 5-year Treasuries was an isolated occurrence. Gold fell for five years in a row on two separate occasions!

**Table 2: Is Gold Really Worth the Pain?**

39 Years: 1970-2008	CPI	5-Year Treasuries	Gold	Stock Portfolio <sup>1</sup>
Volatility (SD <sup>2</sup> )	3.1%	6.5%	29.3%	19.6%
# of Losing Years	-	2	16	7
Consecutive Losing Years	-	1	5 (x2)	2
Greatest Loss	-	<b>-5.1%</b>	<b>-32.6%</b>	<b>-42.3%</b> <sup>3</sup>

<sup>1</sup>30% S&P 500 index, 30% Dimensional US Large Value index, 20% Dimensional US Small Cap index, 20% Dimensional US Small Value index. <sup>2</sup> Standard deviation of annual returns.

<sup>3</sup>Two years, 2007-2008.

Still not convinced that short-term Treasuries are a better inflation hedge? Well, consider then that the 8.6% annual return for gold since 1970 included the years 1971-1974 when Nixon took the U.S. off the gold standard. Gold prices had been effectively fixed at \$35 an ounce up till then. Once the dam broke, gold prices quadrupled over those four years while inflation "only" increased 30%.

Add in the "flight to safety" boost gold received from the 73-74 stock market crash and it's pretty hard to see that 8.6% annual return, or 4% over inflation, as a reliable ex-

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pected return over time. Maybe the same can be said of the 5-year Treasury return in excess of inflation since its longer-term average (1926-2008) is 2.5%, not 4%. But really, what would you rather count on: a U.S. Treasury Bond paying a fixed rate of interest, rolling over to a new rate every five years or a piece of heavy, pretty metal that speculators swap back and forth like a hot potato?

The bottom line is that gold is a lousy long-term investment that earns nothing, produces nothing, and is extremely volatile. The only way it makes sense as an inflation hedge is if you can time your way in and out of the stuff profitably. Good luck with that. During the high inflation of 1973-1974, investors were buying gold like there was no tomorrow. Then gold dropped 27% the next two years (when inflation was still high). Oops. In 1979-1980, inflation was high again (12%-13%). The next year, gold dropped 32% (inflation was still 9%). Oops again. Gold has appreciated 221% since 2001 and inflation's been 21%. Oops...?

### Commodities

Instead of just looking to gold, some investors will instead opt for a broad based basket of commodities including Precious Metals, Agricultural, Livestock, and Energy futures, pointing to many of the same expected benefits as gold with better diversification.

The problem is, when it comes to diversified commodity indexes, the whole is no better than the sum of its parts. The benchmark for commodity index performance, the Goldman Sachs Commodity Index, or GSCI, was devised in early 1990. After developing a set of rules to weight, include, or exclude various futures over the simulated period from 1970-1990, Goldman began reporting live index returns in early 1991. Unfortunately, backtesting promise has resulted in real-life disappointment.

From 1970 to 1990, the backtested GSCI outpaced a diversified stock portfolio by 3.7% per year. Since 1991, the “live” index has *underperformed* the stock portfolio by 7.9%. Also, much like gold, commodities exhibit significant risks

that may show up at just the wrong time. Looking at the short but dismal period from July through December of last year, we find the GSCI fell over 62% (a period when the S&P 500 and MSCI EAFE stock indexes “only” dropped 28% and 36% respectively).

What about the inflation hedging ability of a commodities index? Setting aside legitimate questions about the construction of the index, the GSCI only beat inflation by a mere 0.2% over the “live” period 1991-2008, but at the expense of extremely high annual volatility (over 28 times the volatility of inflation itself). This compares to a 4.4% advantage over inflation for 5-Year Treasury Bonds and an 8.1% advantage for the diversified stock portfolio.

Again we ask, how helpful is an asset class with the potential to go almost *two decades* with no real returns and an extreme amount of volatility? Apparently, with expenses on commodity index funds and ETFs ranging from 0.75% to over 1% per year, the only people consistently making money from commodity strategies are the product vendors.

### Investing vs. Speculating

Strategy details aside, adding gold or commodity hard assets to our portfolios presents one very important challenge for Equius clients: it would change the fundamental structure and philosophy of our investment approach. Simply put, *we don't speculate with our clients' money*. Instead, we invest broadly across markets and within asset class dimensions. Unlike stocks and bonds that generate earnings, dividends, and interest, and therefore have expected investment returns that reward investors for owning a share of economic productivity, hard assets such as gold and commodities don't produce anything. So we can speculate that gold or commodity prices may be higher in the future than they're going for today, but there's really no fundamental reason to believe so.

As we continue to claw our way back from a difficult 2008, it's more important than ever that we focus on sound, prudent, and time-tested financial principles. The relationship between risk and return continues to endure and can only be managed through broad diversification across viable capital market asset classes.

There really can be too much of a good thing, even with diversification. And in our view, adding a speculative component to our portfolios through gold or commodities would expose us to unnecessary risk, impairing the stability of our balanced approach to asset allocation and potentially reducing our ability to fully recover short-term portfolio losses.

**Table 3: Reality Check**

Backtest: 1970-1990	CPI	5-Year Treasuries	GSCI	Stock Portfolio <sup>1</sup>	Stock Advantage
Annual Return	6.2%	9.4%	16.4%	12.7%	-3.7%
Volatility (SD <sup>2</sup> )	3.3%	6.8%	22.4%	19.1%	-
Reality: 1991-2008					
Annual Return	2.6%	7.0%	2.8%	10.7%	7.9%
Volatility (SD)	0.9%	6.1%	28.2%	20.8%	-

<sup>1</sup>30% S&P 500 index, 30% Dimensional US Large Value index, 20% Dimensional US Small Cap index, 20% Dimensional US Small Value index. <sup>2</sup> Standard deviation of annual returns.