

Asset Class Returns

April 30, 2009 (YTD)

	2006	2007	2008	Last 10 yrs.*	YTD 2009
Bonds (%)					
One-year	4.8	5.2	4.0	3.9	0.7
Five-Year	3.9	5.2	4.0	4.5	0.7
Intermediate	3.6	9.5	12.9	6.7	-2.4
Long-term	1.7	9.2	22.5	7.8	-9.4
U.S. stocks (%)					
Large Market	15.7	5.4	-37.0	-3.1	-2.4
Large Value	20.2	-2.8	-40.8	0.0	-3.3
Small Market	16.6	-3.1	-36.0	4.2	2.3
Small Micro	16.2	-5.2	-36.7	5.5	-1.6
Small Value	21.5	-10.8	-36.8	6.2	-1.2
Real Estate	35.3	-18.7	-37.4	3.7	-11.6
International stocks (%)					
Large Market	24.9	12.5	-41.4	-0.4	-4.2
Large Value	34.1	10.2	-46.3	2.8	-0.8
Small Market	24.9	5.6	-43.9	5.8	1.1
Small Value	28.4	3.0	-41.7	7.7	0.9
Emerg. Mkts.	29.2	36.0	-49.2	8.6	13.4

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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Ownership: It's Priceless

Phil Jonckheer, Equius Partners

In conversations about the current financial crisis, I've noticed that regardless of one's wealth, nearly everyone wants to focus on worst-case scenarios. Those dire outcomes include wrenching deflation, rampant inflation, a very long period before regaining one's wealth, and a total loss of (material) wealth. People who believe in any of those outcomes are inclined to convert their stocks to cash so as to protect the current value of their investment portfolios. Their plan is to buy back stock funds after markets recover. Unfortunately, this plan defines selling low and buying high and has a very destructive effect on long-term portfolio returns.

The Quest for Certainty

During normal times, investors accept a degree of uncertainty as part of the risk of owning stocks. But at times like these, when the focus shifts so dramatically to worst-case scenarios, investors place a much higher value on certainty. Moreover, since a dollar's loss causes exponentially more pain than a dollar's gain would contribute to a person's happiness, during market declines, investors seek relief by selling stocks so as to capture the certainty of any value even though owning stocks has a much better chance of being profitable.

Although this behavior gives people a sense of control that seems comforting, it usually negatively affects their larger goal of financial security. The reason for this is that the current bad news and worst-case scenarios already are accounted for by the precipitous drop in stock prices. When investors drive prices of securities to low levels they are reflecting their belief that there are higher risks in those securities. However, those lower prices create higher future returns. Sellers of lower priced securities, therefore, reduce their chances of capitalizing on those higher expected returns. The risk (uncertainty) just isn't worth it to them.

There is Hope

There is hope for those who wish to neutralize those wealth-destroying behaviors. Psychologists call it the Endowment Effect and define it as the tendency for people to value a good or service at a much higher amount once their property right to it has been established. A simple word for this is "ownership." If people had more of a sense of ownership over their investments, they would behave more responsibly, rationally and profitably.

A major factor that contributed to our current financial crisis was the creation of an environment that allowed people to shirk the responsibility of ownership. By changing the rules on mortgages, the facilitators and regulators of Fannie Mae and Freddie Mac (our politicians) and those who origi-

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nated and packaged them in an effort to spread and obscure the risk (traditional and investment bankers) allowed people to invest in houses with little if any equity. Furthermore, low interest rates (thank you Federal Reserve) encouraged dramatic leveraging of exotic financial products. This allowed traders to forego ownership of those instruments that were tied to those homes without owners. As Gary Becker, a professor of economics and sociology and the 1992 Nobel Laureate in Economic Sciences observed, the less responsible people are allowed to become, the less they have to worry about things.¹ This would suggest that one of our country's challenges is to instill the sense of ownership more fully into our citizenry once more. In other words, bring back the days when a down payment of at least 20% was required on home purchases!

In the stock markets, people without a sense of ownership will tend to act more like traders, and traders end up with lower returns. Terrance Odean, a Professor at the Haas School of Business observed activity in roughly 10,000 brokerage accounts. He found that the tendency of traders is to purchase securities that under-perform the securities they sell, lowering their overall returns.² Factors used by traders to determine whether to sell a security were typically based on emotions and used arbitrary reference points such as the purchase price and/or a high (or even a low) price point.

Professor Daniel Kahneman, a psychologist and the 2002 Nobel Laureate in Economic Sciences, reinforced the notion of how our behavior can compromise our wealth when he remarked, "If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea...because people are so sensitive to short-term losses. If you count your money every day, you'll be miserable... All of us would be better investors if we just made fewer decisions."³

Ownership: How valuable is it?

Is there any light we can shine on how people value ownership? Dan Ariely, a Professor of Behavioral Economics at Duke University and Ziv Carmon, a Professor of Marketing at INSEAD offer a perspective on how people value ownership. In 1994 they studied how students value basketball tickets at Duke University. Through a raffling system, tickets were awarded to lucky students for a final four game. After the free tickets were distributed, the professors posed as scalpers and found that a student who had not won a ticket would be willing to pay an average of \$170 for a seat at the tournament. On the other hand, the student who had won and therefore owned a ticket would only be willing to sell it for \$2,400. Those who

did not own tickets perceived the value of each ticket as the equivalent of what they could purchase with the money, i.e., beer, food, music and clothes. Those who owned the ticket perceived a value 14 times greater than \$170! That value included the experience of school pride and their expectations of memories they could pass on to their children and grandchildren. This reveals that if the ticket becomes a part of one's life, it is perceived as much more valuable than a commodity.

Along similar lines, researchers have found that owning experiences such as vacations, evenings at the theater and renting a sailboat gave people more happiness than owning objects.⁴ The reasons offered are that the initial happiness of owning something material fades over time, whereas experiences provide happiness through memories that last long after the event. This suggests that wealth can be maximized without spending fortunes.

Our investment approach isn't about buying and holding stocks: it's about owning the global marketplace through asset class funds. Your portfolio is your ticket to financing your investment plan, which allows you to own the values, objectives and priceless experiences that you have determined are important to you.

Investing as an owner isn't about beating others—it's about managing our behavior so that we don't beat ourselves. Risk is not only in the market, it also lies in us and how we choose to behave in the face of market volatility—particularly during the downside phase of that volatility. The deep sense of ownership you have over your portfolio, and the ability to stay focused on what is important to you, have allowed you to make prudent and rational decisions to protect and grow your wealth, and we urge you to continue to maintain this discipline, and therefore, the integrity of your investment portfolio.

We look forward to reconnecting with you to discuss how your portfolio continues to be positioned in a way that enhances your wealth and allows you to focus on those experiences that you deeply value.

¹ "Weekend Interview with Gary Becker," Wall Street Journal, March 21-22, 2009, p. A9.

² Terrance Odean, "Do Investors Trade Too Much?" American Economic Review, December, 1999 pp. 1279-1298.

³ Jason Zweig, "Do You Sabotage Yourself?" Money, May 1, 2001

⁴ "Buying Experiences, Not Possessions, Leads to Greater Happiness," Science Daily, February 17, 2009.



Time for TIPS?

Eric Nelson, Equius Partners

In just the last few months, we have seen Congress pass an \$800 billion stimulus bill and the Federal Reserve expand its balance sheet by over \$1.2 trillion in an effort to buy back Government bonds and provide further support to the mortgage lending and housing markets. It's hard to envision a scenario where these moves will not lead to higher inflation—which begs the question: should we be considering Treasury Inflation Protected Securities (TIPS) in our portfolios?

Fortunately, unlike many investors and professional advisors, we don't make knee-jerk reactions to economic headlines, and we don't populate our portfolios with asset classes just because it gives the appearance of diversification. Most advisors add unnecessary complexity to the portfolio process just to juice up their marketing efforts ("see how complicated this is, you can't possibly do this by yourself?"). We, on the other hand, simply will not make changes in the name of marketing or where we don't believe our clients will benefit. All the research we have done on TIPS indicates to us that adding them to our existing client accounts would violate that policy.

TIPS Characteristics

TIPS are bonds issued through the US Treasury with one small wrinkle: they are inflation protected. Whatever the overall rate of inflation (measured by the Consumer Price Index) throughout the life of the bond, that result, along with its periodic interest payment, is credited to the bonds principal at maturity. Lets look at an example: assume an investor buys a 10-year TIPS with a coupon rate of 1.6%, as is the case today. That investor will earn 1.6% per year plus whatever inflation averages over the life of the bond. Since 1926, inflation has averaged 3.0% per year. If this were to persist over the next decade, our TIPS investor would earn 4.6% per year.

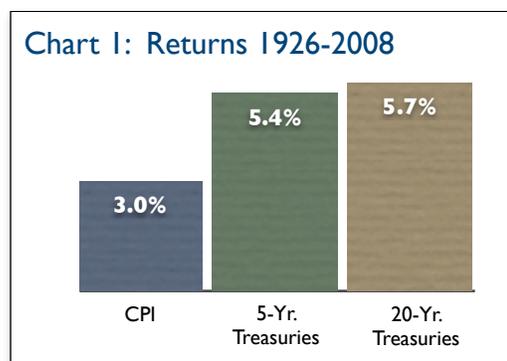
Risk & Returns

Investors in TIPS understand there is no inflation risk for a TIPS if the bond is bought and held till maturity. But you also pay for that in the form of lower returns. How much lower? Academic studies on TIPS indicate they should have between 0.5% and 1.0% less in total returns than traditional bonds. That is the "price" of inflation protection. Since the inception of the Barclays TIPS Index in March of 1997, we find that this is indeed the case. From 1997 through 2008, the

TIPS Index underperformed the comparable Barclays Treasury Index by almost 0.7% per year, so the underperformance estimate in TIPS studies seems to bear out in live results.

More importantly, what about TIPS today? Investors who purchase a 5-year TIPS can lock in a real yield of 1.0%. Going out 10 years only gets us up to about 1.6%. If we compare that with the return for regular bonds over the longest period available, we see how poorly that return stacks up. As Chart 1 shows, 5 year bonds have exceeded the rate of inflation by 2.4% per year and captured almost the entire return of long term bonds. Using historical returns as well as current yields and valuations as our guide, there doesn't appear to be much need for TIPS.

Chart 1: Returns 1926-2008



But return is only one side of the equation. The risk of TIPS is a bit trickier. So long as they are bought and held to maturity, TIPS don't have any inflation risk. Although, as almost any investor can vouch for, a lot can happen between purchase and maturity. So we also need to look at the shorter-term risk of TIPS. First, it's important to recognize that only 10% of total Treasury bond issuance are in the form of TIPS, so they are far less liquid than traditional bonds. Furthermore, there is much more downside risk to TIPS relative to traditional bonds—often when you can least afford it.

Last fall's historic sell-off was a painful reminder of this. A dramatic economic slowdown and falling consumer prices coupled with a liquidity crisis saw TIPS values plummet right along with stocks. In just the short span of September and October, TIPS fell over 12%—an unprecedented loss for default-free fixed income. The worst two-month decline for 5-year

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bonds dating back to 1926 was 7.7% and the worst total decline (over 8 months) was 8.9% during the dramatic interest rate spike of late 1979 and early 1980.

During the two months when TIPS prices declined last year, the S&P 500 was off over 24% and International stocks were down more than 30%. Investors who wished to rebalance part of their bond allocation back to stocks would have had to lock in significant TIPS declines to do so. Income oriented investors dependent on their portfolio for cash flow would have had a painful decision to make: which do I lock in, stock losses or bond losses? Investors who instead opted for 5-year bonds had an easier decision to make. Over the same stretch, 5-year bonds had a gain of over 2%, providing a relatively stable source for income or rebalancing needs.

TIPS and Our Portfolios

While there isn't a lot to get excited about with TIPS on a standalone basis, their prospects diminish even further when we look at them within the context of our existing portfolios. Consider that our bond investments are already short term and very high quality, providing us with a fair amount of inflation sensitivity. As consumer prices begin to rise, we would expect interest rates to climb as investors demand higher rates to compensate them for higher inflation.

Under this scenario, our portfolios of short-term bonds (maximum five-year maturity) will systematically roll over existing holdings into these new, higher interest rate bonds. And because short-term bonds have far less volatility, investors also enjoy ample liquidity to cover spending needs or rebalancing requirements in almost any environment.

On the stock side of our portfolio, we incorporate an additional level of inflation protection: value stocks. We tend to tilt equity allocations towards lower priced value companies because they have higher expected returns, but they also offer excellent intermediate and long-term inflation protection.

Looking at Table 1, we see value stocks actually tend to have their highest relative returns during periods of moderate to high inflation like the 40s and 70s. Conversely, when inflation falls, as it did in the 30s,

value stocks tend to perform poorly.

Financial journalists often cite 1966-1981 as the "lost" period for stocks, as they underperformed risk-free Treasury Bills. In fact, the S&P 500 trailed T-Bills 6.0% versus 6.8% per year and both lost to inflation (7.0%). But as Table 1 also shows, this period of relatively high inflation saw the value stock mix more than double the return of the S&P 500 and outpace inflation by 5.5% per year.

The value stock mix did not outpace inflation every year, but, combined with short-term bonds, *did* offer significant intermediate and long-term returns in excess of inflation with the rebalancing benefits noted earlier—a welcome combination for most investors.

More importantly, we still believe that is the case today. Armed with this knowledge, we struggle to identify how adding TIPS to this mix, with current interest rates of only 1% to 1.6% in excess of inflation, would improve results or reduce the risk of our already balanced portfolios. Investors, along with the help of government purchases, have driven TIPS prices up and expected returns down considerably as witnessed by very low current yields. Add to that the reality that TIPS exhibit significant risk of loss over short periods of time and provide a poor hedge against our existing portfolio holdings, and it's pretty clear: there's no need for us to use TIPS in our already well diversified asset class portfolios.

Next month we will tackle gold and commodities as inflation hedges.

Table 1: Annual Returns By Decade (%)

Period	CPI	S&P 500 Index	DFA Value Index	Difference
1930-1939	-2.0	-0.1	-4.6	-4.5
1940-1949	5.4	9.2	15.5	6.3
1950-1959	2.2	19.4	19.1	-0.3
1960-1969	2.5	7.8	11.7	3.9
1970-1979	7.4	5.9	13.2	7.3
1980-1989	5.1	17.5	20	2.5
1990-1999	3.0	18.2	16.8	-1.4
2000-2008*	2.5	-3.6	3.1	6.7
1966-1981	7.0	6.0	12.5	6.5

*9 years only. "DFA Value Index" is 60% DFA U.S. Large Value Index and 40% DFA U.S. Small Value Index. "Difference" is DFA Value Index minus S&P 500. Indices 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.