

Asset Class Returns

December 31, 2008 (YTD)

	2005	2006	2007	2008	Last 10 yrs.*
Bonds (%)					
One-year	2.3	4.8	5.2	4.0	4.0
Five-Year	1.7	3.9	5.2	4.0	4.7
Intermediate	1.6	3.6	9.5	12.9	6.6
Long-term	6.6	1.7	9.2	8.6	6.7
U.S. stocks (%)					
Large Market	4.9	15.7	5.4	-37.0	-1.5
Large Value	10.2	20.2	-2.8	-40.8	2.2
Small Market	6.1	16.6	-3.1	-36.0	4.8
Small Micro	5.7	16.2	-5.2	-36.7	6.4
Small Value	7.8	21.5	-10.8	-36.8	7.3
Real Estate	13.2	35.3	-18.7	-37.4	7.6
International stocks (%)					
Large Market	13.5	24.9	12.5	-41.4	1.3
Large Value	15.3	34.1	10.2	-46.3	4.8
Small Market	22.0	24.9	5.6	-43.9	7.0
Small Value	23.2	28.4	3.0	-41.7	9.5
Emerg. Mkts.	29.9	29.2	36.0	-49.2	9.5

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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Millions Are “Madoffed” Everyday Especially in 401(k) Plans

Jeff Troutner, Equius Partners

Consider this: an investment guru develops a number of investment strategies funded by a modest amount of initial assets. Some strategies fail, but a relatively few result in superior returns. Third party sources (personal wealth and pension consultants, stock brokers, and investment advisors) promote the past returns of the winning strategies to their clients—often for a substantial ongoing fee. Millions of new dollars flow to the guru from investors with very little, if any, clue as to the source of the guru’s returns. Eventually the strategy fails (future returns fall far below expectations) and investors are left holding whatever remains. The investors and the referral sources blame the guru and the scenario is repeated over and over again.

Sounds like what Bernard Madoff perpetrated with his \$50 billion Ponzi scheme, right? Absolutely. And this is how the vast majority of investors, particularly 401(k) participants, handle their most serious money every day—encouraged, cajoled, and facilitated by an army of stock brokers, SEC-Registered investment advisors, and pension consultants. The difference is we’re talking about *trillions* of dollars here, not billions. And it’s all perfectly legal.

What I described is the mutual fund industry and the general business of investment advice in this country. The approach has been institutionalized in defined contribution retirement plans and millions of hard working Americans will end up with relatively paltry retirement balances as a result.

Selling Past Performance

Here’s how the typical 401(k) plan works.

An investment or pension consultant recommends several mutual funds within a number of “style” categories. The funds chosen by the consultant are based almost exclusively on past performance. The total number of funds typically ranges from about a dozen to well over one hundred. Plan participants can then choose to build a portfolio using these funds. Despite the availability of fund profiles outlining holdings, strategy, and managers, the typical plan participant chooses the *best performing* fund in each category. *Recent* performance tends to be very important.

Now, consultants know participants choose their funds this way and they also know that plan sponsors choose their consultants this way. In other words, past performance is *everything*. That’s why a smart consultant will hedge his (or her) bet and position several funds in each category. That way, when winners inevitably turn into losers and losers turn into winners, the blame for choosing the “wrong” one falls on the participant. If a fund stays a loser (performance consistently lags), the consultant “earns” his fee by

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replacing the loser with a new winner. Think of a cat chasing its tail or a child jumping from one pretty horse to another on a merry-go-round. This is the typical plan participant—aided and abetted by a well-paid consultant (who can always blame the fund manager) and the plan sponsor (who can always blame the consultant). In the meantime, by effectively buying high (winners) and selling low (losers) the participants in the plan watch their balances slowly erode or, at the very least, grow much slower than the overall return of the stock market.

This cycle continues until a new human resources executive or CFO is hired by the plan sponsor and one of his Wall Street buddies (probably broker) blows the whistle on the current consultant and his lack of fund selection skills. The new consultant introduces his own selection of four and five-star funds and the cycle continues.

Hiding the Odds

Were plan participants ever told that something like 75% of mutual fund managers fail to beat a comparable index fund over time? Were they ever told that knowing the 25% of “winners” in advance is virtually impossible? Not likely. Participants and investors in general have no clue where returns really come from and the consultants and brokers aren't telling them. So the legal Ponzi schemes continue with new suckers just another retirement plan or cold call away.

I'm not confident that this cycle will be broken in the retirement plan industry anytime soon. The massive mutual fund complexes like Fidelity, T. Rowe Price, and Franklin Templeton are too powerful and rich and have too many friends in Congress. But progress is being made. The Vanguard Group, a major purveyor of index funds, remains one of the biggest mutual fund companies in the country and DFA, whose funds we use primarily, has risen from number 96 to 14 in size over just the past six years based on assets under management.

You might be wondering how investment advisors and pensions consultants can continue to promote the belief that returns come from gurus and winning gurus can be known in advance. Are these people dishonest, uninformed, or delusional?

Clearly some are dishonest and their personal financial success takes priority over their clients'. They're slick salespeople who plan on a certain annual turnover of clients. As long as they can fool enough people to replace those who move on, they've made progress. Others are uninformed. This is no excuse, of course, since they're supposed to be professionals on whose expertise even more uninformed investors rely. But

some are blissfully ignorant and wish to stay that way—the pay is very good and a Morningstar mutual fund database subscription is very cheap.

Most, including some of the brightest people running some of the biggest pension plans and endowments, are simply delusional. Here's what David Swensen, the Yale University endowment's chief investment officer had to say in a recent interview (1/13/09):

Wall Street Journal: ...Other endowments have attempted a Yale-like approach, usually with less success. What goes wrong?

Mr. Swensen: A lot of institutional investors think they are emulating Yale, but they are not. Most endowments use fund of funds and consultants, rather than making their own well-informed decisions. You can divide institutional investors into two camps: those who can hire high-quality, active-management investors and those who can't. If you are going to invest in alternatives, you should be all in, and do it the way Yale does it -- with 20 to 25 investment professionals who devote their careers to looking for investment opportunities. Or you belong at the other end, with a portfolio exclusively in index funds with low fees. If you're not going to put together a team that can make high-quality decisions, your best alternative is passive investing. With a casual attempt to beat the market, you're going to fail.

WSJ: What about fund of funds and consultants? Can they be a solution?

Mr. Swensen: Fund of funds are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital. If an investor can't make an intelligent decision about picking managers, how can he make an intelligent decision about picking a fund-of-funds manager who will be selecting hedge funds? There's also more fees on top of existing fees. And the best managers don't want fund-of-fund money because it is unreliable. You need to be in the top 10% of hedge funds to succeed. In a fund of funds, you will likely be excluded from the best managers. [Mr.] Madoff also relied enormously on these intermediaries. He wouldn't have had nearly as much resources were it not for fund of funds.

It's clear that Swensen has advantages other investors do not and his message is that without these advantages all investors, not just college endowments, should index their portfolios. But Yale had a terrible 2008, just like everyone else, despite Swensen's access to the top-10% of managers. He, as well as everyone else, has had access to Bill Miller of Legg Mason Value Trust fame, who was solidly in the top-10% of mutual fund managers for years. Yet, Value Trust was down 55% last year and ranks in the *bottom 3%* of funds over the past 10 years! No wonder he's not referred to as the “legendary” Bill Miller anymore.

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Those Who Should Know Better

There is a group of investment advisors that should be singled out as particularly delusional, to the point of being dishonest. These are advisors I call “fence sitters” due to the fact that they straddle the fence between active and passive investing. My biggest complaint with DFA over the years has been to allow these advisors to use their funds. Ultimately, however, it’s the advisor’s responsibility to do what’s right by *their* clients, not DFA’s.

A fence sitter is an advisor who *understands* and *promotes* the benefits of indexing and asset class investing, yet claims to “enhance” an indexed portfolio by adding active fund managers to the mix. Some call this “core and explore.” In fact, “explore” is simply a marketing term for speculation using the client’s money. With a 75% chance of hitting a dry hole, this kind of exploring simply adds an additional, and often substantial, cost to most portfolios. Are these advisors arrogant, believing they alone possess the impossible talent of knowing the 25% of successful active managers in advance? Are they insecure in their ability to add value to a relationship using a pure asset class indexed strategy? Or do they recognize a potential marketing advantage when they see one and rely on the ignorance of investors to buy into it? Chances are, it’s all three.

I don’t have a problem with speculation or trying to beat the odds—on your own with your money. I have a problem with brokers and advisors who do either *deceptively* with other peoples’ money. This is what happens everyday with trillions of dollars of 401(k), endowment and foundation, and personal assets entrusted with investment professionals who should know better.

Unfortunately, This Ain’t Brain Surgery

Imagine going to your doctor expecting an informed and professional diagnosis of a medical problem, followed by a recommended treatment. Now imagine that your physician is being paid (by drug companies, medical device manufacturers, etc.) to sell you certain treatments with very low odds of success—odds supported by reams of academic studies—or, alternatively, gives (sells) you what you want, instead of what you need?

The public outrage at the inevitable bad results of such an approach would lead very quickly to a better system. Yet, this is exactly how *my* industry operates today. I’m not at all confident that things will change radically for the better any time soon, but I’m encouraged by the growing number of advisors who are now offering *pure* asset class strategies to serious investors and taking the time to explain *why*.

I believe that Equius clients are some of the most informed and rational investors in the world, yet we are reminded almost daily of what we don’t know about markets and investor behavior. To stop learning is to make ourselves vulnerable to an industry that relishes ignorance and naiveté and exposes us to the possibility of being Madoffed—legally or illegally.

How to Avoid Being Madoffed Legally

Know the odds.

Read Charles Ellis’s book, *Winning the Loser’s Game*. When we developed our asset class investment strategies in 1992 and began publishing *Asset Class*, Mr. Ellis and his publishers were kind enough to allow us to reprint the book chapter by chapter. Our clients know the odds and they haven’t changed with subsequent editions of the book through the years!

Trust a strategy, not a guru.

Either do your own research into asset class investing (Ellis’s book plus Bill Bernstein’s *The Intelligent Asset Allocator* should be sufficient) or insist that your advisor take the time to thoroughly review and discuss the principles of asset class investing to you. Clarity, transparency, and healthy skepticism are absolutely critical in investing. We demand it of DFA and every other organization or individual we deal with.

Use your common sense.

Anyone with a few hundred dollars and fifteen minutes can select “top-10%” mutual funds based on *past performance*. Only David Swensen and God know the top-10% of mutual funds or advisors in advance. If selecting top money managers is so easy, why did the legendary Peter Lynch fail to select an adequate replacement for management of Fidelity’s Magellan fund after he retired?*

Understand the sources of risk and return.

Returns come from risk, not from gurus. If you want low returns, buy Treasury Bills. If you want higher returns, add the stock asset classes that reward risk-taking over time. Use broadly diversified, passively-managed asset class funds. The 14.5% annual return generated by U.S. small value stocks since 1973 came with the significant market declines of 1973-1974 and 2008, and everything in between. *You can’t get the return without taking the risk.*

Be patient.

With an asset class indexed strategy, you are investing very broadly in the U.S. and foreign *economies* over the long-run, not in gurus. Free-market economies and stock markets can be volatile, but reward risk-taking over time. Most gurus do not.

Pay for value-added services, not speculation.

You can speculate on your own. It’s honesty, discipline, clarity, transparency, low costs, and quality counseling that are in short supply in this industry.

*Fidelity Magellan’s assets have declined from a peak of \$105 billion to less than \$20 billion today due to poor management.



Surviving a Crisis

Phil Jonckheer, Equius Partners

January 19, 2009 was the tenth anniversary of my father's passing—a good time to reflect on his life in the context of what we're experiencing today.

My father had just celebrated his 21st birthday in Amsterdam when Nazi bombs leveled Rotterdam. My dad lived through the Second World War with only the clothes on his back. Although the situation is not as dire, many people in 2009 whose portfolios have dropped by 35% feel as if they've lost everything. What can we learn from my father about what it takes to lose everything—and survive?

Humility and Compassion

My father belonged to the Dutch underground. As an operative in his occupied country, he blew up bridges, created blockades, and smuggled Jews and other vulnerable travelers through Nazi strongholds. Risking his life daily, he was nevertheless called to compassionate action on behalf of those people most persecuted by the Nazis. Stripped of opportunities to do the normal activities of a man in his twenties—pursue an education, start a family—my father returned to what was most important to him, and what no invader could take away: his physical strength, his courage, and his willingness to help others.

Personal Relationships

As the Nazis began to lose their hold on Europe, they started aggressively herding young Dutchmen to munitions factories. My dad's chances of survival in either the Netherlands or those factories dropped precipitously. After taking stock of the deteriorating, dismal and extremely dangerous conditions, my father decided to strike a deal with a farmer that for years had provided him with cheeses for his day sails on the Zuider Zee. In exchange for work, the farmer agreed to hide my father from the Nazis.

Around the same time, my dad's brother (who also lived in the Netherlands) was rounded up in a movie theatre and summoned for work in the factories. Fortunately for him, and my family, the Dutch doctor assigned to do the medical examinations was a close friend of the family. He administered a pill that made my uncle vomit uncontrollably. Making sure that the Nazis saw the condition of this sickly young man, the doctor ensured that my uncle was not conscripted into service.

Meanwhile, on the farm, my dad was eating well – which was just another way the farmer saved his life, as food was extremely scarce in Holland during the war. (In fact, when the war was over, my dad got accused briefly of collaborating with the Nazis, as the rich foods of the farm left him robust and strong). When the Nazis came to the farm to search for fugitives, the farmer directed my father to lie beneath bales of hay. He could have been executed for hiding my dad, but instead the farmer's compassion trumped his concern for his own life as he chose to save my dad's life, over and over, in ways big and small. The trust my father placed in the relationship, and the commitment the farmer gave in return, saved his life, just as the relationship with the doctor saved my uncle.

What's Valuable Endures Forever

What this part of my family's history underlines for me is that the most valuable things in life have nothing to do with money. And since they have

nothing to do with money or material goods, then no person or crisis can take them away.

We cannot ignore the daunting financial challenges we all face. The steps we recommend to avoid even greater losses during times like these run parallel to those my father took to survive: Do your homework; understand risks; trust your plan, then trust others to help you implement it (think of my dad negotiating with the farmer); blend your analyses with common sense; and be patient (think of my dad in the hay).

History is littered with pessimists who view conditions with Malthusian-tainted lenses that do not allow them to think clearly about problems and solve them rationally. Research indicates that investors who react to dismal outlooks (usually based on simple extrapolations of most recent trends) all too often cause more harm to their portfolios than the market.

Drawing on the qualities exhibited during my father's war experience, we continue to believe that the best solution to your long-term financial health is to remain dedicated to your investment plan, which we created for you by understanding risk and blending analysis with common sense. We look forward to working with you through these challenging times. Thank you for your business.

When one door of happiness closes, another opens; but often we look so long at the closed door that we do not see the one which has been opened for us.

Helen Keller