

**July 2007**

## Asset Class Returns

June 30, 2007 (YTD)

	2004	2005	2006	Last 10 yrs.	YTD 2007
<b>Bonds</b>					
One-year	0.9	2.3	4.8	4.2	2.6
Five-Year	2.9	1.7	3.9	5.4	2.2
Intermediate	4.3	1.6	3.6	6.3	0.9
Long-term	7.1	6.6	1.7	7.4	-1.0
<b>U.S. stocks</b>					
Large Market	10.7	4.9	15.7	8.3	6.9
Large Value	18.2	10.2	20.2	11.9	8.9
Small Micro	18.4	5.7	16.2	13.5	6.1
Small Market	17.9	6.1	16.6	11.7	6.7
Small Value	25.4	7.8	21.5	15.8	7.1
Real estate	32.1	13.2	35.3	15.2	-6.3
<b>Int'l stocks</b>					
Large Market	18.8	13.5	24.9	7.9	11.2
Large Value	28.8	15.3	34.1	11.6	13.2
Small Market	30.9	22.0	24.9	10.6	13.8
Small Value	34.8	23.2	28.4	12.9	14.0
Emerg. Mkts.	29.9	29.9	29.2	10.2	20.4

### 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 12/31/06.

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*This newsletter is published by*  
**Equius Partners, Inc.**  
4 Hamilton Landing, Suite 205  
Novato, CA 94949  
Phone: 415-382-2500  
Fax: 415-382-2005  
email: [jeff@equiuspartners.com](mailto:jeff@equiuspartners.com)  
Web Site: [www.equiuspartners.com](http://www.equiuspartners.com)

**Editor: Jeffrey C. Troutner**

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## The Value Angst

*Jeff Troutner, Equius Partners, Inc.*

Value stocks have been on a run—for the last 80 years. Oh, and the past five years or so as well. Those brave, adventurous souls who have bucked conventionality and the safe harbor of super large, super popular growth companies and ventured out into the uncertain world of mostly boring, but sometimes scary, low-priced value stocks have been richly rewarded. So why on earth is there so much angst in the investment community over whether value stocks will continue to do as well in the future?

The easy (and usually wholly sufficient) answer is that Wall Street was built on angst, with periods of calm (for vacation time) and giddiness (for new wives and high-priced toys) thrown in occasionally to keep things really interesting. Fear and greed sell. That's it. End of story. So the new fear is that the party's over for value and investors should start thinking about shifting money around again before it's too late. Given that the Wall Street talking heads usually wait until an asset class has taken a beating before they "predict" its demise makes this value angst even more intriguing. Wishful thinking? Perhaps. In any case, let's take a look once again at value stocks and decide for ourselves whether there is need for concern.

First, what are "value" stocks? Simply, they are low-priced stocks—big, small, and in between. They are low-priced for a reason. The "behaviorists" would say that value stocks reflect a mispricing caused by dumb investors. That could very well be the case. If so, investors have been dumb for a very long time. Since far too many investors gain their "knowledge" from Mad Money Cramer or Money magazine, I feel pretty certain this general dumbness will continue in the future. We can call this way of thinking the Graham/Buffett school of value investing.<sup>1</sup>

There is another explanation for the low prices of value stocks. Some very smart academics at the University of Chicago and other places of higher learning claim that value stocks have low prices because *they are riskier* than those big, popular, successful growth stocks with names like Cisco, Qualcomm, Worldcom, Enron...oops, I mean Google, Apple, and Amgen. In other words, investors will only buy dull, unexciting value stocks if the price is low enough to convince them to take the risk that these stocks will grow up some day to be growth stocks. This way of thinking can be called the Fama/French school of value investing.<sup>2</sup>

So whom should we believe? I say, believe them both. Why not? On one side of the "debate" you have world-class academics armed with 80 years of theoretical and statistical evidence and on the other side you have one of the world's richest men armed with almost as many years of empirical, real world evidence. The bigger question should be, what is the best way to implement a value strategy? The behaviorists spend hours upon hours scouring balance sheets and income statements to come up with a relative handful of "undervalued" stocks for a portfolio. The academics say that's a waste of time and exposes investors to something called "unsystematic risk" which is generally unrewarded over time and can be diversified away. Since the methodology touted by the academics is less prone to human error and involves spreading risk over many thousands of low-priced stocks, we believe their approach is the most prudent one for our clients. And since it

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looks at *all* stocks and focuses on the roughly 25% lowest price-to-book value stocks, there are always thousands of stocks at any given moment that fit the bill.

In fact, the list of potential value investments is *dynamic* and the mutual funds that invest this way are, in effect, “self-flushing.” Stocks go in because of their low prices and get flushed out when their prices have increased to the point they no longer qualify as value stocks. Think “buy low, sell high.” Has a nice ring to it, doesn’t it? In contrast, S&P 500 index funds, which tend to be dominated by large growth stocks, see little change in their holdings over time, and when they do change it’s usually a nice low-priced stock being booted for a high flyer. Google was added last year. Need I say more?

Now let’s look at results. I’ll use the S&P 500 as my growth stock proxy and a 50/50 blend of the Fama/French large and small value indexes as our value proxy. A review of rolling 60-month (5-year) returns since 1927 shows the following:

**88% of the 5-year periods show positive returns for the S&P 500.**

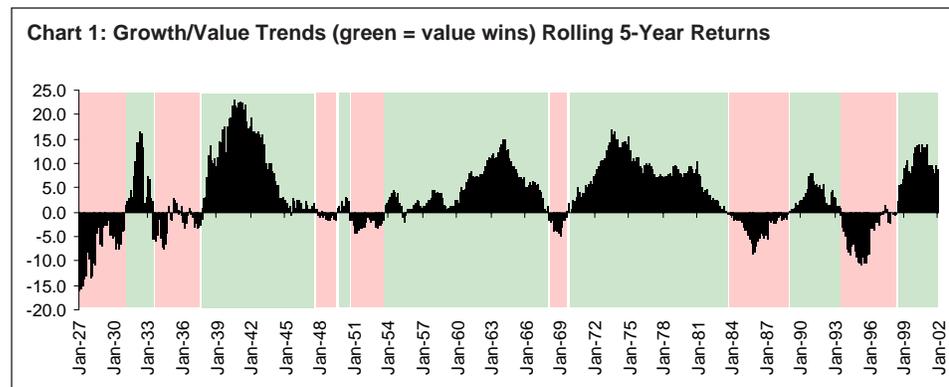
**90% of the 5-year periods show positive returns for the 50/50 value mix.**

**Value wins or ties 67% of the time (there were nine five-year periods when returns were identical).**

**Value won 60% of calendar years since 1927.**

Okay, so far we know that stocks in general reward patient investors and value wins most of the time.

We can also identify 14 distinct periods since 1927 when either value beat growth or growth beat value. The longest periods were value-dominated (value minus growth was positive).\*



The average annual return over a 5-year rolling period was 13.9% for value stocks and 10.4% for the S&P 500. Looking at Table 1 we can see that of the seven periods when the S&P 500 won, two of those periods had higher returns for value stocks than the average 5-year period and two others had pretty good annual returns (12.3% and 11.4%). Yes, in the late 1920’s and early 1930’s we had a really bad stretch for value stocks. Of course, growth stocks suffered as well.

Over half the time when growth beat value, rational investors would have been perfectly happy with the value stock returns and during the other three periods growth returns were hardly robust.

**Table 1: Growth/Value Trends (green = value wins)**

5-Year Periods	Start	# Periods	Average S&P 500	Average Value Mix	Average Difference
1	Jan-27	48	-10.5%	-17.9%	-7.3%
2	Jan-31	29	16.1%	22.8%	6.7%
3	Jun-33	52	2.9%	0.9%	-1.9%
4	Oct-37	120	11.9%	21.8%	9.8%
5	Oct-47	21	18.3%	17.4%	-0.9%
6	Jul-49	13	23.3%	24.9%	1.6%
7	Aug-50	38	20.1%	17.7%	-2.4%
8	Oct-53	171	10.3%	15.4%	5.0%
9	Jan-68	19	3.9%	1.3%	-2.6%
10	Aug-69	166	10.8%	18.5%	7.8%
11	Jun-83	67	15.1%	12.3%	-2.8%
12	Dec-88	54	15.3%	18.6%	3.3%
13	Jul-93	59	16.0%	11.4%	-4.6%
14	Jun-98	44	0.2%	9.8%	9.6%

**Table 2: Growth/Value Trends (sorted by Ave. Difference)**

5-Year Periods	Start	# Periods	Average S&P 500	Average Value Mix	Average Difference
4	Oct-37	120	11.9%	21.8%	9.8%
14	Jun-98	44	0.2%	9.8%	9.6%
10	Aug-69	166	10.8%	18.5%	7.8%
2	Jan-31	29	16.1%	22.8%	6.7%
8	Oct-53	171	10.3%	15.4%	5.0%
12	Dec-88	54	15.3%	18.6%	3.3%
6	Jul-49	13	23.3%	24.9%	1.6%
5	Oct-47	21	18.3%	17.4%	-0.9%
3	Jun-33	52	2.9%	0.9%	-1.9%
7	Aug-50	38	20.1%	17.7%	-2.4%
9	Jan-68	19	3.9%	1.3%	-2.6%
11	Jun-83	67	15.1%	12.3%	-2.8%
13	Jul-93	59	16.0%	11.4%	-4.6%
1	Jan-27	48	-10.5%	-17.9%	-7.3%

From this analysis it appears that value stocks do poorly during serious depressions and recessions. This seems logical since bankruptcies and liquidations would be prevalent during these periods and only the strongest would survive. So, one can avoid

value fearing another depression or invest with confidence that our system has changed sufficiently to preclude a repeat. One could also hedge her bet by mixing some S&P 500 into the allocation.

Core value *indexing* involves buying thousands of stocks from many industries and all the developed countries at much lower prices than large growth stocks. Using funds like DFA’s that “self-flush,” you’re assured of owning the cheapest 25-30% of large and small stocks all the time. These aren’t static

(or relatively static) sets of stocks like the S&P 500 or a REIT fund that will float way up in price and then way down in price. They aren’t, in other words, roach motels where stocks check in, but they seldom, if ever, check out.

<sup>1</sup> Not because Ben Graham, the father of value investing, or one of his students, Warren Buffett, are dumb. On the contrary, they were/are brilliant investors who were able to find gems *and manage them* (in Buffett’s case) where others could not.

<sup>2</sup> Eugene Fama, Sr. and Ken French (now a professor at Dartmouth) introduced their “Three Factor Model” in 1992.

\* The chart and tables refer to rolling 5-year periods starting monthly on 1/27. Therefore, the first 5 year period is 1/27 to 12/31, the next is 2/27 to 1/32, and so on. The last of the 48 5-year periods when growth won in Period 1 of Table 1 was 12/30 to 11/35. Clear as mud, right?