

November 2007

Asset Class Returns

October 31, 2007 (YTD)

	2004	2005	2006	Last 10 yrs.	YTD 2007
Bonds					
One-year	0.9	2.3	4.8	4.2	4.4
Five-Year	2.9	1.7	3.9	5.4	4.4
Intermediate	4.3	1.6	3.6	6.3	5.7
Long-term	7.1	6.6	1.7	7.4	4.3
U.S. stocks					
Large Market	10.7	4.9	15.7	8.3	10.8
Large Value	18.2	10.2	20.2	11.9	3.3
Small Micro	18.4	5.7	16.2	13.5	3.6
Small Market	17.9	6.1	16.6	11.7	5.0
Small Value	25.4	7.8	21.5	15.8	-1.0
Real estate	32.1	13.2	35.3	15.2	-3.8
Int'l stocks					
Large Market	18.8	13.5	24.9	7.9	19.4
Large Value	28.8	15.3	34.1	11.6	20.0
Small Market	30.9	22.0	24.9	10.6	17.9
Small Value	34.8	23.2	28.4	12.9	15.7
Emerg. Mkts.	29.9	29.9	29.2	10.2	46.1

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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Past performance is no guarantee of future results.

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Optimism Pays

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Optimism

1. a disposition or tendency to look on the more favorable side of events or conditions and to expect the most favorable outcome.

Since our founding, optimism has been the basis for our growth as an investment advisory firm and the underlying current powering our clients' portfolio returns. Ours is not *blind* optimism or *over-optimism* of the kind suggested by the above definition, however. Rather, our optimism is based on knowledge and confidence; two of the three pillars (along with discipline) that allow us and our clients to survive and thrive in the face of so much short-term uncertainty, economic and market turmoil, and investment industry nonsense. Because it is rooted in knowledge (continually enhanced), ours is a *rational* optimism, which leads us to expect a *favorable* outcome, not necessarily the *most* favorable one.

Macro-Optimism

Optimism is the faith that leads to achievement. Nothing can be done without hope and confidence. — Helen Keller

Our optimism starts at the macro level with faith in free markets and free people. Free markets and free people lead to free trade, a focus on personal responsibility, and ultimately to a high standard of living. This has been proven throughout time by the major developed democracies around the world. Freely elected governments can nurture something approaching a level playing field by enforcing laws against monopolies, fraud, and criminal behavior; they can provide for the common good through infrastructure development and social safety nets; and they can provide an adequate defense against belligerent governments, groups, or individuals. Governments can also get in the way of economic growth and improvement in general living standards by unnecessary intrusions in free markets; high taxes; "social engineering," trade barriers; and many other ways.

While we all have opinions on how our society can progress to the *most* favorable outcome, it's unrealistic and irrational in my opinion to expect anything approaching that. But we can expect (at least in mostly free countries) that an *equilibrium* will be reached *over time* that will continue to produce the economic growth necessary to provide inflation-beating portfolio returns in line with personal needs or desires to take risk.

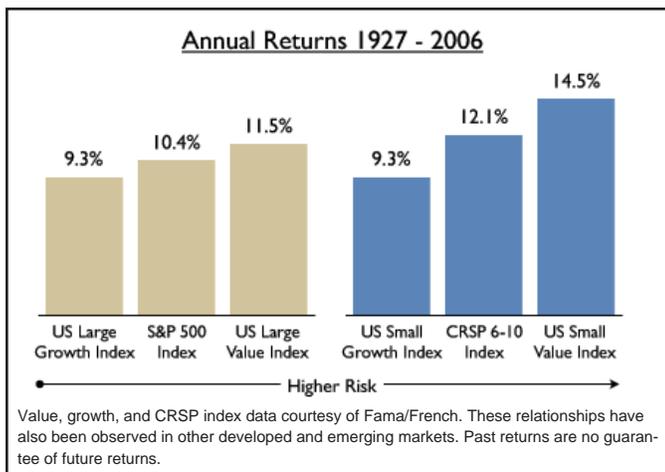
This is why we can look to the "old" economies of Europe, for example, with optimism despite 40 years or more of a disturbing move toward socialism. The countries that are showing the highest growth rates and improvements in standard of living are those that are emerging from the socialist governments of the past and are spurring economic growth through free trade and low, flat tax systems. This encourages risk taking and entrepreneurship, which, in turn, leads to innovation and competitive advantage. The old European economies are not blind to this trend and are showing positive signs of dealing with their super-sized welfare systems, high tax environments, high unemployment, and

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declining demographics. This ever-changing global dynamic is causing social/economic equilibrium in these countries to shift in a way that portends greater economic growth (and higher stock prices) in the future. The ultimate level of this balance depends, of course, on the desires of each individual society and how they react to a changing world.

Micro-Optimism

On a more micro, or portfolio, level our optimism is based on observing over 80 years of financial market data, studying the very best of academic research, and relying on good common sense. Common sense tells us that whenever high returns exist with low risk, investors will flock to the opportunity until a rational equilibrium sets in. Prices, in this case, will be bid up as demand increases, forcing *future* returns to be lower—commensurate with the low risk. This is what free markets do. And they do it very quickly and efficiently in most cases. Academic research supports this; with the Fama/French “Three Factor” model leading the way.¹ Looking at various long-term time horizons for U.S. and foreign developed stock markets, as well as emerging markets, Fama & French have shown a direct relationship between risk and return. Observing the returns of asset classes, as defined by the Fama & French research, we are able to develop a level of confidence in these risk/return relationships that investors (speculators) looking at the stock market as one big gamble simply cannot.



Equi-Optimism

I'm an optimist, but I'm an optimist who takes his raincoat.
— Harold Wilson

It's one thing to be optimistic and confident in the long-term; it's another to stay confident and optimistic when things seem to be falling apart all around you. *But when aren't things "falling apart"?* Rising oil prices, falling dollar, billion dollar corporate losses, terrorism, inflation, rising interest rates, volatile stock markets...these and many other shocks to global economic systems have been with us for as long as I can remember and from all that I can read of economic history. Free people and free markets are resilient and not only survive challenging times, but continue to thrive, often on a higher level. In the meantime, uncertainty and economic turmoil can be so

unsettling (or occur at the wrong time) that even the most optimistic of investors would be wise to hedge their risks. This is why, for example, despite our confidence in U.S. small value stocks providing higher returns over time we recommend a diversified asset class portfolio to all of our clients that includes varying degrees of short-term bonds and large, growth, and foreign stocks.

It appears fashionable today to bash the U.S. economy and its future and go gaga over the “super-heated” economies of China, India, and Russia. We've seen this movie before. Remember “Japan, Inc.”? I do, as our portfolio returns were affected by the *decline* of Japanese stocks during much of the 1990's. What's different this time is that one of the new sweetheart economies is a one-trick pony (Russia and oil), one is solidly communist with massive government control and ownership of companies (China), and one is a very young democracy with social and political challenges most Americans cannot fathom (India). Can these economies overcome their challenges and provide a stable and welcome alternative for capital seeking good risk-adjusted returns? Of course, eventually. But ignoring the unique risks of these countries and considering them alternatives to the U.S. and other developed markets is naive at best.

A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.
— Sir Winston Churchill

The U.S. pessimists usually cite the falling dollar as evidence of our “decline” as an economic powerhouse (as if this is the first time the dollar's dropped). A recent article in *The Economist* points out, however, that the “countries whose currencies have gained most [against the dollar] are high interest-rate economies, such as Turkey, Brazil, and New Zealand, commodity producers, such as Canada, or a mixture of both, such as Australia.”

As the Wall Street Journal points out, “Central-bank interest rates are 16.75% in Turkey, 11.25% in Brazil, 8.25% in New Zealand, 6.75% in Australia and 5.75% in the U.K. High interest rates may prop up a currency for a while by attracting international ‘hot money.’ But super-high interest rates, like those in Turkey and Brazil, are typically a symptom of inflation-prone monetary policy, requiring a high risk premium to bribe investors to hold that country's IOUs. In any case, high interest rates are certainly not something most Americans would envy or hope to emulate.” Interest rates are not the whole story behind currency fluctuations, of course. But contrary to popular belief in some quarters, a declining U.S. dollar does not portend the long-term decline of the U.S. economy.

Merrill Lynch used to advertise that they were “Bullish on America.” We're certainly that, but we are also optimistic about changes we're seeing among other developed nations and we're very cautiously optimistic that some of the emerging markets will continue to move toward freer markets in a responsible way. Maintaining long-term allocations confirms this optimism, while shifting allocations to chase current trends can trap oneself in the enervating loop of pessimism that naturally evolves from buying high and selling low.