EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

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

February 2008

Asset Class Returns

January 31, 2008 (YTD)

	2005	2006	2007	Last 10 yrs.	YTD 2008
Bonds (%)					
One-year	2.3	4.8	5.2	4.1	0.4
Five-Year	1.7	3.9	5.2	5.1	0.6
Intermediate	1.6	3.6	9.5	6.4	2.7
Long-term	6.6	1.7	9.2	7.0	2.6
U.S. stocks (%)					
Large Market	4.9	15.7	5.4	5.8	-6.0
Large Value	10.2	20.2	-2.8	8.9	-3.8
Small Market	6.1	16.6	-3.1	9.0	-6.9
Small Micro	5.7	16.2	-5.2	10.6	-7.6
Small Value	7.8	21.5	-10.8	11.5	-3.9
Real Estate	13.2	35.3	-18.7	10.8	0.0
International stocks (%)					
Large Market	13.5	24.9	12.5	8.6	-7.6
Large Value	15.3	34.1	10.2	13.0	-8.1
Small Market	22.0	24.9	5.6	14.3	-7.6
Small Value	23.2	28.4	3.0	16.2	-6.6
Emerg. Mkts.	29.9	29.2	36.0	16.0	-8.7

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 12/31/07.

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The Anti-Bubble Asset Classes

Jeff Troutner, Equius Partners

Bubbles, bubbles everywhere.

A quick search of Wall Street Journal articles over the past three months yields no less than 20 references to "bubble" in the headline alone. Expand the search to include references within the body of the article and the list expands to 20 *pages*. This bubble in bubble articles has been inflated by the rise and fall of the real estate sector, which followed by only seven years the so-called bubble in large growth, tech, and Internet stocks. Now we read of bubbles in grain prices[1], "old masters" art[2], Chinese stocks[3], hedge fund salaries[4], and even Wall Street arrogance[5] (as if...).

It's easy to make light of the new investment word du jour, but the fact is sharply rising and then falling prices in major sectors of our (and the world's) economy affect everyone to some degree and usually cause fear and apprehension for investors— emotions that very often lead to irrational and short-sighted decisions. As extreme as most bubbles are, it's a simple fact that the vast majority of investors, regardless of experience or education, fail to recognize when one has occurred and is about to burst. Profitable timing of bubbles seems every bit as difficult as timing normal up and down trends. But reacting to a perceived bubble too soon or too late can be far more costly than mis-timing much milder cycles. Just consider those people who were burned by over-concentration in growth stocks earlier this decade and turned around and placed what was left in "no-lose" real estate. Some people never learn.

Most experts will tell you that the best defense against bubbles is diversification. We certainly second that wisdom. But Equius takes an additional step by emphasizing diversification among asset classes that, because of how they are defined, structured, and managed, can add a second line of defense against over-optimism and over-pessimism.

Roach Motels

Remember the old Black Flag commercials for their "Roach Motel" product? Their tag line was "bugs check in, but they don't check out." I often refer to large company and sector index funds (such as real estate) in the same way. Stocks in the S&P 500 are selected by a committee and the list of 500 stocks remains static until one is eliminated by a merger or acquisition or the committee replaces an "old" economy stock with a "new" economy stock. Both of these events happened at the same time recently when Google replaced Burlington Resources (railroads), which had been acquired by ConocoPhillips (oil). There's nothing inherently wrong with this, of course. The S&P 500 stocks are very representative of the overall economy and growth in corporate earnings.

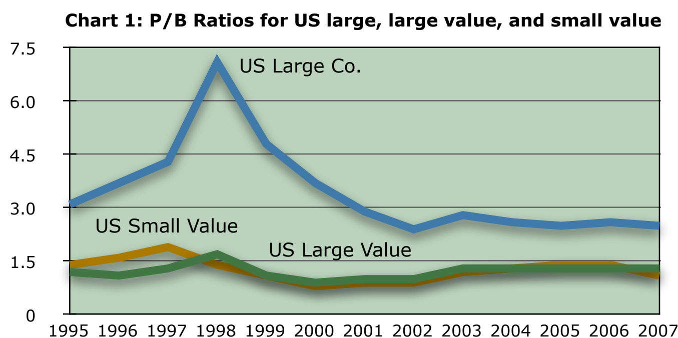
But the fact remains that S&P 500 companies (and those of the MSCI EAFE international index, REIT indexes, and emerging markets large company indexes) are selected because they have *become* the dominate companies in their respective industries, which is reflected in their very high market valuations (price times shares outstanding). Most stay in their index until their price stagnates or falls.

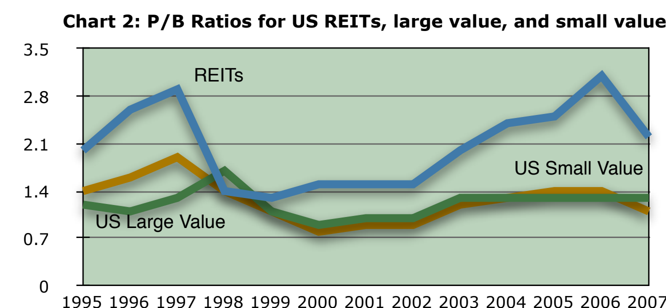
"I want my bubble back"

It's true that many stocks in these indexes are considered "value" stocks due to their low prices relative to their book values. But the impact of these stocks on the total return of the index is overwhelmed by the market cap domination of the very large growth stocks. More importantly, these value stocks do their thing (up and down price movement) within a closed system and, like their growth stock brethren, only leave once they're exterminated (like pests) by the index committee.

Now consider what's goes on in small cap and value indexes. Stocks are included because of their *low prices*. Unlike the Roach Motels, stocks leave these indexes because their prices have *risen* to the point where they no longer qualify for the indexes. Some of these stocks might even find their way back into the small cap and value indexes again due to a price drop. This structure represents the disciplined and unemotional application of the "buy low, sell high" philosophy most investors wish to embrace but find so difficult in times of over-optimism and over-pessimism.

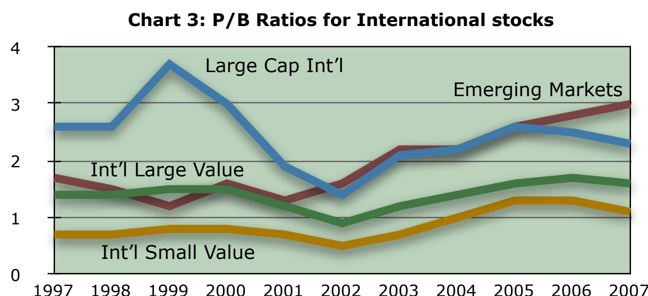
To illustrate this, let's look at the changes in price-to-book ratios for U.S. and foreign asset class funds over recent periods. Chart 1 shows the significant increase in the price-to-book ratio of large growth stocks (S&P 500) from 1995-1998 and the decline in the ratio from 1999-2002. In contrast, the ratio for U.S. large and small value stocks stayed much more stable and consistent over the total period. From 1999-2002, the total return for the DFA US Large Company Fund (S&P 500-based) was -25.0% compared to +2.1% for the DFA US Large Cap Value Fund and +37.1% for the DFA US Small Cap Value Fund.





When we look at domestic REITs compared to U.S. large value and small value we see a similar relationship. Chart 2 shows an increase in the price-to-book ratio for REITs from 1995-1997, then a drop that brought the ratio more in line with value stocks. The ratio rose through 2006 and fell sharply again last year. The total return for REITs from 1998-1999 was -17.1% compared to +17.3% and +4.8% for large and small value stocks respectively. In 2007, the returns were -18.7%, -2.8%, and -10.7% respectively.

Finally, let's look at the international side of the equation. Chart 3 shows the spike in the price-to-book ratio for international large stocks from 1997-1998 (DFA could only provide us with emerging markets data starting in 1997) and then a steep decline through 2002. The ratio climbed again through 2005 before falling off a bit the past two years. The price-to-book ratio for emerging markets large company stocks stayed in line with international large value and small value until 2001 and has steadily increased since then.



The total return for international large stocks from 2000-2002 was -41.9% compared to -22.6% and -2.2% for international large and small value stocks respectively. Emerging markets stocks fell 40.2% over the same period. The price-to-book ratios for all of these asset classes have risen since 2002. But the much steeper increase in the emerging markets ratio since then is reflected in a 110 percentage point greater total return over the nearest best performer, international small value stocks. Unless book values for emerging markets stocks increase significantly, investors should expect these ratios to decline as prices adjust downward at some point.

Conclusion

All equity asset classes are subject to unique risks and all go through their ups and downs in performance. So attempting to exploit changes in price-to-book ratios among asset classes through tactical shifts is almost always a loser's game.

It's clear though that the disciplined buy low, sell high structure of small cap and value asset class funds tends to moderate fluctuations in the average price-to-book ratios for these funds. Including these asset class funds in a diversified portfolio can smooth the ride and provide another line of defense (along with rebalancing to target allocations) against price "bubbles" caused by over-optimism and over-pessimism.

[1]Farmers Wonder if Boom In Grain Prices Is a Bubble, *The Wall Street Journal* (WSJ), 1/31/08; [2]The "Old Masters" Hedge, *WSJ*, 1/5/08; [3]Bullish Appetite for China Begins to Wane, *WSJ*, 12/5/07; [4]A Source of Our Bubble Trouble, *WSJ*, 1/17/08; [5]Popping Wall Street's Arrogance Bubble, *WSJ*, 2/7/08.

Returns referenced in this article are the actual returns for select Dimensional Fund Advisors (DFA) mutual funds and are net of mutual fund expenses. The returns do not reflect a deduction for Equius Partners advisory fees.

Past performance does not guarantee future returns. Fund returns are for illustration purposes only and should not be construed as recommendations by Equius Partners.