EQUIUS PARTNERS

Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

October 31, 2008 (YTD)

	2005	2006	2007	Last 10 yrs.*	YTD 2008
Bonds (%)					
One-year	2.3	4.8	5.2	4.1	2.2
Five-Year	1.7	3.9	5.2	5.1	0.9
Intermediate	1.6	3.6	9.5	6.4	2.2
Long-term	6.6	1.7	9.2	7.0	0.4
U.S. stocks (%)					
Large Market	4.9	15.7	5.4	5.8	-32.7
Large Value	10.2	20.2	-2.8	8.9	-36.4
Small Market	6.1	16.6	-3.1	9.0	-30.5
Small Micro	5.7	16.2	-5.2	10.6	-31.3
Small Value	7.8	21.5	-10.8	11.5	-31.0
Real Estate	13.2	35.3	-18.7	10.8	-30.4
International stocks (%)					
Large Market	13.5	24.9	12.5	8.6	-41.8
Large Value	15.3	34.1	10.2	13.0	-46.8
Small Market	22.0	24.9	5.6	14.3	-45.3
Small Value	23.2	28.4	3.0	16.2	-43.4
Emerg. Mkts.	29.9	29.2	36.0	16.0	-48.4

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 12/31/07.

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The Government's to Blame—Now What?

Jeff Troutner, Equius Partners

The federal government—through seriously misguided actions of the Federal Reserve and deplorable Congressional "oversight" of Fannie Mae and Freddie Mac—has caused the worst financial crisis since the Great Depression. And the make it-up-as-you-go decisions of the U.S. Treasury to implement the $700 billion "bailout" program approved by Congress has only made matters worse. The confusion and uncertainty surrounding this debacle have introduced a massive new risk to the financial markets and the economy as a whole. Stock markets around the world are trying to adjust as a result and may very well have overstated the risk. But we'll only know for sure in hindsight, so for now we have to play the hand we've been dealt.

Expectations

Market declines of the magnitude of the 1973-1974 period have been built into our expectations as investment advisors and consistently communicated to clients for the past 16 years. Over the 21-month period from January 1973 through September 1974, the S&P 500 fell 43%.

In just the 12 months ended last month, the S&P 500 was down 36% (capped by an atrocious October decline of 16%) and so far in November (through the 13th) the market is down another 6%. So we've reached our downside expectations in less time than it took 35 years ago, and we have no way of knowing how much further this market will fall.

We have spent the past month and a half researching the events, warnings, and analyses leading up to this financial debacle and have come to the conclusion that seriously misguided government intervention in our market economy is the primary and overwhelming cause of the crisis. Everything else—Wall Street greed, over-leverage of financial institutions, loose lending policies, speculative real estate investing, lying borrowers, etc.—are the effects of what Congress and the Administration did and did not do along the way.

Market forces were overwhelmed, in other words, by a political risk that was so large and so misunderstood (aided and abetted by an irresponsible, severely biased, and mostly ignorant press) that normal assessments of risk and return were virtually worthless.

We don't have the space in this article to explain all the details behind our conclusion and, frankly, others have articulated the case better than we could. So, we've posted links to some of the most influential articles from many sources on our website. They can be found at EquiusPartners.com by clicking on the "Blog" tab and going to "A Credit Crisis Reading List." This list will be continually updated.

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A Lone Voice (Almost) in the Financial Wilderness

As the market began its collapse in late September, it occurred to me that I had been reading about an impending disaster precipitated by the collapse of Fannie Mae and Freddie Mac for a couple of years. What I found as I started digging back through the archives was that these warnings began in early 2002—over six years ago! (See the Excerpts From A "Credit Crisis Reading List" box on page 3.)

Since then, there has been a steady flow of follow-up editorials and articles in *The Wall Street Journal*, some more politically pointed than others. But all have a consistent theme of irresponsible government interference in the financial markets; an appalling lack of government oversight and regulation in key areas (yes, the *Journal* advocated responsible regulation); and an unholy alliance among politicians, lobbyists, and (surprise!) greedy Wall Street opportunists that had the potential of a major financial disaster.

I have to admit that as I was reading these articles, I didn't quite "get it." The Journal seemed a bit obsessed with an issue very few others found troubling. Only after the fact did I find that others were also sounding the alarm—some as prominent as Warren Buffett. Others, like William Poole, the president of the St. Louis Federal Reserve, who gave a speech in 2003 to the Office of Federal Housing Enterprise Oversight (OFHEO) Symposium, were simply ignored.

All were drowned out by the tsunami that is the mortgage industry, their lobbyists, and Congress's desire to promote what has arguably become a new entitlement in this country: home ownership. A mainstream press—more interested in promoting sensationalism and feeding hungry like-minded lemmings—eschewed serious investigative journalism when it was needed most. Their collective response now is simply to blame "greed" and move on in the same irresponsible and immature way as before.

Not surprisingly, the more democratic and diverse new media of the Internet is stepping in to fill this gaping void. YouTube videos are springing up that show the foolishness of our Congressional "leaders" during the debates concerning Fannie and Freddie as early as 2003. Recently, a video compilation was produced showing the ridicule Peter Schiff of Euro Pacific Capital received at the hands of Fox News and their lineup of experts (search "Peter Schiff Was Right 2006-2007"). The point isn't that Schiff was right (his portfolios have actually suffered as much or more as a result of the market collapse since he overweighted foreign stocks). The point is that the herd mentality was drowning him out and no one in the media had the brains or the guts to dig deeper and get to the truth.

In fact, two of the experts in the video are people we have a lot of respect for and who are otherwise very rational, knowledgeable, and experienced (Art Laffer and Ben Stein). This, if nothing else, is evidence of a massive new force in the markets that cannot be ignored any longer.

No political party or economic theory comes out of this unscathed either. Both major parties and our political process, influenced as they are by powerful lobbyists representing special interests groups, are to blame. Regulation and deregulation are to blame. Greedy and irresponsible executives at public companies and the government-sponsored enterprises (GSE's like Fannie and Freddie) are to blame. The Federal Reserve and their easy money policies and a debased U.S. currency are to blame. Unscrupulous and greedy mortgage lenders and foolish borrowers are to blame.

So Now What?

Given what we know about the government's role in the crisis, the gross mismanagement of an ill-conceived "bailout," and the general perception of even more massive government intervention under the incoming administration, do we consider making an exception to an otherwise rational policy of no market timing? If so, should we anticipate an event like this every 35 years or so; or more often in anticipation of even greater political influence in the markets going forward? We don't know these answers. But this "perfect storm" in the financial markets has heightened our interest in tracking, assessing, and measuring in some way the risks associated with this intersection of public and private influences on the financial markets. This article, therefore, is just the beginning of a process.

One thing you can count on is a constant parade of self-serving pundits showing up on the major financial and news networks claiming that "buy-and-hold" is dead . We've seen this movie before. In fact, every decline in the markets of any significance brings out the buy-and-hold naysayers. But what do they offer in return other than 20/20 hindsight?! Nothing, of course. They are feeding on and perpetuating fear—pure and simple. In the case of the talking heads on CNN, Fox, etc. it's pure unadulterated ignorance.

Market timing is an absurd and dangerous strategy. In its "black box" tactical form, it's prone to nasty timing errors (too early and too late). In its more common subjective form, it's driven almost entirely by emotion. Fear causes investors to get out near market bottoms and greed causes them to get in near tops.

If the current financial crisis does not convince you of this (on top of the lessons learned from the stock market crash only six years ago), nothing will. Fannie Mae and Freddie Mac loaded up on sub-prime and Alt-A mortgages much more aggressively near the end. Major commercial and investment banks did the same and, in the case of the latter, increased borrowing (leverage) dramatically while they were at it. Almost all were still holding the bag when the house of cards collapsed, Rome was burning , and Congress was fiddling.

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The big losers in this crisis so far are rational investors (both U.S. and foreign) who did not know the full story of the risks being created by the GSE's and their political allies and the American taxpayers who are now providing an almost unimaginable amount of "bailout" funds to every company (and soon every municipality?) that comes begging, hat in hand.

Stay the Course

Only through broad and efficient diversification can we hope to tame, or at least moderate, the market's more nasty tendencies. And occasionally, like now, the only effective diversification is your bond allocation—assuming that even there the emphasis in on broad diversification, short maturities, and very high quality—no gimmicks or "free lunches."

We're not inclined to believe there's any middle ground between market timing and buy-and-hold. But we're extremely concerned about what's happened and what we strongly perceive as the government's role in causing it and, now more importantly, in dealing with its aftermath. We will be discussing this with Dimensional Fund Advisors and their cadre of academics, as well as others we respect in the field of financial economics. As always, we'll inform you of our findings. In the meantime, let's all focus on better markets and a recovering economy.

Some After-Thoughts

We debated among the Equius Team about whether this article should be published. There is certainly a degree of anger and frustration in my "voice" throughout and there's a hint of a departure from our cast-in-stone principle of no market timing. But I felt the article was important for a couple of reasons:

First, I *am* angry. I think critical information that led to this crisis was withheld from the market by irresponsible politicians and a compliant national press. Responsible voices were either drowned out or dismissed altogether. A sound-bite and herd mentality developed at a time when critical thinking and serious analysis were sorely needed .

Second, *nothing is cast in stone*. We've always said to our clients that we set a very high bar for everything we do. But a bar is not a ceiling. We cannot limit our intellectual curiosity and stop looking for answers if we ever expect to avoid something like this again. As I said in the article, there might *not* be a better answer than the broad diversification, structure, and discipline we already have in place. But we'll never know unless we keep searching.

We remain as optimistic as ever in our economic system and the strength, entrepreneurial spirit, and perseverance of the American people. We are confident that our economy and markets will recover in due time, and the turnaround is likely to be as unexpected and dramatic as the collapse. Our hand remains firmly on the tiller as we navigate this storm and look ahead to better weather.

Excerpts From "A Credit Crisis Reading List"

We were reading President Bush's budget the other day (we know, get a life), when we came across an unusual mention of our all-time favorite companies -- Fannie Mae and Freddie Mac. What we found is a tale we think taxpayers and investors should want to hear.

It seems that Fan and Fred, two "government-sponsored enterprises" that hold the majority of all home mortgages in the U.S., have been growing their debt at an annual rate of 25%. They now have about $2.6 trillion in debt outstanding, a big number in any case, but really big considering that taxpayers are on the hook for it. The budgeteers also expressed some anxiety about Fan and Fred's increasing dependence on derivatives.

Hmmm. Where have we heard this before? The more we've since looked at Fan and Fred the more they look like poorly run hedge funds: lots of leverage and snarkily hedged risk. The word Enron ring any bells?

Last year, Fan's debt/equity ratio was about 60 to 1, more than five times the average for commercial banks. Moreover, as mortgage lenders, Fannie's equity can hardly be said to be well-diversified. Risk thus becomes a critical question.

"Fannie Mae Enron?," *The Wall Street Journal*, February 20, 2002

...Also in 2005, Fannie and Freddie began buying vast amounts of subprime and "alt-A" mortgages with, in many cases, virtually no down payments, that had been taken out by people with low credit scores and low incomes relative to their monthly payments. To finance more and more affordable housing, as leading Democrats, and some Republicans, had urged, the GSEs dramatically lowered their traditional underwriting standards.

Between 2005 and 2007, Fannie and Freddie "sold out the taxpayers" by financing almost $1 trillion in such highly risky mortgages, according to "The Last Trillion Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac."

"When Fannie And Freddie Opened The Floodgates", *National Journal Magazine*, October 18, 2008

Now that the federal government has been required to take effective control of Fannie and Freddie and to decide their fate, it is important to understand the reasons for their financial collapse--what went wrong and why. In his statement on September 7 announcing the appointment of a conservator for the two enterprises, Treasury Secretary Henry M. Paulson pointed to their failed business models as the reason for their collapse. This was certainly a contributing element, but not the direct cause. The central problem was their dependence on Congress for continued political support in the wake of their accounting scandals in 2003 and 2004. To curry favor with Congress, they sought substantial increases in their support of affordable housing, primarily by investing in risky and substandard mortgages between 2005 and 2007.

"The Last Trillion-Dollar Commitment", American Enterprise Institute, September 30, 2008

What's Not Different

Phil Jonckheer, Equius Partners

> *Life is being on the wire; everything else is just waiting.*
> *Karl Wallenda*

Many things are different today—not the least of which is the value of our portfolios. Irrespective of how the economic, political and/or social landscapes have changed, the stock market continues to cycle—albeit with increasing volatility. These cycles are precisely why stocks are risky. The drop in account values is the downside of the risk investors have to embrace if they want to be rewarded. Those declines (and subsequent increases) have occurred and will continue so long as risk and return are related.

In evaluating today's financial landscape, it is important to separate economic, political and/or social developments from stock market volatility. In pricing risk, investors look far beyond current events. We do not anticipate that the violent fluctuations in short-term corporate earnings caused by our government's meddling in Fannie Mae and Freddie Mac will dramatically influence how investors price risk in the long run. Nonetheless, we feel we cannot ignore the question that Jeff introduced in the first part of this newsletter: whether the government's distortion of risk alters how it ultimately relates to expected returns. We fully intend to continue studying the implications of such distortions.

One way to measure how risk is priced today (and how expected returns on the market are higher than they were last year) is through the credit markets. On September 30th CNBC reported: "Credit is available, definitely, if you can verify your income and if you are willing to pay the price (of a higher interest rate)." In other words, the expected return (what banks demand on the money they extend) has increased. This indicates that risk and return continue to be related.

As the economic malaise continues, there is a good chance that our government will be allowed to use the financial meltdown to wield more control over industries and markets. Although we are aware this could introduce more volatility into our markets, history demonstrates that government involvement does not necessarily nullify the relationship between risk and return. From 1933 through 1945 our government spawned a huge number of projects. Even if one might argue that the natural flow of free markets was compromised during that time, and even if one might further conclude that such government intervention might have distorted investment risk, what didn't change was how asset classes delivered returns commensurate with their risks. Annualized returns for US asset classes during that 13-year period were: Large Growth: 11.4%; Large Value: 13.3%; Small Growth: 21.9%; and Small Value: 23.1%. For people to remain invested and reap the rewards, a capitalist's courage was required in the face of our country's then 25% unemployment, a 66% drop in world trade from its 1929 high due to a 50% increase in tariffs, world economic output at 50% of its 1929 high, marginal income tax levels as high as 63%, 44% of all first mortgages in default, and 9,000 bank failures. It also was necessary to remain fully invested in the stock market throughout the Second World War.

In order to consider if more recent political forces might distort the fundamental relationship between risk and return, we studied the history of stock market returns from 1983 through 2007 in Australia, Austria, Belgium, Canada, Denmark, France, Germany, Hong Kong, Italy, Japan, Netherlands, Norway, Singapore, Spain, Sweden, Switzerland, United Kingdom and the United States. We could not detect any consistent relationship between a country's market returns and its form of government.

We are aware that a swooning market can force people to loose sight of what is important since rapidly declining markets are a painful reminder of what cannot be controlled. Lack of control can make people feel powerless and affect the way they process information. University of Texas' Professor Jennifer Whitson reports that "when you sense that you lack control you're much more likely to try twisting and pretzeling explanations and seeing patterns that aren't there."[1] Even the slightest change in conditions can be construed as another reason for further problems. Gary Becker, the 1992 Nobel Laureate in Economics, reminds us that "the crisis that kills capitalism has been said to happen during every major recession and financial crisis ever since Karl Marx prophesied the collapse of capitalism in the 19th century." [2] We must be careful about allowing a constantly (even a dramatically) shifting economic, political and social landscape to influence our thinking in a way that forces us to reach conclusions that run counter to the evidence that continues to demonstrate that risk and return are related.

On the other hand, we must not be blind to the reality of how vigorously markets have fluctuated recently and whether it might be possible to take advantage of those gyrations while still maintaining our discipline of investing in structured asset class funds. To date the evidence lies in favor of strictly adhering to our investment plans even in the face of powerful and seemingly compelling economic, political, social and psychological forces that demand our attention and appear to threaten the integrity of how risk and return are related. With our colleagues at DFA and Schwab, and with the depth and breadth of academic research to which we have access, we will continue to explore the possibilities of capitalizing on other factors that might promote your wealth in the interest of realizing what is important to you—adding balance to your wealth despite uncertainty.

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[1] For Investors, Dealing With a Loss of Control, Jason Zweig, Wall Street Journal, October 7, 2008, Pages D1&D3.

[2] We're Not Heading For a Depression, Gary Becker, Wall Street Journal, October 7, 2009, Page A27.