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Adding Balance to Wealth℠

ASSET CLASS℠

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

March 2010

Asset Class Returns

February 28, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
Bonds (%)					
One-year	1.9	4.0	5.2	3.7	0.4
Five-year	4.2	4.0	5.2	4.8	2.0
Intermediate	-0.7	12.9	9.5	6.9	2.3
Long-term	-12.1	22.5	9.2	7.4	2.1
U.S. stocks (%)					
Large Market	26.5	-37.0	5.4	-1.0	0.4
Large Value	30.2	-40.8	-2.8	4.4	3.1
Small Market	36.3	-36.0	-3.1	5.7	4.0
Small Micro	28.1	-36.7	-5.2	6.3	3.7
Small Value	33.6	-36.8	-10.8	9.1	5.2
Real Estate	28.2	-37.4	-18.7	10.5	0.8
International stocks (%)					
Large Market	30.6	-41.4	12.5	1.4	-3.8
Large Value	39.5	-46.3	10.2	6.7	-4.8
Small Market	42.0	-43.9	5.6	8.7	-1.0
Small Value	39.5	-41.7	3.0	11.3	-2.0
Emerg. Mkts.	71.8	-49.2	36.0	9.5	-3.2

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 U.S. Large Co. fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA U.S. Micro Cap fund
U.S. Small Market	DFA U.S. Small Cap fund
U.S. Small Value	DFA U.S. 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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Whose "Lost Decade"?

Eric Nelson, Equius Partners

The financial media is falling all over itself to proclaim the 2000-2009 period as the "Lost Decade." This is due to the sad fact that the S&P 500 stock market index managed to *lose* 9.1% in total return over the last ten years (with dividends included). The purpose of "lost decade" headlines is to 1) make stocks look really scary, 2) question the validity of a buy-and-hold strategy, and 3) question the wisdom of indexing portfolios. All these things play into Wall Street's greedy hands, of course, by keeping money moving to generate commissions and sell more products. Wall Street then rewards the media with millions of dollars in new advertising.

The truth is this *was not* a lost decade for our clients. They have learned from extensive historical evidence and solid research that holding a portfolio that includes long-term "tilts" to small cap and value stocks in a disciplined manner is often the best antidote to general market turmoil.

We've Been Here Before

Table 1 shows the four negative ten-year calendar periods for the S&P 500 index since 1926, before inflation. The worst ten-year period for the index was the 1999-2008 period—worse than the years that included the Great Depression. It could have been even worse. As the "Balanced Stock" column shows, small cap and value stocks felt the brunt of the Depression but performed much better in more recent downturns.

Table 1: Lost Decades Since 1926, Nominal Total Returns

	Before Inflation		
Calendar 10-Year Periods	S&P 500	Balanced Stock	65/35 Stock/Bond
1929-1938	-8.5%	-33.3%	12.6%
1930-1939	-0.5%	-23.5%	21.9%
1999-2008	-13.0%	38.4%	67.2%
2000-2009	-9.1%	68.1%	91.3%

Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Balanced Stock is 30% S&P 500 index, 30% Dimensional US Large Value index, and 40% Dimensional US Small Value index. 65/35 Stock/Bond is 35% 5-Year Treasury Notes, 19.5% S&P 500 index, 19.5% Dimensional US Large Value index, and 26% Dimensional US Small Value index. Source: Dimensional Fund Advisors Returns Program.

Table 1 only shows part of the story, however. The effect of inflation should always be considered when evaluating investments to determine the actual purchasing power of certain strategies. When we look at inflation-adjusted returns (Table 2), we see many more "lost decades" and we also see more clearly the positive effects of more targeted small cap and value stock diversification.

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Table 2: Lost Decades Since 1926, Total Real Returns

	After Inflation		
Calendar 10-Year Periods	S&P 500	Balanced Stock	65/35 Stock/Bond
1929-1938	11.7%	-18.6%	37.5%
1930-1939	22.3%	-5.9%	49.8%
1965-1974	-31.8%	-9.1%	-1.7%
1966-1975	-20.7%	4.4%	9.0%
1968-1977	-22.3%	16.6%	17.3%
1969-1978	-28.4%	-2.2%	2.4%
1970-1979	-13.2%	44.7%	31.2%
1972-1981	-18.2%	48.0%	23.2%
1973-1982	-16.9%	65.3%	41.9%
1999-2008	-32.2%	7.9%	30.3%
2000-2009	-29.2%	31.0%	49.1%

See footnotes for Table 1.

Since the Great Depression saw prices of goods and services fall, the real returns for the S&P 500 for the first two periods were actually positive. The small cap and value-tilted stock allocation (Balanced Stock) was still down, but not nearly as much after the effects of *deflation* were considered. The 65/35 Stock/Bond allocation shows positive returns for both periods.

Now look at the periods added to Table 2. All these produced positive S&P 500 returns *before* inflation. But *after* inflation, these returns were negative across the board.

Notably, however, the small cap and value-tilted stock allocation performed significantly better, with positive returns for most periods. The 65/35 Stock/Bond allocation shows positive returns for all but one period.

Realistic Expectations Are Critical

The nominal return for the S&P for the past ten years works out to about a 1% *annual* loss for the index. Around the end of 1999, many of the smartest and most reputable financial economists (including Eugene Fama and Ken French) were suggesting very low or even negative nominal returns for the S&P 500 for the next decade. We pointed this out in our January 2000 *Asset Class*, with an article titled "Should We Fear a Total U.S. Market Collapse? Or Is a Gradual 'Rotation' Among Asset Classes More Likely?"

Our concern at the time was that concentrating on a large growth stock-biased index like the S&P 500 to indict *all* stocks (including small company and value stocks) was not necessarily relevant for investors like our clients who owned and were committed to staying with a balanced asset class portfolio.

A few months prior to that article, we outlined the shortcomings of the "Total Stock Market" index funds being touted as worthwhile alternatives to S&P 500 index funds by John Bogle of The Vanguard Group (and others). Bogle had good intentions (like us, he was trying to keep investors from the very destructive habit of market timing). However, both the S&P 500 and Total Stock Market indexes are dominated by a relatively small group of very large growth stocks. Therefore, his suggestion that the latter would provide meaningful diversification into small cap and value stocks was sadly naive. It also ended up costing investors billions of dollars, unnecessarily.

Unfortunately, even some advisors who index portfolios were seduced by Bogle's message. Whether they stuck stubbornly to more market-based strategies or chose inferior small cap and value index funds or ETFs, the results were far from optimal. Trying to save a few basis points on fund expenses instead of concentrating on index fund construction led to a lot of bad decisions. Some advisors took excessive and unrewarded risks on the fixed income side. Others tried to enhance returns using "alternative" investments, such as hedge funds and commodities. Lately, we're seeing much greater allocations to emerging markets and gold. These "enhancements" are often implemented at the worst possible times (what you would expect from *reactive* decisions).

Managing Expectations

Looking back, we and the financial economists were right. The S&P 500 *did* produce negative nominal and real returns for the decades ended 2008 and 2009. And we did see a rotation in return leadership from indexes dominated by large growth stocks to those tilted much more to small cap and value stocks (a relationship we expect long term as well).

Our goal for the *Asset Class* articles in late 1999 and early 2000 was to set realistic expectations for our clients who were committed to buying and holding a diversified asset class portfolio. Selling the S&P 500 index funds from our portfolios because of high price/earnings ratios and low future expected returns was not an option. We've seen market timing of this kind (and others) fail miserably and cost investors much more than buying into and staying with an *intelligently* diversified asset class portfolio. We felt this way seventeen years ago when we started down this path and we're just as committed to this strategy today.

A Contrast in Integrity: From Oakland to Geneva

Jeff Troutner, Equius Partners

I had the opportunity recently to attend two very different investment forums. The first was an "active versus passive" debate, sponsored by a local community foundation in Oakland, in which I was a spectator and, ultimately, a provocateur. The second was a four-day DFA-sponsored gathering of European investment advisors in London. At the latter event I presented our seventeen years of asset class investing experience to 150 or so advisors who were in the process of transitioning their practices from active to passive investing. The two events could not have been more different in so many important ways. Reviewing these differences offers an inside look at my industry—and the things of which I am most proud and most ashamed.

The Non-Debate

Let's start with the community foundation-sponsored "debate." First, the sponsor of the event is a community *foundation*, whose trustees are held, presumably, to the principles of The American Law Institute's 1992 restatement of The Prudent Investor Rule. This text is dominated by the language of Modern Portfolio Theory and The Efficient Market Hypothesis. It is unambiguous in placing a heavy burden on trustees to prove the value of active strategies. Their generous use of the word "uncompensated" throughout to describe active management risk gets to the heart of what this debate *should* have been about. Yet, even the "moderator," who is a paid consultant to the foundation, made the mistake of suggesting that inefficiencies exist in small cap and foreign markets to a degree that active managers can exploit. No proof, of course (it doesn't exist), just a blatantly ignorant statement right out of a 1980s-era Wall Street marketing brochure.

My understanding is that a debate is "a formal discussion on a particular topic in a public meeting, in which opposing arguments are put forward." This was not a debate. Not only did the "passive" advisor also use active strategies in portfolios in the form of mediocre, retail-level hedge funds, private equity, and other ridiculously expensive packaged products (with no evidence of value added), but the evidence he used in support of indexing was essentially a bunch of quotes from other people. For example, he noted that only about 20% of active managers beat the market over time, but his "evidence" was simply a quote by John Bogle.

The active advisor was worse. Almost the whole of his presentation was to review the growth of debt in the U.S. (implying, of course, our future demise as a productive nation); the enormous GDP growth of "China, India, and Rest of Asia" (implying, of course, the future trend of those countries' stock prices); the terrible "bubbles" we've experienced recently and the need to avoid them; and the apparent need of investors to hire someone like him to point these things out. Sprinkled throughout were words of wisdom such as "The stock markets are forward looking but legally blind" (with a graphic of Mr. Magoo for emphasis) and this little tidbit: "Although most active managers do not outperform their benchmarks, many do." At least he said one thing true and relevant to a debate.

Really, the best the active guy could do was to have the "moderator" call on the owner of his firm, who was in the audience, to ask a question. Instead of a question, what we all had to endure was a rambling marketing pitch that in essence suggested that at one time his firm actually *did* beat the market—for a while. He then pointed out why they failed to beat the market *consistently*, but quickly added that he was able to sell his firm in spite of his track record. His new firm would, he promised, beat the market.

As many in the audience sat stunned, another active advisor smelled an opportunity to market *his* firm. This advisor over the past few years had been a darling of a certain discount brokerage firm that refers some clients to outside advisors. After receiving millions of dollars in this way, the advisor timed the market incorrectly and crashed and burned in the recent market turmoil—taking millions of dollars of client money and all his promises of "superior performance" down with him. Now he stood to ask his question but admitted first that, yes, only about one in five active managers beat the market. And, yes, you can't know who they are in advance. He then played the best card in his hand: he asked (in a very serious and measured tone) if *not trying* wasn't, well, gosh, kinda like...un-American??

To my astonishment, the passive guy sheepishly agreed. It *does* seem a little un-American to not try. What he didn't say was that investors who pay an advisor a fee are *entitled* to know the very low odds of any well-meaning, patriotic American trying to beat the market *with their money*! Tell them, in other words, that you are speculating—not investing—with their money, then let them decide whether they want to gamble on your skills or not.

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No, he didn't say that. *I* had to stand up and ask why these advisors don't feel compelled to be totally honest with their clients and explain the odds, why trustees of foundations and their consultants aren't held to higher fiduciary standards, and why our regulatory system allows them all to get away with it. Pitiful.

Hope

In stark contrast to the faux debate in Oakland, I was invited to speak to several groups of European advisors in London and meet with a couple individually in Geneva. This experience was all about transparency, research, evidence, value-added, and delivering the best client experience. These advisors were either throwing off the lies and myths of the Dark Side as former purveyors of active strategies or starting fresh and committed to doing things right from the start. Since the financial services industry there appears to be about fifteen years behind ours in many ways, Dimensional Fund Advisors (DFA) felt that our long history of applying asset class investing principles in a consistent and disciplined way in the States would be useful to these advisors.

As usual, DFA did a stellar and very professional job of presenting all the data, research, perspectives, and history to support their more institutional version of "passive" investing. I was tasked with putting a real-world face to all of it.

The title of my presentation was "17 Years of Financial Bliss." This was obviously tongue-in-cheek, since those seventeen years were immensely challenging in terms of building the business. Our first couple of years were spent trying to explain what "indexing" was to investors who had never heard the term before. The next five years were spent defending a long-term small cap and value portfolio tilt at a time when large growth, technology, and Internet stocks were all the rage and every stock picker was a genius. We then endured the market decline from 2000 to 2002, when stocks became a dirty word (even though our strategy held up very well over the period). The 2003-2007 period saw the strategy hitting on all cylinders, but we were then hit with the global financial crisis and "the end of the world as we know it." Keeping clients focused and committed in order to benefit from the eventual recovery was not particularly blissful but clearly necessary.

Overall, our commitment and confidence in common-sense principles and first-rate financial economics research over those seventeen years paid off for us and our clients. The "bliss" in the title was a reference to the whole experience—our clients' experience, how well we slept at night doing what we were doing for clients, and the experience of working with a unique company like DFA throughout. To find and work with a company in the U.S. financial services industry that does not compromise its principles and does not sell its soul for short-term gain was important in maintaining our confidence in an asset class approach.

This forum also gave me the opportunity to express my gratitude, on behalf of our clients and ourselves, for two people who have radically transformed the investment industry in the U.S. over these past seventeen years, but in very different and significant ways.

The first is John Bogle, the former chairman of The Vanguard Group, who has almost single-handedly made indexing mainstream in this country. There's no question he's added value with his emphasis on traditional indexing principles and his focus on costs. But Bogle has failed in two significant areas that have had very negative impacts on the client experience. First, he doggedly avoids giving any credence to the Fama/French research, and second, he has failed to assign any real value to advisors who help clients define and stay with a disciplined, long-term asset class strategy.

Both of these positions have cost investors dearly over the past ten years (as Eric points out in the previous article). Anyone who disagrees with me on this point should take a close, hard look at their own investment behavior over the past couple of years or consider all the *advisors* who couldn't stick to their principles when they mattered most. Fund expenses matter, but not without discipline.

The person who has had a much more significant impact on investor wealth in the U.S. over the past 20 years is Dan Wheeler of DFA. Dan convinced the principals at DFA to move beyond the institutional market and offer their funds to "retail" investors through educated and committed financial advisors. Over time, he took the message to Canada, Australia, New Zealand, Chile (where DFA is a star in arguably the best retirement system in the world), and Europe through his former role as Global Director of Financial Advisor Services at DFA.

The amount of wealth created *and* preserved by better asset class diversification and better advisor knowledge and discipline is enormous, yet Dan is virtually unknown outside of advisor circles. And he's totally OK with that. No one calls him "St. Dan" and there are no "Wheelerheads" on the Internet discussion boards. Just a whole lot of moms and pops and retirement plans that have prospered thanks to his vision. Thanks, Dan.