

Asset Class Returns

December 31, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
Bonds (%)					
One-year	1.9	4.0	5.2	3.1	1.2
Five-year	4.2	4.0	5.2	4.6	5.3
Intermediate	-0.7	12.9	9.5	6.3	6.9
Long-term	-12.1	22.5	9.2	7.1	10.3

U.S. stocks (%)

Large Market	26.5	-37.0	5.4	1.3	14.9
Large Value	30.2	-40.8	-2.8	5.3	20.2
Small Market	36.3	-36.0	-3.1	8.3	30.7
Small Micro	28.1	-36.7	-5.2	9.6	31.3
Small Value	33.6	-36.8	-10.8	11.1	30.9
Real Estate	28.2	-37.4	-18.7	10.5	28.7

International stocks (%)

Large Market	30.6	-41.4	12.5	3.9	9.3
Large Value	39.5	-46.3	10.2	7.8	10.6
Small Market	42.0	-43.9	5.6	11.7	23.9
Small Value	39.5	-41.7	3.0	13.5	18.1
Emerg. Mkts.	71.8	-49.2	36.0	15.6	21.8

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 12/31/10.

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Past performance is not a guarantee of future results.

Equius Partners, Inc.
3 Hamilton Landing, Suite 130
Novato, CA 94949
Phone: 415-382-2500
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2010 Market Review

Jeff Troutner, Equius Partners

The past year offered an interesting mix of positive and negative news as investors around the world eagerly anticipated signs of economic recovery and financial stabilization. While most financial markets logged positive returns for a second straight year, investors had to endure a host of troubling news and pessimistic market predictions. Even eight months into the year, the S&P 500 Index was down 5.9%. But diversified, long-term investors were rewarded with attractive market returns, as the S&P 500 closed the year up 15.1%, with 10.8% of the gain coming in the fourth quarter. (Returns are in U.S. dollars throughout this article.)

Stocks performed well in the U.S. and most developed countries, and across size and value risk factors, despite ongoing concerns over a possible double-dip recession, rising government indebtedness, and inflation. Thirty-seven out of forty-five countries tracked by MSCI achieved positive returns in both local currency and U.S. dollar terms.

Fixed income returns were positive, thwarting assertions that bond prices were in dangerous "bubble" territory. Despite continued weakness in residential housing and commercial property, real estate securities around the world outperformed the broad equity market. Diversification across the size and value risk dimensions proved rewarding in both U.S. and non-U.S. markets, particularly among small company stocks.

As shown in the U.S. Stock Market Performance chart on the next page, the broad U.S. stock market logged strong performance, returning 16.9% for the calendar year. The chart features some of the year's most highly publicized events. These events are not offered as an explanation of market performance, but simply to illustrate that long-term investors faced a major challenge to stay disciplined in a volatile news environment. Although investors must deal with uncertainty in all markets, 2010 may have presented a more intense challenge as markets watched for signs of economic recovery from the global financial crisis.

The World Stock Market Performance chart, also on the next page, offers a snapshot of global stock market performance as measured by the MSCI All Country World Index. Actual headlines from publications around the world are featured. Again, these headlines are just a sample of many events during the year.

Throughout the year, investors could find a host of reasons to avoid stocks and wait for more positive news before returning to the market. As these select headlines suggest, determining the right time to invest is a difficult task, since the market anticipates news and quickly factors in new information.

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U.S. Stock Market Performance

Russell 3000 Index with Major Events during 2010



World Stock Market Performance

MSCI All Country World Index with Major Headlines during 2010



Continued on page 3

In retrospect, it was a good year for globally diversified investors. But if investors had shaped their market expectations and decisions according to economic news, they likely would not have expected positive returns. The following are a few dominant themes during the year.

Mixed Economic Signals

Although investors in the U.S. and Europe awaited signs of a rebound, economic news was mixed, with some measures showing gradual improvement and others offering evidence that the economy remained vulnerable. Favorable news included moderate economic expansion in the U.S., euro zone, and Australia, as well as rising factory orders and manufacturing activity, rebounding auto sales and automaker profits, slowing growth in U.S. bankruptcies, declining home foreclosures, and an improving financial services sector. In late Q3, U.S. corporate cash levels reached \$1.9 trillion, which, as a percentage of total corporate assets, was the highest since 1959. In late Q4, initial claims for unemployment fell to the lowest level in two years.

Negative news included continuing high jobless rates in the U.S. and other developed markets. U.S. unemployment began the year at 9.7%, dipped to 9.5% in July, but climbed to 9.8% in November. Personal bankruptcies in the U.S. increased 9%, reaching their highest level since 2005. Also, bank failures in 2010 were the worst since 1992, during the savings and loan crisis.

Housing and Real Estate

The global property decline that helped trigger the 2008 financial crisis began to ease in 2010. Home prices improved in the U.K. but remained weak in the U.S., with monthly sales of new homes falling at one point to the lowest level since tracking was initiated in 1963. Foreclosures increased dramatically in the first half of 2010, before improving in Q4. However, 2010 proved to be another successful year for REITs, despite recurring predictions of a brewing commercial real estate collapse that would trigger a financial crisis.

Quantitative Easing and Fiscal Stimulus

Governments and central banks took additional actions to stimulate economies and shore up financial markets. The most direct support came as central banks supported government bond markets in the U.S. and Europe. The Federal Reserve's November announcement of a second round of quantitative easing (known as "QE2") sparked concern that additional monetary stimulus would stoke inflation and debase the dollar. According to some, the actions helped lift stocks and corporate bond markets. In December, the extension of the Bush-era tax cuts and a 2% reduction in Social Security payroll taxes in 2011 improved economic expectations.

Sovereign Debt Worries

During the year, the weakening finances of some European states, including Portugal, Ireland, Italy, Greece, Spain, and Belgium, raised concern that the financial crisis had moved from private-sector banks to public-sector balance sheets. These concerns led to the downgrading of certain government debt and widening of bond yield spreads. The euro zone countries and International Monetary Fund responded with loans that were conditional on some sovereign borrowers taking drastic austerity measures.

Inflation vs. Deflation

Despite moderate inflation in most economies during 2010, economists warned that continued government budget deficits and monetary expansion would drive up prices. Conversely, the U.S. central bank was concerned that inflation was so low that the economy might slip into a deflationary cycle. In fact, potential deflation was one of the main reasons the Fed implemented QE2 and pumped \$600 billion into the banking system. By year-end, the Fed indicated that the deflation threat was easing.

Higher Commodity Prices

Commodities climbed during 2010, with many sectors reaching price levels not seen in decades. Copper prices, which are considered a bellwether of economic activity, rose 33%, and oil gained 15% to finish 2010 over \$91 a barrel. Agricultural commodities, a traditionally volatile sector, saw even more extreme price swings. Concern about a weakening dollar drove up precious metals, with gold exceeding \$1,400 per ounce and silver up 81% for the year.

Investor Confidence

In the wake of the financial crisis, investors who have become more risk averse or accepted the tenets of a "new normal" in the economy and markets chose to remain in fixed income assets. Bond funds in the U.S. received a massive net inflow of money in the past two years, suggesting that many investors who fled stocks may have missed out on much of the rebound in equities. Throughout most of 2010, investment flows were leaving the U.S. stock market and moving to emerging markets. In December, flows turned sharply positive in the U.S., with an estimated \$22 billion directed to U.S. stock funds.

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Not-So-Smart Money

Small cap stocks outperformed large cap stocks by a significant margin in most global markets last year, but capturing the size premium required both patience and a willingness to ignore the advice from those claiming to identify the best-performing asset classes in advance. U.S. small stocks got off to a strong start last year as the Russell 2000 Index jumped to a gain of 18.6% through April 23, more than double the return of the S&P 500. But as stock prices wilted during the summer, small caps fell even faster, and by August 24 both large cap and small cap indices were down roughly 5% for the year. A surprisingly strong rally during the remainder of the year drove the Russell 2000 up 31.5%, and for the year as a whole it was the best performance for U.S. small stocks since 2003.

Large Cap Indices	Small Cap Indices	Size Premium
Russell 1000 16.1%	Russell 2000 26.9%	10.8%
S&P 500 15.1%	S&P Small Cap 600 26.3%	11.2%

The strength in small cap stocks caught a number of financial pundits flat-footed. An article appearing in the *Wall Street Journal* in mid-November 2009¹ claimed “small caps aren’t looking that cheap anymore” and suggested that the stock market rally was in the midst of “an important change that has put the less-volatile large caps back in favor.”

In a similar vein, the 2010 Investor’s Guide issue² of *Money* argued that “smaller and junkier” stocks often did best in the early stage of a rally, but since the bull market appeared to be maturing, now was the time to switch gears: “Speculative frenzy eventually gives way to the fundamentals,” they said, “and that should bring your focus back to high quality blue-chip stocks this year.” *Money* identified ten stocks to capitalize on this trend, including stalwarts such as ExxonMobil and Johnson & Johnson. Investors following this advice not only missed out on the strong performance of small cap stocks, they failed to capture the market rate of return from large cap stocks as well: the ten stocks selected by *Money* had an average price-only return of 6.3% compared to 12.8% for the S&P 500® Index.

SmartMoney likewise emphasized large-cap stocks in their annual forecast issue,³ but for a different reason. They foresaw a good chance the U.S. would remain mired in recession and favored large multinationals such as Procter & Gamble and Coca-Cola that “sell

goods worldwide and don’t need an economic rebound to make money.” Their twelve stock picks produced an average price-only gain of 7.5% for the year.

Fortune made little distinction between large cap and small cap stocks in their 2010 Investor’s Guide issue⁴ and instead chose to repeat the familiar refrain that an uneven economic recovery would reward clever stock-picking: “Making judicious stock selections will be crucial in what is likely to be a topsy-turvy year.” It was indeed a topsy-turvy year for the markets, but even more so for *Fortune*’s ten stock selections. Among the combined thirty-two stocks selected by *Fortune*, *Money*, and *SmartMoney* for 2010, *Fortune* had both the best performer for the year (Salesforce.com, up 78.9%) and the worst performer for the year (Amedisys, down 31.1%). *Fortune* finished last in this three-way magazine competition, with an average price-only return for their picks of 1.75%.

To its credit, the same issue of *Fortune* included a useful article on the appeal of a simple index fund approach: “Stock picking, whether you do it yourself or pay a pro to do it for you, is a mug’s game,” they wrote. “You’re better off buying and holding a cheap, diversified, and consistent index fund, which passively invests in the stocks listed on a broad market benchmark.”

Good advice, but we suspect it won’t be long before catchy cover stories such as “Top Ten Stocks for the Year Ahead” are crowding the magazine racks once again. And last year’s results offer another example of how easy it can be to miss out on all the rewards the capital markets have to offer.

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¹ Donna Kardos Yesalavich. “Large-Cap Stocks Are Back in Favor” *Wall Street Journal* November 12, 2009.

² Pat Dorsey. “What’s Ahead for Stocks” *Money* January/February 2010.

³ Reshma Kapadia and Russell Pearlman. “Where to Invest 2010” *SmartMoney* January 2010.

⁴ Katie Benner, Scott Cendrowski, and Mina Kimes. “The Best Stocks in 2010” *Fortune* December 21, 2009.