EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

July 31, 2011 (YTD)

	YTD 2011	Last 10 yrs.*	2010	2009	2008
Bonds (%)					
One-year	0.7	3.1	1.2	1.9	4.0
Five-year	4.4	4.6	5.3	4.2	4.0
Intermediate	4.4	6.3	6.9	-0.7	12.9
Long-term	6.4	7.1	8.9	-12.1	22.5
U.S. stocks (%)					
Large Market	3.8	1.3	14.9	26.5	-37.0
Large Value	3.5	5.3	20.2	30.2	-40.8
Small Market	3.6	8.3	30.7	36.3	-36.0
Small Micro	2.7	9.6	31.3	28.1	-36.7
Small Value	1.8	11.1	30.9	33.6	-36.8
Real Estate	12.3	10.5	28.7	28.2	-37.4
International stocks (%)					
Large Market	3.0	3.9	9.3	30.6	-41.4
Large Value	1.4	7.8	10.6	39.5	-46.3
Small Market	2.9	11.7	23.9	42.0	-43.9
Small Value	2.0	13.5	18.1	39.5	-41.7
Emerg. Mkts.	0.6	15.6	21.8	71.8	-49.2

Descriptions of Indexes

One-Year 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 Market	DFA U.S. Small Cap fund
U.S. Small Micro	DFA U.S. Micro 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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America Is a Value Stock

Jeff Troutner, Equius Partners

Contrary to the dominant message from Wall Street, value stocks are not "undervalued" stocks. This notion is so old school—refuted by so much credible research from many sources—that I can't listen to professional stock pickers (several of whom are friends) without feeling sorry for them and their clients. The obvious advancements in computer technology and information delivery, as well as the astronomical increase over the past forty years in the number of investors buying and selling stocks and setting prices, has created a very efficient market. No amount of clever marketing will change this fact.

Of course, the Wall Street marketers will use short-term market volatility, bubbles and crashes, and the *past* performance of a constantly rotating list of "superstar" mutual fund and hedge fund managers to try to refute this truism. And apathetic, fact-challenged investors will continue to believe them. Extremely profitable myths die hard on Wall Street.

Prices Are Based on Perceived Risk

Stocks are no longer undervalued or overvalued. Stocks are riskier and less risky. This is true of markets as well. Prices are set based on all known information and the forecasts of millions of investors as they place buy and sell orders with brokers. Prices change, either up or down, once new information and new forecasts enter the equation. As prices drop, expected returns increase—reflecting the extra reward investors demand for taking the extra risk. As prices rise, expected returns decrease—reflecting the lower risk perceived by investors.

Although the amount of information any one person can have or process is limited, and the accuracy of each buyer or seller's forecasts will vary widely, the fact that millions of people are constantly trading results in prices that, for long-term investment purposes, accurately reflect risk and expected return. In other words, there is wisdom in crowds.

So, risk and return are directly related. Poor or inexperienced leadership and management, high debt, stagnant or declining revenues and market share, high expenses, an obscure or declining brand, general pessimism, and an uncertain future increase risk and drive prices down. This is America today but, more to the point, this is how *value* stocks are created. Risk perception and how it changes over time also explains the general differences in large and small company stock prices and the ups and downs of the overall market.

This risk/return relationship is easily recognized in longer-term data. Unfortunately, far too many investors are actually speculators (another manipulation by Wall Street) with short-term expectations, no patience, and no discipline. So the risk/return relationship in the short run is volatile and

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unpredictable. You can only hope to realize higher returns from value or small cap stocks if you are willing to tolerate short-term volatility, be patient and disciplined, and allow markets, not gurus, to deliver the long-term expected returns. Here's some data:

	Large Stocks		Small Stocks	
Time Period	Value	Growth	Value	Growth
Full Period: 1928-2010	**10.6%**	7.2%	**13.3%**	8.0%
Average 20-Year Return	**13.5%**	9.7%	**16.0%**	9.9%
% of 20-Year Returns When Value Wins	**94.0%**		**100.0%**	

Maybe you think the market is inefficient and you don't have the smarts or the time to outguess the market, so you decide to hire an expert. Fine. Just consider this:

Of 153 actively managed mutual funds that are categorized by Morningstar as large, mid, or small value stock funds, 68% failed to outperform a 60/40 mix of the Russell 1000 Value and Russell 2000 Value indexes over the past fifteen years.* So assuming an investor is patient and disciplined enough to hold the same fund for that long, he has about a 1 in 4 chance of beating much more diversified index funds. Good luck finding that fund today. There are now 618 actively managed value-style mutual funds and ETFs to choose from, many of which will either change investment managers, merge, or shut down well before another fifteen years passes by.

The reality is that no one stays with an actively managed fund for fifteen years. The average is about three years. The harder reality is that buyers of active funds buy "winners" high and sell "losers" low, just like stocks.

Asset Class Funds Anyone?

Just to rub a little more salt into the old-schooler's wounds, let's consider how asset class funds managed by Dimensional Fund Advisors (which are passively managed and based on the proprietary indexes used in the table above) performed over the past fifteen years.

The DFA US Large Value fund beat 70% of the survivors in the Morningstar database and the DFA US Small Value fund beat 93% of them.

A 60/40 mix of the two DFA funds, rebalanced annually, beat 83% of the actively managed funds. Furthermore, the average fund in the Morningstar screen spreads risk over only 120 stocks, while the mix of DFA funds spreads risk over 1,720 stocks.

It May Seem Counterintuitive

But wait, you ask, aren't the millions of people piling into Apple and Google stock doing it because they think they're going to get a higher return than if they buy, say, Microsoft or Dell? Well, yes, short-term speculators certainly are. And they might turn out to be right, *if* they're not left holding the bag when the fun ends. But millions of *investors* (those who supposedly have long investment time horizons) are doing the same thing. We call these people "sheeple."

These sheeple are not just your average Joe or Sally investor—with limited financial, statistical, and economic knowledge. They are joined by thousands of professional investors, decision makers for pension and profit sharing plans, and foundation and endowment investment committees. Stock picking today, especially chasing hot stocks, is an equal-opportunity destroyer of wealth.

The Market Is a Value Stock

Changing risk perception also influences market prices in general. This is certainly the case today. Prices are lower and expected returns are higher due to the pessimism and uncertainty weighing on our economy. Investors have the opportunity to realize the higher future returns these lower prices portend, but they must remain patient and disciplined. If the risk is too great to bear, the wise move is to add high-quality, short-term bonds to a portfolio mix (reducing risk *and* return). This should be a long-term decision, not one based on "timing." It's foolish to take market risk up to now only to miss the potential rewards later. Investors tend to move back into stocks *after* prices go up substantially and expected returns are lower, not when prices go lower based on even more risk.

Rebalancing based on well-defined rules is the best way to deal with price/risk volatility. On the fund level, this is done by the fund manager. DFA, for instance, will sell value stocks that have risen in price (and are headed to *possible* growth stock status) based on strict indexing rules. They then add stocks that have fallen in price to value stock status. These changes are what drive the performance of indexed value funds and are clearly consistent with a disciplined buy-low, sell-high approach.

On the portfolio level, Equius rebalances client portfolios between stock and bond allocations. As expected returns rise (prices fall), we bring the stock allocation back up to the client's stated policy. As expected returns fall (prices rise), we sell stocks and buy short-term bonds.

Absent a clear crystal ball or a massive Wall Street–type ego, this is your best course. Match a risk-based portfolio to your personal risk tolerance, rebalance when the opportunity arises, and reap the long-term rewards of a prudent, modern, and *rational* approach to investing.

Table returns are DFA indexes. "Large Stock" indexes are the 20% highest price-to-book (growth) and 20% lowest price-to-book (value) stocks of the top half of the total stock market (after DFA proprietary screens). "Small Stock" indexes are the 25% highest price-to-book (growth) and 25% lowest price-to-book (value) stocks of the bottom half of the total stock market. "20-Year Returns" are rolling periods beginning each month from 1/1928 to 1/1991. **Past performance is no guarantee of future returns. This data is for illustration purposes only.**

*This failure rate would be much higher if Morningstar included in the database funds that closed or merged due to bad performance. In one study, Vanguard states that in the 1990s 55% of funds failed (closed or merged). This suggests only a 1 in 5 chance of buying *and* holding an actively managed fund that beat an index fund over the past fifteen years.