EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

August 31, 2008 (YTD)

	2005	2006	2007	Last 10 yrs.*	YTD 2008
Bonds (%)					
One-year	2.3	4.8	5.2	4.1	2.0
Five-Year	1.7	3.9	5.2	5.1	1.4
Intermediate	1.6	3.6	9.5	6.4	3.3
Long-term	6.6	1.7	9.2	7.0	3.9
U.S. stocks (%)					
Large Market	4.9	15.7	5.4	5.8	-11.4
Large Value	10.2	20.2	-2.8	8.9	-9.8
Small Market	6.1	16.6	-3.1	9.0	-4.9
Small Micro	5.7	16.2	-5.2	10.6	-6.5
Small Value	7.8	21.5	-10.8	11.5	-4.8
Real Estate	13.2	35.3	-18.7	10.8	1.9
International stocks (%)					
Large Market	13.5	24.9	12.5	8.6	-16.0
Large Value	15.3	34.1	10.2	13.0	-19.6
Small Market	22.0	24.9	5.6	14.3	-15.8
Small Value	23.2	28.4	3.0	16.2	-15.5
Emerg. Mkts.	29.9	29.2	36.0	16.0	-18.2

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 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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September 2008

Herds: Safety Nets or Hijackers?

Phil Jonckheer, Equius Partners

> *Men go mad in herds, while they only recover themselves slowly and one by one.*
> Charles Mackay,
> *Extraordinary Popular Delusions and the Madness of the Crowds*

During the past few weeks, stock markets from New Zealand to New York have been careening downward and soaring upward with impressive and daily gusto. In the face of such swings, we are confronted with a choice between: 1) following the natural, powerful herd instinct to buy or sell; or 2) following the discipline of your investment plan. The second path creates more wealth but can be difficult for people to maintain under stress. This newsletter addresses that phenomenon.

James Surowiecki, a financial historian and author of *The Wisdom of the Crowds* offers us this definition of herding: "Humans, like other animals, gather for protection. In unstable markets, this leads to trend-following: buy when others buy, sell when they sell… When a stock starts to rise, traders often assume that there must be a good reason, and as more people buy the stock, the more certain others become that there must be a good reason to do so (even if they don't know what that is). These strategies can magnify trends instead of countering them. The result is that an individual stock can move up or down ten per cent on a day with no real news."[1] In other words, stock prices can fluctuate without any information other than the realization that prices are moving (thanks to the herd mentality).

Paul MacLean, a neuroscientist at Yale University and who ran the Laboratory for Brain Evolution at the National Institute of Mental Health, helped us understand that what forces us to follow a herd is the part of our brain called the limbic system. Dr. MacLean discovered that we are controlled by signals from three parts of our brains: The primal (basal ganglia) which we share with reptiles; the emotional (limbic system) which we share with mammals; and the rational (neocortex) which is distinctly human, and which gives us the ability to reason. The limbic system works in a primitive manner, exactly as it does in animals that rely exclusively upon it to survive. Its nature is to be unreasoning, impulsive and rigid. Herding behavior derives its power from this portion of our brains. Dr. MacLean observed that one of the primordial tools of survival originate from emotional impulses in the limbic system that compel individuals to seek signals from others and align their feelings and convictions with those of the group. The intellect of the neocortex and the emotional wiring of the limbic system are so independent that "the limbic system has the capacity to generate out-of-context, affective feelings of conviction that we attach to our beliefs regardless of whether they are true or false."[2] Feelings of certainty brought on by aligning oneself with a group can be so overwhelming that they become non-negotiable even in the face of logic and contradiction. They can

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attach themselves to a political doctrine, a social plan, a religion, the "certainty" of winning on the next spin of the roulette wheel, even (imagine!) the path of a financial market.[3] This tendency is so powerful that Robert Thatcher, a neuroscientist at the University of South Florida College of Medicine in Tampa, suggests, "The limbic system is where we live, and the neocortex is basically a slave to that."[4]

Therefore, in moments of fear, the limbic system forces us to seek the direction of the herd in a way that is identical to how our emotions led us to scramble for protection when reacting to an attack from a saber-tooth tiger. This fundamental, primordial reaction worked as a protective measure as we meandered the Serengeti plains. It can be extremely detrimental, however, to our financial health as we grapple with the bears and bulls of Wall Street. The reason is that in a panicked state, our limbic system hijacks rational thought in the interest of pursuing what is seemingly the safest route: that of the crowd. It takes this route impulsively, proceeding on its conviction at all costs.

As we are aware, the press fuels this mentality. I noticed that as markets rocked and rolled during the week of September 15th, the size (font) of the leading business periodicals' headlines increased by 40% to 70%. They also used language like "Panics" and "Shocks" – siren calls to our limbic systems to dash off with the panicked herd.

What ensues is an (unwarranted) feeling of overconfidence which exacerbates the mood of the stampeding herd. Surowiecki explains: "A 2005 study of traders and investment bankers at two large banks found that they significantly overestimated their knowledge of finance and the accuracy of their predictions. A 2002 survey of experienced foreign-exchange traders found, similarly, that they were far surer of their market forecasts than performance justified. Overconfidence matters, because it can encourage excess trading. A study of individual investors by the economists Markus Glaser and Martin Weber, for instance, found that investors who thought more highly of their ability traded more. What's worse, the effect seems to be magnified in times of uncertainty. The business-school professors Itzhak Ben-David and John Doukas, in a study based on twenty years of trading by institutional investors, found that when there's a profusion of "ambiguous information" about stocks investors trade more frequently, not less. And they do so even though, on average, they end up losing on their trades."[5] Therefore, the current state of prices swooning dramatically can be traced back to the herd mentality during the upswing of the cycle when prices, lending and leverage were blindly embraced by the herd.

Rather than trying to second-guess the market, we instead accept its volatility. Selling asset classes that are overweighted in your investment plan and buying those asset classes that are underweighted allows us to profit from the extreme market swings (up and down) caused by herding.

Whether it's a psychologist, economist or capitalist, the consistent message to those who want to enhance their wealth is to build an investment plan based on the knowledge of how markets (specifically asset classes) work and incorporate that science into what is fundamentally important to you. That knowledge leads to the confidence and the discipline required to trump the powerful forces of herding that cause people to abandon their carefully constructed investment plans. Here are a few quotes underscoring these concepts:

Professor Daniel Kahneman (Princeton Professor of Psychology and 2002 Nobel Laureate in Economic Sciences): "Investing should be an orderly process: decisions based on what the market does are likely to be wrong."[6]

Professor William Sharpe (Stanford Professor of Finance and 1990 Nobel Laureate in Economic Science): "Some investments have higher expected returns than others. Which ones? Well, by and large they're the ones that will do the worst in bad times. Therefore, if you want more return, you have to take more risk of doing badly in bad times. And those of us who put our money in index funds say, 'Thank you very much.' We get to free-ride on other people's convictions."[7]

Charles (Chuck) Schwab: "You've got to understand that markets go up and down. Over longer periods, stocks generally have always gone up. But any specific stock may never come back. Buy an index fund, and you're going to have long-term growth almost to a certainty. Buy an individual stock, and you never know. You could go to zero.... And there's a whole other area, which is how you react. We get very emotional and do dumb things."[8]

As the markets continue to fluctuate (sometimes wildly), we urge you maintain your confidence in the integrity of your investment plan. This will allow you to benefit from the inevitable surge in market values that will be reflected in your portfolio since it is invested in asset classes that will compensate you for the risks that you bear – if you are patient. And although it is challenging at a deeply primordial level, we strongly urge you not to succumb to the tempting and powerful emotional forces that try and seduce you to follow the herd. Instead we urge you to continue to embrace your portfolio as you would a home, as an owner, with the understanding that, as Warren Buffet reminds us, "Bear markets are periods when equities are returned to their rightful owners."

[1] Suowiecki, James, That Uncertain Feeling, The New Yorker, September 1, 2008

[2] MacLean, Paul. (1990). The Triune Brain in Evolution: Role in Paleocerebral Functions. New York: Plenum Press

[3] Prechter, Robert R. (2003). Pioneering Studies in Socionomics. Gainesville, Georgia: New Classics Library, pp. 294-308.

[4] Ibid.

[5] Surowiecki, James, That Uncertain Feeling, The New Yorker, September 1, 2008,

[6] Kahneman, Daniel, Master of the Imperfect Mind, Money Magazine, August 23, 2007

[7] Sharpe, William, The Man Who Explained it All, Money Magazine, July 6, 2007

[8] Schwab, Charles, We Talked to Chuck, Money Magazine, July 6, 2007

What Others Are Saying About the Current Market...

"I have not looked at any of my holdings and don't intend to. I don't want to be tempted to jump because I think I'd be more likely to jump in the wrong direction than the right one. My advice has always been to choose a sensible diversified portfolio and stop reading the financial pages. I recommend the sports section."

Quotation attributed to Richard Thaler, professor of behavioral science and economics, University of Chicago Graduate School of Business.

Source: Young, Lauren. "Where the Pros Are Putting Their Own Money." Business Week, October 6, 2008.

"This has been a volatile week in global financial markets. I'm sure you don't need me to report the news to you, and I won't pretend I can predict how this downturn will stack up against ones we've seen before. No one knows how all this will play out. However, after talking with clients and having conversations with our investment team and the financial economists who consult to us, I want to offer two observations that I hope will be useful to you.

My first observation is that, while one hesitates to say that markets are "working" when they are so erratic, they are in fact doing exactly what they are supposed to do. We believe that markets are always moving toward equilibrium. For that to occur, prices have to be set, securities must be bought and sold, and trades need to clear. All of this is happening pretty smoothly around the world, despite the anguish sellers are feeling about sharply lower prices for many stocks.

Markets don't always get pricing right in the short run. That's the nature of risk. The table below displays three sets of returns for the S&P 500 Index and for Treasury bills, the "riskless" asset.

For the 17 years 1965-1981, the returns for both stocks and T-bills are about 6% per year. 1981 was Dimensional's first year. Financial markets were under stress, volatility was high and there was a general feeling of pessimism about equity markets since risk hadn't been rewarded for a long time. One financial magazine had as its cover story "The Death of Equities". Our view was that there was too much pessimism. There is no sensible risk/return story to explain why stocks should have a zero risk premium. There was no reason to get out of equities.

At the end of 1981, there were no articles saying that the next 18 years would be possibly the best 18-year period ever for US stocks. And yet that turned out to be the case. From 1982 to 1999, the S&P 500 had an 18% return per year, compared to 6% a year from Treasury bills. The attitude was the opposite of the 1981 viewpoint. People were too optimistic, in general. We think of S&P 500 stocks as having about a 10% cost of capital. When investors get 18% a year for S&P 500 stocks, they should enjoy it, but not count on it into the future.

The final line on the table displays the results for this millennium, a period of just under nine years. The return on the S&P 500 is almost flat. Once again, there is a lot of pessimism. Once again, we believe that pessimism might be overblown. Without making a forecast, we feel that a zero return for stocks is not the market-clearing expectation. We feel that clients should maintain their normal commitment to equities.

Which brings me to my second point: Because it's impossible to predict how markets will move at any time, diversification is critically important. Dimensional's investment approach results in portfolios that are broadly diversified and not concentrated in individual companies. As a result, although our funds' performance has been affected by declining stock prices, Dimensional isn't in the state of crisis that we hear other money managers may be experiencing right now. Our company is healthy."

Quotations attributed to David Booth, Chief Executive Officer, Dimensional Fund Advisors. Data quoted is from sources we believe are reliable, but we cannot guarantee its accuracy.

Period	S&P 500 Index	One-Month T-Bill
January 1965-December 1981	6.3%	6.7%
January 1982-December 1999	18.5%	6.2%
January 2000-September 18, 2008	-0.6%	3.1%

Why We Continue to Avoid Active Management

Jeff Troutner, Equius Partners

I was recently made aware of a "study" by the investment firm Robert W. Baird & Co., Inc. The company is a large ($73 billion) advisory firm based in Milwaukee, Wisconsin that specializes in wealth management for individuals.

The Baird study is titled, "Investors' Paradox—All High-Performing Managers Underperform." It's pretty clear from the beginning that the purpose of the study is to justify their use of active money managers to build client portfolios rather than using low-cost, passively-managed index or institutional asset class mutual funds.

In order to make their case, Baird focuses on the 38% of a 1,334 fund database that outperformed a relevant benchmark by 1% or more per year net of fees over the *past* 10 years ended 2007. Nowhere in the study does Baird claim to know who those top-38% managers were *in advance*, yet the whole rest of the "study" is essentially asking investors (their clients and prospects?) to be patient with these really successful managers because:

(1) at times they *underperform* for several years;

(2) you might have to wait the *full 10 years* to realize the superior performance; and

(3) investors who are not *patient* and chase returns ultimately hurt their returns.

Talk about creative marketing! Under the guise of a legitimate "study" this firm does not *explicitly* state that they knew who these managers were in advance. But by spending 15 pages defending periods of underperformance by these managers and preaching patience to their clients, they are clearly *implying* some talent at picking superior managers in advance.

Advisors to 401(k) plans who practice the hope-springs-eternal philosophy of fund selection will be popping this "study" out of their alligator-skin briefcases faster than you can say fraud! The fact that it ignores the essential premise —that we only know who the superior managers are in *hindsight*—is totally irrelevant and potentially very damaging to their marketing efforts.

I have to admit, however, that I did manage to find one tidbit of value out of the "study." Baird discovered that high-performing funds that were upgraded from a 4 to a 5-star Morningstar rating actually *underperformed* funds that were downgraded from a 3 to a 2-star rating (by almost 1.5% per year!)

There are a couple morals to this story for me. The first is that firms like Baird can still become very large and successful by obscuring the truth and perpetuating the myth that superior managers can be known in advance.

Second, there is very little hope that the 401(k) market will ever be reformed and the odds actually placed in the *participants*' favor as long as this kind of drivel is allowed the light of day. According to the Baird "study," 62% of the managers in the database failed to beat a benchmark (read: index fund) by at least 1% and Morningstar ratings are essentially worthless. Yet the business is absolutely dominated by well-paid advisors who ignore these odds (using other people's money) and who base their "research" and fund recommendations on Morningstar ratings!

It should also be pointed out that the mainstream media aids and abets these snake-oil salesman. The *Wall Street Journal* evidently thought enough about the study to write its own article on it—a favorable one, of course. It can be found at webreprints.djreprints.com/2002550169837.html.

The Baird "study" is here: www.rwbaird.com/Docs/Investors-Paradox.aspx

Our Thoughts on the Current Crisis in the Financial Markets

The process of researching and analyzing the meltdown in our country's debt markets is an ongoing process for us. But what we conclude in terms of the causes and potential solutions are almost irrelevant, except as an intellectual exercise, since we know that *acting* upon our conclusions would involve rank *speculation*, which is the consistently discredited foundation of *market timing*.

This has been drilled into our brains once again by the staggering amount of bad timing exhibited by what was thought to be the best brains in the financial business. How many of the Lehman Brothers', Merrill Lynch's, Bear Stearns', Washihgton Mutual's, and AIG's do we have to see meltdown before we're convinced that trying to predict tops or bottoms of markets is insane? At what we *now* recognize were extremes in the debt market (in lending, borrowing, credit ratings, leverage, real estate development, speculative behavior, etc.) were completely ignored by the brainiacs who were paid billions to know these things and who ultimately lost billions for themselves and their shareholders due to their bad timing!

So, are *we* now going to try to predict the market turns or the extent of the current downturn and change asset allocation recommendations in response? Not a chance. We're going to continue to monitor accounts and look for opportunities to rebalance to target allocations and encourage greater investment during a time when expected returns have increased dramatically. We believe the benefits of the broad diversification of asset class investing will prove out and draw even more investors to our strategy.

We also continue to provide sound counsel to our clients as they deal with the emotions of such trying times.