EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

October 31, 2010 (YTD)

	2009	2008	2007	Last 10 yrs.*	YTD 2010
Bonds (%)					
One-year	1.9	4.0	5.2	3.7	1.3
Five-year	4.2	4.0	5.2	4.8	7.9
Intermediate	-0.7	12.9	9.5	6.9	9.9
Long-term	-12.1	22.5	9.2	7.4	14.8
U.S. stocks (%)					
Large Market	26.5	-37.0	5.4	-1.0	7.8
Large Value	30.2	-40.8	-2.8	4.4	10.4
Small Market	36.3	-36.0	-3.1	5.7	16.2
Small Micro	28.1	-36.7	-5.2	6.3	16.4
Small Value	33.6	-36.8	-10.8	9.1	14.8
Real Estate	28.2	-37.4	-18.7	10.5	25.4
International stocks (%)					
Large Market	30.6	-41.4	12.5	1.4	5.8
Large Value	39.5	-46.3	10.2	6.7	6.5
Small Market	42.0	-43.9	5.6	8.7	14.9
Small Value	39.5	-41.7	3.0	11.3	8.2
Emerg. Mkts.	71.8	-49.2	36.0	9.5	15.3

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 12/31/09.

Equius Partners is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of any mutual fund and read the prospectus carefully before investing. Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. **Past performance is not a guarantee of future results.**

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Simplifying Complexity

Jeff Troutner, Equius Partners

It doesn't get much simpler than investing your long-term retirement money in a mix of stocks and high-quality, short-term bonds that meets your risk and return objectives. If you use index funds for this purpose, you've also eliminated the uncertainty and potential disasters of gurus making bad guesses with your money; you've significantly reduced your investment costs and taxes; you've increased your diversification and made it more stable and predictable; and you've maintained the highest liquidity and access to your money. In other words, with investing, simpler is better.

But stocks go down sometimes. Rational investors work that bit of cold, hard truth into their expectations and deal with it. They try to block out the useless and mind-numbing noise emanating from Wall Street through its media pimps; they are patient, they are focused, and they live within their means and their investment risk profile. In other words, they get it and they deal with it.

Others are constantly in search of the same or higher returns of a simple stock/bond portfolio but with much less risk. They will be looking forever. And that's why Wall Street and active management will be with us forever.

The Schwab Example

I read recently that Charles Schwab & Co. purchased Windward Investment Management. Windward manages about $4 billion by applying a market timing strategy to make shifts among 40 different "asset classes" using exchange-traded funds (ETFs). The firm's modus operandi is to sail with prevailing investment winds until those winds shift again and its proprietary (i.e., secret) computer algorithm indicates the need for a change in course. While tacking and jibing with their clients' money, Windward sells this strategy as sophisticated "risk management."

For a firm that constantly markets itself as the antithesis of traditional Wall Street brokerage firms, Schwab could not have made a more Wall Street move with this purchase. They also could not have sent more confusing messages to their clients and brokers at a time when investors in general are in need of insightful leadership, wisdom, and direction as they try to navigate volatile economic and market waters. The messages:

- Investors (or their advisors) should constantly change their portfolios to reflect the current "investment winds." Discipline, patience, and buy-and-hold (with disciplined rebalancing) are old school.
- Anything that can be packaged and sold to investors should be considered an asset class. This includes everything so eloquently explained

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by "The Great Fool Theory"—that yet-to-be-recognized-by-the-Nobel-Committee supposition that something's worth buying as long as *we believe* someone else is willing to pay more for it later.

- The "endowment approach," which de-emphasizes investments in the liquid capital markets (stocks and bonds) and heavily emphasizes complex and illiquid "alternative" investments and assets classes, is alive and well—despite being roundly criticized for the disastrous results it led to at the Yale and Harvard endowments.
- Exploitation of market and *marketing* trends that lead to short-term shifts in investment plans are more important than the long-term client experience.

As long-time participants in Schwab's Advisor Network we know how difficult it is to compete with "hot hand" advisors for the attention of clients and brokers who *we're told* have a long-term investment perspective. Over the past ten years we've seen at least a half dozen of these firms grow rich with referrals, only to be tossed aside as the next hot hand emerges.

This merry-go-round of active managers satisfies client *wants* in the short term but effectively ignores client *needs* and seriously diminishes wealth over time. Unfortunately, the same kind of thinking is being applied to almost every 401(k) plan in this country. Prominent court cases and new regulations are starting to change this culture in the defined contribution plan market. We would normally expect Schwab to take steps to change this culture of advice at their firm and demonstrate they are truly different from Wall Street. Sadly, buying and promoting Windward is not a step in that direction.

The Apple Example

We're confident in the merits of the Equius strategy, which limits portfolios to the liquid capital markets (both domestic and foreign) broken down into essentially four to six (not 40!) asset classes. And we would never destroy a good plan with costly and anxiety-inducing market timing. Our strategy also focuses like a laser beam on investor behavior and the ways we can eliminate common mistakes and misconceptions.

This simplified, focused, user-centric, and well engineered approach has served our clients well for eighteen years. But it's also nice to know that we share these principles with perhaps the most successful CEO of the last twenty-five years: Steve Jobs of Apple. In a refreshingly honest interview with Leander Kahney of Cultofmac.com, John Sculley, the onetime CEO of Apple, recently described what makes Jobs special.*

I have been an Apple fan (some would say fanatic) since I purchased my first Macintosh in 1985, and I've followed them closely through the years. The "computer for the rest of us" broke out from the herd that was dominated by Microsoft, Compaq, HP, Dell, and the rest of the computer industry. Apple dared to be different by concentrating on the *user experience* first and foremost.

Jobs took a very complex tool used primarily by businesses and turned it into a consumer product. As more and more computer manufacturers were born, with different ideas on the engineering and integration of hardware—but all based on an unstable, convoluted, and pretty universally hated operating system—users were having very different experiences and perceiving very different value from their machines. This was not the case with Apple users, as I can attest.

As Sculley points out in the interview, Jobs was a perfectionist and a great designer. He wanted buyers of Macintoshes to have the best experience possible and realize the greatest value from their computers. He was highly critical of his industry and didn't align himself or his products with others in the business. His focus was always on the user, without compromises, and with attention on just a few important things. Jobs is described as a minimalist who constantly reduces things to their simplest levels. But what he does is not simplistic. It's simplified. As Sculley says, "He simplifies complexity."

Now consider Jobs' view of the computer world in light of what goes on every day in the investment industry and Schwab's purchase of Windward. Investing in stocks used to be dominated by institutions, just like computers used to be owned almost exclusively by businesses. When the baby boomers started entering their investing years, Wall Street became like the PC-dominated computer industry—complex, inconsistent, buggy, frustrating , confusing, and prone to its own version of the dreaded blue screen of death. Investors were constantly "restarting" their portfolios because they were using an inferior operating system (active management) that did not deliver as promised and left them searching for value.

Indexing and asset class investing have changed this dynamic for investors. As the Windwards of the world and Wall Street in general continue to promote complexity, secret proprietary schemes, illiquidity, and constant change, we'll concentrate on the essence of risk and return and on communicating sound, common-sense principles to our clients. We'll bring clarity and simplification to investing, resulting in a superior user experience compared to the herd. We'll also continue to do all our work at Equius on our iMacs, while thoroughly enjoying the experience.

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*http://www.cultofmac.com/john-sculley-on-steve-jobs-the-full-interview-transcript/63295

Portfolio Endurance

Jeff Troutner, Equius Partners

The need for retirement planning doesn't end with the onset of retirement. A new retiree's focus shifts from building wealth to managing and preserving it. One major challenge is to make the investment portfolio supply cash flow for the duration of life—and through different economic and market conditions.

Experts have studied portfolio longevity or endurance to help retired investors reduce the odds of depleting their wealth too soon. The studies evaluate how a portfolio might endure under the stress of changing markets and spending levels. The resulting models estimate portfolio survival in terms of statistical probabilities.[1] While the technical details are beyond the scope of this article, the general conclusions are more intuitive.

Three main factors drive portfolio endurance: asset mix, spending level, and investment time frame. Certain aspects of these factors are within an investor's control, while others are not. Let's briefly consider them.

Asset Mix

Asset mix describes the ratio of stocks to bonds in a portfolio. This determines risk exposure and expected performance and is one of the most important decisions investors of all ages can make. Historically, stocks have outperformed bonds and outpaced inflation over time. This return premium reflects the higher risk of owning stocks.[2] Consequently, the larger the equity allocation, the greater a portfolio's expected return—and risk.

Keep in mind that risk and return go together. A higher allocation to equities increases the risk of experiencing periods of poor returns during retirement. But if you can handle the risk, having more equity exposure in a portfolio enhances its return potential. Growth can bring higher cash flow, inflation protection, and portfolio endurance over time. This is why most advisors believe that most investors should have an equity component in their portfolios, with actual weighting depending on your time frame, risk tolerance, and spending flexibility.

Spending Level

Portfolio withdrawal is typically described in terms of a specified dollar amount (e.g., $50,000 per year) or a percentage of annual portfolio value (e.g., 5% of assets each year). Neither method is ideal, however—and for different reasons. Briefly consider each one:

- *Specified dollar amount*: Withdrawing a fixed amount each year and adjusting it for inflation can provide a stable income stream and preserve your living standard over time. But the portfolio may survive only if future withdrawals represent a small proportion of the portfolio's value. One academic study quantified this amount. It found that a retiree with at least a 60% stock allocation can withdraw up to 4% of initial portfolio value (adjusted for inflation each year) and enjoy a high probability of never running out of wealth.[3] A higher withdrawal amount is not likely to be sustainable, especially if the portfolio faces an extended period of negative returns.

- *Percent of annual portfolio value*: Withdrawing a fixed percentage of assets based on annual asset value makes it unlikely that you will deplete retirement assets, because a sudden drop in market value would be accompanied by a proportional decline in spending. But this method can produce wide swings in your living standard when investment returns are volatile.

Retirees who need relatively consistent cash flow may want to combine these two methods. One way is to withdraw cash flow according to a rule that combines past spending (e.g., an average of the past thirty-six months of cash flow) with a payout rate applied to current portfolio value. You can weight these factors to favor your preference for either more stable cash flow or a greater chance of portfolio survival. In effect, you are customizing your withdrawals to smooth out consumption while responding to actual investment performance.

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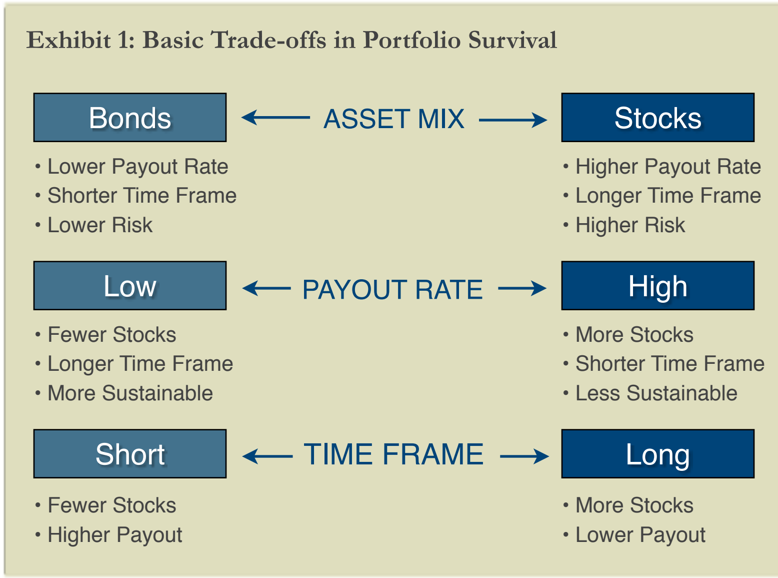
Investment Time Frame

Investment time horizon may be the hardest to estimate, especially if it is the same as your life span. In this case, you can only guess how long your portfolio must support spending. If you plan to bequeath assets, your investment time frame may extend beyond your lifetime. This may influence your risk and spending decisions as well.

Time frame forces a trade-off between the short term and long term. Retirees with a longer investment time horizon might choose a higher exposure to equities. But they may have to offset this risk by being more flexible about spending over time. Elderly retirees and others with a short time horizon may choose a less risky allocation or a higher payout rate, although they can experience rising spending levels too. In any case, retirees should think carefully about equity exposure and avoid taking more risk than they can afford.



Considerations

Planning involves assumptions about the future—assumptions that may not pan out. Although you cannot avoid making assumptions, you can ask whether they are realistic and consider how your lifestyle might change if future economic and financial conditions are much different than projected. For instance, you may assume an average return based on historical performance. But there is no certainty that future portfolio returns will resemble those of the past, regardless of time frame. Moreover, short-term results may vary drastically, which could force hard financial choices. Investors should think in terms of probability, not history.

Managing asset mix, payout, and time horizon inevitably involves trade-offs. Exhibit 1 illustrates the dynamics. For example, a bond-dominated portfolio with a lower expected return may suit investors with a shorter time horizon, or require them to accept a lower payout rate to increase the odds of portfolio survival. A portfolio with a higher allocation to equities may be appropriate for someone with a long time horizon or a strong desire for a high payout rate, but a higher assumption of risk also results in greater uncertainty about future wealth.

Retirees who take this route must be able to handle the risk emotionally, and they should be ready to adjust their lifestyle in response to market downturns. In fact, investor flexibility plays a role in all the trade-offs.

Finally, although you cannot fully control these and other factors involved in portfolio endurance in retirement, having more wealth can improve the odds of having a less stressful financial life. A more substantial nest egg might enable you to take fewer risks, enjoy a higher sustainable spending rate, or extend the productive life of your portfolio.

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[1] Cooley, Philip L., Carl M. Hubbard, and Daniel T. Walz. 1998. "Retirement Savings: Choosing a Withdrawal Rate That Is Sustainable," AAII Journal 20: 16–21. Also see: Bengen, William P. 1994. "Determining Withdrawal Rates Using Historical Data," Journal of Financial Planning 7: 171.

[2] From 1926 to 2009, the S&P 500 Index returned an average 9.8% per year compared to 5.4% for long-term government bonds and 3.0% inflation. Sources: Standard & Poor's Index Services Group for S&P 500 Index; long-term government bonds and inflation provided by Stocks, Bonds, Bill, and Inflation Yearbook™, Ibbotson Associates.

[3] Cooley, Hubbard, and Walz, 16–21 (see first footnote).

This article is a slightly edited version of one provided by Dimensional Fund Advisors.