EQUIUS PARTNERS
*Adding Balance to Wealth*℠

# ASSET CLASS℠

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

April 2012

## Asset Class Returns

**March 31, 2012 (YTD)**

| | YTD 2012 | Past 10 Yrs.* | 2011 | 2010 | 2009 |
|---|---|---|---|---|---|
| **Bonds (%)** | | | | | |
| One-Year | 0.4 | 2.6 | 0.6 | 1.2 | 1.9 |
| Five-Year | 1.5 | 4.5 | 4.5 | 5.3 | 4.2 |
| Intermediate | -0.5 | 6.4 | 9.4 | 6.9 | -0.7 |
| Long-Term | -5.7 | 8.7 | 29.3 | 8.9 | -12.1 |
| **U.S. Stocks (%)** | | | | | |
| Large Market | 12.5 | 2.8 | 2.1 | 14.9 | 26.5 |
| Large Value | 13.1 | 4.6 | -3.1 | 20.2 | 30.2 |
| Small Market | 12.7 | 6.7 | -3.2 | 30.7 | 36.3 |
| Small Micro | 12.3 | 7.1 | -3.3 | 31.3 | 28.1 |
| Small Value | 13.4 | 8.1 | -7.6 | 30.9 | 33.6 |
| Real Estate | 10.6 | 10.1 | 9.0 | 28.7 | 28.2 |
| **International Stocks (%)** | | | | | |
| Large Market | 11.0 | 4.9 | -12.3 | 9.3 | 30.6 |
| Large Value | 11.3 | 7.6 | -16.9 | 10.6 | 39.5 |
| Small Market | 14.5 | 11.0 | -15.4 | 23.9 | 42.0 |
| Small Value | 16.7 | 11.9 | -17.5 | 18.1 | 39.5 |
| Emerg. Mkts. | 13.6 | 14.2 | -17.4 | 21.8 | 71.8 |

**Descriptions of Indexes**

| | |
|---|---|
| One-Year Bonds | DFA One-Year Fixed Income Fund |
| Five-Year Bonds | DFA Five-Year Global Fixed Fund |
| Intermediate Bonds | DFA Intermed. Gov't Bond Fund |
| Long-term Bonds | Vanguard LT U.S. Treas. Fund |
| U.S. Large Market | DFA US Large Co. Fund |
| U.S. Large Value | DFA US Large Cap Value Fund |
| U.S. Small Market | DFA US Small Cap Fund |
| U.S. Small Micro | DFA US Micro 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 |

"Past 10 Yrs." returns are ended 12/31/11.



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# Don't Cut Off Your Nose

*Jeff Troutner, Equius Partners*

Index funds have become increasingly popular due to active managers' persistent failures to meet their beat-the-market objectives, and this failure is largely due to the high costs associated with stock picking, market timing, sector rotation, and other speculative schemes these managers employ.

Though active strategies can be very costly, a far more damaging aspect of long-term investing is the tendency to make emotional and speculative decisions at extreme periods in market cycles. DALBAR, among others, calculates that this behavior ends up costing two to three times as much as the average annual cost of 2% for active management.

A large, powerful voice in the indexing community has a simple answer for this: buy low-cost, total market index funds and do your own investing. Interest rates are historically low, the global stock markets have generated low returns for 11 years, and many "experts" project low future returns, so who wouldn't heed such advice?

Is long-term investing really that simple? Of course not. The devoted proselytizers of this approach are not only ignoring an important and growing body of *behavioral* research (which sheds light on the costly pitfalls of do-it-yourself investing) but also disregarding or disparaging the best *financial* research of the past 20 years. This research shows that enlightened investors can improve their returns over traditional indexing, within acceptable risk parameters, by taking a more balanced approach to asset allocation.

By ignoring the latest research, or wrongly portraying it in their marketing efforts and through the financial media, these diehard believers in total market indexing are literally costing—not saving—long-term investors billions of dollars in retirement savings. They act as if the end of financial history occurred in 1976 with the creation of the first retail S&P 500 Index Fund. They are wrong.

As you may have guessed, the large, powerful voice belongs to The Vanguard Group, which I admire, on the one hand, for pulling investors out of the clutches of Wall Street but am continually challenged to respect, on the other hand, for displaying symptoms of financial schizophrenia and severe myopia.

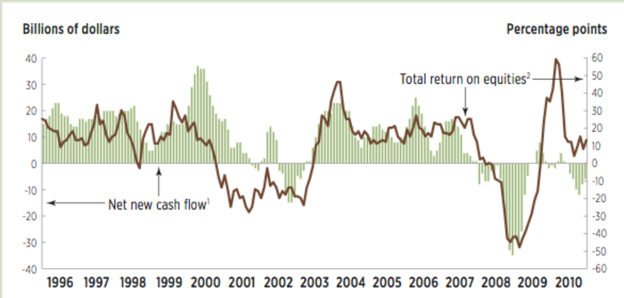
Vanguard's strong voice and success in attracting assets to traditional indexing has also lured major Wall Street firms, including State Street, BlackRock, and Invesco, to invade the indexing turf, all the while corrupting it by creating hundreds of index and sector-based ETFs for investors to trade in and out of as they chase asset class, sector, and country returns. Figure 2.4 on page 2 shows exactly this kind of bad investor behavior over the past 15 years.

*Continued on page 2*

FIGURE 2.4

**Net Flows to Equity Funds Related to Global Stock Price Performance**

*1996–2010*




[1] Net new cash flow to equity funds is plotted as a six-month moving average.
[2] The total return on equities is measured as the year-over-year change in the MSCI All Country World Daily Total Return Index.
Sources: Investment Company Institute and Morgan Stanley Capital International

## Blind Faith

Vanguard induces cult-like behavior from its funds' shareholders. In fact, diehard groups of these believers refer to themselves as "Bogleheads" in reference to the company's former chairman, John Bogle (often referred to as "St. Jack").

I admire plenty about John Bogle and count myself among his fans (at the age of 83, he's still going strong). He has been on a righteous crusade for decades to convert active investors to indexing. But his one-dimensional ideology is too simplistic and unbending in a multidimensional, complex, ever-evolving world. Once you decide that an ideology is so pure and perfect that nothing—new information, new facts, new perspectives—will change your mind, you become blind to the reality around you, you ignore flaws in the ideology or the people promoting it, and you miss opportunities for further growth. Here are what I consider Vanguard's major flaws:

*Vanguard is an active/passive fence-sitter*

Despite Vanguard's reputation as *the* index fund provider and leading voice in the indexing arena, a large part of its fund business focuses on active management. Over the past 15 years, Vanguard's active funds' performance has been mixed (see Table 2 on page 4). What message is Vanguard *really* trying to convey to investors? That it is among the anointed who can successfully pick winning active managers *in advance*? That the markets are not *really* efficient? That the securities concentration, style drift, management changes, and market timing risks of active management *really* don't cost investors dearly over time?

In a November 2011 white paper titled "A review of alternative approaches to equity indexing," Vanguard states that "...investors are best served by gaining equity exposure in their portfolios through a broad-market-cap-weighted index." So here's an idea, Vanguard: *best* serve them by *not* offering actively managed funds.

*Vanguard dismisses Fama & French's Research*

Financial history did not end in 1976 when Vanguard created the first *retail* index fund based on the S&P 500 Index.[1] In 1981, a new institutional investment firm, Dimensional Fund Advisors (DFA), introduced a small company index fund based primarily on research by Rolf Banz at the University of Chicago. In 1992, Eugene Fama and Ken French, also at the University of Chicago, improved on the single-factor "beta" model of asset pricing by conducting further research into the size factor and the value factor (the return difference between low-priced "value" stocks and higher-priced "growth" stocks). DFA embraced this new research and began introducing in 1993 U.S. and foreign funds based on Fama/French principles.

The Fama/French Three Factor Model is state of the art in financial economics today, yet the aforementioned Vanguard white paper acknowledged it only briefly. After stating that, in fact, "...smaller-cap and value stocks have demonstrated outperformance over the broad market in the very long run (Fama and French, 1992; 1993), a hotly debated topic in both the academic and practitioner communities is: *Why* should the size and value risk factors lead to an expectation of higher returns?"

Almost begrudgingly, the paper's authors write, "Some researchers [evidently it wasn't important to name Fama and French as *the* researchers] have suggested that the value effect is a manifestation of a 'distress risk' that provides investors with a higher expected return to compensate for investing in firms with above-average risk attributes, although recent empirical studies investigating this theory remain inconclusive."

More telling of Vanguard's ideological bias is the conclusion the authors drew on this important body of research: "Regardless of whether small-cap and value stocks *should* be expected to earn a higher return over time, perhaps most important for investors is the fact that both small cap and value stocks have undergone long periods of *underperformance* relative to the broad market. ...This is an example of the potential for alternative strategies' embedded biases to work to the detriment of investors. That is, when a given segment of the equity market is expected to outperform over the very long run, but demonstrates consistent under-performance over many years, will investors actually remain committed to that strategy, or will they invest only after smaller and value stocks have outperformed?"

Vanguard's conclusion here wouldn't necessarily lead investors astray, but its lack of context and completeness certainly could. In fact, the conclusion is correct. This is why Equius and similar advisors spend so much time reviewing stock market history with clients through the more complete lens of asset class investing and the

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Fama/French Three Factor Model. We strive to develop rational and realistic expectations over *all* market cycles, and we provide sound and steady counsel during "long periods of underperformance" in order to help clients meet their long-term objectives.

Since our firm's founding in the early 1990s, we've faced numerous historically significant cycles. From 1995 to 1999 the broad market (CRSP 1-10 Index) outperformed small cap and value stocks by a wide margin (see Table 1, Period 1). While many small cap and value fund managers and investment advisors shifted clients into much larger, higher-priced stocks to "keep up" with the broad market, we stayed the course and kept our clients focused on the expectations they had (rightly) come to accept. From 2000 to 2011, the broad-based indexes produced little return while small cap and value stocks boosted portfolio returns significantly (see Table 1, Period 2). A 60/40 blend of large and small value stocks beat the total market return by 2.3% per year over the full period (10.6% vs. 8.3%).

| **Table 1<br>Index Total Returns (annualized)** | **Period 1<br>1995-1999** | **Period 2<br>2000-2011** | **Total Period<br>1995-2011** |
|---|---|---|---|
| CRSP 1-10 Index | 239% (27.7%) | 15% (1.2%) | 290% (8.3%) |
| DFA US Large Cap Value Index | 189% (23.7%) | 37% (2.7%) | 297% (8.5%) |
| DFA US Small Cap Value Index | 140% (19.2%) | 255% (11.1%) | 751% (13.4%) |
| 60%/40% DFA Indexes* | 170% (21.9%) | 107% (6.2%) | 458% (10.6%) |

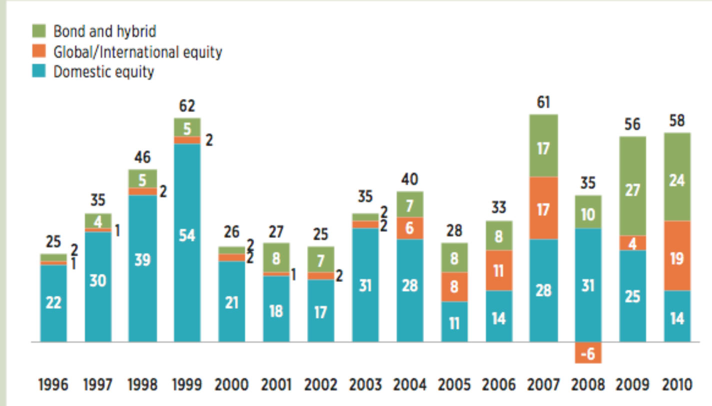
*60% DFA US Large Cap Value Index, 40% DFA US Small Cap Value Index. Indexes are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

This 17-year period included a 5-year stretch when small cap and value stocks underperformed the large growth-stock dominated broad market compared to a 12-year stretch when the broad market underperformed. This, Vanguard, is an example of the potential for *broad-based market strategies'* embedded biases to work to the detriment of investors.

Now let's look at another chart from the Investment Company Institute (Figure 2.9). It shows the tremendous growth in assets for domestic equity index funds from 1996-1999 and a very steep drop-off from 2000-2002, with little recovery thereafter. Although not shown, the bulk of the asset flow was into and out of Vanguard-type broad-based index funds.

Looking at Table 1 again, you can see why. It can be reasonably assumed that much of the money that went into S&P 500 and Total Stock Market index funds in Period 1 was due to their outstanding *performance*—driven by the stocks of large technology, telecommunications, and other growth companies—and not by a belief in indexing as a core investment *philosophy*.

FIGURE 2.9
**Net Flows to Index Funds**
*Billions of dollars, 1996–2010*




Note: Components may not add to the total because of rounding.

New indexed ETFs account for some of the lack of growth in these mutual funds in recent years, but evidence shows that this ETF money moves in, out, and around as a result of active trading and chasing asset class returns—not exactly what Vanguard had in mind.

### A Good Advisor Is Worth the Cost

Read our article "Should We Fear a Total U.S. Market Collapse or is a Gradual Rotation Among Asset Classes More Likely" from our January 2000 issue of *Asset Class* to see just how little our investment approach and messaging to clients have changed over the past 12 years.[2] We recognized the *unusual* outperformance of the broad market indexes over the small cap and value indexes and the inevitable correction to come, so our goal was to help our clients (and other readers of *Asset Class*) remain committed to the strategy rather than give up on indexing, asset class investing, or stocks altogether, as so many investors did after the steep declines that followed.

Many of the investors who became disillusioned with stocks after the first market collapse moved to real estate investments, leading to disastrous results. Some of these investors got back in well after the market recovery started in March 2003, bailed out again after stocks fell in 2008 and early 2009, and haven't gotten back in despite the strong recovery since March 2009—except maybe to buy Apple stock near its highest price ever.

In contrast, we've always wanted our clients to profit as much as possible from the inevitable recovery by staying in the market and avoiding any degree of market timing—which includes *not* selling the "overpriced" S&P 500

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position (although rebalancing the asset classes to established client targets was certainly in order).

I recall very clearly Bogle's and Vanguard's recommendation then (as now) that investors stay with the broad-based market indexes and, if anything, move from the S&P 500 Index funds to the Total Stock Market Index funds for greater diversification into small cap and value stocks. We pointed out the folly of this advice in our September and November 1999 issues of *Asset Class*.

Our commitment to more balanced asset class portfolios is not a violation of efficient market theory, as Vanguard diehards will suggest. Rather it's a recognition, based on sound research and nearly 20 years of actual experience, that efficient markets are multidimensional and that while the market as a whole (all investors collectively) prefers the safety of very large growth stocks and the lower expected returns they produce, individual investors may rationally choose a different course. Investors may derive more value by moving away from the herd based on their *personal* preferences, knowledge, and risk tolerance, while also benefiting from an experienced financial advisor's ongoing counsel and advice.

**Vanguard Alternatives**

The Vanguard white paper I referred to earlier criticizes primarily the new "fundamental" indexing methods. Although these methods result in funds tilted more heavily toward small cap and value stocks (just as any equal weighted index strategy would), we agree with Vanguard's support of traditional market-capitalization indexes on both theoretical and practical grounds. Where we differ with Vanguard is on the best way to market-cap weight indexes tilted toward these other risk dimensions.

As I pointed out earlier, DFA is the only firm that has embraced the Fama/French research in a way that captures more of the small cap and value return premiums using a passive, market-capitalization-weighted methodology while maintaining broad diversification. DFA offers investors an alternative to traditional index funds— one that incorporates the important Fama/French research and allows for *personalized* asset class diversification with rational expectations of better-than-market returns. Yes, the DFA funds require an advisor and the added cost (and benefits) that entails. Investors must judge for themselves whether this combination of superior asset class fund structure and management along with an experienced and disciplined advisor is worth the additional cost. The challenge is to not cut off your nose to spite your face—something far too many investors do.

I'll close this article with Table 2, which shows the returns for Vanguard's retail active and indexed funds and DFA's structured asset class funds with at least a 15-year track record covering the U.S. large growth, large value, small growth, and small value asset classes (Morningstar categories). Investors should decide, perhaps with a good advisor's guidance, whether a more balanced and diversified asset class approach is right for them.

[1]For background on the creation of the first index fund of any kind and its ties to DFA, see "The Origin of the First Index Fund" at www.crsp.com.

[2]The Equius Partners *Asset Class* newsletters are available at www.equiuspartners.com/newsletter.php.

**Note**: For an illustration of how dedicated financial advisors add stability and focus to an asset class strategy, see "What Discipline Looks Like…" on the Equius blog (Jan. 2012).

| **Table 2<br>Fund Returns & Expenses** | **Expense Ratio** | **15-Yr. Return (Annual)** |
|---|---|---|
| **U.S. Large Growth or Blend** | | |
| Vanguard Capital Opportunity | 0.48% | 11.9% |
| Vanguard PRIMECAP | 0.45% | 9.5% |
| Vanguard Morgan Growth | 0.41% | 6.8% |
| Vanguard Total Stock Market Index | 0.17% | 6.5% |
| Vanguard Growth Index | 0.24% | 6.3% |
| Vanguard Dividend Growth | 0.31% | 6.3% |
| DFA US Large Company | 0.10% | 6.0% |
| Vanguard 500 Index | 0.17% | 6.0% |
| Vanguard Growth & Income | 0.32% | 6.0% |
| Vanguard Growth Equity | 0.52% | 5.3% |
| Vanguard U.S. Growth | 0.44% | 2.2% |
| **U.S. Large Value** | | |
| DFA US Large Cap Value I | 0.28% | 7.6% |
| Vanguard Equity-Income | 0.31% | 7.4% |
| Vanguard Windsor II | 0.35% | 7.0% |
| Vanguard Windsor | 0.39% | 6.0% |
| Vanguard Value Index | 0.24% | 5.9% |
| **U.S. Small Growth or Blend** | | |
| DFA US Small Cap I | 0.37% | 9.3% |
| DFA US Micro Cap I | 0.52% | 9.7% |
| Vanguard Explorer | 0.50% | 8.7% |
| Vanguard Small Cap Index | 0.24% | 8.5% |
| **U.S. Small Value** | | |
| DFA US Small Cap Value I | 0.52% | 10.6% |
| Vanguard Small Cap Value Index* | 0.24% | 7.2%* (8.7%) |

Period shown is 4/1996 to 3/2012. Shaded funds are passively managed index or asset class funds, and non-shaded are actively managed. Vanguard funds are "Investor"-class shares. *Vanguard Small Cap Value Index return is from 6/1998 to 3/2012 due to fund's inception date. The return for the DFA US Small Cap Value Fund for the same period is in parentheses. Past performance is not a guarantee of future results. DFA fund returns do not include the fees for an independent financial advisor. This data is for illustrative purposes only.