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ASSET CLASS℠

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

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Social Responsibility

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> *"There has been too little emphasis on the principle that the basic essential of an education is the ability to think—to think in terms of human values, to think in terms of social responsibility, to think in terms of what the cumulative effect of your daily activities is in term of your clients' welfare and of your character. This need, while not peculiar to your profession, is especially accentuated there because in the final analysis yours is a profession affected with a public interest."*

These words were spoken by William O. Douglas, the commissioner of the Securities and Exchange Commission (SEC), in a speech to a group of young people just entering the securities industry. The year was 1936 and the title of the speech was "Customers' Men."[1] Douglas was warning his idealistic, eager, and ambitious audience of the corrupting influence the retail brokerage side of Wall Street was likely to bring to bear on their ethics and their desire to do well and *good* by their new careers.

I found this speech as I was preparing to write a perspective on a new article by Charles Ellis,[2] the author of *Winning the Loser's Game* (now in its fifth edition, with 500,000 copies sold). The article, titled "Murder on the Orient Express: The Mystery of Underperformance,"[3] was published in the July/August 2012 edition of the CFA Institute's *Financial Analysts Journal* and is a thorough indictment of the institutional money management side of our business.

Both articles shine a brilliant, objective, and unbiased light on two sides of our industry that consistently cost investors dearly—either directly from the brokerage/active management side or indirectly through the irresponsible actions of retirement plan, foundation, and endowment "fiduciaries" who are tasked with making decisions for millions of beneficiaries.

My inclination (as many of you know) is to outline much of what both Ellis and Douglas have to say on the ethics, motives, and results of the dominant culture of our industry and add support based on my own experiences and observations. This is the easy route, since objective, quantitative evidence abounds and powerful anecdotal evidence piles up every day. It's harder (at least for me) to take the different approach of simply outlining how we and our investment approach are different and why, and hoping that our clients and other readers of *Asset Class* recognize a different ethic and a different balance of priorities in terms of what is best for clients and what might maximize our revenues and profits as a business.

But given all the negativity about our industry today, on top of very well-articulated perspectives by Ellis and Douglas, I'm going to refrain from piling on too much. Instead, I strongly encourage you to read each article on your own

Continued on page 2

Asset Class Returns

June 30, 2012 (YTD)

	YTD 2012	Last 10 yrs.*	2011	2010	2009
Bonds (%)					
One-Year	0.6	2.6	0.6	1.2	1.9
Five-Year	2.5	4.5	4.5	5.3	4.2
Intermediate	2.1	6.4	9.4	6.9	-0.7
Long-Term	4.5	8.7	29.3	8.9	-12.1
U.S. stocks (%)					
Large Market	9.4	2.8	2.1	14.9	26.5
Large Value	8.4	4.6	-3.1	20.2	30.2
Small Market	8.3	6.7	-3.2	30.7	36.3
Small Micro	8.2	7.1	-3.3	31.3	28.1
Small Value	8.2	8.1	-7.6	30.9	33.6
Real Estate	14.7	10.1	9.0	28.7	28.2
International stocks (%)					
Large Market	3.2	4.9	-12.3	9.3	30.6
Large Value	0.7	7.6	-16.9	10.6	39.5
Small Market	3.8	11.0	-15.4	23.9	42.0
Small Value	3.9	11.9	-17.5	18.1	39.5
Emerg. Mkts.	4.4	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
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 12/31/11.

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and draw your own conclusions. I'll focus on what each man proposed as a solution to fix a broken culture, suggest why I think they're wrong, and propose what I believe is a more effective alternative.

Reform From Within?

Here's Douglas again (77 years ago!):

> *"In sum, if the institution of customers' men* [the retail brokerage industry] *is to survive, it must have meticulous regard for the standards of conduct governing fiduciaries. It cannot survive if it ostensibly serves the customers but actually serves the employees and employers. It must redefine its functions. It must forsake the idea of salesmanship and concentrate on investment services."*

Despite the industry's concerted efforts to recharacterize and promote stockbrokers as "financial consultants" and "financial advisors" over the last 30 years or so, they remain non-fiduciaries. Rather, they are *sellers* of their firms' products and services, receive sales commissions as the dominant form of compensation, and, as a result, are trained to sell to their customers' *wants*, not *needs*. Education—in terms of what truly works and does not work in investing; the true source of returns; the difference between investing and speculating; and the importance of modifying behavior to reduce transaction costs, changes in strategy, and emotional decision-making —is simply not at the *core* of what they do.

This does not mean that all (or even most) stockbrokers are unethical. It does mean that far too many are undereducated in the areas of finance, statistics, and economics (as Douglas points out), particularly in the area of Modern Portfolio Theory. Furthermore, their financial incentives and the culture in which they operate too often work against the best interests of serious, long-term investors and it's highly unlikely that those factors are going to change in our lifetime (they haven't in at least seventy-seven years). For a more recent perspective on this, read "A Fancy Financial Adviser Title Does Not Ensure High Standards" from the June 6, 2012 edition of *The New York Times*.

Before I move on to Ellis' perspective on the institutional investing realm, it's important to make a distinction here in terms of responsibility. Anyone dealing with Merrill Lynch, Morgan Stanley, Smith Barney, or any other brokerage firm has made that choice *on her own*. As much as she will ultimately be driven to blame those firms or their brokers for bad investment recommendations or unrealistic expectations, the buck must stop with her.

If I can find a perspective as enlightening as Douglas' from 77 years ago or a *New York Times* article from a month ago within seconds of entering a search term in Google, anyone can. Yes, reading them and coming to logical conclusions takes some critical-thinking skills, but I believe our clients possess these skills in abundance.

For me, the most significant aspect of Charley Ellis' article is the fact that he's indicting the part of our industry controlled by the most experienced, most highly educated, and most respected investment experts we have in this country. These *are* legal fiduciaries and the beneficiaries of their decisions have little, if any, control over the financial outcome. Ellis' conclusion?

> *"If our profession fails to deliver on its promises, negative consequences could be in the offing for us as well as for our patient, long-suffering clients. ...Seen correctly, active management may be the only service ever offered that costs more than the value delivered."*

So What's the Answer?

Let's face reality: the financial industry will not reform itself. Given all that's happened in the financial markets and our industry over the years, combined with the disgraceful ineptitude of our politicians to devise even marginally beneficial regulations, along with thoroughly unprofessional and irresponsible financial journalism, this call strikes me as both delusional and naive.

The fact is, investors must take care of themselves *first* by seeking knowledge that they, their family, their friends, and others can use to protect their assets from a mostly predatory industry. They must then demand more from their financial advisors (a topic for a future article).

Firms like Equius Partners, as insignificant as we are in this massive industry, can also continue to do the best we can for clients, as responsible fiduciaries, while effectively communicating the principles, benefits, and challenges of asset class investing. We continue to develop programs and initiatives to deliver this kind of evidence-based knowledge more broadly and effectively. [4]

It also helps to have people as experienced and reputable as Charley Ellis to help us spread the word. But unless someone picks up his book, his views will continue to be buried in professional journals and ignored by the mainstream press. You can help to shift the balance and force change by sharing your experience with asset class investing and advisors like Equius with others, by recommending Ellis' book, and by passing on copies or links to these articles. If not you, who?

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[1]A graduate of Exeter and Yale College, Ellis earned an MBA (with distinction) at Harvard Business School and a PhD at New York University. He is the founder and chairman of Greenwich Associates, an international strategy consulting firm. His article "The Loser's Game" won the CFA Institute's prestigious Graham & Dodd award in 1977. Longtime readers of *Asset Class* will remember that the first 15 or so articles of this newsletter, starting in mid-1993, were devoted to reprinting the second edition of Ellis' book chapter by chapter (with his permission, of course).

[2]www.cfapubs.org/doi/pdf/10.2469/faj.v68.n4.2

[3]www.sec.gov/news/speech/1936/111236douglas.pdf

[4]www.nytimes.com/2012/07/07/your-money/beware-of-fancy-financial-adviser-titles.html

[5]These include educational forums targeted to spouses, children, and grandchildren of clients and a series of iPad apps being developed for investment advisors and investors outlining the features and benefits of indexing and asset class investing.