

Asset Class Returns

February 28, 2013

	YTD 2013	Past 10 yrs.*	2012	2011	2010
Bonds (%)					
One-Year	0.1	2.3	0.9	0.6	1.2
Five-Year	0.2	4.0	4.8	4.5	5.3
Intermediate	0.0	5.3	3.7	9.4	6.9
Long-Term	-2.0	7.4	3.5	29.3	8.9
U.S. stocks (%)					
Large Market	6.6	7.0	15.8	2.1	14.9
Large Value	8.3	8.4	22.1	-3.1	20.2
Small Market	7.3	10.9	18.4	-3.2	30.7
Small Micro	6.9	10.4	18.2	-3.3	31.3
Small Value	8.4	11.3	21.7	-7.6	30.9
Real Estate	4.7	11.4	17.5	9.0	28.7
International stocks (%)					
Large Market	2.7	8.4	17.8	-12.3	9.3
Large Value	1.5	10.2	16.6	-16.9	10.6
Small Market	4.3	12.8	18.9	-15.4	23.9
Small Value	5.8	13.5	22.3	-17.5	18.1
Emerg. Mkts.	-0.7	17.4	19.2	-17.4	21.8

All returns except "YTD" (Year to Date) are annualized.

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

"Past 10 yrs." returns are ended 12/31/12.

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.

Equius Partners, Inc.
3 Hamilton Landing, Suite 130
Novato, CA 94949
Phone: 415-382-2500
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Snippets

Jeff Troutner, Equius Partners

A few thoughts and observations...
random

First, do no harm

Half the harm that is done in this world is due to people who want to feel important. They don't mean to do harm — but the harm does not interest them. Or they do not see it, or they justify it because they are absorbed in the endless struggle to think well of themselves. —T. S. Eliot

I think this is an apt description of active money managers (i.e., almost the whole of the investment industry) and most politicians.

What is the correct risk premium expectation for stocks?

Suggesting a 6% expected risk premium for stocks is standard in our industry. It refers to the return, net of the one-month U.S. Treasury Bill return (considered "risk-free"), investors should expect from the stock market over time. Running some numbers recently, I came across this:

Annual Return: 1928-2012 (85 years)	
Dimensional US Market Index	9.54%
One-Month Treasury Bills	3.54%

Hmm...

Source: DFA Returns Program

Annualized compound returns. Indices are not available for direct investment. 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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Why are 87% of all assets in equity mutual funds actively managed?

This is a question that has intrigued me for at least 20 years, and I plan to address it in more depth in a future *Asset Class*. But I happened on an article* recently posted on the University of Chicago Booth School of Business web site, of all places, that had me shaking my head. The article referenced a paper by two Chicago Booth professors, Lubos Pastor and Robert F. Stambaugh, titled “On the Size of the Active Management Industry.” Here’s how the article began:

The popularity of active funds need not be puzzling

Fund managers who actively pick stocks rather than passively follow an index of companies have long taken a beating. A long line of studies has shown that the majority of active mutual funds—weighed down by high charges and expenses—yield low returns relative to comparable passive funds. For instance, a study finds that in the past 23 years an aggregate portfolio of active equity mutual funds in the United States underperformed various benchmarks by about one percent a year. Most active fund managers who succeed in beating the market in one year tend to fail in the next, dashing investors’ hopes that there is more to a manager’s stellar performance than just good luck. Altogether, the evidence firmly suggests that for most investors it does not pay to seek the skills of an active manager.

Bingo! But why?

...as the industry grows, more money chases opportunities to outperform the market, which makes it harder for active managers to find bargain-priced stocks for their clients.

Bingo again! So why, exactly, are 87% of stock fund assets actively managed?

Investors think about alpha when deciding how much money to invest in active funds. They do not know what alpha exactly is, but they can learn about it by observing the returns of active fund managers. If these returns turn out to be disappointing, for instance, then investors update their views about alpha downward and reduce their investment in active funds.

However, they will not pull out all of their money. The belief that future returns are inversely related to the size of the industry cushions the fall in the share of financial assets that goes into active funds. Rational investors know that if other people withdraw their money, too, then it will be easier for active managers who represent the remaining investors to find good deals and generate higher returns. Because a reduction in the size of this industry implies a higher alpha, investors will take out some of their money but keep a substantial amount invested in active funds to take advantage of higher expected returns. If all investors think the same way, then it is easy to see how the industry may gradually become smaller over time but still remain a formidable presence.

Huh? Are you kidding me?

I’ve been immersed in investor behavior and financial economics for more than 30 years, and I can safely say that neither I nor any investor I’ve ever met thinks this way.

Takeway? Choose your academics wisely. If there were an official Ivory Tower Award, I’m sure these guys would win it.

*[Active Thinking](#), Lubos Pastor, *Capital Ideas*, University of Chicago Booth School of Business

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The death of alternatives?

The amount of money shifted out of stocks *after* the dot-com crash (2000-2002) and the debacle known as the “global financial crisis” (2007-2008) is staggering. Foolishly, some people have been letting their money sit in cash equivalents, but many people shifted much of this capital to “alternative” investments such as real estate, commodities, precious metals, hedge funds, venture capital, and private equity. This seismic shift was fueled not just by short-term stock market performance but also by the success of (and resulting media frenzy around) the “endowment approach,” made popular by the success of the Yale University endowment fund.

Given that U.S. stocks appreciated by 15.8% *per year* in the four years following the dot-com crash and 15.4% *per year* in the four years following the global financial crisis (and the fact that the endowment strategy failed miserably during the global financial crisis), you would think the endowment approach would have lost its luster by now.¹

Sadly, it hasn’t—yet. A poll conducted by *The Wall Street Journal*² shows that its readers put just 8% of their portfolios in stocks and 44% were placed in alternatives.

The 44% statistic stunned me until I remembered a presentation I downloaded a

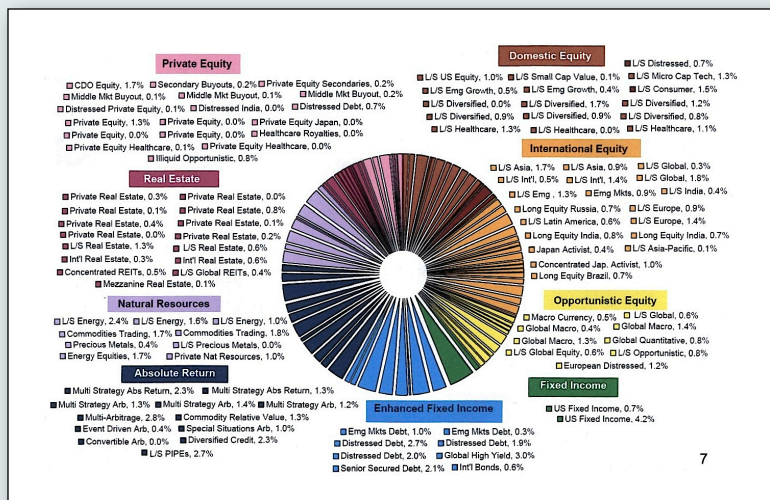
few years back on a Merrill Lynch product called “The Endowment Fund.” Merrill Lynch marketed it to retail investors (at a 2.5% front-end load and at least a 2% annual fee) who wanted to mimic the approach taken by Yale, Harvard, and so many other “enlightened” endowment funds.

What I remembered most clearly about that product was its diversification, shown in the chart below. Mind boggling, right? That’s the picture of “democratized investing,” the phrase marketers used to lure naive investors who wanted to invest like Yale (and that a writer for the *Houston Chronicle*³ refers to as “envy investing”).

The lead manager for the product was Mark W. Yusko, the former head of the University of North Carolina endowment, who was just fired in January after a wave of investor withdrawals from the fund (triggered by persistent bad performance) forced it to block further withdrawals.

The once-lauded endowment investment committees suffered from the same leadership flaws we see in the 401(k) and pension markets: herd mentality, consultant dependency, and overall intellectual laziness. What’s also similar is the lack of accountability and consequences for the decision makers. In the end, it’s the students

(or their parents), retirees, and others who pay the price of this stupidity.



¹[Educational endowments and the financial crisis: social costs and systemic risks in the shadow banking system](#), Tellus Institute

²[Plain-Vanilla Investments? No Thanks, Say Readers](#), February 3, 2013, *The Wall Street Journal*

³[Steffy: The perils of envy investing](#), November 1, 2012, *Houston Chronicle*

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A Fourth Factor?

Dimensional Fund Advisors recently introduced four new U.S. and international large and small cap “growth” mutual funds based on new research into a fourth factor, or dimension, of portfolio returns.

Here's what Dimensional says about the new research:

More recent research by Fama, French, and Robert Novy-Marx, among others, shows that expected profitability—as measured by the direct profitability of book equity, for instance—is another reliable and robust dimension of expected returns. Controlling for the previously mentioned dimensions of returns [market, size, and relative price], more profitable firms have higher expected returns than less profitable firms. The research breakthrough in this case is not the discovery of expected profitability as a dimension of expected returns per se ... rather, it is the discovery of reasonable proxies for expected profitability, which allow us to use profitability as another dimension of expected returns in the creation of investment solutions.

So what does this mean for Equius clients?

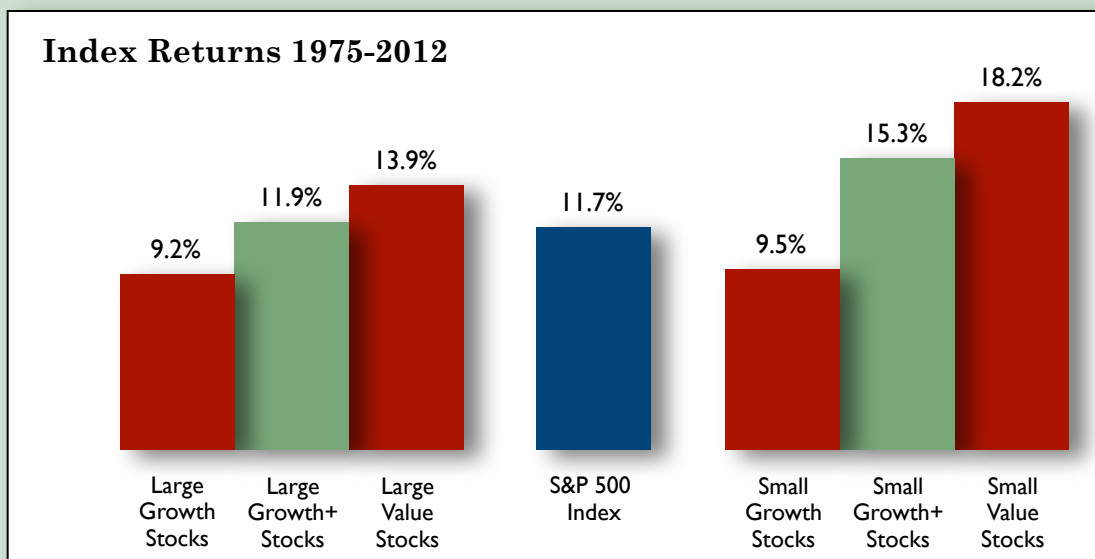
In terms of the four new funds: nothing. We have excluded large and small growth stock asset classes from our client portfolios for 20 years,

and the table below shows just why we do this. Large and small growth stocks have much lower expected returns than do large and small value stocks (compare the red bars). The growth indexes enhanced with the direct profitability factor boost the large and small growth returns pretty significantly (the green bars), but they still lag the expected returns of value stocks by a wide margin.

We see potential in this research in its application to an S&P 500 or other market-type index that is already tilted a bit toward value and small cap stocks. Using the 1975-2012 data below as a guide, starting at the S&P 500 level of expected return instead of the large growth level shows great promise. If Dimensional offers a new fund of this type we will consider replacing the Vanguard 500, DFA US Large Company, or other similar market-type fund with it.

Dimensional might also apply the new research to its large and small value funds, bumping up expected return or increasing diversification while leaving expected return constant.

Equius is reviewing this research, its implications, and its potential application for our client portfolios. We will provide additional perspectives on the subject soon. Stay tuned!



Source: DFA Returns Program; Large Growth Stocks = Dimensional US Large Cap High Price-to-Book index, Large Growth+ Stocks = Dimensional US Large Cap Growth index, Large Value Stocks = Dimensional US Large Cap Value index, Small Growth Stocks = Dimensional US Small Cap High Price-to-Book index, Large Growth+ Stocks = Dimensional US Small Cap Growth index, and Small Value Stocks = Dimensional US Small Cap Value index. Data starts in 1975 due to current research limitations for the new indexes.

Annualized compound returns. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. **Past performance is not a guarantee of future results.**