Other Voices

Connecting the Dots

Jim Parker, Dimensional Fund Advisors

Human beings love stories. But this innate tendency can lead us to imagine connections between events where none really exist. For financial journalists, this is a virtual job requirement. For investors, it can be a disaster.

"The Australian dollar rose today after Westpac Bank dropped its forecast of further central bank interest rate cuts this year," read a recent lead story on Bloomberg.

Needing to create order from chaos, journalists often stick the word "after" between two events to imply causation. In this case, the implication is the currency rose because a bank had changed its forecast for official interest rates.

Perhaps it did. Or perhaps the currency was boosted by a large order from an exporter converting U.S. dollar receipts to Australian dollars or by an adjustment from speculators covering short positions. Markets can move for many reasons.

Likewise from another news organization, we recently heard that "stocks on Wall Street retreated today after an escalation of tensions in the Ukraine."

Again, how do we know that really was the cause? What might have happened is that a trader answered a call from a journalist asking about the day's business and tossed out Ukraine as the reason for the fall because he was watching it on the news.

Sometimes, journalists will throw forward to an imagined market reaction linked to an event that has yet to occur: "Stocks are expected to come under pressure this week as the US Federal Reserve meets to review monetary policy settings."

For individual investors, financial news can be distracting. All this linking of news events to very short-term stock price movements can lead us to think that if we study the news closely enough we can work out the direction in which the market will move. But the jamming of often unconnected events into a story can lead us to mix up causes and effects and focus on all the wrong things. The writer and academic Nassim Taleb came up with a name for this story-telling imperative: the narrative fallacy.

The narrative fallacy, which is linked to another behavior called confirmation bias, refers to our tendency to seize on vaguely coherent explanations for complex events and then to interpret every development in that light. These self-deceptions can make us construct flimsy, if superficially logical, stories around what has happened in the markets and project it into the future.

The financial media does this because it has to. Journalists are professionally inclined to extrapolate the incidental and specific to the systematic and general. They will often derive universal patterns from what are really just random events.

Building neat and tidy stories out of short-term price changes might be a good way to win ratings and readership, but it is not a good way to approach investment. Of course, this is not to deny that markets can be noisy and imperfect. But trying to second-guess these changes by constructing stories around them is a haphazard affair and can incur significant cost. Essentially, you are counting on finding a mistake before anyone else does. And in highly competitive markets with millions of participants, that's a tall order.

There is a saner approach, one that doesn't require you to spend half your life watching CNBC and checking Bloomberg. This approach is methodical and research-based, a world away from the financial news circus.

The alternative consists of looking at data over long time periods and across different countries and multiple markets. The aim is to find factors that explain differences in returns. These return "dimensions" must be persistent and pervasive. Most of all, they must be cost-effective in order to be captured in real-world portfolios. This isn't a traditionally active investment style where you focus on today's "story" and seek to profit from mistakes in prices, nor is it a passive-index approach where you seek to match the returns of a widely followed benchmark.

This is about building highly diversified portfolios around these dimensions of higher expected returns and implementing consistently and at low cost. It's about focusing on elements within your control and disregarding the daily media noise.

Admittedly, this isn't a story that's going to grab headlines. Using the research-based method and imposing a very high burden of proof, this approach resists generalization, simplification, and using one-off events to jump to conclusions.

But for most investors, it's the right story.

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ASSET CLASS℠

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

May 2014

Asset Class Returns

April 30, 2014

	YTD 2014	2013	2012	2011	Past 10 yrs.*
Bonds (%)					
One-Year	0.2	0.3	0.9	0.6	2.2
Five-Year	1.4	-0.4	4.8	4.5	3.6
Intermediate	2.4	-3.5	3.7	9.4	4.7
Long-Term	7.7	-11.4	3.3	28.2	6.1
U.S. stocks (%)					
Large Market	2.5	32.3	15.8	2.1	7.4
Large Value	2.3	40.3	22.1	-3.1	8.9
Small Market	-2.1	42.2	18.4	-3.2	10.2
Small Micro	-2.9	45.1	18.2	-3.3	9.3
Small Value	-0.7	42.4	21.7	-7.6	10.0
Real Estate	14.2	1.4	17.5	9.0	8.2
International stocks (%)					
Large Market	2.5	20.7	17.8	-12.3	7.0
Large Value	2.8	23.1	16.6	-16.9	8.1
Small Market	4.3	27.4	18.9	-15.4	10.3
Small Value	5.7	32.4	22.3	-17.5	10.9
Emerg. Mkts.	0.3	-3.1	19.2	-17.4	11.6

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	Long-term Gov't Bond Index
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 12/31/13.

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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Stock Investing and Mountain Biking

Jeff Troutner, Equius Partners

My main recreational passion is mountain biking. I'm fortunate to live in the place where mountain biking started (Mt. Tamalpais in Marin County) and ride regularly with some of the sport's earliest enthusiasts (yeah, they're a *lot* older than I am…wink, wink). In fact, a local high school, Sir Francis Drake High, has won four of the last five California state championships in mountain biking, with the other won by another local school, Redwood High (Phil Jonckheer's alma mater).

I mention this because after we published the "Stock Market Centerfold" in the April *Asset Class*, I spent more time studying the visual presentation we created with the "returns matrix." At first, the downward sloping aspect of the matrix concerned me. Would it, even subliminally, suggest that the stock market falls consistently in price over time, for example? This perspective risked shifting focus from the increasingly more consistent green areas (positive returns) during longer time periods and obscuring the very important message that patience and discipline are well rewarded by stocks generally and our investment approach specifically (particularly in the areas of small cap and value).

Then my mind conveniently drifted to mountain biking and my winter sports passion, snowboarding. Both require learning good balance, along with the ability to adapt to steep and quickly—sometimes sharply—changing up-and-down terrain, to reach the end of the ride satisfied and in one piece.

Both also involve fairly steep learning curves to master the techniques. The first year or two of both sports involve a mixture of a few precious moments of exhilaration combined with far too frequent and painful crashes. There's no "trying" either sport if you want to enjoy their benefits long-term. You have to *commit* to the potential for a lot of pain early on to find out that both sports are actually less difficult and far more rewarding than you probably ever imagined.

How is investing any different, really? I personally (like most of our clients) had to go through years of the pain of active management before I learned better techniques and principles. Even after embracing indexing and asset class investing in the early 1990s, Phil and I (and our early clients) had to endure several years when the results of our approach lagged much more conventional and popular approaches. And despite the confirmation we've all received since 2000 that asset class investing is clearly superior to active management in any form and

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here to stay as a viable long-term strategy, we've had challenging setbacks, such as in the late 2008–early 2009 period when we had to take our lumps, stay focused and disciplined, and recover from some rather unavoidable falls.

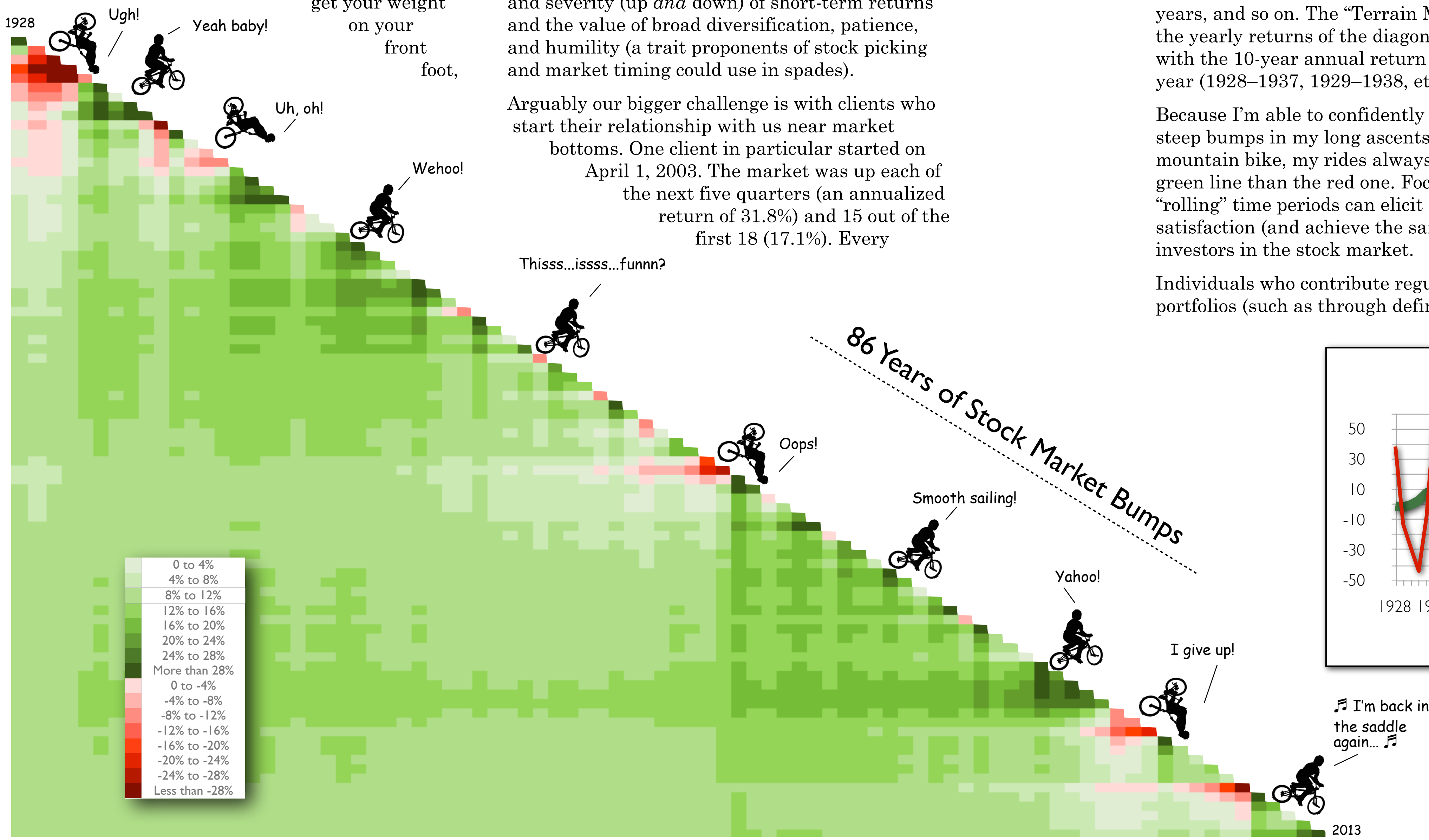
How Long?

So if the typical duration to move up the learning curve for mountain biking and snowboarding is a couple of years or so, what might it be for asset class investing? That depends on when you start and how severe the early challenges are. Based on my own experience, I've told all the novices who want to learn snowboarding that the sooner they move up to steep terrain, the faster they'll improve. That's a bit counterintuitive, right? But the key to snowboarding is learning to turn. And because the key to turning is to get your weight on your front foot, the steeper the hill, the easier it is to keep your weight on the front of the board, and thus the easier it is to turn (up to a point, of course).

In mountain biking, hesitating at the most technical spots of steep terrain will almost always result in a painful fall. Having the knowledge (gained from experience and/or proper coaching) that you can push through these difficult spots and keep rolling develops the confidence and discipline you need to reach your ultimate goal.

After setting realistic expectations at the start of our advisory engagement, an immediate downturn in the market can actually set the foundation for a long and even more rewarding relationship. We navigate our clients through the doubts and other emotions a down market elicits—often as they continue to contribute and purchase stocks at lower prices—until markets recover. With this guidance, our clients come to understand the randomness and severity (up *and* down) of short-term returns and the value of broad diversification, patience, and humility (a trait proponents of stock picking and market timing could use in spades).

Arguably our bigger challenge is with clients who start their relationship with us near market bottoms. One client in particular started on April 1, 2003. The market was up each of the next five quarters (an annualized return of 31.8%) and 15 out of the first 18 (17.1%). Every meeting we had with this client through the third quarter of 2007 was devoted primarily to damping down expectations. When the inevitable downturn occurred—in this case as the result of the global financial crisis—our client was much better prepared than the average investor was to weather that storm. Our relationship with this client has since grown to include many branches and generations of his family—all benefitting from the valuable lessons that the severe ups and downs of that period provided.



Using the Matrix for Perspective

The visual aspect of the returns matrix that makes it such a valuable learning tool is the way it enables readers to quickly see and compare returns from 1 year to 86 years and *everything in between.*

Moving down from anywhere on the diagonal (where the yearly returns lie) allows investors to view the *annualized* returns for 2 years, 3 years, 4 years, and so on. The "Terrain Map" below plots the yearly returns of the diagonal (red line) along with the 10-year annual return from each starting year (1928–1937, 1929–1938, etc.) shown in green.

Because I'm able to confidently ride through the steep bumps in my long ascents and descents on a mountain bike, my rides always feel more like the green line than the red one. Focusing on longer "rolling" time periods can elicit the same feeling of satisfaction (and achieve the same result) for investors in the stock market.

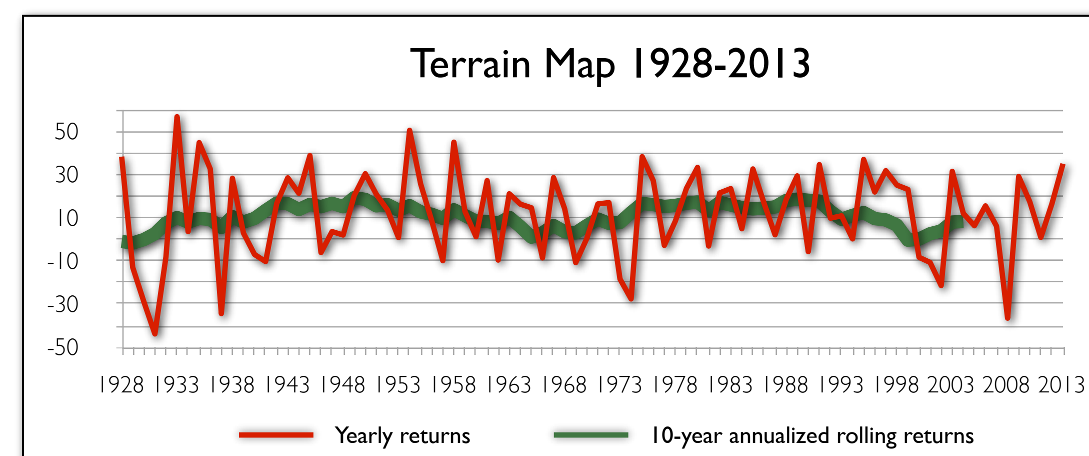
Individuals who contribute regularly to their portfolios (such as through defined contribution retirement plans) should keep in mind that even though the returns on dollars contributed during severe down periods may take some time to recover, the much higher returns on dollars contributed during the recoveries will bring the overall average up, sometimes dramatically.

Finally, what I haven't shown is a matrix for a more diversified asset class portfolio. In most periods (the years of the Great Depression and 2008 being the most notable exceptions), adding a pronounced small cap and value tilt to the portfolio reduces the deep reds and increases the deep greens in the short term and tends to improve annual compound returns significantly over time.

Conclusion

As with mountain biking and snowboarding, I knew the challenges of asset class investing going in. But I was confident that surviving the initial learning curve and persevering through the inevitable ups and downs would eventually pay off with many years of very satisfying results. This is the message we strive to convey to clients throughout the duration of our relationship with them.

Also similar with my sports passions, I know my, our clients', and our team's learning has not ended and that we'll have many more challenges in the future. Building and maintaining confidence, relying on the work of partners and colleagues with similar goals and values, and facing—even enjoying on some level—the inevitable challenges will make all the effort worthwhile.



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