EQUIUS PARTNERS

Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

September 30, 2014

	YTD 2014	2013	2012	2011	Past 10 yrs.*
Bonds (%)					
One-Year	0.3	0.3	0.9	0.6	2.2
Five-Year	1.9	-0.4	4.8	4.5	3.6
Intermediate	3.3	-3.5	3.7	9.4	4.7
Long-Term	13.6	-11.4	3.3	28.2	6.1
U.S. stocks (%)					
Large Market	8.3	32.3	15.8	2.1	7.4
Large Value	7.2	40.3	22.1	-3.1	8.9
Small Market	-4.0	42.2	18.4	-3.2	10.2
Small Micro	-5.8	45.1	18.2	-3.3	9.3
Small Value	-3.0	42.4	21.7	-7.6	10.0
Real Estate	14.3	1.4	17.5	9.0	8.2
International stocks (%)					
Large Market	-1.0	20.7	17.8	-12.3	7.0
Large Value	-1.7	23.1	16.6	-16.9	8.1
Small Market	-2.2	27.4	18.9	-15.4	10.3
Small Value	-1.1	32.4	22.3	-17.5	10.9
Emerg. Mkts.	2.9	-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.

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October 2014

Smart Value

Jeff Troutner, Equius Partners

Smart Beta. Strategic Beta. Fundamental Indexing. All these terms have recently been invented by very smart players in the investment industry to describe an opportunity Equius has recognized (and exploited on behalf of our clients) for *over twenty years*—namely, that investors who tilt portfolios toward small cap and value stocks *can* earn an expected return premium over the market return. (I emphasize "can" because the tilt is only part of the story, the rest of which I'll discuss throughout this article.)

Smart beta is classic Wall Street packaging. Firms—most notably Charles Schwab and BlackRock through their use of exchange-traded funds, or ETFs—are falling all over themselves to introduce new products and services based on smart beta. Ironically, this latest investing trend is fueled by the amazing(!) realization that most active managers can't beat the market over time—again, an investing reality Equius and its clients have known for *over twenty years*.

These two new groundbreaking "discoveries" by the experts at Schwab, BlackRock, and others has led to another new development that is sure to appeal to a new generation of tech-savvy investors: the birth of the "robo advisor." Packaged as low-cost alternatives to traditional, human-heavy investment advisory services, these Internet-driven creations will no doubt attract a following. They will also, no doubt, fail to meet investor expectations as just about every other Wall Street creation has for the last thirty years.

And this, dear readers, is the real point of this article, not smart beta. Our clients have benefited for so long from knowledge and principles that only now are being recognized by many in the investment industry. That knowledge is not limited to what's really driving smart beta or the consistent failure of active management or the importance of controlling costs. It covers a whole range of issues and defines in clear terms our value proposition with clients. For reasons I hope will become evident by the end of this article, we call that value proposition "smart value."

Smart value is what we deliver to clients in return for their investment advisory fee. It is the sum total of two very different sets of skills and qualities. First, and most critically, are the core values, principles, experience, knowledge, focus, consistency, and discipline we bring to every client relationship. These are important *human* qualities, the intrinsic value of which is not easy to quantify except over time and in

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relation to other advisors in our field. Because every relationship and every personality we work with is different, we can't calculate this value in clear basis-points terms. But these qualities have had *by far* the greatest financial and emotional impact on our clients. And we're certain that this impact cannot be replicated, let alone sustained, by complex computer algorithms, simple questionnaires, or the new robo advisor business model.

The second set of skills involves much easier-to-measure metrics such as success in reducing mutual fund expenses, properly assessing differences in index fund construction and expected risk and return characteristics, and improving portfolio tax efficiency. This is the *easy* part of what we do. Not surprisingly, these very basic skills define the complete value proposition offered by the low-cost robo advisor systems. Also not surprisingly, most of these nonhuman interfaces compromise these simple tasks by putting ease of marketing and delivery ahead of optimum client outcomes.

So while the actual people behind these scaled-down systems *may* share our belief in the significant impact the first set of human skills has on long-term portfolio returns and the overall quality of a *long-term* investment relationship, they have placed the burden of mastering these skills and the responsibility of capturing their value solely on the investor.

Given how rarely these human skills are delivered well to investors by real people, this new Internet-delivered model is destined to fail investors in much the same way the defined-contribution 401(k) model—prone as it is to performance chasing and market timing—is failing so many investors saving for retirement.

The Components of Smart Value

The industry experiences of our founders, our team's personal values, and the dogged pursuit of investment truth serve as the inspiration for our smart value proposition with clients. Smart value then is essentially the combination of our industry roots, our understanding of investor behavior, and the structure and discipline we place around our investment process.

Our industry experience intersecting with our personal values has taught us not to *exploit* investor behavior, but rather to understand it and modify it in a positive way whenever possible.

Our industry experience intersecting with our dogged pursuit of investment truth has taught us why active managers fail to meet most investors' expectations, why indexing is the better course for long-term investors, and how indexing can be improved upon further by a more robust understanding of security risk and expected returns. What follows is a more detailed outline of our smart value approach to client relationships.

The Roots of Smart Value

Smart	Value
Recognize and understand the true nature of our industry and the realities of investor behavior.	Places the clients' interests first. Improves, does not exploit, client behavior, leading to better outcomes.
Recognize and understand the low odds of stock picking and market timing in the modern era.	Captures much more of the capital markets returns for clients through indexing. Increases odds of preferred outcomes.

My years as a stock broker, followed by two years with a market timing firm, taught me that some business models are not built on a client-first philosophy. I came to realize that a focus on the short term, acceptance of high client turnover, and exploitation of investor emotion are what really define that model.

As I've mentioned in previous articles, my journey has been similar in many ways to the one taken by Equius clients (except that I was on the other side of the value equation). It took ten years of actual experience to realize traditional methods of active management were at a severe disadvantage in the modern era of investing and, therefore, were destined to detract from, not add value to, an investment relationship.

But my career move toward a smart value approach wasn't complete until I invested the intellectual capital to understand *why* traditional methods of active management were failing so consistently and predictably. Two of my heroes in the investment business, Ben Graham and Charles Ellis, along with a couple of academics at the University of Chicago I was only vaguely familiar with, supplied the answers.

Armed with sound evidence, impeccable reputations, and rare courage, these men stood in the path of a powerful industry—propelled by decades of momentum and fueled by a powerful marketing engine—and called for drastic changes in the industry's approach to long-term investing.

I was inspired. In 1992, I began offering a radical new investment approach called indexing that transitioned quickly into "asset class investing" and which serves as the foundation for our smart value proposition with clients today. A wall plaque I had created at the time summarized this new approach concisely: "They pick stocks. We invest in markets. They sell dreams. We deal with reality. *It's your choice.*" Another declares: "The trouble with following the herd is stepping in what it leaves behind. *Leaders never follow*."

Early in this journey I was fortunate to meet someone with the same vision, Phil Jonckheer, and we agreed to merge our firms to form Equius Partners. For over twenty years, we've pushed back against an industry that was bent on discrediting our views. Today, that industry is trying hard to emulate them.

Moving Beyond Market Indexing

Value Roots Critically Reconsidered

Smart	Value
Understand the nature of the small cap and value risk/return premiums.	Increases portfolio returns depending on each client's acceptable risk parameters.
Understand the differences in index fund construction and management.	Fully capture return premiums of those asset classes.

As readers of *Asset Class* know, I have always been a proponent of "value investing" from my many years studying and admiring the work of Ben Graham and Warren Buffett. But rejecting active management meant accepting that even the great Buffett is human and therefore fallible and mortal. With so much credible evidence that past performance of active managers is not persistent, how could we bet our clients' retirement assets on one man's talent (and health) in order to gain value stock exposure?

Fortunately, we didn't have to. Looking at these stocks as an *asset class* defined by their price-to-book ratios, Fama and French (1992) showed that value stocks outperform *without* elaborate individual security analysis techniques. Their explanation that the value return premium was due to higher *risk* makes perfect sense and is consistent with efficient market theory.

Shortly after we adopted an all-index investment approach, Dimensional Fund Advisors introduced a series of U.S. and non-U.S. value stock index funds based on the work by Fama and French. Since mid-1993 when they were introduced, the core Dimensional U.S. value stock funds based on the Fama/French research have significantly outperformed the overall stock market and index funds and ETFs based on commercial indexes—the evidence of which is readily available through services like Morningstar.

Our clients have benefited from indexing value stocks since 1995. Almost twenty years later, the new "smart beta" strategies are attempting to reap the same benefits with less proven, less transparent, and more complex methodologies.

Understanding and Managing Risk

At the Client Level

Smart	Value
Understand each client's perception of risk and modify if inconsistent with investment time horizon.	Less stress, more confidence in outcomes, higher expected return compounding over time.

An investor's perception of stock market risk is often shaped by Wall Street and the media's need to heighten emotion in order to spur activity. This usually leads to a short-term, narrow, and ever-changing view of stock market risk.

Through an in-depth initial and ongoing discovery process, which includes a review of past investment decisions and experiences, we are able to learn a great deal more about our clients' perception of stock market and other risks and how they affect decisions and attitudes.

Aligning a more rational view of risk with a long-term investment time horizon allows investors to confidently seek a higher return for their portfolios. This increases their chances of meeting retirement and other long-term goals.

At the Portfolio Level

Smart	Value
Understand how asset classes work together in a portfolio to enhance overall return within risk limits.	Optimizes portfolio returns by rejecting pseudo asset classes, needless complexity, and high costs.

With the Fama/French research on value stocks centered on *risk*, it follows that our overall approach to portfolio management should be centered on risk. Doing so allows us to match portfolios with each client's unique *risk tolerance* and *return objectives* (while honoring a generally accepted investing principle that risk and return are directly related). Understanding both of these at the start of a relationship (and reinforcing them over time) is very important, and aligning them is often our first challenge with clients.

Introducing core asset classes like small cap and value stocks within a *portfolio* structure (and rejecting pseudo asset classes like commodities, hedge funds, REITs, private real estate, and others) adds significant additional value in the form of higher expected portfolio returns.

Focus on the Big Stuff

Smart	Value
Align investment time horizon with asset class and portfolio risk/return analyses.	Allows acceptance of higher compounded expected returns over the life of the relationship.

At Equius, we place much greater emphasis on the potential *return* enhancement of adding (or excluding) an asset class to a portfolio than we do on marginal *risk* reduction. In other words, adding 1% of annual compounded return to a portfolio over a long-term relationship with us is much more important than eliminating 1% or 2% of annual return *volatility*.

The extra compounding return is what our clients eat, enjoy, or give away in their retirement. Reducing annual volatility by a marginal amount can cost a portfolio dearly over time while offering no additional benefit over a long-term investment relationship. Low cost/low value investment business models driven by computers and robo advice simply cannot, or will not, finesse such an important and ultimately valuable consideration.

Be Strong When Others Falter

Smart	Value
Understand the value of portfolio rebalancing within a disciplined buy-and-hold investing philosophy. Set tolerances to optimize returns and reduce costs.	Maintains portfolio risk characteristics within acceptable limits. Improves long-term portfolio returns, especially during extreme market cycles.

We have long recognized the same negative effect on long-term returns from simplistic robo rebalancing systems. Portfolio rebalancing controls risk. But if it's implemented too often, it will *reduce* long-term returns (by too quickly reducing allocations to higher-return asset classes) and *increase* transaction and tax costs to the portfolio.

Thoughtful and disciplined rebalancing during extreme market cycles, like 2001-2002 and 2008-2009, on the other hand, can greatly enhance returns *that compound for the portfolio over time*.

"Extreme" rebalancing (forced selling of bonds and buying of stocks against prevailing "wisdom") requires a disciplined, confident, and effective investment counselor who can properly recognize and carefully address real client fears and concerns while avoiding destructive emotional reactions. Equius Partners demonstrated those qualities and skills during these most recent difficult periods.

Communication and Focus

Smart	Value
Communicate frequently with clients. Align current issues with core principles and rational expectations. Promote healthy skepticism and critical-thinking skills.	Prepares clients for likely outcomes without forecasting. Increases confidence and discipline during extreme cycles, leading to higher returns.

An important element of the Equius smart value approach is the quality and frequency of our communication with clients, the primary vehicle being this *Asset Class* newsletter. Published since mid-1993, timely articles in *Asset Class* have helped our clients successfully navigate one of the most volatile periods in stock market history.

Asset Class also serves as a historical record of Equius principles and values and demonstrates how consistently we have delivered our smart value proposition to clients.

Finally, *because* there is a historical record (available to the public since day one on our web site), *Asset Class* has helped enforce *our* discipline as advisors. In other words, we can't just talk the talk. We also have to walk the walk.

Know Your Limits, Seek Optimal Outcomes

Smart	Value
Leave other skills to other experts.	Ensures other client needs are handled optimally.

Rather than package estate planning, taxation, insurance, and charitable giving within our perceived skill set, we offer an oversight role for clients as they engage more qualified experts in each of these fields. In fact, we view many of today's "wealth management" models with the same skepticism as I once did the "one-stop shop" approach promoted by brokerage firms in the 1980s: nonexperts offering average services to justify marginal, if any, real value for clients.

Equius has always been a different kind of financial planning firm because our primary focus has always been on what we know best—*the essence of a long-term investment relationship*. We believe this approach leads to greater wealth accumulation over time with the least amount of stress and uncertainty on the part of our clients.

Equius Partners is fully committed to delivering our smart value proposition to current and future clients. We appreciate those who have placed their confidence (and financial assets) with us as well as the professional partners who continue to inspire us with their integrity and unique skills.