EQUIUS PARTNERS
Adding Balance to Wealth℠

ASSET CLASS℠

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

Asset Class Returns

December 31, 2014

	2014	2013	2012	2011	Past 10 yrs.*
Bonds (%)					
One-Year	0.3	0.3	0.9	0.6	2.1
Five-Year	2.9	-0.4	4.8	4.5	3.6
Intermediate	5.2	-3.5	3.7	9.4	4.8
Long-Term	23.9	-11.4	3.3	28.2	7.5
U.S. stocks (%)					
Large Market	13.5	32.3	15.8	2.1	7.7
Large Value	10.1	40.3	22.1	-3.1	8.1
Small Market	4.4	42.2	18.4	-3.2	8.8
Small Micro	2.9	45.1	18.2	-3.3	7.8
Small Value	3.5	42.4	21.7	-7.6	7.9
Real Estate	31.1	1.4	17.5	9	8.1
International stocks (%)					
Large Market	-5.2	20.7	17.8	-12.3	4.6
Large Value	-7.0	23.1	16.6	-16.9	4.6
Small Market	-6.3	27.4	18.9	-15.4	6.7
Small Value	-5.0	32.4	22.3	-17.5	7.1
Emerg. Mkts.	-1.7	-3.1	19.2	-17.4	8.6

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 US Large Company 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 12/31/14.

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First, Philosophy

Jeff Troutner, Equius Partners

If the last 20 years has taught us anything, it's that choosing and consistently following the right investment *philosophy* is critical to the success of long-term investing. Given the S&P 500 index's strong relative performance in 2014 (and the resulting financial media spin), investors should focus more than ever on the long-term investment philosophy they've chosen.

The core investment philosophies for most investors are:

- **Active "Investing"**—stock picking, market timing, and other strategies based primarily on predictions and forecasts by people who believe they can outsmart everyone else (i.e., the market). More akin to speculation than investing.
- **Index Investing**—based on the belief that markets work and there is "wisdom in crowds." Generally limited to investing in total market funds or ETFs.
- **Asset Class Investing**—an advanced form of indexing that more profitably exploits the multiple risk/return dimensions of groups of securities (i.e., asset classes).

Over the last 20 years, we have experienced a number of short periods dominated by one asset class or the other, with many of these periods so extreme that they have been referred to as either "bubbles" or "crashes" (we illustrated this volatility in last month's *Asset Class* in the article "Yearly Returns Are Random"). Volatility in the financial markets should preclude the option of being tossed about helplessly with the investment winds, yet so many investors not moored to a particular investment philosophy have done and will continue to do just that.

So how have these competing philosophies performed over the last 20 years and grown or diminished in popularity? And how does last year's experience fit into this narrative?

From 1995 to 1999, individual investors, mutual fund managers, and independent investment advisors did pretty well in absolute terms, yet trailed the performance of the S&P 500 and NASDAQ indexes—in some cases by a wide margin. As a result, the indexing philosophy gained adherents as never before.

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The ensuing sharp market correction of 2001-2002 not only took the bloom off of indexing, it elevated the belief that really smart investors can predict these extreme market cycles and protect portfolios from downside risk. Based on the widely noted successes of a relative handful of these enlightened ones, the active investing philosophy staged a comeback. The use of expensive and exclusive hedge funds, private equity, and venture capital deals became very popular, especially among trustees of college endowments and public retirement plans.

After 2002, some investors sought other "alternatives" that didn't fit the three core philosophies and wandered off into real estate and commodities speculation. Surprisingly (to these folks), the stock market recovered and did exceptionally well until the bottom fell out of the real estate market and stocks plunged in 2008-2009. Hedge fund managers failed to hedge and the illiquidity of private equity and venture capital proved challenging. Many investors gave up on stocks altogether as a result. Active investing suffered again, particularly the expensive and exclusive type.

Since March 2009, the S&P 500 has returned almost 22% annually, is up a total of 217%, and was the (almost) undisputed heavyweight champion of the world in 2014 (up 13.7%). Score one for indexing, again.

So it appears we've come full circle. And wayward investors reacting to wayward markets and following wayward advice have been battered by the experience.

The Asset Class Experience

I'm proud to say that Equius clients who have invested their *intellectual* capital as well as their *financial* capital with us are anything but wayward. In fact, I'm confident they have gained *greater* confidence and comfort in the philosophy they've chosen as a result of the volatile and unpredictable set of circumstances of the last 20 years.

As investment winds blow from every point of the compass and in varying degrees of intensity, Equius clients have sailed through rough markets aboard a stout ship, *Asset Class Investing*, equipped with a sturdy and true rudder set to a wise course.

The annualized returns shown in the "Yearly Returns Are Random" illustration in last month's *Asset Class* attest to the fact that asset class investing has performed as expected and in a way clearly superior to that of the competing philosophies of index investing and active investing.

For the 19 years 1995-2013, U.S. large company stocks (a very good proxy for the S&P 500 index) returned 9.9% annually. U.S. large and small value stock indexes returned 11.9% and 15.7%, respectively.[1] Yes, the higher expected returns of small and large value stocks come with higher expected risk—there's no free lunch. And yes, it takes a very good and experienced fund manager to capture as much of this increased expected return as possible without resorting to the speculative hopefulness (or should it be hopelessness?) of active investing. That's what we've come to expect, and have received, from a firm like Dimensional Fund Advisors.

In contrast, investors following the ideology of active investing have been treated more like too-trusting passengers on a rudderless barge, pushed this way or that way by ever-changing market winds, unable to navigate a consistent course to their final destination.

Last Year's Experience

The strong performance of the S&P 500 index last year drives another nail in the coffin of active investing. But it's likely also to cause some investors to question the benefits of asset class diversification. Investors who piled into S&P 500 or total market index funds in 1999-2000, often attracted by the low costs, experienced a "lost decade" of zero return (or worse) as a result. Some gave up on stocks completely at some point.

Foreign asset classes also performed poorly last year relative to the S&P 500. Should this deter us from maintaining global portfolios?

Without a basic understanding of the principles and benefits of an asset class investing philosophy, investors are doomed to repeat mistakes of the past. We see it coming.

Undue Influence

Last year, in an ironic twist, two prominent men of investing—who sit at opposite ends of

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the philosophical spectrum—made provocative statements that are sure to impact many investors in unexpected ways.

Warren Buffett, a staunch advocate of active investing and the most famous "value" investor of all time, stated in his annual letter to Berkshire Hathaway shareholders that he has advised the trustee of his wife's future inheritance to invest 90% of the money in an S&P 500 index fund—preferably Vanguard's.

Then in early December, John Bogle, of index investing fame and former chairman of The Vanguard Group, stated that he "wouldn't invest outside the U.S."[2]

Irony is often amusing, but in my view there's nothing amusing about either Warren Buffett effectively giving up on value stocks or John Bogle giving up on non-U.S. stocks and engaging in market timing.

Buffett built his vast wealth on "value investing," primarily in his early years when he could purchase smaller companies and avoid having a major impact on their prices as he accumulated shares. Yet by recommending an S&P 500 index fund (dominated as it always is by very large *growth* stocks) to the trustee of his wife's wealth, he has cast value investing overboard.

Maybe he believes there are no more experts as talented as he is who can pick individual stocks with similar results. Yet value investing has remained a successful investing strategy—*if done through an asset class investing philosophy*. Buffett's correct in embracing indexing. He's shortsighted to not extend its principles to small cap and value stock indexing as well (the same mistake Bogle makes in his regular pontifications).

Implications

In 2014, the S&P 500 index crushed most of the competition. It was up 13.7% while U.S. large and small value stocks were up 10.1% and 3.5%, respectively.[3]

What are investors and advisors following active management philosophy to do now? No doubt, there will be a substantial shift in portfolio allocations to S&P 500 index funds as a result of what Buffett wrote. More slyly, many active fund managers will continue to run their portfolios as quasi-index funds, but at much higher fees.

And what of John Bogle's view on investing in foreign stocks? In 2014, the S&P 500 index equivalent for foreign stocks, the MSCI EAFE index, was *down* 4.5%. Foreign large and small value stocks were *down* 7.0% and 5.0%, respectively.[4] Was this what influenced Bogle?

Broad philosophical pronouncements based on recent short-term returns is not the stuff of great men of investing. Referring once again to our "Yearly Returns Are Random" illustration last month, we can see that international stocks generally lagged U.S. stocks over the full 19-year period. Maybe *this* influenced Bogle.

But how many investors know that for the last 16 years, ended 2013, U.S. and foreign large, large value, and small value stocks produced nearly identical annual returns?[5] The prior three years the S&P 500 compounded at 31.2% *per year*. Extreme short-term returns can skew longer-period returns and for some, unfortunately, long-term expectations. U.S. and foreign markets seldom move in tandem year after year. In terms of long-term portfolio risk and return, this is a good thing.

For those still inclined to assign too much importance to "recency" in returns, or to following popular opinion as investment winds change, I leave you with a modified version of the "Yearly Returns Are Random" illustration on page 4. Here we feature emerging market stocks, which were purposely *not* part of the U.S./foreign discussion above. Note in particular the "winning" years for the asset class in contrast to its annualized return from 1995 to 2013. Think about it. We have.

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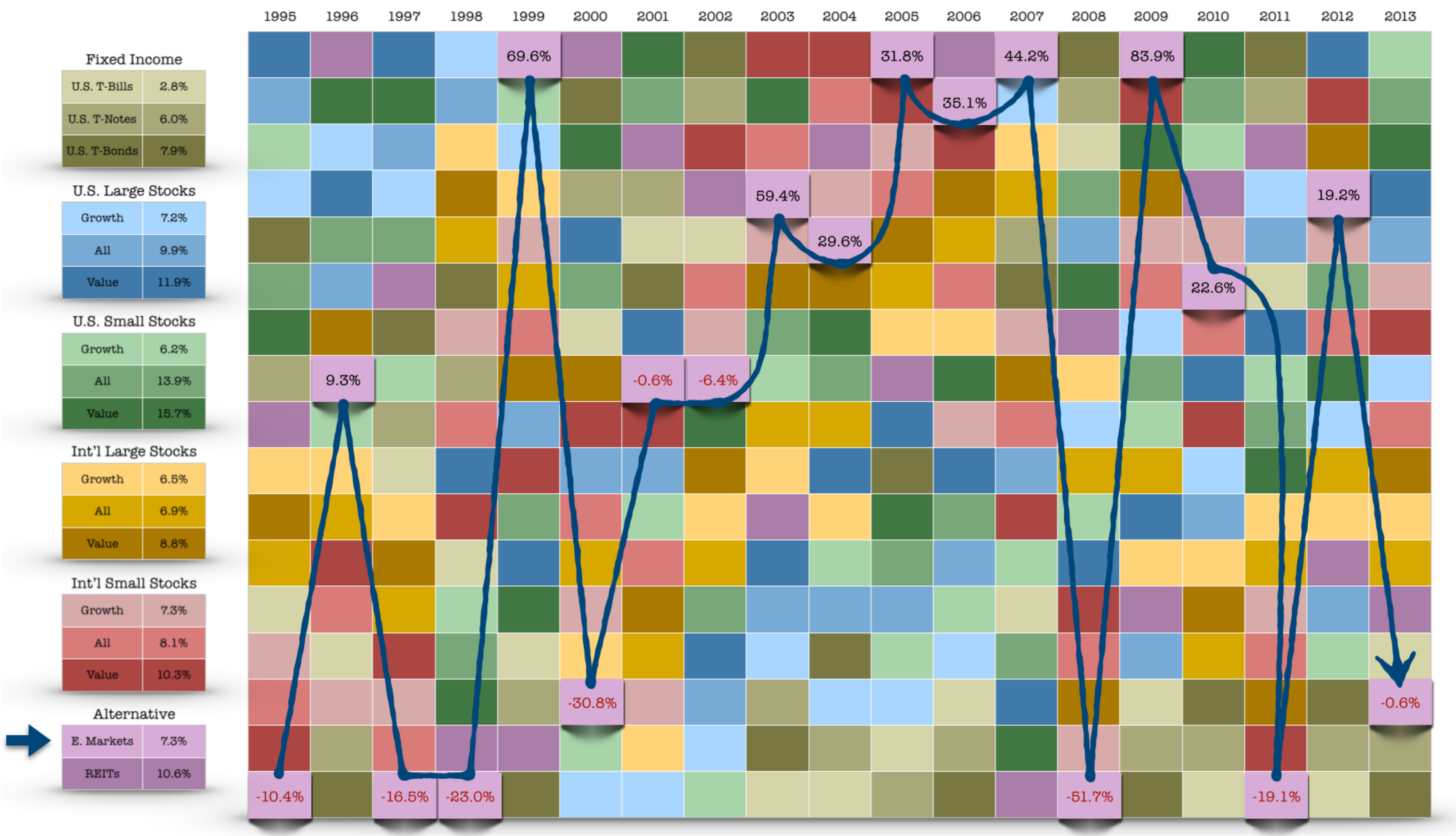
[1]U.S. large and small value stocks = Dimensional US Large Cap Value and Dimensional US Small Cap Value indexes, respectively. 2014 returns were not available at time of printing.

[2]"Jack Bogle: I Wouldn't Risk Investing Outside the U.S.," Bloomberg, Dec. 9, 2014.

[3]U.S. large and small value stocks = DFA US Large Cap Value fund (DFLVX) and DFA US Small Cap Value fund (DFSVX), respectively.

[4]Foreign large and small value stocks = DFA International Value fund (DFIVX) and DFA International Small Value fund (DISVX), respectively.

[5]S&P 500 index 6.0%, MSCI EAFE index 5.9%. DFA US Large Cap Value fund 8.3%, DFA International Value fund 7.9%. DFA US Small Cap Value fund 10.9%, DFA International Small Cap Value fund 11.6%



Asset Class Returns Ranked Highest to Lowest Each Year

Annual Return is 1995-2013. Index Description and (Source): U.S. T-Bills = One-Month US Treasury Bills (Morningstar); U.S. T-Notes = Five-Year US Treasury Notes (Morningstar); U.S. T-Bonds = Long-Term Government Bonds (Morningstar); U.S. Large Stocks, Growth = Dimensional US Large Cap High Price-to-Book Index (Dimensional); U.S. Large Stocks, All = Dimensional US Large Cap Index (Dimensional); U.S. Large Stocks, Value = Dimensional US Large Cap Value Index (Dimensional); U.S. Small Stocks, Growth = Dimensional US Small Cap High Price-to-Book Index (Dimensional); U.S. Small Stocks, All = Dimensional US Small Cap Index (Dimensional); U.S. Small Stocks, Value = Dimensional US Small Cap Value Index (Dimensional); Int'l Large Stocks, Growth = Dimensional International Large Cap Growth Index (Dimensional); Int'l Large Stocks, All = Dimensional International Large Cap Index (Dimensional); Int'l Large Stocks, Value = Dimensional International Large Cap Value Index (Dimensional); Int'l Small Stocks, Growth = Dimensional International Small Cap Growth Index (Dimensional); Int'l Small Stocks, All = Dimensional International Small Cap Index (Dimensional); Int'l Small Stocks, Value = Dimensional International Small Cap Value Index (Dimensional); Alternative, E. Markets = Dimensional Emerging Markets Index; Alternative, REITs = Dow Jones US Select REIT Index (Dow Jones). Asset Class Investing, Inc., does not guarantee the accuracy or completeness of this information. Past performance is no guarantee of future returns.