THE EDUCATED INVESTOR

Spring 2003

The Big Picture

Whether the chart below is news to you or familiar territory, the performance of various asset classes since the 1920s remains an important reminder for us all during these uncertain times in which no investment feels "safe."

For example, most are aware that large-cap stock returns during the past three years have moved significantly downward. But small-cap value and fixed income returns have inched upward during the same period. In other words, over short periods, various asset classes have rarely moved in tandem. But in the long run, they have all moved upward, and the riskier asset classes have moved upward more dramatically.

It is important to recognize that the downward movements that may feel cataclysmic to us as they are occurring are more accurately depicted as small wiggles when putting them into historical perspective.

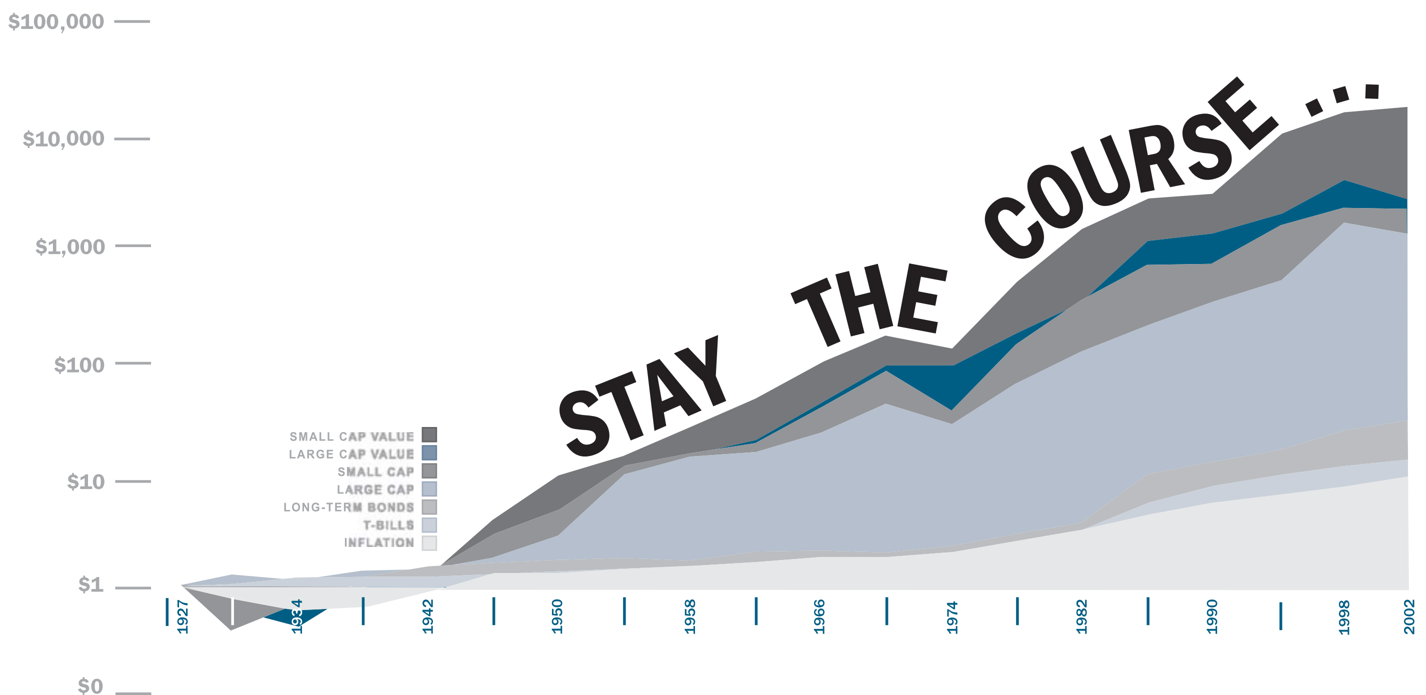
In the face of the short-term uncertainties that tempt us to stray, remember these key concepts which we explore in more detail in the remainder of this newsletter:

- Academic inquiry and its practical application to the prudent investor continues its steady path to discovery.
- Dramatic global events both recent and historic indicate familiar market patterns.
- Behavioral traits that can cause damage to our investment experience remain easy to identify, once you know what to look for.

While technology and other innovative advances have brought us far as a global community, it remains as impossible as ever to predict the full impact of today's world events on tomorrow's market. What we can do is reaffirm that our recommendations for the prudent investor remain the same regardless:

- Build and adjust a portfolio based on diversification across asset classes, in accordance with your tolerance for risk and based upon achieving your investment objectives.
- Rebalance when needed.
- Adhere to the policies and goals that your investment advisor helped you carefully and objectively design.

The rest is all just wiggles in the road.



The Big Picture (Continued)

Among our consistent messages is that the past returns of a particular stock, fund or sector cannot help predict future success or failure. Fund prospectuses, advertisements and promotions abound with this same cautionary statement. Neither can past performance help you guess when to move in and out of the market.

So are we delivering a mixed message if we encourage you to remember your market history to help you maintain your investment discipline? Let us explain the difference.

It's Academic

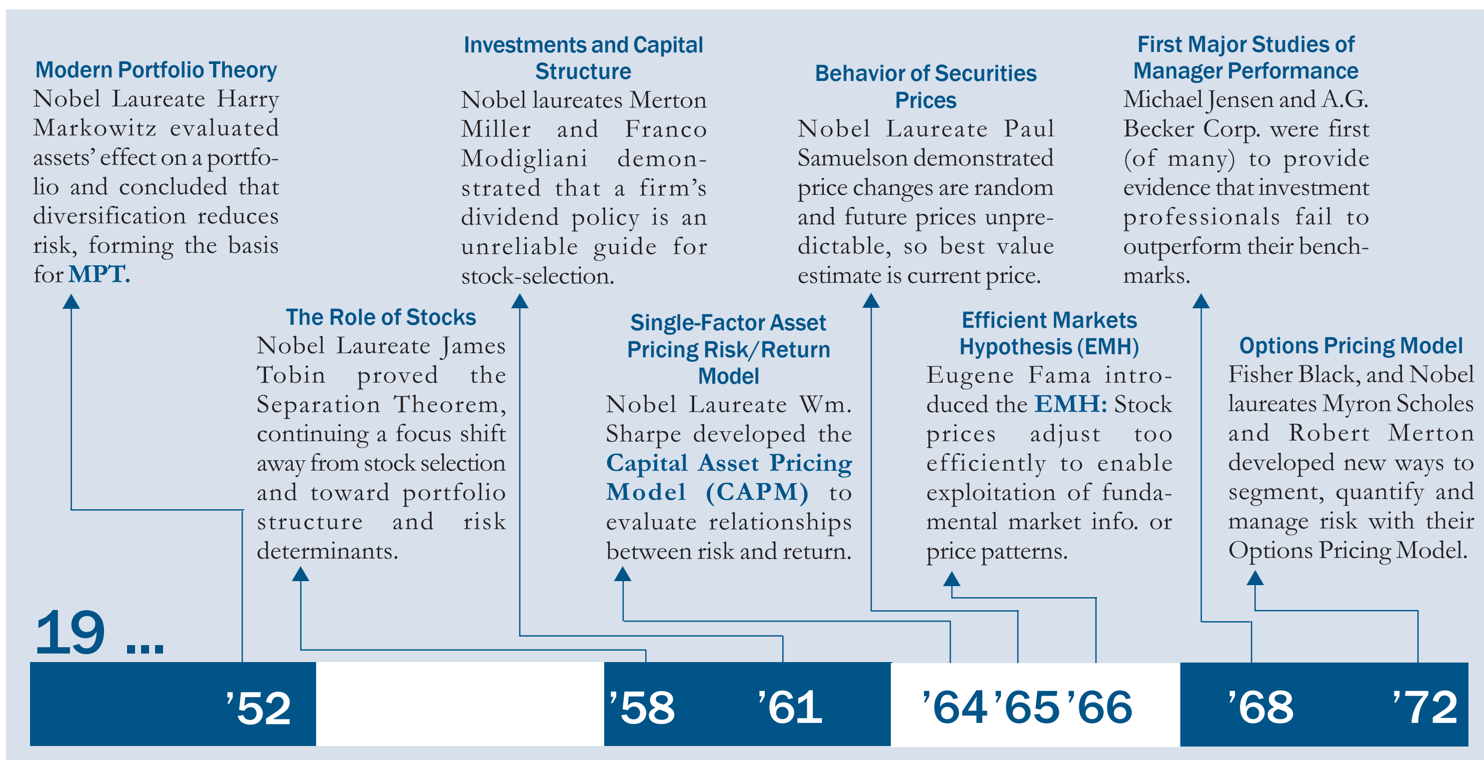
Academic research beginning in the 1950s and continuing today has consistently demonstrated that stock-picking and market-timing techniques have failed to overcome the costs involved in trying to implement them. The same research has indicated the preferred approach of capturing the returns of various asset classes (representing the major determinant for investment returns) in a manner that is long-term, low-cost and tailored to your unique risk tolerance.

This is the type of historical understanding we encourage, summarized in the timeline below. It is the type that formed the basis for the ground-breaking Efficient Market Hypothesis and for the Nobel prize awarded to the founders of Modern Portfolio Theory. It is the type that helps us keep our eyes on the horizon we seek to reach, even when the winds of change are kicking up dust storms in front of us.

As the World Turns

On the other hand, there is the short-term history of an individual stock, sector or market behavior. This is the type of "history" that is, in effect, the sand of which the dust storm is comprised, causing confusion rather than clarity. For example, illustrations abound of the damage caused to investors who responded to short-term market movements of the recent past by shifting from stocks to fixed income during bear markets:

- The chart on page 3, "Dramatic Events in Recent History," provides an example of the folly of trying to time one's participation in the market based on short-term history. In all but two of ten national or global crises the market recovered within a year of the crisis-end.
- According to a report from the Schwab Center for Investment Research, during



the 12 months following the end of a bear market (a period that, alas, can only be identified in retrospect), investors who remained fully invested on average received a 47 percent return. Investors who instead missed the first six months of recovery because they had moved out of the market saw their returns drop to only 11 percent. (Both examples use the S&P 500 as a proxy for the market, from 1926-2002, Ibbotson Associates.)

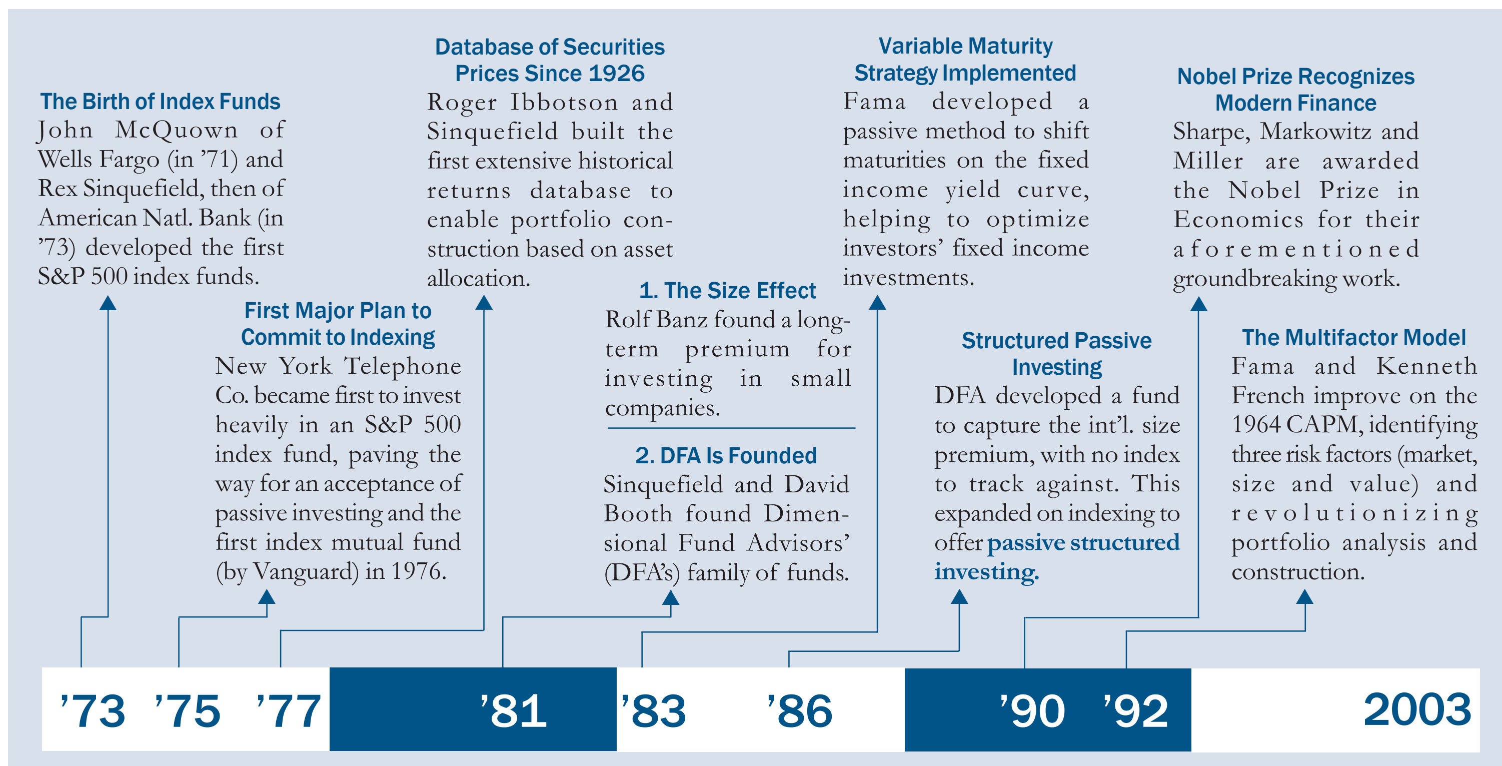
- William Bernstein, in his book *The Four Pillars of Investing*, describes how most investors abandoned stock investing entirely following the most ferocious bear market to date, the Great Depression. The Federal Reserve Board found that 90 percent of the public was still reluctant to purchase or hold common

Continued on page 4

Dramatic Events in Recent History

Date	Event	DJIA % Change*	Market 1 Yr. Later
Dec. 7, '41	Japan attacks Pearl Harbor	–3.50%	2.88%
June 25, '50	North Korea invades South Korea	–4.65%	15.13%
Sept. 24, '55	President Eisenhower has heart attack	–6.54%	5.72%
Oct. 22, '62	Cuban missile crisis ensues	–1.85%	33.89%
Nov. 22, '63	President Kennedy assassinated	–2.89%	24.99%
Aug. 9, '74	President Nixon resigns	–0.97%	5.98%
Mar. 30, '81	President Reagan shot	–0.26%	–16.90%
Aug. 2, '90	Iraq invades Kuwait	–1.20%	4.95%
Jan. 16, '91	US attacks Iraq during Kuwait invasion	4.57%	24.45%
Sept. 11, '01	World Trade Center destroyed	–7.13%	–10.66%

* Represents the percentage change between the prior day market close and the first trading session response to the referenced event.



Source: Dimensional Fund Advisors

The Big Picture (Continued)

stocks in 1940. Yet those few hardy souls who purchased stocks at the depth of the Depression (June 1932) and held them through 1960 were rewarded with annualized 16 percent returns. Even those who purchased a stock portfolio at September 1929 market highs and held tight through 1960 received an 8 percent annualized return.

None of our examples are meant to imply that the market will respond in any predictable way to current events. The S&P 500 could be up within the coming year, or it could experience its first period of four consecutive down years since the Depression. The point is, in the face of global uncertainty, the most reasonable response is to prepare for all possibilities by remaining steadfastly diversified across an array of asset classes that can be expected to move out of tandem (to have low correlation) with one another.

We're Only Human

An understanding of academic research helps impart an appreciation for the importance of a diversified portfolio. Another lesson learned in time is the intricate relationship between some of our most essential human traits and our success or failure as investors. Over the years, professors of behavioral finance have analyzed and shed much light on this topic. Whether you believe the academic research indicating that markets are efficient, behavioral finance experts analyze the related questions: Are investors behaving rationally, and if not, can this irrationality be exploited by those who know better?

The first question is easy to answer, as it is pretty obvious that we humans are not always rational. Among the most common behavioral stumbling blocks is overconfidence, or investors' belief that they are more in control and more knowledgeable than they actually are. Overconfidence can serve us well in some aspects of life, helping us achieve success where negativism might cause us to fail. But in investing, overconfidence can result in an underdiversified portfolio, as investors believe they will be smarter or luckier than their fellow market participants at predicting the future of an individual stock or the market as a whole. It can also result in uncompensated expenses from excessive trading as they endlessly seek their next big winning investment.

Less obvious is an answer to the second question: Can market "experts" exploit the masses by anticipating their irrational behavior and capitalizing on the resulting "bargains"? The answer lies in the fact that market prices are rarely driven by just a few investors. Rather, market prices result from *all* of the market's trades — rational, irrational and everywhere in between. A December 9, 2002 *Fortune* article described, "For all their work on investor irrationality and market anomalies, [behavioral finance professors] still believe that markets work pretty well and that trying to outguess the collective wisdom of millions of investors is usually futile," particularly, we would add, once the costs of the attempt are included.

We leave you with these thoughts from US statesman Carl Schurz, who witnessed the era of the Civil War: "Ideals are like stars. You will not succeed in touching them with your hands. But like the seafaring man on the desert of waters, you chose them as your guides, and following them you will reach your destiny." In other words, stay the course!

Worth Repeating

Worth Repeating

"We may be through with the past, but the past is not through with us."

— Bergen Evans

Our Basic Tenets

Our objective is to design portfolios using passive asset class funds that maximize investors' returns within their tolerance for risk. Here is what sets us apart:

- Fee-only investment management
- A disciplined investment strategy
- Access to institutional no-load passive asset class funds
- Fixed income expertise
- An academic Nobel Prize-winning investment approach
- Continued access to academic research
- A tax-efficient focus, with valuable tax and estate-planning ideas
- Risk tolerance assessment
- Periodic portfolio rebalancing
- Regular communications and state-of-the-art reporting
- **MOST IMPORTANT ... A TRUSTED ADVISOR RELATIONSHIP**

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