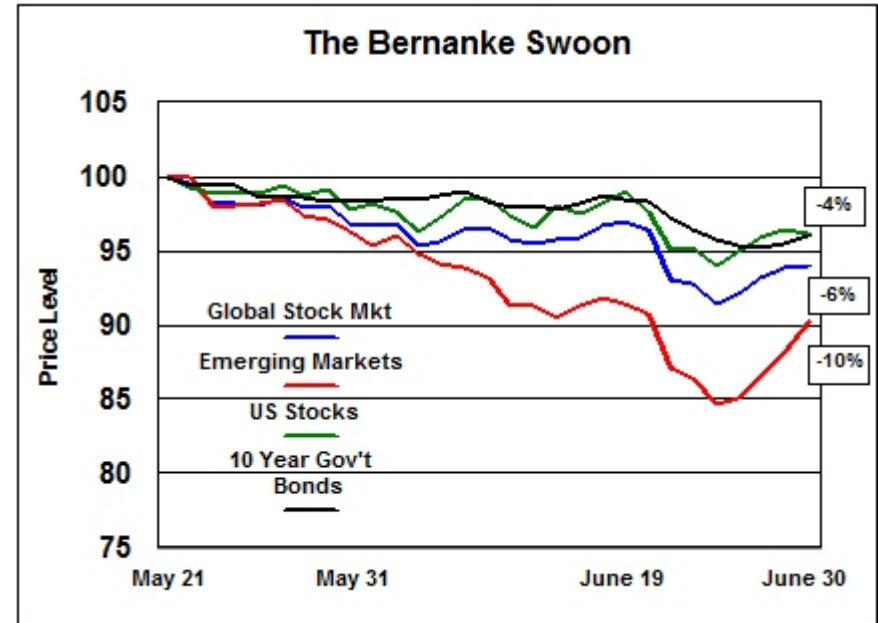


From: Warner A. Henderson, ChFC

Subject: **The Art of Letting Go**

Volatility and Risk returned to the markets with a vengeance following a relatively unabated six month surge through mid-May of close to 25% for the Global Stock Market. Stocks may have continued their ascent a while longer were it not for Ben Bernanke's statements on May 23rd and June 19th in which he *reminded* investors that the Fed will begin pulling back on its stimulus programs given an improving economic forecast. Ironically, Bernanke's statements on June 19th were quite upbeat, yet the investment speculators (i.e., those who trade on short-term information and wreak havoc for the rest of us) focused mainly on the prospect of higher interest rates. There was no materially new information offered by Bernanke; he merely reinforced what he had been saying for more than a year. Nonetheless, speculators were spooked at the thought of higher borrowing costs which, if introduced too soon, might slow economic growth and create a headwind for stocks and corporate earnings (a result Bernanke is hoping to avoid). In reaction, there was a broad sell-off in stocks the day after Bernanke's June comments with the Dow Jones Industrial Average plunging by 352 points (2.3%); the biggest one day drop in more than eighteen months. The impact on the US bond market was also sharply negative as intermediate-term government bond values fell by 5% (longer-term bonds were hit even harder). From our perspective, it was understandable that longer-term bonds would suffer in reaction to the prospect of rising interest rates (one reason why we've been recommending shortening bond maturities), but the reaction in the stock market seemed overblown. Emerging Markets stocks suffered even larger losses not only in reaction to Bernanke's reminders, but also due to continued signs of *slowing* economic growth in China, Brazil and many of the larger emerging economies (more on this topic later).

So here we are once again; entering the summer months with a stock market

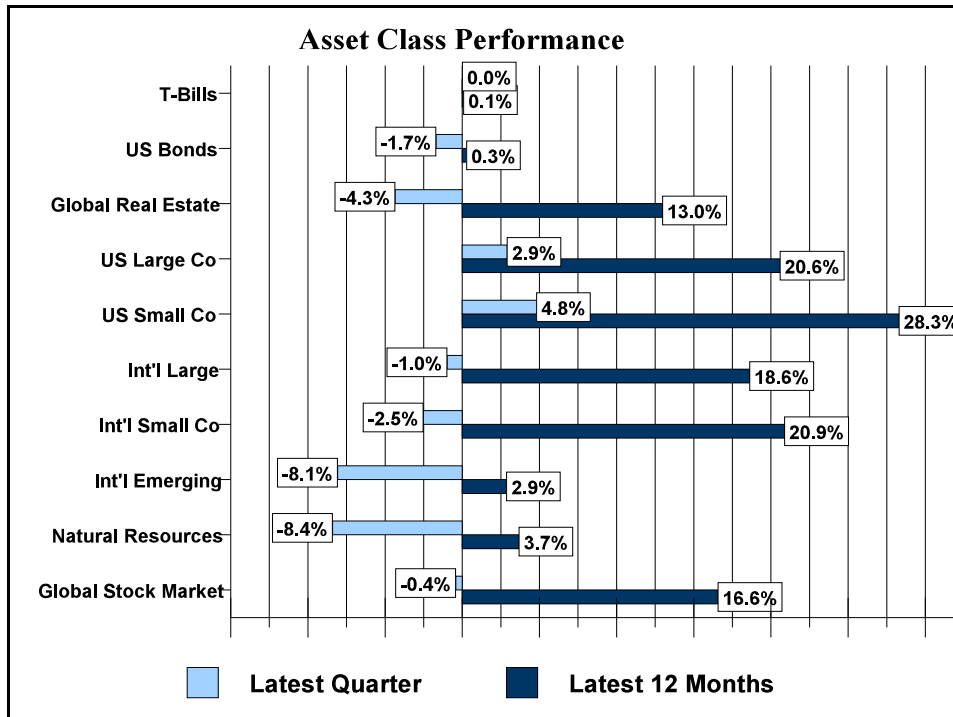


displaying the same sort of volatility we've *endured* over the past five years (perhaps volatility has become the "new normal"). Not only is the market reacting to Bernanke's statements and the prospect of higher interest rates, but the geopolitical scene has deteriorated as well. As global investors, we certainly cannot control the gyrations in the stock market or global geopolitical events, but we can control many important factors in our portfolio's construction that will improve the odds of a successful voyage into the future toward our goals. We'll delve into some of the important factors later in this report, but first, let's take a look back on recent performance which for the past twelve months has been remarkably positive for most of the major asset classes.

#### Asset Class Performance Observations

For the trailing twelve months, the Global Stock Market, as measured by the MSCI All Country World Index, generated a surprisingly positive return of close to 17%. Stocks in the Developed Markets posted the best gains led by US Small Co's (+28.3%), International Small Co's (+20.9%), US Large Co's (+20.6%),

International Large Co's (+18.6%) and Global Real Estate (+13%). Sub-par performance came from Natural Resources (+3.7%), Emerging Markets (+2.9%), US Bonds (+0.3%) and US T-Bills (-0.1%).

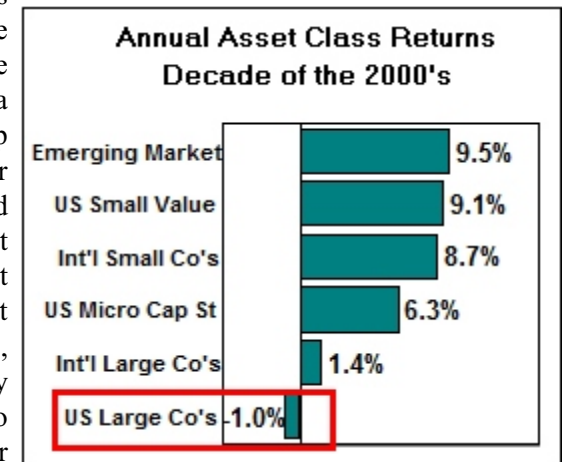


For the quarter, the Global Stock Market was down by just 0.4%, though within the market the various asset class returns were quite divergent. Only two of the assets classes posted positive results; US Small Co's (+4.8%) and US Large (+2.9%). US T-Bills, once again, generated a zero percent "return", although with the prospect of the Fed tapering off on its stimulus, there's hope we may all live to see positive Treasury Bill interest rates. In negative territory in descending order were Int'l Large Co's (-1.0%), US Bonds (-1.7%), Int'l Small Co's (-2.5%), Global Real Estate (-4.3%), Emerging Markets (-8.1%) and, lastly, Natural Resources (-8.4%). Bonds and Real Estate probably suffered due to their linkage to interest rate risk (i.e., as interest rates rise, yield-oriented investments tend to react negatively). Losses in Emerging Markets and Natural Resources were probably less impacted by rising interest rate fears than by signs of slowing growth in many of the major emerging economies and the prospect of slackening

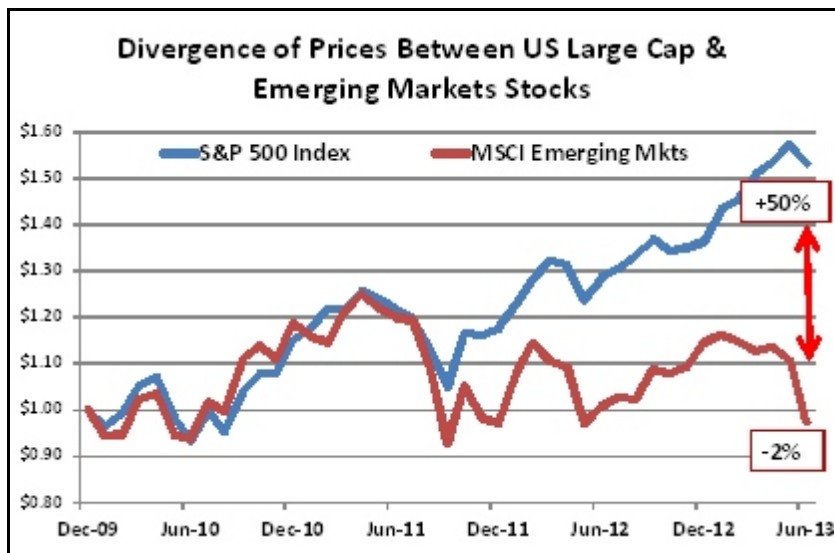
demand for commodities. (Some strategists are forecasting an end to the out-performance we have seen from Emerging Markets stocks over the past ten years, with US stocks, having significantly lagged during that time, poised for superior returns. Other strategists are forecasting just the opposite given significantly lower stock prices in the Emerging Markets relative to US stocks. We feel there is validity to both points of view which is another reason to diversify across many different asset classes and regions around the globe.)

### What's Up (or Rather Down) with the Emerging Markets?

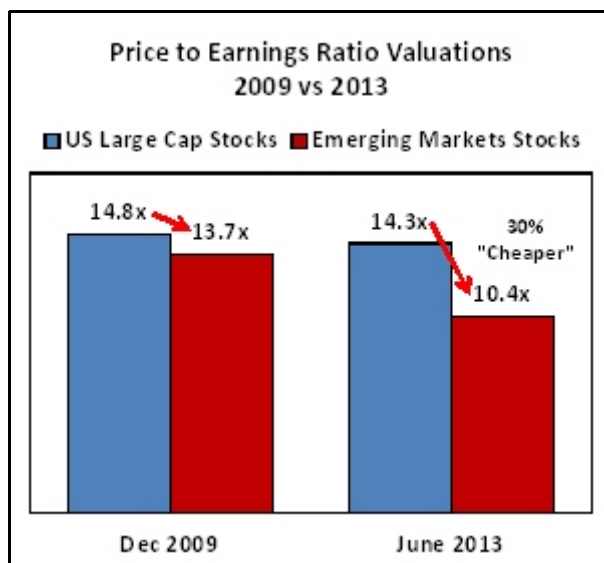
For the decade of the 2000's (ending December 31, 2009), the best performing major asset class was Emerging Markets (EM's) which was propelled primarily by the growth of China as it ascended to become the second largest global economy. Other notable growth performers were Brazil, Russia and India which, when combined with China, are referred to as the "BRIC" economies. Investor capital flowed into the Emerging Markets in recognition of their faster growth and relatively attractive stock valuations in the early 2000's. By the end of the decade, the MSCI Emerging Markets Stock Index gained 154% while the S&P 500 Index (i.e., US Large Cap stocks) fell by 10%; clearly a lost decade for US Large Cap stocks, but a winning decade for Emerging Markets stocks (and several other important asset classes as indicated in the chart at right). It is important to point out that at the beginning of the decade, the S&P 500 Index was wildly *over-valued* with a Price to Earnings Ratio (P/E Ratio) greater than 30 (about twice as expensive as the historic average of 15 times earnings), so the simple law of averages would explain most of the S&P 500's under-performance.



In looking at performance since the end of the last decade (12/31/2009), the prices of US Large Cap Stocks have risen by more than 50% to new record highs while Emerging Markets stocks have lost 2%. One explanation might be that EM stocks were over-valued in 2009 and the performance divergence was merely a price correction; similar to the way US Large Cap stocks corrected following their



wildly over-valued status in 2000. However, in 2009 Emerging Markets stocks were slightly *under-valued* compared to US Large Caps stocks based upon comparative Price to Earnings Ratios, so we don't believe a price correction explains the performance divergence. If anything, one could argue today that US Large Cap stocks are considerably over-valued relative to EM stocks which are now selling at close to a 30% discount (i.e., a P/E Ratio of 10.4x versus 14.3x for US Large Cap stocks).



If relative stock valuations don't explain the performance lag, perhaps the slowing growth rates in the Emerging Markets, especially in China, provides a more logical explanation. In looking at the data, the International Monetary Fund (IMF) recently published their quarterly *World Economic Outlook*. They forecast economic growth in the US over the next twelve months to rise from just under 2% to

2.7%; hardly robust, but heading in the right direction at least. Europe is expected to barely climb out of recession in 2014 and Japan's growth, having picked up recently, is expected to slacken in 2014. Growth in China and the Emerging Markets has significantly cooled off since 2011, but they are expected to maintain higher levels of growth than the US, Japan or Europe in 2013 and 2014. Nonetheless, the slowdown in the rate of growth in the Emerging Markets may be the best explanation for the divergence in stock prices over the past two years. Some strategists see continued weakness in EM stocks in the near term, which may be possible, but given the fact that EM stocks are trading at a significant discount compared to US Large Caps and most other Developed Markets stocks, we believe that the price divergence has created an attractive opportunity for out-performance in the *long-run* (note the emphasis on long-run).

IMF World Economic Forecast of GDP Growth				
Region	2011	2012	2013 Est.	2014 Est.
China	9.3%	7.8%	7.8%	7.7%
Emerging Mkts	6.2%	4.9%	5.0%	5.4%
Worldwide	3.9%	3.1%	3.1%	3.8%
United States	1.8%	2.2%	1.7%	2.7%
Japan	-0.6%	1.9%	2.0%	1.2%
Europe	1.5%	-0.6%	-0.6%	0.9%

### The Art of Letting Go

Enclosed with this report is an article recently written by Jim Parker, Vice President of DFA in Australia (Dimensional Fund Advisors has offices in major financial centers around the globe). Jim points to the Chinese philosophy of Taoism which offers insight not only for its followers, but for investors as well. In Taoism, the word "wuwei" means "non-doing" or the "action of non-action". In applying this concept to investing, Parker says that "the busier we are with our long-term investments and the more we tinker, the less likely we are to get good results." Rather than focusing on things we cannot control, such as short-term movements in the market or the news headlines, the best course is to "let go" of the uncontrollables and pay attention to factors we *can* control, such as (1) establishing an acceptable level of risk through diversification, (2) minimizing investment management fees in order to retain more of what we earn and (3) following a disciplined investment plan which enables us to deal with life's uncertainties in a rational rather than reactionary manner. By incorporating such controls, we can let go of life's distractions and improve the odds of a successful investment journey over our lifetimes.

## OUTSIDE THE FLAGS

By Jim Parker  
Vice President  
DFA Australia Limited



May 2013

# The Art of Letting Go

In many areas of life, intense activity and constant monitoring of results represent the path to success. In investment, that approach gets turned on its head.

The Chinese philosophy of Taoism has a word for it: “wuwei.” It literally means “non-doing.” In other words, the busier we are with our long-term investments and the more we tinker, the less likely we are to get good results.

That doesn’t mean, by the way, that we should do nothing whatsoever. But it does mean that the culture of “busyness” and chasing returns promoted by much of the financial services industry and media can work against our interests.

Investment is one area where constant activity and a sense of control are not well correlated. Look at the person who is forever monitoring his portfolio, who fitfully watches business TV, or who sits up at night looking for stock tips on social media.

In Taoism, by contrast, the student is taught to let go of factors over which he has no control and instead go with the flow. When you plant a tree, you choose a sunny spot with good soil and water. Apart from regular pruning, you leave the tree to grow.

But it’s not just Chinese philosophy that cautions us against busyness. Financial science and experience show that our investment efforts are best directed toward areas where we can make a difference and away from things we can’t control.

So we can’t control movements in the market. We can’t control news. We have no say over the headlines that threaten to distract us.

But each of us can control how much risk we take. We can diversify those risks across different assets, companies, sectors, and countries. We do have a say in the fees we pay. We can influence transaction costs. And we can exercise discipline when our emotional impulses threaten to blow us off-course.

These principles are so hard for people to absorb because the perception of investment promoted through financial media is geared around the short-term, the recent past, the ephemeral, the narrowly focused and the quick fix.

We are told that if we put in more effort on the external factors, that if we pay closer attention to the day-to-day noise, we will get better results.

What's more, we are programmed to focus on idiosyncratic risks—like glamor stocks—instead of systematic risks, such as the degree to which our portfolios are tilted toward the broad dimensions of risk and return.

Ultimately, we are pushed toward fads that the financial marketing industry decides are sellable, which require us to constantly tinker with our portfolios.

You see, much of the media and financial services industry wants us to be busy about the wrong things. The emphasis is often on the excitement induced by constant activity and chasing past returns, rather than on the desired end result.

The consequence of all this busyness, lack of diversification, poor timing decisions, and narrow focus is that most individual investors earn poor long-term returns. In fact, they tend to not even earn the returns available to them from a simple index.

This is borne out each year in the analysis of investor behavior by research group Dalbar. In 20 years, up to 2012, for instance, Dalbar found the average US mutual fund investor underperformed the S&P 500 by nearly 4 percentage points a year.<sup>1</sup>

This documented difference between simple index returns and what investors receive is often due to individual behavior—in being insufficiently diversified, in chasing returns, in making bad timing decisions, and in trying to “beat” the market.

Recently, one of Australia's most frequently quoted brokers broke ranks from the industry and gave the game away on this “busy” investing. In his final note to clients before retiring to consultancy work, Morgan Stanley strategist Gerard Minack said he had found over the years that investors were often their worst enemies.<sup>2</sup>

“The biggest problem appears to be that—despite all the disclaimers—retail flows assume that past performance is a good guide to future outcomes,” Minack said.

“Consequently, money tends to flow to investments that have done well, rather than investments that will do well. The net result is that the actual returns to investors fall well short not just of benchmark returns, but the returns generated by professional investors. And that keeps people like me employed.”

It's a frank admission and one that reinforces the ancient Chinese wisdom: “By letting it go, it all gets done. The world is won by those who let it go. But when you try and try, the world is beyond the winning.”



*“Outside the Flags” began as a weekly web column on Dimensional Fund Advisors’ website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor’s control—including portfolio structure, fees, taxes, and discipline. Jim’s flags metaphor has been taken up and recognized by Australia’s corporate regulator in its own investor education program.*

1. “Quantitative Analysis of Investor Behavior,” Dalbar, 2013.

2. Gerard Minack, “Downunder Daily,” Morgan Stanley, May 16, 2013.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. This information is for educational purposes only and should not be considered investment advice or an offer of any security for sale. Diversification does not eliminate the risk of market loss. Past performance is no guarantee of future results.

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