

## Investment Perspective

First Quarter 2007

"When someone says that the free market isn't working, what he means is that he doesn't like the way the free market is working." - [Nicolas Martin, Indianapolis Star](#)

SFP Core Strategies*	Quarter 1	
	2007	One Year
US S&P 500 (Enhanced)	0.57%	11.26%
US Large Value	2.01%	15.44%
US Micro Cap	1.66%	3.24%
US Small Value	3.07%	8.89%
US Equity Real Estate	3.49%	21.31%
International Large Value	5.03%	25.41%
International Small Cap	8.15%	21.52%
International Small Value	9.06%	24.27%
Emerging Markets	4.40%	21.85%
Emerg Mkts Small Cap	7.35%	30.63%
Emerging Mkts Value	7.42%	30.32%
Ultra Short Fixed Income	1.34%	5.14%
Shrt/Inter Global Fixed Inc	1.33%	5.27%
<b>SFP Model Portfolios</b>		
SFP Income Portfolio	1.84%	8.41%
SFP Balanced Portfolio	2.24%	10.57%
Non SFP Std Balanced	0.78%	8.50%
SFP Aggressive Growth	2.64%	12.66%

Well, despite a steep February drop and generally increased volatility, the markets performed quite nicely for the quarter. The S&P 500 stock index, which best represents the typical U.S. investor's stock market position, eked out a small gain of .18 percent, but the broader picture was better. Small and value stocks in the U.S. netted between 1 percent and 2 percent for the quarter, while international returns were outstanding.

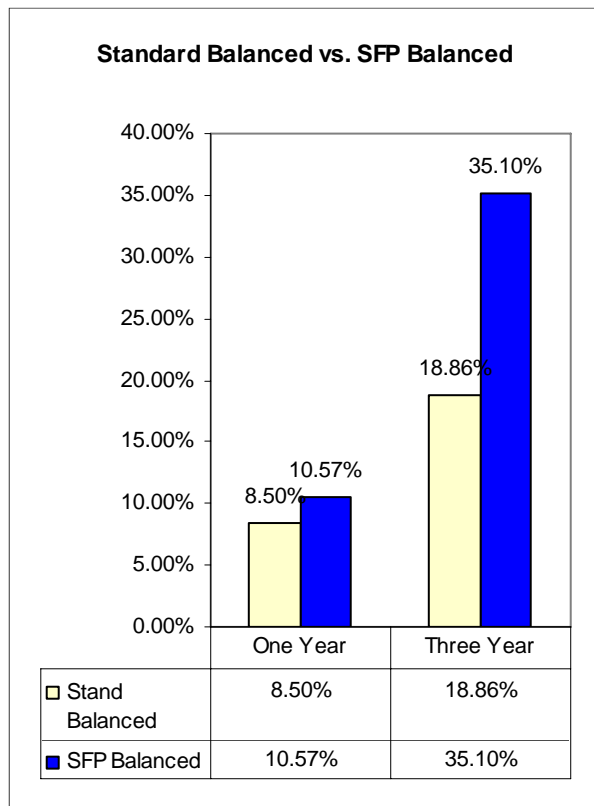
Bond prices did strengthen, likely as fears of a looming recession popped up, or perhaps as a shelter from the volatile stocks, which drove down interest rates.

In the developed markets, our SFP International Core Strategies returned 5.03 percent, 8.15 percent, and 9.06 percent in the first quarter alone. The emerging markets also did well with our strategies returning between 4.4 percent and 7.42 percent. (Please see the performance chart.)

These excess returns over the S&P's flat performance led to the SFP Balanced Portfolio's relative out-performance. While the Standard Balance portfolio netted .78 percent, our portfolio earned 2.24 percent. For the one-year period, the SFP portfolio is nicely ahead, with an extra 2.07 percent of return. (Please see comparison graph.)

Perhaps the biggest surprise of the quarter is that our emerging markets strategies were able to finish strongly. While the 416-point drop in the Dow may have made big headlines in the United States, it was only an echo from that 9-percent, one-day drop in China. The SFP Emerging Markets Strategies do not have Chinese holdings, but with investments in South Korea, India, and Taiwan, rumblings in their large neighbor's market are felt.

Often large market movements, such as the big drop in the United States on Feb. 27<sup>th</sup> or the decline in China (equivalent to about a 1200 point drop in the Dow) are cited as evidence that the markets are not efficient. How can the Efficient Market Hypothesis (EMH) hold up in the face of the 20-percent, one-day drop experienced back in 1987?



But it's our contention that these moves aren't evidence that EMH is incorrect. While the hypothesis *does suggest* is that the market price of a stock is the best indication of its actual value. The hypothesis does not suggest the market price is always "right," or outwardly rational. Just like individuals, groups of people do make mistakes. The EMH does, however, suggest that trying to predict the mistakes is largely futile.

Back in 1976, The Vanguard Group decided to put the EMH to the test and created the S&P 500 Index Fund. The index was chosen because would provide a cost-effective way of owning a representative piece of the market. The EMH formed the basis of the strategy, not a desire for passive index investing.

And this worked phenomenally. This fund, originally dismissed by investment professionals as a novelty that doomed investors to mediocre returns, grew to become the **second-largest fund in history**.

Today, about five trillion dollars are invested in index funds. With this kind of interest, it is not surprising to see a great number of new index products offered to investors. But it's buyer beware: many of these should not be confused with the index products of the past. They are not based on the EMH, but rather "new and improved" hypothesis.

One hypothesis suggests that market participants don't always buy and sell based on considerations like sales and profit. A distinguished economist, Jeremy Siegel, suggests that other factors such as diversification, liquidity and taxes drive a divide between actual prices and fundamental values. He refers to this as "noise," and proposes a Noisy Market Hypothesis to better explain price movements and market anomalies.

It is suggested that there is a better way to invest in the face of noisy markets. The traditional indexes use a market-cap weighting that forces investors to put more money in stocks "overvalued" due to "noise". The contention is that weighting indexes according to fundamentals such as dividends can help protect investors from "mispricings."

Our belief is that there is essentially no fundamental value that is different from the market price itself. Perhaps investors are willing to accept a lower return to hold a sexier company like Apple than a company that markets cigarettes to kids. There are many factors that determine market prices. Just because they cannot all fit on a financial statement does not mean they're less valid than "fundamental" factors such as dividends.

In fact, large swings in the market are good examples of how efficient and fast the market does react to new information. But with some of the new index funds, we are expected to believe that we can generate excess profits by using new index products - that mispricings can be studied, identified and advertised and that the market will not adjust. It will sit quietly and dole out its extra profits to new indexers.

These funds may outperform conventional indexes, but this is not because these new indexes are outsmarting markets but because they will have *different risk profiles* than the conventional indexes, in much the same way our small and value strategies have outperformed with their different risk profiles. Our fear is these new index funds will shift the thinking back, back to a belief that hurt investors throughout history – the belief that you can outsmart the markets.

Give me a call if I can explain anything in greater detail. Meanwhile, the sun is coming. Enjoy your spring!

Sincerely,

*Brian J. Skaggs, CFP*

The information in this newsletter should not be construed as investment advice. Investment advice is only given in the context of individualized interactions that ideally result in the development of a continually evolving financial plan. \*Total returns as measured by the performance of associated DFA funds - advisor fees not included in strategy performance. Advisor fees are subtracted from model portfolio performance at 8.3 basis points per month. This information is believed to be reliable, but we do not guarantee the accuracy of the information. **Past performance is not an indication or guarantee of future performance.**