

7.40	66.10	31.39	21.43
3.90	56.22	26.66	15.99
0.39	46.33	22.59	11.90
-1.09	36.12	18.58	9.86

# Cedarwinds Quarterly

Performance Updates and Market Commentary for Long-Term Investors

Vol. 2 Q1-06

## Asset Class Returns\*

	2/28/06 YTD	Annualized Returns**		
		1 Year	3 Years	5 Years
<b>Bonds</b>				
Short-Term	0.60	2.30	1.60	2.88
Two-Year	0.61	1.90	1.51	3.16
Five-Year	0.48	0.77	2.06	4.93
Intermediate	0.29	1.72	2.53	4.73
<b>U.S. Stocks</b>				
Large Market	2.93	4.85	14.25	0.39
Large Value	4.37	10.24	20.56	9.14
Small Micro	9.41	5.69	26.22	16.45
Small Value	8.45	7.79	29.16	19.11
Real Estate	9.72	13.15	26.54	19.02
<b>Int'l Stocks</b>				
Int'l Large Value	7.81	15.27	30.57	11.53
Int'l Small	6.24	21.96	36.35	18.09
Int'l Small Value	7.55	23.23	40.37	22.62
Emg Mkts	9.18	29.86	39.29	17.81
Emg Mkts Value	9.97	30.81	47.61	25.51
Emg Mkts Small	10.81	25.75	40.96	21.94
Continental Small	12.68	18.40	36.18	18.19
Japanese Small	-2.06	38.29	41.11	18.53
Asia Pacific Small	8.25	8.00	30.44	18.65
UK Small	9.24	12.63	29.76	12.60

## Description of Index Funds

Short-Term Bonds	DFA 1-Year Fixed Fund
Two-Year Bonds	DFA 2-Year Global Fixed Fund
Five-Year Bonds	DFA 5-Year Government Fund
Intermediate Bonds	DFA 5-Year Global Fixed Fund
Large Market	DFA Large Company Fund
Large Value	DFA US Large Value Fund
Small Micro	DFA US Micro Cap Fund
Small Value	DFA US Small Value Fund
Real Estate	DFA Real Estate Fund
Int'l Large Value	DFA International Value Fund
Int'l Small	DFA International Small Fund
Int'l Small Value	DFA International Small Value Fund
Emg Mkts	DFA Emerging Markets Fund
Emg Mkts Value	DFA Emerging Markets Value Fund
Emg Mkts Small	DFA Emerging Markets Small Fund
Continental Small	Continental Small Company
Japanese Small	Japanese Small Company
Asia Pacific Small	Asia Pacific Small Company
UK Small	United Kingdom Small Company

\*Source: Dimensional Fund Advisors ([www.dfaus.com](http://www.dfaus.com))

The information contained herein is obtained from sources we believe are reliable, but we cannot guarantee its accuracy.

\*\* Calculated based on calendar year results.

Past performance does not guarantee future returns.

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## INDEXING THE GLOBAL VILLAGE

*"There's something happening here  
What it is ain't exactly clear"*

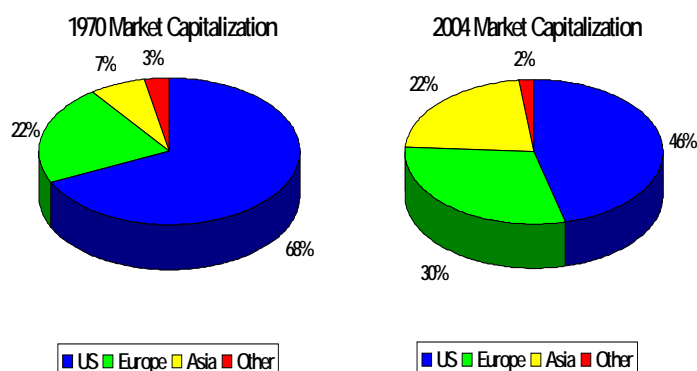
(For What It's Worth, Buffalo Springfield)

### Introduction

As an asset allocation strategy, the investment rewards derived from diversified foreign market exposure have been extremely compelling (more like "TOTALLY AWESOME, Dude!") over the last several years. Importantly, our view is that the value of foreign asset class representation in portfolio positioning is not merely cyclical; rather, it reflects a powerful secular shift in the evolution of the global equity markets. Increasingly, we believe it is absolutely critical to have *appropriate global exposure* in the design of all long-term, well-diversified portfolios. This edition of our newsletter explores the key reasons, methodology and advantages associated with the global diversification strategy we employ in the construction of our model index fund portfolios.

### Key Trends

Readily apparent from the chart below is the growing proportion of non-U.S. market share as measured by total market capitalization.



Source: World Federation of Exchanges

It wasn't very long ago that the United States represented a much larger percentage of the total world economy. The U.S. share of global equity value declined from 68% in 1970 to 46% at the end of 2004, a decrease of nearly 33%. Thus, to be properly diversified, a portfolio cannot afford to ignore international investments. For investors, the key asset allocation question becomes, *"What is the most effective way to achieve global diversification given expected risk-return relationships and my overall tolerance for risk?"* To help put this question in perspective, it is useful to consider the major trends that are shaping the global investment environment.

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## Global Darwinism

Changes at the most fundamental level are driving the rapid evolution of the global markets. Think of these environmental influences as a form of global Darwinism, where local and regional economic ecosystems are constantly mutating based on dynamic macro and micro forces. Some of these forces are cyclical, others are more permanent; some are obvious and direct, others are more complicated, subtle and unpredictable. For investors, these forces offer the possibility of significant rewards; however, the downside can be harsh, sudden and unforgiving. And unlike the physical world where the natural selection process may take millions of years to occur, these economic changes are happening on a daily basis. In this evolving global marketplace, investors must be willing to alter their traditional asset allocation strategies, often characterized by “home-country bias,” in order to successfully adapt to the new investment environment.

## Change Drivers

To help frame out the investment implications, consider four interrelated “change drivers” that are profoundly influencing the evolution of the global marketplace:

### 1. The Internet

Virtually every country and every person on earth is either currently connected to or has the opportunity to participate in the global information network. For the first time in human history, we now have the potential—for better or worse—to operate as a unified human society without constraints of time and space. As a result of this potential, we are on the early edge of a dynamic new form of capitalism—**knowledge capitalism**. New forms of knowledge production, access, distribution and ownership are emerging. In this model, it is not simply access to information that defines relevance: what is more important is the potential to create economic value and competitive advantage by the conversion of information to knowledge.

### 2. Borderless Economies

The upshot of this new form of global capitalism is that the markets are no longer U.S. centric, country specific or dominated by large transnational companies. There is a **great leveling process** going on here. Information moves around in a highly fluid manner and all markets are increasingly open-architected, accessible and competitive.

In simple terms, the globalization of knowledge flattens the economic playing field, transforming the large corporation into a web of multi-directional networks—a **virtual global village**. Advancing technology and free-flowing information are changing the traditional physical definition of geographic borders (readers are encouraged to visit <http://earth.google.com> to better appreciate the implication of this statement). Economies and geo-politics are increasingly

measured by information access and intellectual capital. As a consequence of economic liberalization, technological advances, capital markets efficiencies, and demographic shifts, the world has embarked on a massive realignment of economic activity. Consumers, wherever they live, will increasingly have information about and access to the same products and brands.

At this unique inflection point, geography is not the primary constraint on the limits of social and economic organization. We work and communicate not just globally but also instantaneously. According to results of a recent study by McKinsey, more than two billion people now use cell phones. We send nine trillion emails a year. We do a billion Google searches a day, more than half in languages other than English. Not only are recent trends mind-boggling, this is arguably just the beginning of what is a massive tectonic shift occurring in the global community.

### 3. Emerging Markets

A key trend with the global markets is the growing might of emerging economies, especially India and China, and a commensurate interest in them among American investors. We believe emerging market stock exchanges will outpace the more mature U.S. and E.U. markets by a wider margin in the future because emerging economies are growing faster than those in North America or Western Europe. Another argument for investing abroad—it is getting less expensive as foreign exchanges embrace technology, foreign investment and the development of permanent trading partners.

According to recent reports in the Wall Street Journal, there is strong evidence of the growing clout of companies from emerging markets: “Armed with piles of cash from rising commodity prices and abundant financing, they are snapping up targets in Europe and the U.S., a trend that could shift the global economic balance of power in some industries. Companies from developing nations are tending to focus on deals with a longer-term view to potential profits. Many don’t have the same shareholder pressure to show quarterly profit growth as do publicly held companies in the U.S and Europe.”

*“What we are witnessing is the integration of the emerging markets into the global economic community.”*

### 4. Global Entrepreneurs

Emerging markets are excellent seedbeds for innovation and creativity. Developing economies have become an

invaluable springboard for entrepreneurs looking to compete successfully abroad. These new opportunities—and risks—dramatically empower those people and organizations seeking a better life. It's not logical to think that the U.S. can continue to stand alone in the world, enjoying the best the world has to offer, while three billion new-comers from India, China or the former Soviets remain satisfied with a lower standard of living.

### Risk Considerations

If you think active stock picking strategies in the U.S. market is tough work, how can this approach be successful in the more complicated international markets, especially over longer periods of time? Yet most investors continue to ignore the cruel math behind actively managed foreign investment styles—high volatility, high costs, poor diversification, style drift and underperformance. Foreign investing is a process that is complicated by many variables—economic, cultural, social, political, and environmental. As members of an increasingly global economic community, we are all influenced by the price of energy, acts of terrorism, pandemic health concerns, grinding poverty and debt in third-world countries, environmental degradation and natural disasters. We are all impacted by different currency exchange rates, spending deficits, inflation rates, commodity supply and demand relationships, and balance of payment issues. There is no doubt that global markets are turbulent and that stocks can be more volatile than those of developed markets, partly because they tend to be smaller-cap issues. **Bottom line:** International investing is a complicated process involving multiple risk factors!

### Our Approach

Our blended index fund portfolio strategy aims to **simplify the complexities** of foreign investing. Our philosophy is that calculating appropriate global exposure requires a **holistic, top-down investment approach**. We argue that trying to choose which foreign markets or stocks to invest in is a fool's errand and that investors significantly benefit by owning a broad market basket of foreign index funds.

Our case for international investing hinges on the correlation between international markets. As long as there is a less than perfect correlation, meaning that international markets do not move in lockstep with each other, allocating assets to foreign investments should reduce the volatility of an investor's portfolio and improve returns over longer time periods.



### Model Portfolio Exposure

Appropriate diversification using our blended index fund approach enables investors to capture the gains from regions performing well, while avoiding the major storms and doldrums associated with trying to predict which region is likely to outperform or when. The model portfolios used in our core asset allocation strategy hold over 11,000 individual equity positions across 37 countries in six separate international and emerging market asset classes.

#### Model Portfolio Exposure

Developed Markets Countries	Emerging Markets Countries
Australia	Argentina
Austria	Brazil
Belgium	Chile
Denmark	Czech Republic
Finland	Hungary
France	India
Germany	Indonesia
Greece	Israel
Hong Kong	Malaysia
Ireland	Mexico
Italy	Philippines
Japan	Poland
Netherlands	South Africa
New Zealand	South Korea
Norway	Taiwan
Portugal	Thailand
Singapore	
Spain	
Sweden	
Switzerland	
United Kingdom	

Total Number of Foreign Countries: 37

Total Number of Equity Positions Held: 11,041

As of December 31, 2005

### Performance Dynamics

An analysis of results for the year ended 11/30/05 shows returns in emerging markets were higher, on average, than in developed country markets. Based on the significant variance in performance between countries—a phenomenon that tends to occur year after year—it is clear that investors are far better off holding a diversified blend of foreign positions versus attempting to “guess” which countries, sectors or individual stocks will be winners. Moreover, our strategy for domestic investing carries over to owning foreign equities; specifically, over the longer term, small cap stocks outperform large cap stocks and value stocks

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outperform growth stocks. This relationship holds for both the foreign developed markets and the emerging markets.

#### 2005 Developed Markets Returns\*

Highest		Lowest	
Austria	29.7%	Portugal	-4.9%
Canada	25.2%	Ireland	-2.2%
Norway	24.5%	New Zealand	3.3%
Japan	21.6%	Italy	5.1%

#### 2005 Emerging Markets Returns\*

Highest		Lowest	
Turkey	80.7%	Malaysia	0.5%
Brazil	73.9%	Thailand	4.1%
Argentina	67.4%	Indonesia	6.1%
Mexico	54.0%	Taiwan	6.9%

\*Year-ended 11/31/05, US \$  
Source: Morgan Stanley Capital International

In addition to country diversification, a second performance dynamic that must be considered in constructing a properly allocated global portfolio is the relative correlation between domestic and foreign style exposures. The correlation matrix below illustrates this point.

#### Correlation Matrix 1996 - 2005

Asset Class	Correlation
S&P 500 Index	1.00
Intl Value	0.56
Intl Small	0.27
Intl Sm Value	0.19
Emg Mkt	0.37
Emg Mkt Value	0.37
Emg Mkt Small	0.34

Data Source: Dimensional Fund Advisors

The chart highlights that over the last ten years there has been very low correlation between the foreign market asset classes we use in our model portfolios compared to the S&P 500 Index. This means that excellent diversification would have been achieved

by carefully blending U.S. large cap exposure with the foreign index funds we use as part of our non-U.S. investment strategy.

For example, on the basis that a one-to-one relationship reflects perfect correlation (no diversification benefit), the International Small Value index fund correlated very weakly with the S&P 500 Index over this period because of the low .19:1 correlation factor. This implies a high diversification benefit would have been achieved using these two funds in a blended portfolio. We use sophisticated analytical techniques to measure and mix appropriate levels of exposure to the other small and value styles to maximize the benefit of foreign asset class diversification.

Finally, our diversification strategy seeks to achieve a **predictable risk-return relationship over time**. Based on historical fund return data, we are able to blend together weightings of asset classes in proportions that create a level of predictability to portfolio volatility and performance outcome. In this manner we aim to match client risk tolerance levels with the most appropriate global asset class mix. Overall, this non-correlation relationship is key to maximizing investment returns while dampening portfolio risk.

#### Summary

There can be no mistaking that a powerful secular shift is occurring in the global markets. Globalization is a done deal, it is *fait accompli*. The nature of this pattern suggests a permanently stronger relative influence on the part of foreign markets compared to the U.S. stock market. Indeed, our view is that we are in the early stages of an unprecedented, worldwide economic transformation that is redefining the meaning of capitalism and challenging longstanding investment tenets. We believe this case will only get stronger as the 21<sup>st</sup> century rolls forward.

Ubiquitous access to information is creating a new form of global capitalism based on knowledge. The challenge is to figure out what it all means from an investment perspective. Compared with domestic investing, the variables associated with foreign market investing are far more complex.

In this context, appropriate global diversification serves to maximize longer-term performance while minimizing risk. We believe investors will benefit from careful top-down country evaluation, disciplined country allocation and broad diversification, especially into small cap and value companies. Our asset allocation methodology using best-in-class index funds is designed to provide efficient participation in these dynamic asset classes through a thoughtful, risk-adjusted, low-cost exposure to the global markets. We are highly confident that by appropriately "indexing the global village," investors will be well-positioned to take advantage of the profound and exciting changes that are transforming all markets.