2005	2006	2007	2008
11.91	23.74	4.74	4.70
10.84	21.79	4.25	-4.66
9.77	19.84	3.74	-13.93
8.71	17.88	3.47	-18.53

Cedarwinds Quarterly

Performance Updates and Market Commentary for Long-Term Investors

Vol. **4** Q3-09

Asset Class % Returns*

	YTD 9/30/2009	2008	Annualized Returns** 3 Years	5 Years
Bonds				
Short-Term	1.93	4.02	4.66	3.42
Two-Year	1.92	4.08	4.60	3.28
Five-Year	1.53	8.36	5.93	4.24
Intermediate	3.97	4.02	4.38	3.54
Domestic Stocks				
Large Market	19.39	-36.78	-8.29	-2.19
Large Value	25.41	-40.80	-11.56	-2.05
Small Cap	31.93	-36.01	-10.23	-1.99
Small Value	29.86	-36.79	-11.81	-1.51
Micro Cap	24.84	-36.72	-11.35	-2.71
US Real Estate	17.59	-37.36	-11.68	0.59
International Stocks				
Int'l Large Value	39.55	-46.33	-7.41	3.34
Int'l Small	41.29	-43.87	-9.52	3.41
Int'l Small Value	42.30	-41.68	-8.31	5.07
Int'l Real Estate***	36.13	-51.92	N/A	N/A
Emg Mkts	59.88	-49.20	-3.72	8.53
Emg Mkts Value	76.41	-53.94	-2.56	11.05
Emg Mkts Small	79.05	-54.53	-4.84	6.91
Continental Small	44.74	-47.96	-6.00	5.77
Japanese Small	12.08	-12.12	-10.92	4.97
Asia Pacific Small	79.55	-57.04	-5.72	2.35
UK Small	57.25	-53.02	-14.44	-2.13

***2007--inception date of 4/07

Description of DFA Index Funds		TICKER
Short-Term Bonds	1-Year Fixed Fund	DFIHX
Two-Year Bonds	2-Year Global Fixed Fund	DFGFX
Five-Year Bonds	5-Year Government Fund	DFFGX
Intermediate Bonds	5-Year Global Fixed Fund	DFGBX
Large Market	Large Company Fund	DFLCX
Large Value	US Large Value Fund	DFLVX
Small Cap	Small Cap Fund	DFSTX
Small Value	US Small Value Fund	DFSVX
Micro Cap	US Micro Cap Fund	DFSCX
US Real Estate	US Real Estate Fund	DFREX
Int'l Large Value	International Value Fund	DFIVX
Int'l Small	International Small Fund	DFISX
Int'l Small Value	International Small Value Fund	DISVX
Int'l Real Estate	International Real Estate Fund	DFITX
Emg Mkts	Emerging Markets Fund	DFEMX
Emg Mkts Value	Emerging Markets Value Fund	DFEVX
Emg Mkts Small	Emerging Markets Small Fund	DEMSX
Continental Small	Continental Small Company Fund	DFCSX
Japanese Small	Japanese Small Company Fund	DFJSX
Asia Pacific Small	Asia Pacific Small Company Fund	DFRSX
UK Small	United Kingdom Small Company Fund	DFUKX

*Source: Dimensional Fund Advisors (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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THE RISK – RETURN RELATIONSHIP

PART 9: THE MOST IMPORTANT ASSET CLASS OF ALL

Introduction

This edition of Cedarwinds Quarterly marks the return to our series on how we manage the risk-return relationship in our investment management activities. Our focus is to identify and describe what, in our judgment, is the most important asset class of all. Due to the nature of this asset class, we have separated our analysis into two sequential newsletters: the current version treats the topic on a broad, conceptual level; the next edition will drill more deeply into a quantitative view using specific examples to drive home key points.

As background, previous newsletters in our risk-return series have addressed a broad range of risk topics including: the impact of costs; the importance of rebalancing; asset class correlations and volatility measurement; globalization trends and the value of diversification; the influence of investor psychology; and the mathematics used to create predictable risk-return relationships across our model portfolios. A basic understanding of these topics and how they interrelate is vital to developing an appreciation for how we manage the risk-return relationship in our investment program.

Because asset class selection is by far and away the most important decision investors make in terms of managing the risk-return relationship, it is entirely logical to ask the question: "What is the most important asset class?" Before answering this question, it is first helpful to define what we mean by the term "asset class."

The Evolving Definition of Asset Class

The primary purpose in the development of an asset class definition is to help categorize risks into reasonably discrete groups so that constraints can be assigned. Twenty years ago, a simple and intuitive definition of asset classes was sufficient. The traditional definition was based on the inherent attributes of the assets. An asset class was a category of assets, such as stocks, bonds, or cash. More recently, other types of asset classes have been added to the mix, such as real estate, commodities, derivatives and private equity, or a subdivision thereof.

In the traditional view, an asset class was composed of investment opportunities having generally similar characteristics including: a common, identifiable underlying economic driver; a common legal and regulatory structure; relatively high correlation characteristics; fairly stable risk and return characteristics; and performance features that could be captured and compared against investable passive benchmarks.

But in recent years, as new financial instruments and investment vehicles that share characteristics of multiple asset classes have emerged, the traditional lines between asset classes have become blurred. In particular, the question of transparency is front and center in this increasingly complex investment world. With so many new boundary-crossing assets, the old taxonomy of asset classes no longer neatly subdivides the world of investments.

The Question Answered

This brings us back to the objective of this newsletter. In view of all these changes and the increasing complexities of the investment business, just what is the most important asset class? The answer is really quite simple. It is a four letter word—it is TIME.

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Defining Time

Over many centuries, the notion of time has been the subject of fierce debate and thoughtful musings by philosophers, scientists and artists, all probing fundamental questions of definition, meaning and relevance. When considered more narrowly as an asset class, time can be thought of as a transcendent asset. From this perspective, time is the most important asset class of all because it represents the contextual component for every investment decision we make. Time is the basic context in which the financial markets operate, revealing every hour of every day the way we value ourselves and the resources of the world around us. Time is like a long strand of invisible DNA: it is our ultimate inheritance, embodying everything that has occurred in the past, all that is happening in the present and everything that will occur in the future.

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Looked at it this way, time represents much more than simply another risk category that needs to be effectively managed. However, unlike the more traditional asset categories such as stocks and bonds, defining time as an asset class is problematic because it forces us to think outside the traditional investment box. There is a clear universality and purity to it, yet there are many paradoxical and conditional dimensions as well. Time is not a hard asset and we can't own it, yet it is measurable and has value despite its intangible nature. Time is completely transparent, yet it can also obscure the reality of things.

In the human dimension, each of us has a finite amount of time in terms of lifespan—a mere millisecond on the great cosmic clock, yet time is essentially infinite. Time is a classic "wasting asset"—yet it is virtually limitless in terms of the universe we inhabit. Time is a great equalizer—we each have 24 hours a day to get things done and one life to live—yet for each of us our priorities are different because of the individual choices we make or the circumstances we are faced with.

Time is linear, directional and transitional—past, present and future. Time has velocity—it can move slowly or quickly depending upon the context in which it is being considered. Time also has a spiritual dimension as reflected in the use of the term "zeitgeist" which literally means time spirit. The context for this spiritual element relates to the time period or era in a society which reflects the intellectual, cultural, ethical and political climate. But time is also circular and endlessly repetitive—the hours of the day, the four seasons, the cycle of life.

In important ways, the manner in which each of us, on our own terms, relates to and defines time can have a huge impact on our individual life experiences and investment outcomes. We can feel hopelessly trapped in time or incredibly liberated by fully leveraging the opportunity the gift of time provides us with. Time can move quickly from being a static asset to a rapidly changing one as our circumstances shift or the context in which we make decisions evolves. Our individual attitudes, feelings, memories and expectations all have a significant bearing on how we interpret and use the asset of time.

Measuring Time

To help explain how time qualifies as an investment asset class, some brief historical perspective is useful. Time had no measurable value before the invention of the mechanical clock in Europe in the 13th century. The clock freed man from dependence on the sun and moon. It made possible the ability to order the day, define the night, organize work, and perhaps most important, measure the cost of labor, by tracking the number of hours that went into a project. A good thing, right?

Fast forward to today and ironies are everywhere. If the invention of the clock liberated us from dependence on the sun and moon, it has now enslaved many of us who live according to the "time is money" mantra. And time does not discriminate—just ask many of the professionals and tradespeople—the attorneys, accountants, physicians and consultants, the cab drivers, plumbers and production-line workers—who are under the gun to generate more and more billable hours and time-based revenues. The pace of modern life has become a race against time with everyone seemingly obliged to play "beat the clock."

The pace of modern life has become a race against time with everyone seemingly obliged to play "beat the clock."

From an investment perspective, the time metric is the most ubiquitous element of all in terms of how the industry operates. Time sets the standard for quantifying the quest for value creation. Indeed, any investment rate of return calculation must, by definition, include a time component as the fundamental context for measuring value. Whether it is the formula that quantifies the "time value of money" or calculates the "growth of wealth," all measures require an input variable "N" for the number of periods being measured or "t" as a reference to the time period in question. Generally speaking, measuring time is the easy part—it is essentially a mechanical endeavor.

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Managing Time

It is the management of time which presents the greatest dilemma of investing. In the investment decision-making process, time management is about managing risks in an inherently uncertain world. Even though risk implies that unanticipated events can happen and will happen—a definition that captures the idea of volatility—that statement specifies no time dimension. However, once we introduce the element of time, the linkage between risk and volatility begins to clarify. In concept, the passage of time helps investors manage the risk-return relationship more effectively. Much of our work is based on the notion that over time, there is a "reversion to the mean" in terms of investment performance. The research behind our investment program offers strong evidence that longer term asset class performance tends to cluster around an average rate of return within generally predictable ranges of volatility.

The theory is that asset allocation, a diversification technique, can help investors manage the risks and returns of their portfolio. In this regard, the most important factor influencing the asset allocation strategy is the amount of time, or time horizon, available to hold an investment. The longer an investment is held, the more likely that long-term growth and investment returns will overcome short-term ups and downs in performance. Being able to hold an investment long term helps investors tolerate more volatile investment instruments and take advantage of the higher returns such investments usually produce. As an investor's time horizon becomes shorter, the risk of losing capital on a volatile investment becomes greater. Thus investing in lower-risk instruments like bonds can lower your exposure to market losses.

But the risk of investing in stocks and bonds isn't the chance that your rate of return might vary from an average; it is the possibility that a severe decline in the market might wipe you out. That risk never goes away, no matter how long you hang on. The belief that extending your investment holding period can eliminate market risk is simply not accurate. Time might be your ally. But it also might turn out to be your enemy. Just ask those who were hoping for a comfortable retirement in early 2007, only to see their life savings take a big hit when the world markets crashed. While a longer time horizon gives you more opportunities to recover from crashes, it also gives you more opportunities to experience them.

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Past, Present and Future

A reasonable analytical model for managing time as an asset class is to break it down into three discrete dimensions—past, present and future. These three pieces, when connected, can be thought of as the investment time continuum. The first piece—the past—is factual and immutable. It is what it is (or was). The basic problem we face as investors is how to interpret the past. Think about how much the financial industry revolves around examining and interpreting the past. There's no shortage of financial "experts" on TV, or in magazines and newspapers sharing their opinion about what will happen next. But let's be honest, they are just guessing. No one, regardless of how well-educated they may be or what they do for a living, can accurately predict what will happen in the future. No one is consistently smarter than the market.

So if we are comfortable with the proposition that the past cannot be changed and the future is unpredictable, we are left with the question of how to effectively manage the present as a window to the future. This is without a doubt the most important risk question in terms of the investment management process. The fundamental challenge is that the present is a temporary and transitional place that is defined by its two edges—the past and the future. It is a richly textured, reflective, interpretive, and anticipatory place where reality can take many forms based on individual and collective feelings, attitudes, memories and experiences. It can be deeply cynical or irrationally exuberant and it can be both at the same time. It is a moment-to-moment place, always moving, always changing.

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In the final analysis, the present is a place where investors must constantly manage on the margin because it is always turning into the past and the future is continuously becoming the present. The reset button is permanently in the "on" position in the present. But despite the randomness of events, it is also a place where there tends to be a strong gravitational pull to a central point of equilibrium where a natural and logical order to things can exist.

We Are All Edge Dwellers

In the final analysis, managing time is about risk management and the decisions we all make living on the thin edge between the past and the future. It is about the integration of how we behave in an environment that is constantly changing. We end this newsletter with two simple perspectives that capture the essence of what has been presented above. The first is courtesy of lyrics from the song *Fly Like An Eagle* by the Steve Miller Band: "Time keeps on slippin', slippin', slippin' into the future." The second is a quote from the character Gandalf in *Lord of the Rings*: "All we have to decide is what to do with the time that is given to us." The first reference implies the inevitability of change and how time, as a contextual element, is always moving forward. The second quote supports the idea that it is our behavior that determines how well we are able to cope and succeed in an environment that is constantly evolving. Using specific examples, we will explore these two points of view from an investment perspective in our next installment of Cedarwinds Quarterly.