



# DHK FINANCIAL ADVISORS

Matching institutional investors with  
*low-cost, globally diversified*  
investment solutions

# Marketing book

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# About DHK

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## DHK Financial Advisors, Inc.

Established in 1993, we serve in the capacity of *chief investment officer* to assist in the governance of charitable organizations, associations, endowments, foundations, and retirement plans.

## Our focus

Our focus is to help fiduciaries manage risk and maximize returns through broad, global diversification and insist on low-cost investment solutions. We are uniquely positioned to:

- Stress the importance of diversification and discipline;
- Focus on *asset class investing*;
- Demystify the investment process and be held accountable for investment results;
- Structure portfolios that minimize future regret through broad asset class diversification and avoid mistakes made by most institutional investors;
- Package risks to align with the interests of our clients.

“Investment advice for a fee is a paradox. Anybody who really knew just wouldn’t share their knowledge. Why should they? In five years, they could be the richest person in the world! Why pass it on?”

— Alfred Cowles, *Economist*

# People

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## Founders

### **Timothy W. Dempsey** *Director & President*

- Bachelor of Arts, Hartwick College
- Master of Business Administration, New Hampshire College
- Commonfund, Fairfield, CT
- Prime, Buchholz & Associates, Inc., Portsmouth, NH

### **Thomas M. Kelly** *Director*

- Bachelor of Science, Boston College
- Master of Business Administration, University of Chicago
- H.C. Wainwright & Company, New York, NY
- L.F. Rothschild, C.E. Unterberg, Towbin, New York, NY
- Purcell Graham & Co., New York, NY
- Dimensional Fund Advisors, Inc.
- Windham Capital Management, LLC

## Associates

### **Nina-Rosa Duddy** (1993)

- Lewes Grammar School for Girls/Lewes Priory School
- Institute of Development Studies, Sussex, England
- Office of A. Ervin Howell, MD, York, ME
- Prime, Buchholz & Associates, Inc., Portsmouth, NH

### **Douglas A. Cullum** (2002)

- British Institute of Marketing & Sales Management
- British Institute of Training Officers
- British Army Signals Intelligence
- Fludes Ltd., UK
- Brintons Ltd., USA

### **Ryan L. Brady** (2007)

- Bachelor of Arts, University of New Hampshire
- E.B. Capital Markets, LLC, Dover, NH
- Twenty Ten Fund Services, LLC
- Makaira Capital, LP

### **Wendy E. Kessler** (2008)

- Bachelor of Arts, University of New Hampshire
- State of New Hampshire, Concord, NH

### **Sarah B. Nuse** (2009)

- Bachelor of Science, Texas A&M University
- Texas A&M University, College Station, TX

# Partial client list

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## Over \$850 million in assets

- AAA Western & Central New York
- Albright College
- American Supply Association
- The Association for Community Living
- Association of Governing Boards of Universities & Colleges
- Bay Path College
- Boston Architectural College
- *The Boston Globe* MUST Plan
- The Boston Newspaper Guild of *The Boston Globe*
- Boys & Girls Club of Stamford
- Cazenovia College
- Clarke: School for the Deaf/Center for Oral Education
- Community Foundation of Western Massachusetts
- Congregation B'nai Israel
- Diocese of Ogdensburg
- Editorial Projects in Education
- Foundation for Healthy Communities
- National Association of Independent Schools
- New Hampshire Hospital Association
- Newton Historical Society
- Paul Smith's College of Arts & Sciences
- PHCC National Association Educational Foundation
- Pomfret School
- Sisters of Providence
- Society of Sisters of St. Joseph
- Springfield College
- Springfield Library Foundation
- Springfield Museums Association
- SUNY Plattsburgh: College Foundation; College Auxiliary Services
- SUNY Potsdam: College Foundation; College Auxiliary Services
- Strawberry Banke Museum
- Teamsters Local Union 404 Health Services & Insurance Plan
- Villa Maria Education Center

# Distinctly different

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## Lower fees

Lower fees mean more return to our clients: too often, you get what you do not pay for in the investment business.

“It is not a victimless crime: to make money, you have to take it from someone else.”

— The Economist

## Prudent performance

All investors cannot be above average. Our clients succeed with lower cost structures and broader diversification than their peer groups.

“Something that everyone knows isn’t worth knowing.”

— Bernard Baruch, American financier

## High-probability

We focus on high-probability solutions in order to minimize regret.

# Capital markets & asset class investing

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## Let them work for you

Capital markets have a history of rewarding investors for the capital they supply. Thousands of companies compete for investment capital, and millions of investors compete with each other to find the most competitive returns. Rather than trying to outsmart other investors, apply these principles:

- Focus on asset class investing.
- Risk and return are related.
- Invest in the aggregate financial activity of the global economy.
- Take diversification to its logical conclusion: design portfolios that use all of the world's major asset classes.
- Minimize costs.

*Capitalism works!*

“The only way to consistently outperform the capital markets is to exploit other investors’ mistakes.”

— Charles Ellis, Author of *Winning the Loser’s Game*

“No one knows as much as all of us.”

— Anonymous

# Influence of events

## Market rebounds

Sudden and unexpected events can have a drastically negative influence on the financial markets. However, history has shown that this effect is generally short-lived and markets rebound quickly after such an event. The following table illustrates how the Dow Jones Industrial Average has recovered to—and often surpassed—pre-event levels.

## Effect of sudden events on the Dow Jones Industrial Average

Event	Date	First trading session response			Subsequent change (%)		
		1 day prior	At close	Change (%)	1 mo	6 mo	1 yr
Japan attacks Pearl Harbor, Hawaii	December 7, 1941	116.60	112.52	-3.50	-0.86	-6.19	2.88
North Korea invades South Korea	June 25, 1950	224.35	213.91	-4.65	-4.45	7.36	15.13
President Eisenhower suffers a heart attack	September 24, 1955	487.45	455.56	-6.54	0.04	12.48	5.72
Publication of the Cuban Missile Crisis	October 22, 1962	568.60	558.06	-1.85	15.55	27.41	33.89
Assassination of President Kennedy	November 22, 1963	732.65	711.49	-2.89	6.57	15.37	24.99
President Nixon resigns	August 9, 1974	784.89	777.30	-0.97	-14.71	-8.87	5.98
Assassination attempt on President Reagan	March 30, 1981	994.78	992.16	-0.26	0.56	-14.33	-16.90
Iraq invades Kuwait	August 2, 1990	2899.26	2864.60	-1.20	-8.77	-3.22	24.95
U.S. initiates <i>Operation Desert Storm</i> in Iraq	January 16, 1991	2508.91	2623.51	4.57	11.77	14.97	24.45
World Trade Center towers are destroyed	September 11, 2001	9605.50	8920.50	-7.13	4.75	10.47	-10.66

Source: Dimensional Fund Advisors



# Conventional wisdom

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## Conventional wisdom is always sure but often wrong

- 1 Investors must pay higher fees and work with larger firms to achieve superior investment returns.
- 2 The most significant job of an investor is to select the “right asset manager.”
- 3 Complex investment solutions will yield superior returns.

“An idea is not responsible for the people who believe in it.”

— Don Marquis, American writer

“It is amazing how difficult it is for a man to understand something if he is paid a small fortune not to understand it.”

— Upton Sinclair, American writer

“False presumption: investors act rationally to maximize their economic well-being.”

— Anonymous

“We live in a world where, ‘Just don’t stand there—do something,’ is the watchword.”

— Anonymous

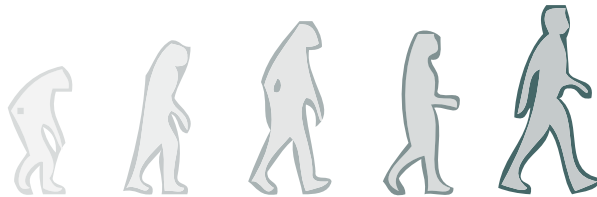
# Investment evolution

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## Basic tenet of financial markets<sup>1</sup>

Investing is a zero-sum game. For every investor who “beats” the market return, there is another who lags: the market is a closed system.

- Today, over 90 % of transactions in the public markets are carried out by institutional investors. Thirty years ago, institutions made-up only 10 % of market activities.
- At least 200 major institutional investors, and another 1,000 small- to medium-sized institutions, operate in the markets all day, every day.
- The fifty largest, most active investors perform 50 % of all transactions in the market. Therefore, about half the time an investor buys or sells, the “other investor” is a giant institutional investor using all its resources to make superior decisions.



“[A]ll investors feel richer when stocks soar. But an owner can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic—no shower of money from outer space—that will enable them to extract wealth from their companies beyond that created by the companies themselves.”

— Warren Buffett, *Founder of Berkshire Hathaway*<sup>2</sup>

“One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute.”

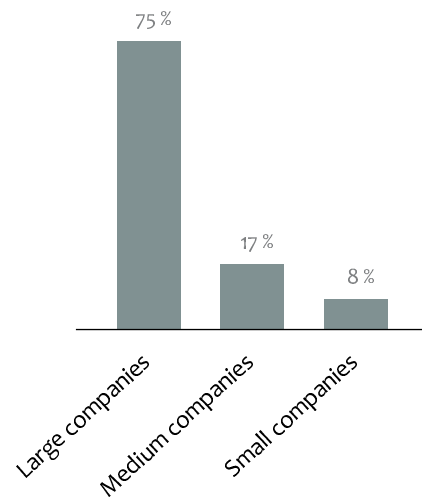
— William Feather, *American publisher*

Source: 1. *Winning the Loser's Game* by Charles Ellis (2002); 2. *Letter to Shareholders: How to Minimize Investment Returns* by Warren Buffet (2005)

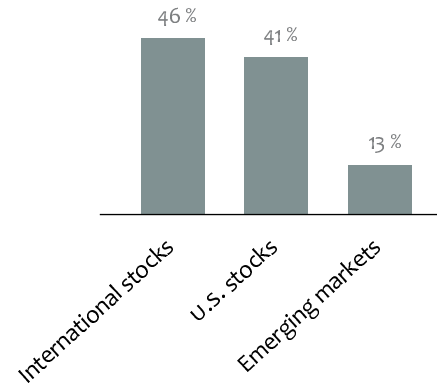
# Asset allocation & capital markets

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Diversified U.S. equity portfolio



Diversified global equity portfolio



Source: The Vanguard Group

# Priorities of a fiduciary

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## Intergenerational equity

The primary goal is to manage the endowment in such a manner so as to preserve the purchasing power of future generations without depriving the current generation.

## Superior peer group performance

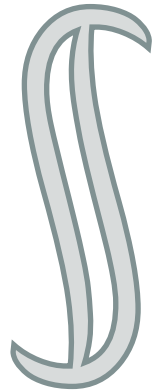
It is vital for organizations to consistently provide superior investment returns in order to maintain present donors as well as attract future donors. Investment results should be in the top half of the annual NACUBO Endowment Study and in the median results of Wilshire Associates' TUCS benchmark.

NACUBO: National Association of College & University Business Officers

TUCS: Trust Universe Comparison Service

## Pre-selecting superior asset managers to outperform indices

"I own last year's top-performing funds. Unfortunately, I bought them this year."  
— *Larry Swedroe, Principal of Buckingham Asset Management*



## Intergenerational equity

“The trustees of an endowed institution are the guardians of the future against the claims of the present. Their task is to preserve equity among generations. The trustees of an endowed university like my own assume the institution to be immortal. They want to know, therefore, the rate of consumption from endowment which can be sustained indefinitely.... In formal terms, the trustees are supposed to have a zero rate of time preference.”

— *James Tobin, Professor Emeritus of Yale University*

# Inflation risk

## Definition

*Inflation risk* is the loss of purchasing power caused by long-term, persistent inflation. It is minimized by investing in asset classes that have historically outperformed inflation.

“Longer-term investors need to be owners of financial assets, not creditors.”

— David Swensen, CIO of Yale University

## Example: United States postal rates



## Frequency, in percent, of assets that ended with a value higher than their initial value\*

Period†	Equity									Agg. bond	Corp. bond	1 yr T-bill	Cash
	100 %	90 %	80 %	70 %	60 %	50 %	40 %	30 %	20 %	100 %	100 %	100 %	100 %
1 yr	60	58	56	57	56	53	53	48	47	42	44	10	9
3 yr	57	60	60	57	56	55	55	49	41	33	36	11	8
5 yr	63	63	63	60	58	52	51	48	39	33	36	10	10
10 yr	68	68	68	66	66	59	51	43	34	25	31	0	0
20 yr	69	69	67	64	60	45	24	19	17	10	10	0	0
30 yr	98	92	77	63	44	27	15	2	0	0	0	0	0
50 yr	96	96	89	71	43	21	7	0	0	0	0	0	0

\* Values are adjusted for inflation and 5 % total spending.

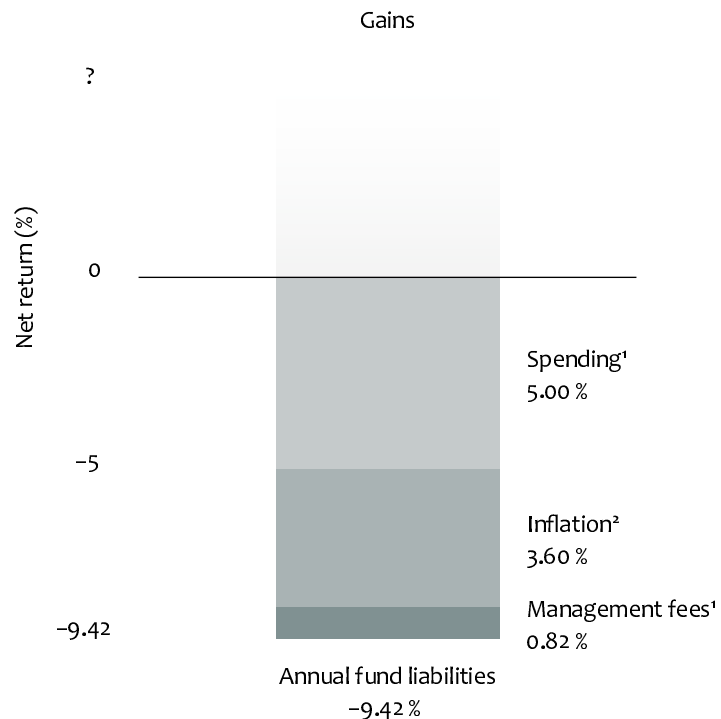
† Periods are taken from the overall period 1926–2006.

■ Highlighted values have a 50 %-or-less chance of achieving intergenerational equity.

Source: Russell Investment Group

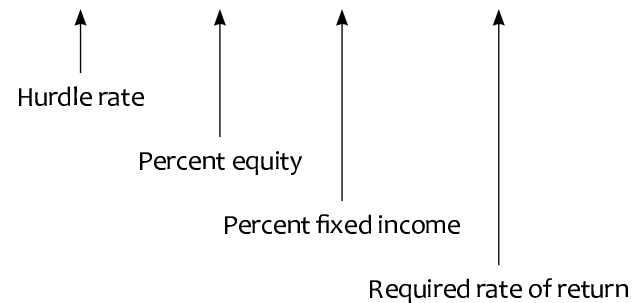
# Hurdle rate

Return necessary to meet the hurdle rate



Required equity return with a 10 yr U.S. Treasury Yield of 3.83 %\*

$$9.42\% = \begin{cases} (60R) + (40 \times 3.83\%), R = 13.1\% \\ (65R) + (35 \times 3.83\%), R = 12.4\% \\ (70R) + (30 \times 3.83\%), R = 11.8\% \\ (75R) + (25 \times 3.83\%), R = 11.3\% \end{cases}$$



\* Rate as of December 31, 2009.<sup>3</sup>

Source: 1. Commonfund Benchmarks Study Above \$10.0 M in Assets; 2. Higher Education Price Index (HEPI); 3. United States Department of the Treasury

# Spending policy

## Levers of spending & their effects

Spending formulas are crucial in ensuring consistency and avoiding hasty decision making—every decision has an impact.

Lever	Intergenerational equity*	Median payout†	Volatility of spending‡	
Asset diversification	▲	▲	▼	▲ Positive effect
Increased contributions	▲	▲	▼	● Neutral effect
Lower spending rate	▲	▼	●	▼ Negative effect
Smoothing effect	●	●	▼	

\* *Intergenerational equity* is the preservation of purchasing power.

† *Median payout* is the amount available for distribution.

‡ *Volatility of spending* describes unpredictable payouts.

Source: *Commonfund Quarterly* by Commonfund (Spring/Summer 2006)



# The importance of gifts on endowment growth

## Yale University

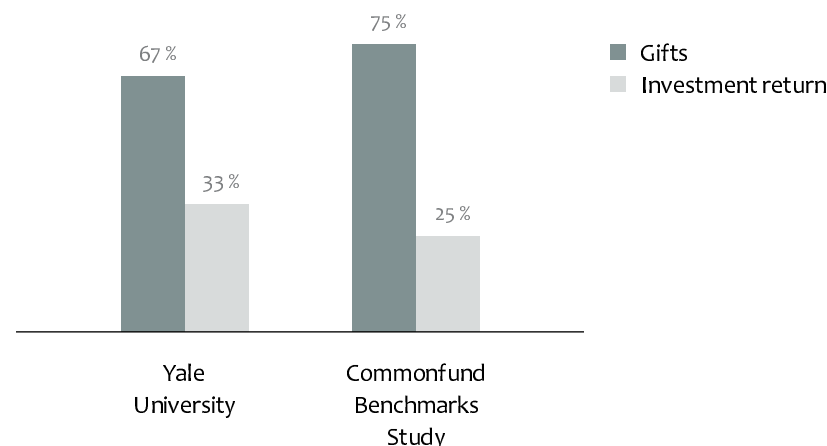
“Note the importance of new gifts to the endowment, with roughly two-thirds of 1998’s targeted value stemming from gifts made since 1950. In other words, in the absence of new gifts over the past forty-eight years, Yale’s endowment would likely total only about one-third of today’s value.”

— David Swensen, CIO of Yale University

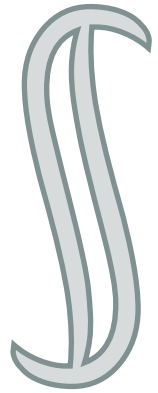
## Commonfund Benchmarks Study

A study conducted by Commonfund Institute on the sources of endowment growth at 390 schools from 1994 to 2004 revealed the following:

- Seventy-five percent of the endowment growth of the median school resulted from gifts and their appreciation. Thus, only 25 % of growth can be attributed to investment returns.
- The median endowment’s additions amounted to 1.8 % annually of the endowment’s market value. Half of the schools averaged between 1.4 % and 3.0 % annually.



Source: 1. *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment* by David Swensen (2000); 2. Commonfund Benchmarks Study (2004)



## Superior peer group performance

“It’s not how good you are that counts but how good you are compared with your competitors.”

— *Charles Ellis, Author of Winning the Loser’s Game*

# Performance expectations & reality

## A closer look at returns & asset allocation

The following table from the National Association of College and University Business Officers (NACUBO) Endowment Study illustrates how large endowments outperform their smaller peers in up-and-down markets.

### 2003 NACUBO Endowment Study\*

Endowment size	1 yr	3 yr	5 yr	10 yr
< \$25 M	3.5	-2.3	2.2	7.2
\$25-50 M	3.1	-2.3	2.4	8.1
\$51-100 M	2.7	-2.8	2.1	8.1
\$101-500 M	2.7	-2.8	3.1	8.8
\$501 M-\$1 B	2.9	-2.3	3.1	9.3
> \$1 B	4.1	-0.7	6.9	11.5

\* Period ending June 30, 2003.

## Reasons

- Smaller endowments rely primarily on the “Big Two”—U.S. stocks and U.S. bonds—while larger institutions utilize many asset classes.
- Fear of failure: “Rather fail conventionally than succeed unconventionally.”
- Small endowments have a misunderstanding of annual risks:

5.00 %	Spending <sup>1</sup>
3.60 %	Inflation <sup>2</sup>
+ 0.82 %	Management fees <sup>1</sup>
<hr/>	
9.42 %	Hurdle rate

Source: 1. Commonfund Benchmarks Study Above \$10.0 M in Assets; 2. Higher Education Price Index (HEPI)

# Review of asset allocation

## Allocation comparison

Investment	2008 Commonfund Benchmarks Study (%)				Example (%)	
	< \$10 M	\$10 – 50 M	\$51 – 100 M	\$101 – 500 M	Harvard <sup>1</sup>	Yale <sup>2</sup>
U.S. equity	49	45	45	34	11	10
International equity	10	14	17	20	22	15
Debt	34	26	20	18	13	4
Alternative investments*	7	15	18	28	54	71
	100 %	100 %	100 %	100 %	100 %	100 %

\* *Alternative investments* include private capital, hedge funds, and real estate.

Source: 1. *Harvard University Financial Report* (2008); 2. *The Yale Endowment* (2008)

# Global portfolios

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## Diversification of investable capital

Over the past few decades, there has been a marked increase in capital flowing to international and emerging markets investments. A portfolio allocation of solely U.S. stocks essentially ignores half of the world's equity investment opportunities. A diversified global portfolio is critical for ensuring adequate diversification and capturing potentially higher returns.

Investment	Portfolio allocation by year (%)	
	1969	2009
U.S. stocks	72	42
International stocks	28	45
Emerging markets	–	13
	100 %	100 %

Source: UBS Global Asset Management

# Long-term asset allocation

## Nineteen-year perspective on the broad issue of asset allocation

Equity		Proxy	Annual return (%)										
			1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Ownership-based	U.S. stocks	Dow Jones Wilshire 5000 Index	-6.2	34.2	9.0	11.3	-0.1	36.5	21.2	31.3	23.4	23.6	-10.9
	U.S. micro stocks (smallest 5 %)	DFA U.S. Micro-Cap Portfolio	-21.6	44.3	23.5	21.0	3.1	34.5	17.6	22.8	-7.3	29.8	-3.6
	Hedge funds (fund of funds)	HFRI Fund of Funds Index	17.5	14.5	12.3	26.3	-3.5	11.1	14.4	16.2	-5.1	26.5	4.1
	Real estate investment trusts	DJ Wilshire REIT Index	-23.4	23.8	15.1	15.1	2.7	12.2	37.0	19.5	-17.0	-2.6	31.0
	Global REITs	DJ Wilshire Global REIT Index	-	-	-	-	-	-	-	-	-	-	-
	Direct real estate	NCREIF Property Index	2.3	-5.6	-4.3	1.4	6.4	7.5	10.3	13.9	16.2	11.4	12.2
	Large international stocks	MSCI EAFE Index	-23.2	12.5	-11.9	32.9	8.1	11.6	6.3	2.1	20.3	27.3	-14.0
	Small international stocks	MSCI EAFE Small-Cap	-	-	-	37.2	8.3	-2.0	-0.1	-24.6	5.4	17.7	-9.2
	Emerging markets (large)	MSCI Emerging Markets Index	-10.6	59.9	11.4	74.8	-7.3	-5.2	6.0	-11.6	-25.3	66.4	-30.6
	Emerging markets (small)	DFA Emerging Markets Small-Cap	-	-	-	-	-	-	-	-	-	85.4	-31.8
	Venture capital	Cambridge Assoc. U.S. Venture Capital	1.7	21.0	13.7	19.9	18.4	48.3	41.9	37.2	27.2	276.6	22.1
	Private equity	Cambridge Assoc. U.S. Private Equity	5.5	9.2	14.5	24.7	11.6	22.7	27.0	30.0	15.6	32.4	1.4
	Commodities	Dow Jones UBS Commodity Index	-	-	3.7	-1.1	16.6	15.2	23.2	-3.4	-27.0	24.4	31.8
	Timberland	NCREIF Timberland Index	11.1	20.3	37.3	22.4	15.5	13.8	10.7	18.9	5.9	10.9	4.4
Credit-based	Cash	Merrill Lynch 91-day Treasury bill	7.9	5.8	3.6	3.1	4.5	5.8	5.2	5.3	4.9	5.0	6.4
	U.S. fixed income	Barclays U.S. Aggregate Bond Index	9.0	16.0	7.4	9.8	-2.9	18.5	3.6	9.7	8.7	-0.8	11.6
	High-yield fixed income	Merrill Lynch High-Yield Master	-4.4	34.6	18.2	17.2	-1.2	19.9	11.1	12.6	3.7	1.5	-3.8
	Global fixed income	Citigroup World Government Bond	12.0	15.8	5.5	13.3	2.4	19.0	3.6	0.2	15.3	-4.3	1.6
	Treasury inflation protection	Citigroup Inflation-linked Securities	-	-	-	-	-	-	-	-	3.9	2.4	13.1
CPI	Consumer Price Index (CPI)	6.1	3.1	2.9	2.8	2.6	2.5	3.3	1.7	1.6	2.7	3.4	

Source: Zephyr Associates

2001	2002	2003	2004	2005	2006	2007	2008	2009
-11.0	-20.9	31.7	12.6	6.3	15.9	5.7	-37.3	28.3
22.8	-13.3	60.7	18.4	5.7	16.2	-5.2	-36.7	28.1
2.8	1.0	11.6	6.8	7.5	10.3	10.3	-21.0	21.5
12.4	3.6	36.1	33.2	13.8	36.1	-17.6	-39.2	28.6
-	-	-	-	12.0	39.1	-12.3	-44.7	32.2
7.3	6.7	8.9	14.5	20.1	16.6	15.8	-6.5	-16.9
-21.2	-15.6	38.6	20.7	14.0	26.3	11.6	-43.1	32.5
-14.3	-9.6	57.8	28.1	23.9	17.4	-0.4	-48.4	43.2
-2.4	-6.0	56.3	26.0	34.5	32.6	39.8	-53.2	79.0
-2.6	-0.2	72.8	28.9	25.8	37.3	38.0	-54.5	99.7
-38.8	-31.2	-2.1	15.2	5.5	8.2	23.8	-0.9	-12.4
-12.1	-8.0	23.3	42.4	50.5	22.7	29.6	-5.6	-8.9
-19.5	25.9	23.9	9.2	21.4	2.1	16.2	-35.7	18.9
-5.2	1.9	7.7	11.2	19.4	13.7	18.4	9.5	-4.8
3.6	1.7	1.1	1.4	3.4	5.1	4.7	1.5	0.1
8.4	10.3	4.1	4.3	2.4	4.1	7.0	5.2	5.9
6.2	-1.1	27.9	10.8	2.3	11.9	2.2	-26.2	57.5
-1.0	16.5	14.9	10.4	-7.0	6.1	11.0	10.9	2.6
7.9	16.7	8.3	8.4	2.9	0.4	11.6	-1.2	11.4
1.6	2.4	1.9	3.3	3.4	2.0	4.1	0.1	2.8

■ Highlighted values indicate the top-performing asset class of the year.

“Committing more than 50 % of a portfolio to a single asset type exposes investors to unnecessary risks.”

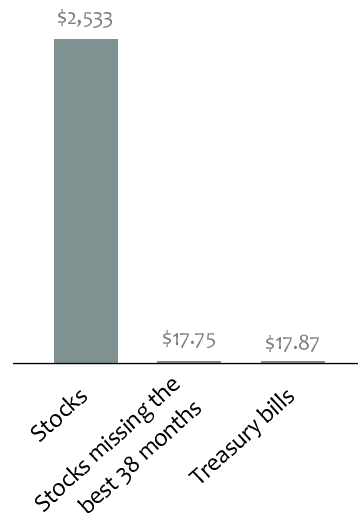
— David Swensen, CIO of Yale University

# Market timing

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## Hypothetical value of \$1.00 invested 1925 – 2004

Although successful market timing may improve portfolio performance, it is difficult to consistently time the market. In fact, failed attempts can lead to significantly lower portfolio returns. The following chart of ending values illustrates risks of trying to time the S&P 500 over a 79 yr period.



Source: Ibbotson Associates

“Evidence points overwhelmingly to the conclusion that active management of assets fails to produce satisfactory results for investors—investors lose; mutual fund managers win.”

— David Swensen, CIO of Yale University



# Outperformance of other investors

## Intellectually beat the market

Only a small number of investors (e.g., Warren Buffett, John Templeton, Dean LeBaron) have pursued the intellectually difficult way to beat the market. To do so, one must have a clearer comprehension of the true nature of investing and see the future more clearly than one's peers. Buffett and others are often initially viewed as being ill-advised until time reveals their decisions were correct. It is incredibly difficult to intellectually beat the market, and very few have the talent or skill to consistently accomplish the feat.

## Outwork the competition

Many investors are involved in the physically difficult way to beat the market. They attempt to work harder than their peers in hopes they may gain new information or insight other investors have missed or overlooked. These investors spend more hours researching, reading, and analyzing all available information. It is difficult to succeed with this method because many people do exactly the same thing. Therefore, it is unlikely that one investor will outperform the market simply by outworking others.

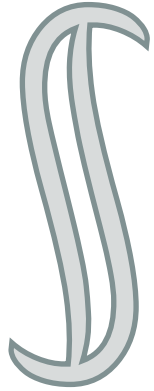
## Develop a long-term policy

Investors need to develop a realistic, long-term investment policy that truly suits their needs and simply stay with it. They should ignore the latest trends, surges, or stock picks even though emotions may pressure a change. Over the years, this approach assures successful investment returns. As Charles Ellis summarizes, "It requires no great genius and no great brawn, but it works."

"I am no longer an advocate of elaborate techniques of security analysis in order to find superior value opportunities. This was a rewarding activity, say, forty years ago, when *Graham & Dodd* was first published, but the situation has changed a great deal since then ... I doubt whether, in most cases, such extensive efforts will generate sufficiently superior selections to justify their cost ... I'm on the side of the *efficient market* school of thought...."

— Benjamin Graham, *Interview with Financial Analysts Journal* (1976)

Source: *The Investor's Anthology: Original Ideas from the Industry's Great Minds* by Charles Ellis (2001)



## Pre-selecting superior asset managers

“It was the triumph of hope over experience. A poll of pension managers taken by *Institutional Investor* found just 17 % of money manager professionals outpaced the S&P Index during the previous decade, but fully 95 % expect to outpace the Index in the coming decade.”

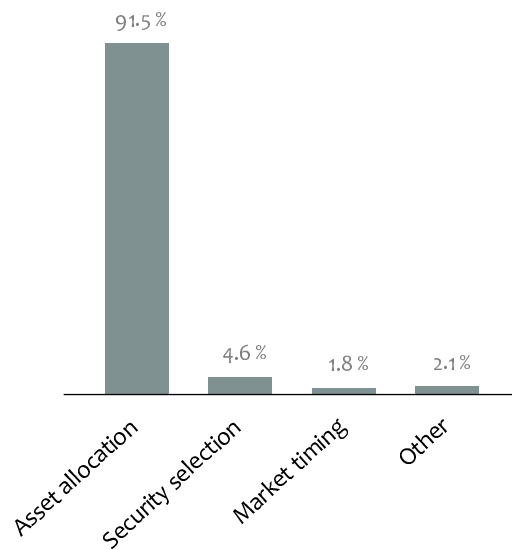
— John Bogle, Founder of The Vanguard Group

# Importance of asset allocation

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## Determinants of portfolio performance

Asset allocation is the most admired—but often least practiced—investment discipline and accounts for 91.5 % of variation in portfolio returns.



“Investment returns stem from decisions regarding three tools of portfolio management: asset allocation, market timing, and security selection, with investor behavior determining the relative importance of each.”

— David Swensen, CIO of Yale University

Source: *Financial Analyst Journal*'s, “Determinants of Portfolio Performance,” by Gary Brinson, Brian Singer, and Gilbert Beebower (1991)

# Outperformance of market indices

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## Three possible avenues

- 1 An investor may gain an advantage if they have information about the market that no one else has.
- 2 Another situation has the investor with the same information as others, but the investor chooses to interpret the information differently.
- 3 Similarly improbable, the investor can have the same information as others, interpret it the same way as others, but the investor chooses to act on the information differently.

“Most investors—both institutional and individual—will find that the best way to own common stock is through an index that charges minimal fees.”

— Warren Buffett, Founder of Berkshire Hathaway

“Most investors would be better-off in an index fund.”

— Peter Lynch, Former Manager of Fidelity Magellan Fund

Source: Russell Folger, Portfolio manager

# Chasing the wrong objectives

Probability of selecting a superior, three-tier asset management team versus the appropriate indices

Equity	Proxy	Mathematics of investing	We are smarter...	Hire an expert...
U.S. equity	Dow Jones Wilshire 5000 Index	50 %	60 %	75 %
International equity	MSCI EAFE Stock Index	50 %	60 %	75 %
U.S. fixed income	Lehman Brothers Aggregate Bond Index	50 %	60 %	75 %
Success rate		13 %	22 %	42 %

“We are not entirely unenlightened on the issue of value added by active management! I add, however, that this paper, distributed to all our clients, has made no perceptible dent in the manager selection practices of the investment committees we work with. Because they are generally composed of very successful, intelligent people, they just know that they can identify superior active managers.

“This business is a giant scam. Roughly 85 % of investment managers don’t add value.”

— Jack Meyer, Former Head of Harvard Management Corporation

At Cambridge Associates, we have a lively, running debate as to whether anyone could pick managers that would beat ‘the market,’ net of fees, over any extended period of time (e.g., ten years or more), and how one might reasonably go about trying to do so. I’m in the camp that thinks it might be possible to pick managers that could consistently beat the market, but it is extremely difficult; and that the usual approach of the typical investment committee is doomed to failure (unless they get lucky).”

— Ian Kennedy, Director of Research at Cambridge Associates

Source: *Beyond Greed & Fear* by Hersh Shefrin (2000)

# Fund of fund opportunities

Source	Hedge funds	Private equity	Venture capital
Alternative Investment Group	Greenlight Capital Lone Star Funds Matterhorn Growth Fund Seligman Tech Spectrum Fund Tiger Asia Management		
commonfund		Bain Capital Clayton, Dublier & Rice Silver Lake Partners Summit Partners TA Associates	Accel Partners Charles River Ventures Insight Venture Partners Kleinor, Perkins, Caufield & Byers Oak Investment Partners
GLENMEDE INVESTMENT MANAGEMENT		Bain Capital Blackstone Capital The Carlyle Group Summit Partners TA Associates	Alloy Ventures Austin Ventures Charles River Ventures Delphi Ventures MIL Venture Partners
PARK STREET CAPITAL		Bain Capital The Carlyle Group Omttrea Capital Summit Partners TA Associates	Accel Partners Battery Ventures IDG–Accel China Growth Fund JMI Equity Prospect Venture Partners

# Skill vs. luck

## Fooled by randomness

An American Century Investments advertisement touted three of their 239 funds that outperformed their benchmark, the S&P 500. Most impressive were the returns of the Value and Equity Income funds over the 10 year period ending **December 31, 2004**.

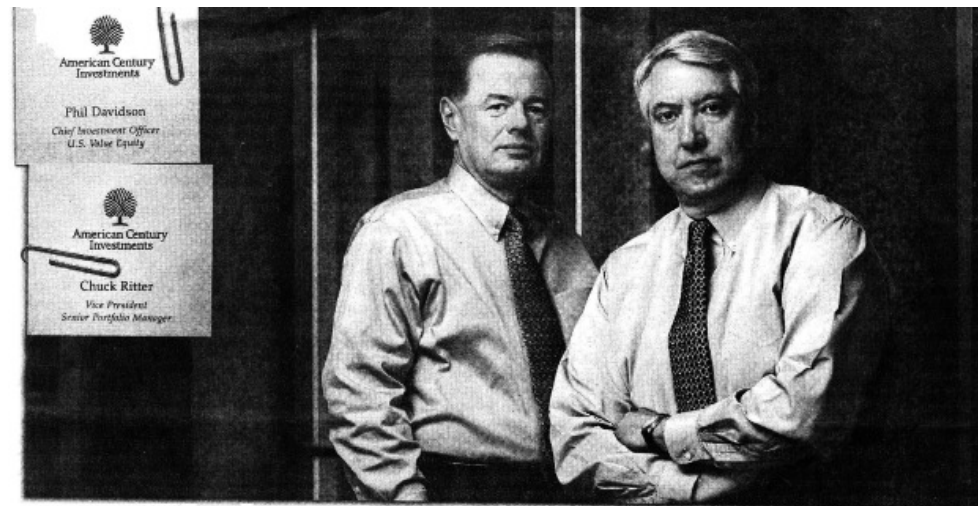
However, since financial market results produce both a winner and a loser, it is often very difficult to determine whether superior performance is attributable to skill or luck. Upon closer inspection, the statistical time required for the results of the Equity Income fund to be a product of skill rather than luck is 40 years. The Value fund would require 123 years of similar performance.

For the 5 year period (ending 12/31/2009) since the ad, the Value fund has provided a .7% annual return versus .42% for the S&P 500 Index; the Equity Income fund returned 2.25% versus the S&P's .42%. Upon further examination, the time required to prove that the Equity Income and Value results observed were due to skill are 140 and 20,000 years, respectively, of comparable performance.

“Don’t confuse brains with a bull market.”

— Charles Ellis, Author of *Winning the Loser’s Game*

Source: *The New York Times* (February 2005)



Meet Phil and Chuck. Please pardon their enthusiasm.  
They’ve just beaten the S&P 500. Again.

Name of Fund	1 Yr.	5 Yrs.	10 Yrs.	Life of Fund	Inception Date
Value* (TWVLX)	14.36%	11.46%	14.05%	12.99%	
Large Company Value* (ALVIX)	14.28%	8.49%		6.59%	7/30/99
Equity Income (TWEIX)	12.53%	12.51%	15.34%	14.74%	8/1/94
S&P 500	10.88%	-2.30%	12.07%	—	—

Average annual total returns as of 12/31/04



## Wilshire institutional mutual funds vs. Wilshire indices, December 31, 2009

Symbol	Fund & index	1 yr	3 yr	5 yr	10 yr
WLCGX	Large Company Growth Fund U.S. Large-Cap Growth Index	34.1	-3.0	0.92	-2.3
		38.6	-2.0	0.72	-7.0
		-4.5	-1.0	0.2	4.7
WLCVX	Large Company Value Fund U.S. Large-Cap Value Index	28.6	-9.6	-0.82	3.1
		14.1	-8.1	0.0	2.0
		14.5	-1.5	-0.82	1.1
WSMGX	Small Company Growth Fund U.S. Small-Cap Growth Index	30.8	-4.8	0.0	3.2
		34.0	-1.7	2.4	-0.9
		-3.2	-3.1	-2.4	4.1
WSMVX	Small Company Value Fund U.S. Small-Cap Value Index	23.1	-6.9	0.5	7.8
		45.5	-6.7	0.9	9.3
		-22.4	-0.2	-0.4	-1.5

Named 2007 Consultant of the Year by *Global Pensions*, Wilshire Consulting provides investment consulting services—which include asset allocation, investment structure, manager search, and performance measurement—to some of the nation's largest foundations and major insurance companies. Wilshire currently consults to more than one hundred clients, with total assets in excess of \$650 billion. Their funds are multi-manager funds advised by Wilshire Associates.

Source: Wilshire Mutual Funds; Wilshire Associates



# Morningstar FundInvestor model portfolios

## Aggressive Wealth Maker\*

Symbol	Fund	Value (\$)	% net assets	YTD	3 yr	Since inception†	Asset allocation (%)	
HACAX	Harbor Capital Appreciation	21,615	18.97	9.83	-5.00	-0.06	Cash	5.97
ARTIX	Artisan International Inv	17,865	15.68	7.09	-7.72	3.39	U.S. stock	59.09
ICSLX	MainStay ICAP Select Equity	14,523	12.75	2.77	-7.98	2.95	Foreign	22.28
SLASX	Selected American Shares S	10,889	9.56	1.19	-10.49	1.11	Bonds	11.88
HABDX	Harbor Bond Instl	10,738	9.42	7.38	8.03	7.38	Other	0.78
OAKMX	Oakmark I	10,716	9.41	6.76	-7.21	0.90		
POAGX	PRIMECAP Odyssey Aggressive	9,426	8.27	9.78	-5.89	-9.06		
TASCX	Third Avenue Small-Cap Value	6,585	5.78	-2.39	-11.38	3.65		
BOGLX	Bogle Small Cap Growth Inv	5,858	5.14	12.44	-15.82	2.08		
LSBRX	Loomis Sayles Bond Retail	5,715	5.02	17.21	1.91	14.29		
WATFX	Western Asset Core Bond Ins	—	—	9.09	1.79	1.28		
	Portfolio	113,931	100.00	6.95	-5.96	1.72		
	Benchmark‡	113,791	100.00	1.45	-5.32	1.70		

\* Data as of July 8, 2009.

† Inception: November 2001.

‡ The benchmark consists of 70 % Vanguard Total Stock Market Index, 15 % Vanguard Total Bond Market Index, and 15 % Vanguard Total International Stock Market Index.

## Wealth Maker\*

Symbol	Fund	Value (\$)	% net assets	YTD	3 yr	Since inception†	Asset allocation (%)	
VBMFX	Vanguard Total Bond Market	34,906	28.53	2.58	6.57	4.67	Cash	4.22
VFINX	Vanguard 500 Index Investor	23,519	19.22	-1.07	-9.46	-0.12	U.S. stock	44.35
OAKMX	Oakmark I	16,074	13.14	6.76	-7.21	0.90	Foreign	11.39
MWTRX	Metropolitan West Total Ret	15,463	12.64	5.85	5.68	4.53	Bonds	38.71
PRWAX	T. Rowe Price New America G	11,928	9.75	16.89	-3.22	-4.48	Other	1.33
TBGVX	Tweedy Browne Global Value	9,376	7.66	9.03	-6.19	5.98		
WPSRX	Westport Select Cap R	6,351	5.19	2.80	-6.51	3.16		
HAIGX	Harbor International Growth	4,730	3.87	10.60	-7.52	-1.43		
	Portfolio	122,348	100.00	5.05	-1.59	2.67		
	Benchmark‡	119,981	100.00	1.73	-1.50	2.40		

\* Data as of July 8, 2009.

† Inception: May 2002.

‡ The benchmark consists of 65 % Vanguard Total Stock Market Index, 30 % Vanguard Total Bond Market Index, and 5 % Vanguard Total International Stock Market Index.

“You can only buy tomorrow’s returns.”

— Larry Swedroe, Principal of Buckingham Asset Management

Source: Morningstar FundInvestor

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