RAPPAPORT REICHES
CAPITAL MANAGEMENT, LLC

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Value and Size Premiums

Most investors understand that, over time, they are rewarded in proportion to the risk they take. Although stocks are more volatile than bonds in the short-term, over time they have offered higher returns.

How are investors compensated for risk within a diversified stock portfolio?

According to academic research[1], relative performance among stocks is largely driven by two factors: size and price. Simply put:

- Small company stocks have higher expected returns than large company stocks

- Lower priced "value" stocks have higher expected returns than higher-priced "growth" stocks

Many economists believe small cap and value stocks outperform because the market rationally discounts their prices to reflect underlying risk. The lower prices give investors greater upside as compensation for bearing this risk.

Chart 1 on the following page documents the frequency with which the value and size premiums have been positive over various time periods in the U.S. stock market from 1926 to 2011.

As the results illustrate, U.S. value stocks have outperformed U.S. growth stocks—and U.S. small cap stocks have outperformed U.S. large cap stocks—in a majority of all the rolling return periods measured. In the international markets, the same relationship holds true, as shown in Chart 2.

How do we take advantage of these "risk factors"? The Dimensional Fund Advisors' Core equity funds that we utilize have a greater emphasis on small cap and value stocks than traditional index funds. To balance out the greater small and value exposure and still include almost every stock in the market, the weight of large cap and growth stocks is reduced.

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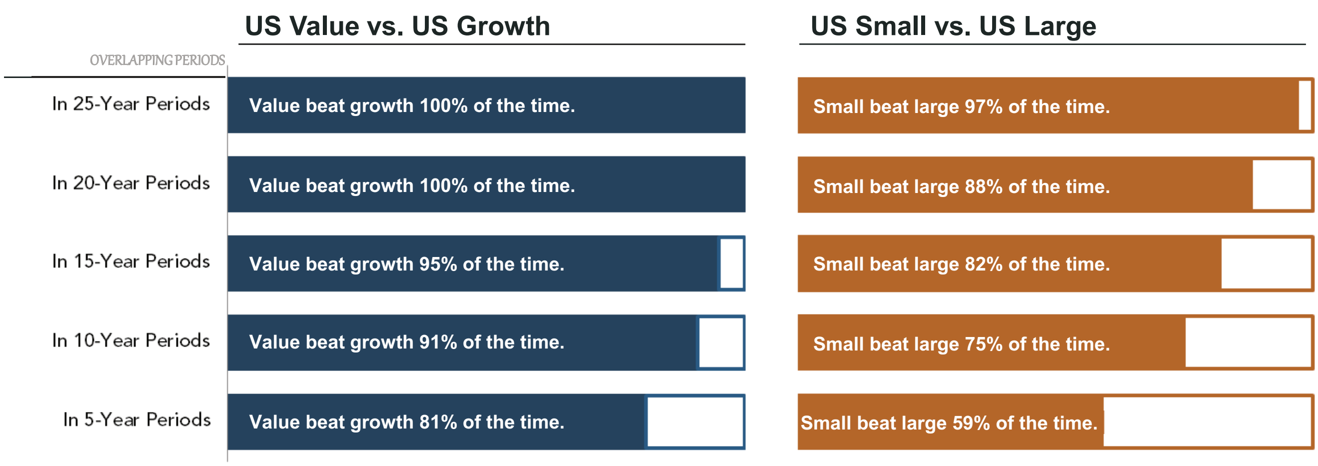
Chart 1: The Risk Dimensions Delivered

July 1926–December 2011



Periods based on rolling annualized returns. Performance based on Fama/French Research Factors. Source: Dimensional Fund Advisors.[2]

Chart 2: The Risk Dimensions Delivered

Periods based on rolling annualized returns. International Value and Growth data provided by Fama/French from Bloomberg and MSCI securities data. International Small data compiled by Dimensional from Bloomberg, StyleResearch, London Business School, and Nomura Securities data. International Large is MSCI World ex USA Index gross of foreign withholding taxes on dividends; copyright MSCI 2012, all rights reserved. Source: Dimensional Fund Advisors.[3]

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Notes

1: For example, see Fama, Eugene F. and French, Kenneth R. (1992) "The Cross-Section of Expected Stock Returns". *Journal of Finance* 47 (2): 427–465.

2 & 3: (Chart 1 & 2 — General Notes)
Securities of small companies are often less liquid than those of large companies. As a result, small company stocks may fluctuate relatively more in price.

Based on rolling annualized returns. Rolling multi-year periods overlap and are not independent. This statistical dependence must be considered when assessing the reliability of long-horizon return differences.

2: (Chart 1)
727 total 25-year periods. 787 total 20-year periods. 847 total 15-year periods. 895 total 10-year periods. 967 total 5-year periods.

3: (Chart 2)
International Value vs. International Growth data:
145 overlapping 25-year periods. 205 overlapping 20-year periods. 265 overlapping 15-year periods. 325 overlapping 10-year periods. 385 overlapping 5-year periods.
International Small vs. International Large data:
205 overlapping 25-year periods. 265 overlapping 20-year periods. 325 overlapping 15-year periods. 385 overlapping 10-year periods. 445 overlapping 5-year periods.

Disclosures

Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

Rappaport Reiches Capital Management is an investment advisor delivering world-class global investment management and financial planning solutions to individuals and families. As an independent firm, we are beholden only to our clients' best interests.

Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.

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