



Adding Balance to WealthSM

Investment Policy
Guidelines & Strategies
Within the Context of

**The American Law Institute's
Restatement of the Law Third: Trusts**

Prudent Investor Rule

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Introduction

The purpose of this paper is to summarize the Equius Partners investment policy guidelines and strategies for the management of client assets within the context of the 1992 restatement of the “Prudent Investor Rule.” Our goals are to provide our clients and trust fiduciaries with a basic foundation on which to build the most appropriate investment strategy and to assist them in developing the confidence to stay with the strategy through all market conditions.

We pay particular attention to portfolio risk and adherence to the principles outlined in the American Law Institute’s Restatement of the Law Third, Trusts: Prudent Investor Rule (1992). Our investment strategy is also heavily influenced by the highly regarded “efficient market” research of academics such as Eugene Fama, Sr. (University of Chicago), Ken French (Dartmouth College), and William Sharpe (Stanford University).

Specifically, we will focus on our policies regarding:

- **Portfolio diversification**
- **Long-term risk and return objectives**
- **Investment related costs**
- **Inflation protection & growth of assets**
- **Our investment advisor responsibilities**

Equius Partners considers each of these principles when developing investment strategies for all of our clients. We believe from experience and through our research of academic and financial industry studies that these principles are fundamental to long-term investment success. The following sections provide additional text from The Prudent Investor Rule and Equius’s specific strategies to address these principles.

The Prudent Investor Rule (Foreword, page IX):

This work restates the basic rule governing investment of assets of a trust, known as the prudent investor rule.

...This formulation of the prudent investor rule affords more latitude for exercise of judgment by the trustee than had been thought permitted by the Restatement Second of Trusts. Moreover, the revised rule focuses on the trust’s portfolio as a whole and the investment strategy on which it is based, rather than viewing specific investment in isolation.

...Reflecting modern investment concepts and practices, the prudent investor rule recognizes that return on investment is related to risk, that risk includes deterioration of real return owing to inflation, and that the relationship between risk and return may be taken into account in managing trust assets. Correlatively, the formulation requires the trustees to take account of the relationship between return and risk in light of the purposes and circumstances of the trust.

...This Restatement is a guide for practitioners of law, trustees, and investment advisers as well as a source of legal authority.

The Prudent Investor Rule (Introduction, page 5, paragraph 4)

Principles of Prudence:

1. *Sound diversification is fundamental to risk management and is therefore ordinarily required of trustees;*
2. *Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the levels of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer;*
3. *Trustees have a duty to avoid fees, transaction costs and other expenses that are not justified by the needs and realistic objectives of the trust's investment program;*
4. *The fiduciary duty of impartiality requires a balancing of the elements of return between production of current income and the protection of purchasing power; and*
5. *Trustees may have a duty as well as having the authority to delegate as prudent investors would.*

Diversification and Risk & Return

The Prudent Investor Rule (Page 6, paragraph 3)

1. *The first two of these principles are fundamental to risk management. ... This pervasive duty [to diversify] and its vital role in minimizing "uncompensated" risk are emphasized in the commentary, not only as a matter of caution but also as a basic aspect of due care and skill. (Page 6, paragraph 1)*
2. *Although carrying uncompensated risk is ordinarily undesirable, the same cannot so simply be said of risks that are compensated by expectations of increased return. This so-called market risk is unavoidable in investing, and fiduciary decisions are therefore concerned with the appropriate degree of that risk. (Page 6, paragraph 2)*
3. *The prudent investor rule recognizes that investments and course of action are properly judged not in isolation but on the basis of the roles they are to play in specific trust portfolios and strategies.*

Equius Partners Policy Guidelines & Strategy:

In developing investment policies for clients, Equius begins with the consideration of the portfolio's stock/bond diversification. We believe this decision has the greatest impact on portfolio risk (measured in return volatility and potential loss of principal). Investors generally accept the fact that stocks are riskier than fixed-income securities, but most are unaware that both asset classes subject investors to what is called "uncompensated risk"—risk exposure that does not result in commensurately higher returns.

Since risk and return are directly related, it's important that we understand our client's objectives and increase or decrease *long-term* exposure to asset class risk appropriately. This requires that we also understand the sources of portfolio risk and expose our clients to only those which have the greatest chance of compensating them with higher returns over time.

Fixed-Income Securities

The primary risks facing investors in fixed-income securities are interest rate risk, term risk, purchasing power risk (inflation), and default risk. Interest rate risk refers to the fluctuations in interest rates and their effect on bond prices. Simply stated, as interest rates rise, bond prices fall. Term risk refers to the fact that interest rate fluctuations have greater effect on longer-term bonds.

Equius Partners believes that from a risk/return perspective, investors are better off in high quality short-term bonds. Table 1 shows the annual risk and volatility for various maturities and indicates that maturities of five years or less provide better diversification benefits than long-term bonds.

Table 1: It Doesn't Pay to Extend Maturities

Maturity	Annual Return	Annual Risk
1-Month Treasury Bills	3.7%	3.1%
5-Year Treasury Bonds	5.4%	5.7%
Long-term Treasury Bonds	5.6%	9.5%

Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Annual Risk = standard deviation of annual returns.

Stocks

After the overall stock/bond mix determined, the next decision involves the allocation among the various stock asset classes. In order to arrive at a prudent strategy for managing stock risk, it's critical to understand the *sources* of risk. "Uncompensated risk" (non-market risk) is risk that can be diversified away. This risk is pervasive in the "active" strategies employed by most independent money managers and mutual fund managers. It is considered uncompensated because, on average, taking this risk does not result in higher returns. In other words, all of the economic forecasts, market trend analyses, and research into individual companies performed by active managers does not, on average, result in higher-than-market returns after factoring in the costs of those efforts.

Market risk, on the other hand, cannot be diversified away and investors are compensated for taking it. In other words, the more market risk an investor takes (e.g., the greater their allocation to stocks), the higher their *expected* return. The only practical way for trustees to eliminate uncompensated risk and isolate market risk is **through the use of index funds or passively-managed "asset class" funds.**

In recent years, the concept of market risk has been expanded to include two additional risk factors. Eugene Fama, Sr. and Kenneth French, academics at the University of Chicago and Dartmouth College respectively, have been at the forefront of this research and have shown that a company's size (market capitalization) and price-to-book ratio are additional risk factors that also cannot be diversified away and investors are compensated for taking these risks.

The price-to-book ratio defines the difference in risk and return characteristics between "growth" stocks (high prices to book value) and "value" stocks (low prices to book value).

Differences in risk and return characteristics are what define asset classes. Chart 1 illustrates these risk dimensions. As investors move away from the market, which is dominated by large growth companies due to market capitalization weightings, they increase their expected returns while taking on greater *asset class* risk. However, these risks can be significantly reduced when included in a diversified asset class *portfolio*.

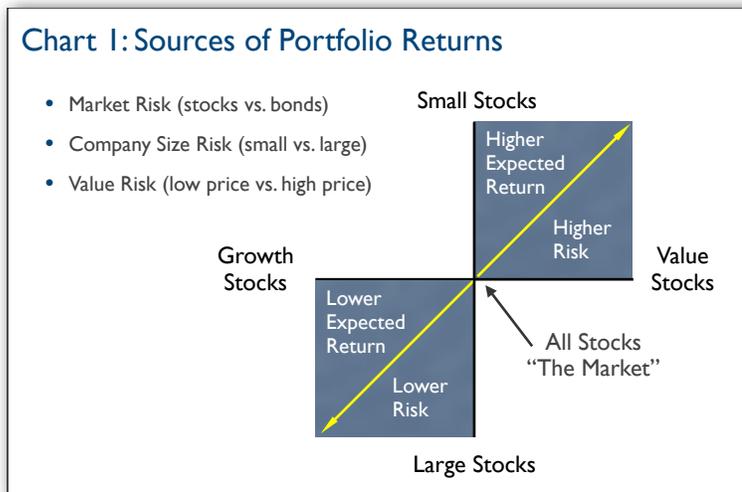
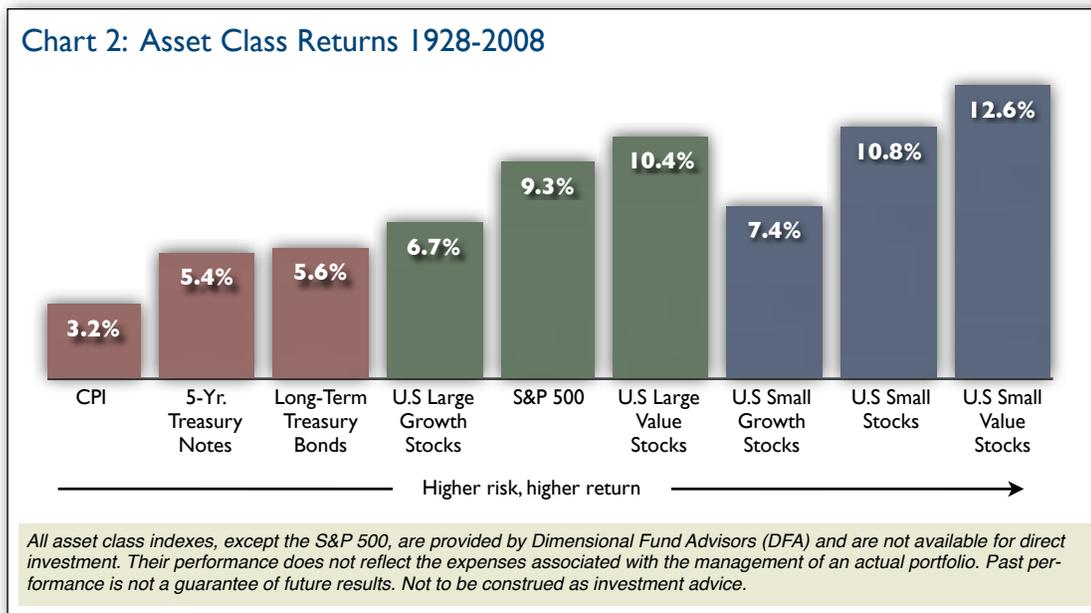


Chart 2 shows the annual compound return for asset classes from 1928-2008. We can observe these same risk/return relationships in foreign markets, even to the level of emerging markets (although the data series for these asset classes is more limited). In the short-run, these relationships can be very different, as shown in the next table. But over time it's clear that investors have been compensated for small cap and value stock risks when these risks are captured in very broadly diversified and highly structured asset class mutual funds.



Market timing, “tactical” asset allocation, or other short-term trend following systems introduce uncompensated risk to the portfolio that should be avoided. Table 2 illustrates the randomness of asset class returns in the short-run. Equius Partners believes that attempting to predict these trends would introduce perhaps the most costly risk to a portfolio.

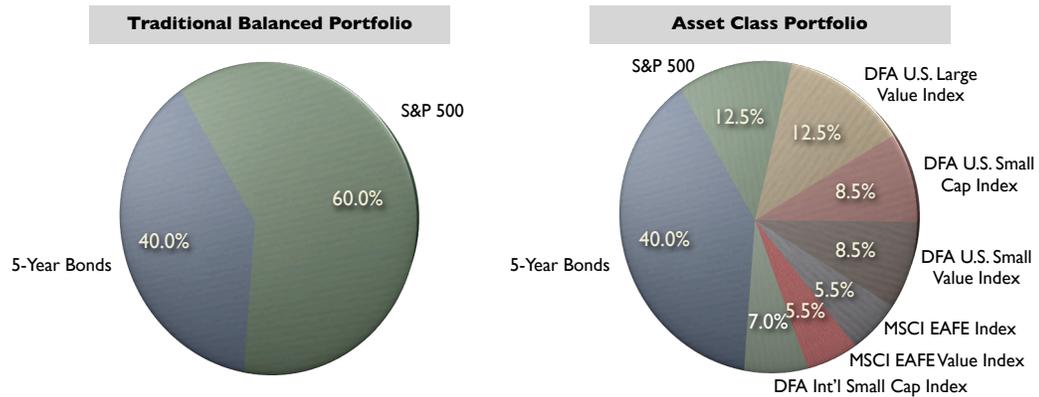
Table 2: Asset Class Returns Are Volatile Over Short Periods (total returns shown)

Period	Streak (yrs.)	S&P 500 Index	DFA U.S. Large Value Index	DFA U.S. Small Cap Index	DFA U.S. Small Value Index
1973-74	2	-37.2	-23.5	-53.9	-42.9
1975-78	4	68.1	117.3	240.8	300.1
1979-80	2	56.8	47.8	96.9	68.7
1981-83	3	41.4	84.0	75.0	141.3
1984-88*	5	104.5	134.2	44.0	63.0
1989-90	2	27.4	8.3	-7.7	-18.9
1991-94	4	56.6	91.7	104.6	163.6
1995-99*	5	251.1	188.5	155.2	140.4
2000-04	5	-11.0	43.0	57.7	182.7
2005-2006	2	21.5	33.5	24.3	30.0
2007-2008	2	-33.5	-47.3	-40.2	-49.5
Annual Return	36	9.2	12.3	11.1	14.9

*Streak changes with new winning asset class. *Winning asset class changed every year. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice.*

The Prudent Investor Rule makes frequent reference to the importance of viewing investments in the context of a total portfolio rather than judging them in isolation. Indeed, this principle—the basis for Modern Portfolio Theory—was a primary motivation for publishing the Restatement of the Law Third in 1992.

Chart 3: The Benefits of Asset Class Diversification



Annual Return: 10.5% → **12.4%**
Annual Risk: 11.2% → **11.2%**

MSCI EAFE Value data starts 1975. Annual Risk = standard deviation of annual returns Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Not to be construed as investment advice. Returns of model portfolios are based on back-tested model allocation mixes designed with the benefit of hindsight and do not represent actual investment performance.

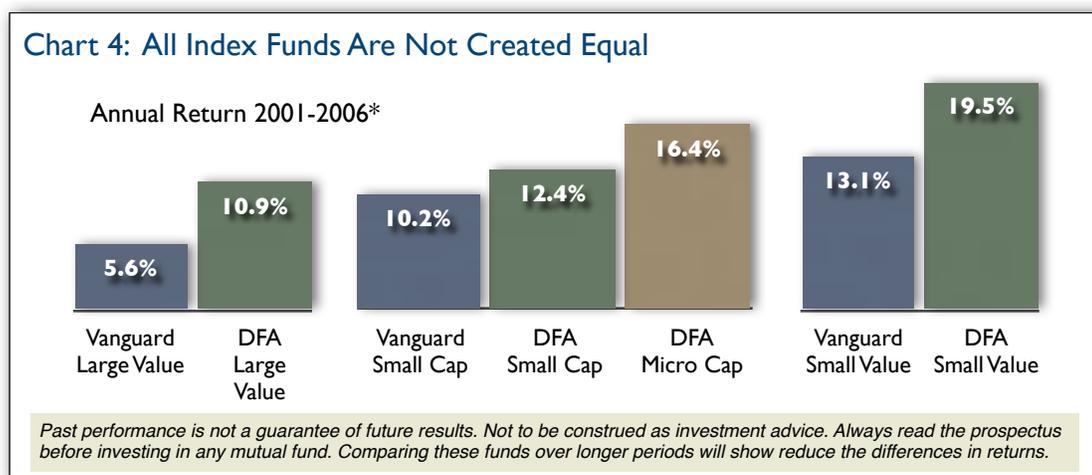
Chart 3 above demonstrates the benefits of what we observe in Table 2, namely, that because of the tendency of the fluctuations of different asset classes to offset one another, a portfolio's *risk* is less than the weighted average of the risk of its individual asset classes. A portfolio's *expected return*, on the other hand, is simply a weighted average of the expected returns of the individual asset classes. **In other words, it is not necessary to introduce the un-rewarded (or uncompensated) risks of active management in order to "beat the market."** Very broad diversification within and among asset classes can achieve the same goal.

The very nature of risk suggests that these relationships do not hold for every period and under all circumstances, but the principles underlying this strategy are sound and these relationships can be expected over the long-term. Additional asset classes that are not well defined by the Fama/French research yet exhibit characteristics that may be useful in meeting trust objectives (e.g., emerging markets and real estate investment trusts, or REITS) may also be considered. These asset allocation decisions will be based on the income requirements and overall risk and return objectives of the trusts.

Index Funds

It is important to capture these risk and return dimensions as fully and as efficiently as possible using the best passively-managed funds. We can test this during periods when value stocks and small company stocks do particularly well. Chart 4 shows such a period and we can clearly see the result of the superior index structure underlying the DFA funds.

Since we expect these asset classes to outperform over the long-term *and* we cannot predict the short-term cycles when asset classes behave differently, it's important that we get on the right "horse" from the beginning and stay on it through all market cycles. In this regard, we fully expect the Vanguard funds to outperform occasionally (such as the 1998-1999 period that favored larger, higher priced growth stocks), but not over longer time frames.



In our effort to use the best tools available in developing client portfolios, Equus Partners reviews regularly all current research on the dimensions of stock returns and screens all passively-managed asset class, index, and exchange-traded funds (ETFs) funds (including the new "fundamental index"-based funds) for those with the best combination of low cost, diversification, fund management and trading skills, tax efficiency, and, most importantly, asset class focus.

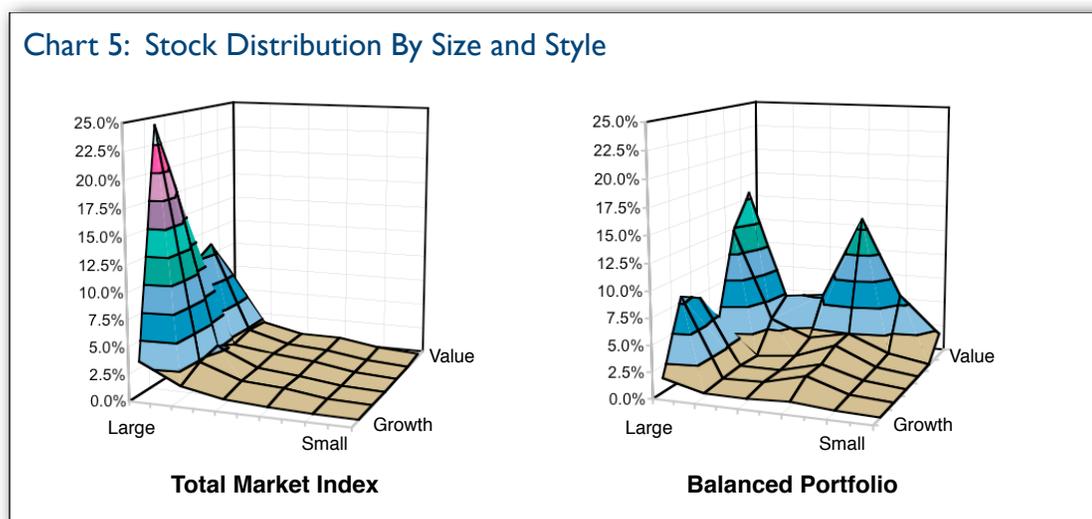
More on Risk

So far, we have discussed risk in terms consistent with the Prudent Investor Rule. For stocks, risk has been defined in terms of volatility of returns (the standard deviation) and downside risk (loss of principal). However, if we define risk as “the odds of not meeting expectations” then risk can take other forms.

“Tracking Error” risk

For example, many investors use benchmarks such as the S&P 500 to judge the performance of the stock portion of their portfolios. But the S&P 500 index is heavily influenced by the performance of a handful of very large U.S. growth companies. As a result, a portfolio that has a more even balance of large, small, growth, and value stocks is likely to perform very differently from the S&P 500 over certain periods. The 1995-1999 period is a perfect example. We’ll call this “tracking error” risk. An investor accepting a more even balance of the asset classes is accepting the greater risk that their returns will, at times, be much different than the S&P 500 index. Not recognizing and accepting this risk ahead of time can lead to very destructive behavior, such as market timing.

Chart 5 shows the distribution of stocks by size (from large to small) and style (from growth to value) in a “Total Market” index compared to a balance of 30% S&P 500 index, 30% U.S. large value, 20% U.S. small, and 20% U.S. small value stocks. As we point out later under “Concentration Risk,” the stock distribution of the Total Market Index is very similar to that of the S&P 500—both are dominated by large growth companies.



Even asset class risk is not easily or neatly defined. For example, “value” stocks are often thought to be less risky than “growth” stocks due to their lower prices relative to accounting fundamentals such as earnings, cash flow, or book value, and low prices suggest less downside risk (i.e., they don’t have as far to fall during rough times). Value stock returns have also tended to be less volatile than growth stocks over long periods. Therefore, the higher long-term returns of value stocks appear to be a “free lunch.” But this is inconsistent with efficient market theory, which concludes that risk and return are directly related and any free lunch will quickly disappear as investors try to exploit it.

This is where the Fama/French research comes in. Fama and French believe the value return premium is due to a “distress” risk and is related to a company’s cost of capital. One way to look at this is to imagine a growth company with strong earnings and good prospects going to a bank for a loan. You would expect that company to pay a lower interest rate on the loan than a company with much weaker earnings growth and less attractive prospects, would you not? Efficient Market Theory suggests that equity investors as a whole price equity capital in the same way. They will pay less for a value stock and expect higher returns for the higher risk or uncertainty of these companies’ future prospects. Yet, this risk does not always show up in either return volatility or downside risk. The same can be said for small company stocks—their earnings growth is less certain and their cost of capital is higher, therefore they have a higher expected return. But the risk of small company stocks seems more obvious than the risk of value stocks since their past history shows them to be more volatile and subject to greater downside risk than large company stocks.

Concentration risk

Another risk related to this discussion we’ll call “concentration risk,” or the risk associated with having too many eggs in one basket. Many investors attempt to avoid this risk by simply investing in a highly diversified “Total Market” index fund. But by concentrating on the fact that these funds hold as many as 3,000 different stocks, they ignore the more important fact that a relative handful of very large growth companies can dominate the performance of such funds. The concentration isn’t in a limited number of stocks, but rather in basically one asset class—large growth stocks. As these stocks reach dizzying heights as they did from 1995-1999, investors are happy. As they sink to despairingly low levels as they did from March 2000 until March 2003, investors feel the effects of “concentration risk.” Investors who concentrated too much on one or two growth industries such as technology and telecommunications have felt even greater levels of this risk.

In the absence of return guarantees in the stock market it would seem that more balance among asset classes, while maintaining broad diversification within each asset class, is the most prudent course for most investors.

Capital Preservation & Growth of Assets

The Prudent Investor Rule (Page 7, paragraph 1)

Modern experience with inflation—so different from experience with the value of money in the formative periods of trust investment law—dictates a greater sensitivity in investment management to the competition between the income and principal interests in a trust, or more broadly, to reflect the needs of both today and tomorrow. In addition, tax consequences within the trust and the tax positions of the various beneficiaries have come to have considerable importance in the management of trust funds, and the trustee’s investment decisions often affect different beneficiaries quite differently in this respect. For these reasons trustees must recognize that the traditional insistence on the preservation of principal includes a consideration of the real value of corpus and a need to balance this concern against a life beneficiary’s typical interest in the production of trust income, with attention to the after-tax worth of each. The prudent investor rule also recognizes that the life beneficiary’s concern over trust accounting income is not the same (or even present) in all trusts, and makes clear in any event that this concern focuses on the portfolio as a whole rather than on each investment. Trust purposes, beneficiary circumstances, and family financial objectives will sometimes allow more than an effort to protect purchasing power and thus may justify a deliberate effort to achieve real growth in some trust estates.

Equius Partners Policy Guidelines & Strategy:

The previous version of the Prudent Investor Rule was published in 1959 and directed trustees “to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived.”

In essence, this second restatement of the original “prudent man rule” of 1830 severely limited trustees on a practical level to the point where most trustees simply invested in long-term fixed income instruments such as Treasury Bonds. The timing couldn’t have been worse. The bull market of the 60’s was followed by the devastating inflation of the 70’s, which in turn was followed by the latest bull market of the 80’s and 90’s.

As a result, the American Law Institute’s Restatement Third “affords more latitude for exercise of judgment by the trustee than had been thought permitted by the Restatement Second of Trusts. Moreover, the revised rule focuses on the trust’s portfolio as a whole and the investment strategy on which it is based, rather than viewing a specific investment in isolation” (Foreword, paragraph 2). We saw the benefit of such thinking in Chart 3 above.

Equius Partners consults with trustees and our clients to determine the most appropriate balance of fixed-income securities and stocks to meet the objectives of the client or trust beneficiaries. In the equity markets, as well as the fixed income market, risk and return characteristics will be analyzed and balanced against income requirements. The effects of inflation, the volatility of interest rates and market values, tax consequences, and the prospects of capital loss will be considered in the context of the total portfolio.

Fees & Expenses

The Prudent Investor Rule (Page 6, paragraph 4)

Although trustees are entitled to indemnification for reasonable expenses, the duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule. This is done to reflect the importance of market efficiency concepts and differences in the degrees of efficiency and inefficiency in various markets. In addition, this emphasis reflects the availability and continuing emergence of modern investment products, not only with significantly varied characteristics, but also with similar products being offered with significantly differing costs. The duty to be cost conscious requires attention to such matters as the cumulation of fiduciary commissions with agent fees or the purchase and management charges associated with mutual funds and other pooled investment vehicles. In addition, active management strategies involve investigation expenses and other transaction costs (including capital gains taxation) that must be considered, realistically, in relation to the likelihood of increased return from such strategies.

Equius Partners Policy Guidelines & Strategy:

This language, along with the discussion of uncompensated risk above, further questions the potential value added of active investment strategies and places a significant burden of proof on trustees to justify the higher costs associated with active strategies.

Various studies over the years have shown that over the long-term the difference in performance between active and passive (indexed) strategies equals the expense difference in the two

strategies. Nobel Prize Laureate and Stanford University professor, William F. Sharpe, articulates this point very clearly in his paper *The Arithmetic of Active Management* (www.stanford.edu/~wfs Sharpe/art/active/active.htm). John Bogle, former chairman of The Vanguard Group, has estimated this expense at about 2% per year.

Asset class investing using mutual funds based on traditional indexes like the S&P 500 or structured passively-managed funds can significantly reduce portfolio costs. However, there are additional benefits associated with index funds that trustees should consider. These include much broader diversification; greater asset class purity; greater asset class stability (less size or style “drift”); lower portfolio turnover, resulting in lower fund expenses and tax impact; and much less impact from manager changes.

In addition, index funds and structured, passive asset class funds tend to get better as they grow larger due to economies of scale, and size has no impact on investment style purity. This is usually not the case with actively-managed funds, which can trend toward mediocrity as they grow larger due to constraints put on managers and/or changes in investment strategy.

Equius Partners considers all of these factors when researching the available indexed and passively managed mutual funds. Since style purity and stability, diversification, and the characteristics of the underlying index are so important to future returns, we consider these factors against the operating costs and cost to buy and sell these funds through financial custodians. All else being equal, Equius will always choose the lowest cost alternative.

The significant increase over the past decade in the number and varying structure of passively-managed investment vehicles warrants even greater care and due diligence on the part of trustees and their advisors. Equius is committed to a thorough evaluation of all such alternatives, including Exchange Traded Funds (ETFs), “enhanced” index funds, and tax-managed funds.

Responsibilities as Investment Advisor

The Prudent Investor Rule (Page 6, paragraph 4)

The last of the above stated principles recognizes that, with proper attention to cost concerns, prudent investing may require or at least benefit from expert assistance in investment matters. Thus, the prudent investor rule views delegation from a positive perspective.

Equius Partners Policy Guidelines & Strategy:

The American Law Institute recognizes that trustees are faced with a myriad of investment choices and strategies. In expanding the discretionary latitude of trustees, the Prudent Investor Rule has also placed a great burden on trustees to avoid taking “bad risks—ones in which there is unwarranted danger of loss, or volatility that is not compensated by commensurate opportunities for gain.” (Page 27, paragraph 3)

Equius Partners believes its primary role is to assist trustees and fiduciary from taking “bad risks.” Our commitment to indexed, asset class strategies is the first step in this process. However, we have found that the *discipline* to stay with an appropriate asset allocation over the long-term has an even greater effect on returns than the choice between active and passive investment strategies.

The importance of investment discipline is well-illustrated in a 2005 article by Morningstar, the mutual fund database firm, titled “Indexing Goes Hollywood.” Morningstar measured the actual performance of index funds over a 10-year period and found that the *dollar-weighted* return was only 79% of the actual time-weighted return of the funds. This indicates a inclination on the part of investors to rush into funds *after* high returns and rush out *after* low returns. The experience of clients of advisors using the DFA funds is very different as shown in the table below.

Table 3: More Discipline, Higher Returns

	10-Year Dollar-Weighted Return	10-Year Time-Weighted Return	Difference	Success %
DFA Funds	12.81%	12.37%	+0.44%	104%
All No-load Index Funds	7.06%	8.94%	-1.88%	79%

DFA Funds includes all Dimensional funds with at least ten years of history as of December 2005. Performance data represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. The investment return and principal value will fluctuate so that an investment's shares, when redeemed, may be worth more or less than their original cost. Total returns include reinvestment of the dividends and capital gains. Source: Morningstar Indexes Yearbook: 2005, "Indexing Goes Hollywood."

Here’s Morningstar’s conclusion: “... Advisors who use DFA [funds] encourage very smart behavior among their clients, even buying more out-of-favor segments of the market and riding them up, rather than buying at the peak and riding the trend down, which is usually the case with fund investors.”

Market timing in any form usually has a severe negative impact on performance, and our ability to communicate effectively the risk of market timing to trustees is the true measure of our success as investment advisors. Therefore, Equius is committed to providing frequent, concise, and focused commentary regarding the principles on which our strategies are based, along with supporting research by leading academics and others in the field of finance.

We also monitor trust investments to insure that allocations remain within target ranges. Periodic rebalancing of the investments maintains the risk and return characteristics of the portfolio as set out in the investment policy and results in a structured “buy low, sell high” discipline that is not based on projections of future market direction. Costs to buy or sell funds and tax consequences are always considered prior to rebalancing.

Finally, Equius provides detailed quarterly reports outlining the holdings, activities, income, and performance of trust accounts and we are available at all times during normal business hours to discuss the portfolio, trust objectives, and our investment philosophy.

Summary

Our analysis and interpretation of the American Law Institute’s 1990 restatement of the Prudent Investor Rule leads us to the following investment policy guidelines:

1. Equius Partners will invest trust assets in index funds or other structured passive funds whenever possible to eliminate uncompensated risk.
2. Equius Partners will broadly diversify trust assets within and among various asset classes in order to reduce portfolio risk.
3. Equius Partners will place significant emphasis on mutual fund costs, transaction costs, and other fees and expenses related to the management of trust assets.
4. Equius Partners will balance return objectives with income requirements and the negative impact of inflation when considering trust investments and asset allocation.
5. Equius Partners will monitor investments, communicate our principles, report trust activity and progress, and rebalance portfolio allocations as delegated by trustees.

The Equius Partners Team

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Sources

Index data in Table 1, Chart 2, Table 2, Chart 3 was provided by Dimensional Fund Advisors (DFA). Primary sources include Standard & Poors, CRSP: The Center for Research in Securities Prices (University of Chicago), and Profs. Fama & French. Data in Chart 4 was obtained from Morningstar’s Principia Pro mutual fund database software.

The Fama/French research is presented in a paper titled, “Characteristics, Covariances, and Average Returns: 1929-1997” by James L. Davis, Eugene F. Fama and Kenneth R. French. This paper can be downloaded from our website at www.equiuspartners.com by clicking on the “Library” tab and clicking on the link under “Academic Papers.” It can also be found, along with additional research by Fama & French and others, on the Social Science Research Network (SSRN) web site at www.ssrn.com.