

Appendix D

DISCLAIMERS, COPYRIGHTS, DISCLOSURES FOR BACKTESTED PERFORMANCE, AND ABOUT THE ARTIST

- **Dalbar, Inc.** is an independent third party not associated with Index Funds Advisors, Inc. The studies referred to in this book by DALBAR were performed by and obtained from DALBAR, Inc. The information is believed to be reliable but accuracy and completeness cannot be guaranteed. It is for informational purposes only and is not a solicitation to buy or sell securities. Use of information from DALBAR does not necessarily constitute agreement by DALBAR, Inc., of any investment philosophy or strategy presented in this book.

- **©2007 Morningstar, Inc. All rights reserved.** Morningstar, Inc is an independent investment research firm not associated with Index Funds Advisors, Inc. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; (3) does not constitute investment advice offered by Morningstar; and (4) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any of this information. Past performance is no guarantee of future results. Use of information from Morningstar does not constitute agreement by Morningstar, Inc. of any investment philosophy or strategy presented in this publication.

- **All Standard & Poor's 500 Index Data ©Copyright 2007 The McGraw-Hill Companies, Inc. Standard & Poor's including its subsidiary corporations ("S&P") is a division of The McGraw-Hill Companies, Inc.** Reproduction in any form is prohibited without

S&P's prior written permission. Neither S&P, its affiliates nor any of their third-party licensors: (a) guarantee the accuracy, completeness or availability of the S&P Data, or (b) make any warranty, express or implied, as to the results to be obtained by the Publisher or any other person from the use of the S&P Data or any other data or information included therein or derived therefrom, or (c) make any express or implied warranties, including any warranty of merchantability or fitness for the particular purpose or use, or (d) shall in any way be liable to the Publisher or any recipient of the Materials for any inaccuracies, errors, or omissions, regardless of cause, in the S&P Data or for any damages, whether direct or indirect or consequential, punitive or exemplary resulting therefrom.

Quotations and portraits:

- Quotes contained in this book are for illustrative purposes only, and in no way imply any endorsements of the goods and services of Mr. Hebner, Index Funds Advisors, Inc. or any affiliates thereof.

Data and Charts:

- Data and charts are copyright of their respective owners and reproduced as supportive research data and not as an endorsement of their respective owners to the content contained herein.

- **Index Funds Advisors, Inc.:** THERE ARE NO WARRANTIES, EXPRESSED OR IMPLIED, AS TO ACCURACY COMPLETE-

NESS, OR RESULTS OBTAINED FROM ANY INFORMATION IN THIS BOOK. Nothing in this book should be interpreted to state or imply that past results are an indication of future performance. This book does not constitute a complete description of Index Funds Advisors, Inc., (IFA) services and is for informational purposes only. It is in no way a solicitation or an offer to sell securities or investment advisory services except, where applicable, in states where IFA is registered, or where an exemption of such registration exists. Information throughout this book whether stock quotes, charts, articles, or any other statements regarding market or other financial information, is obtained from sources which IFA and its suppliers believe reliable, but IFA does not warrant or guarantee the timeliness or accuracy of this information. Neither IFA or its information providers shall be liable for any errors or inaccuracies, regardless of cause, or the lack of timeliness of, or for any delay or interruption in the transmission thereof to the user. All investments involve risk, including foreign currency exchange rates, political risks, different methods of accounting and financial reporting, and foreign taxes.

DISCLOSURE FOR BACKTESTED PERFORMANCE INFORMATION ON THE SIMULATED STRATEGIES OF INDEX PORTFOLIOS (see ifa.com/btp for updates)

1. Index Funds Advisors, Inc. (IFA) was incorporated in March 1999 and placed its first independent client investments in early 2000. The performance information presented in the charts or tables of this book represents backtested performance based on combined simulated index data and live (or actual) mutual fund results from Jan 1, 1927 to period ending date shown using the strategy of buying, holding and annual rebalancing globally diversified portfo-

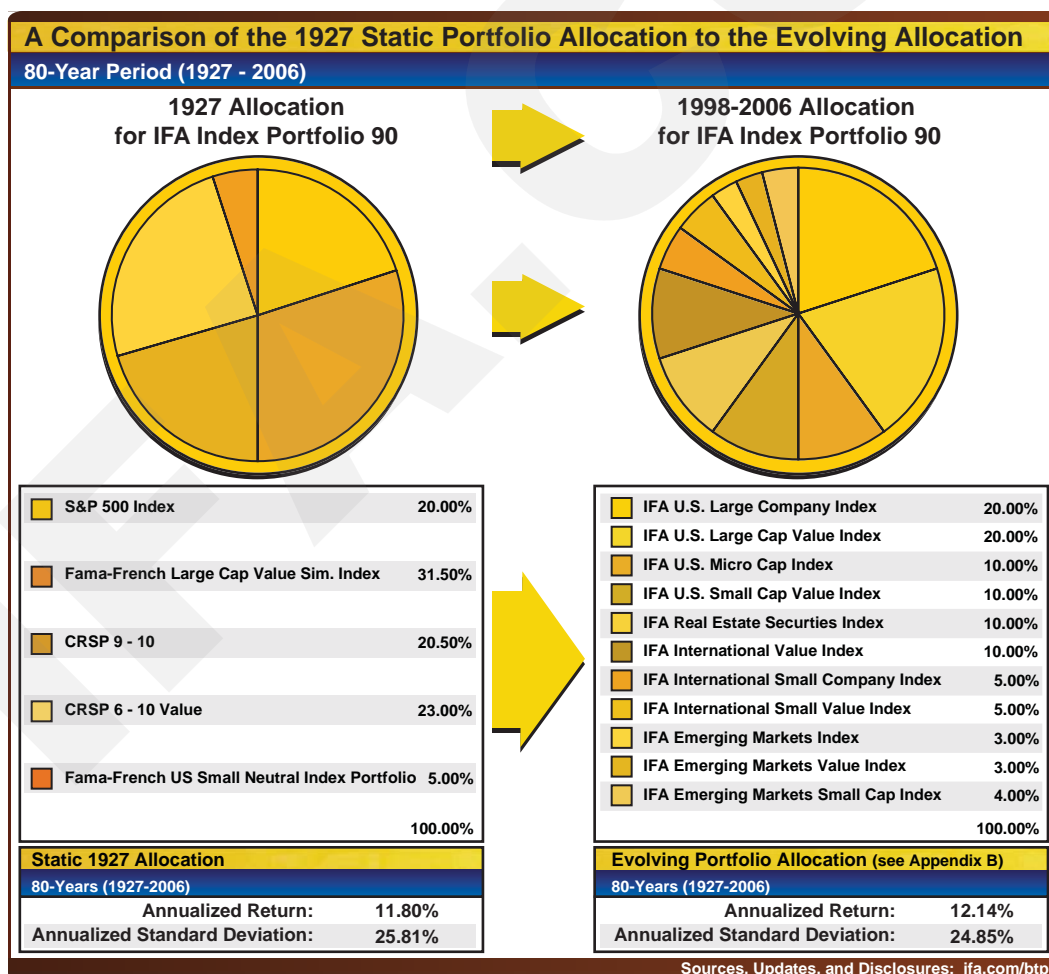
lios of index funds. Backtested performance is hypothetical (it does not reflect trading in actual accounts) and is provided for informational purposes to indicate historical performance had the Index Portfolios been available over the relevant period. IFA did not offer the Index Portfolios until November 1999. Prior to 1999, IFA did not manage client assets. The IFA indexing investment strategy is based on the principles of the Modern Portfolio Theory and the Fama and French Three Factor Model for Equities and Two Factor Model for Fixed Income. The Index Portfolios are designed to provide substantial global diversification (approximately 16,000 companies in 40 countries) in order to reduce investment concentration and the resulting increased risk caused by the volatility of individual companies, indexes, or asset classes. Client portfolios are monitored and rebalanced, taking into consideration risk exposure consistency, transaction costs, and tax ramifications to maintain target asset allocations as shown in the 20 Index Portfolios.

2. A review of the IFA Index Data Sources and Time Series Construction in Appendix B is an integral part of and should be read in conjunction with this explanation of backtested performance information. For detailed descriptions and definitions of the underlying criteria and data used to construct backtested performance, Data Sources and IFA Indexes Time Series Construction in Appendix B. Simulated index data is based on the performance of indexes as described in Appendix B. The index mutual funds used in IFA's 20 Index Portfolios are IFA's best estimate of a mutual fund that will come closest to the index data provided in the simulated indexes. Simulated index data is used for the period prior to the inception of the relevant live mutual fund data. An equivalent mutual fund expense ratio is deducted from both live and simulated data. Live (or actual) mutual fund per-

formance is used after the inception date of each mutual fund. Backtested performance is calculated by using a computer program and monthly returns data set that starts with the first day of the given time period and evaluates the returns of simulated indexes and index mutual funds, as seen in Appendix B.

The IFA Indexes Times Series Construction goes back to Jan. 1927 and consistently reflects a tilt towards small and value equities over time, with an increasing diversification to international markets and the real estate index as data became available. In Jan. 1927, there are five equity indexes and two bond indexes. In Feb. 1955, there are a total of 10 indexes. There are 15 indexes from March 1998 to the present. If the original 5 equity indexes from

1927 are held constant through December 2006, the annualized rate of return is 11.80%, after the deduction of a 0.9% IFA advisor fee and a standard deviation of 25.81%. The evolving IFA Indexes over the same period have a 12.14% annualized return after the same IFA fees and a 24.85% standard deviation. The value of having a longer time series exceeds the concerns of index substitutions over the 1927 to present period. Due to the very high standard deviations of returns (25%), a 60-year or more sample size of data is recommended to reduce the standard error of the mean. In other words, smaller sample sizes introduce larger errors than the errors introduced by stitching together indexes over time. This is the advice IFA provides to its clients. (See Appendix B for the Time Series Construction.)



Appendix D

Backtested performance is calculated by using a computer program and monthly returns data set that starts with the first day of the given time period and evaluates the returns of simulated indexes and index mutual funds, see Data Sources. In 1999, tax-managed funds became available for many different index funds. IFA uses tax-managed funds in taxable accounts. The tax-managed funds are consistent with the indexing strategy, however, they should not be expected to track the performance of corresponding taxable funds in the same or similar indexes. As such, the performance of portfolios using tax-managed funds will vary from portfolios that do not utilize these funds.

3. Backtested performance does not represent actual performance and should not be interpreted as an indication of such performance. Actual performance for client accounts may be materially lower than that of the Index Portfolios.

Backtested performance results have certain inherent limitations. Such results do not represent the impact that material economic and market factors might have on an investment adviser's decision-making process if the adviser were actually managing client money. Backtested performance also differs from actual performance because it is achieved through the retroactive application of model portfolios (in this case, IFA's 20 Index Portfolios) designed with the benefit of hindsight. As a result, the models theoretically may be changed from time to time to obtain more favorable performance results.

4. History of Changes to the IFA Indexes:

1. 1991-1999: Index Portfolios 10, 30, 50, 70 and 90 were originally suggested by Dimensional Fund Advisors (DFA), merely as an example of globally diversified investments

using their many custom index mutual funds, back in 1991 with moderate modifications in 1996 to reflect the availability of index funds that tracked the emerging markets asset class. Portfolios between each of the above listed portfolios were created by IFA in 1999 by interpolating between the above portfolios. Portfolios 5, 95 and 100 were created by Index Funds Advisors in 1999, as a lower and higher extension of the DFA 1991 risk and return line.

2. November 2002: Due to the high similarities of the 1999 versions of Index Portfolios 95 and 100 to index portfolio 90, the 95 and 100 portfolios were moderately modified in November 2002 to have higher exposure to small and value equities throughout the world. According to the extensive research of Eugene Fama, Kenneth French and Jim Davis, utilizing data from the Center for Research of Security Prices (CRSP) over a 68 year period from July 1929 to June 1997, this change has higher risk and return expectations than the previous versions of 95 and 100.

3. January 2004: IFA changed the computer program setting to calculate annual rebalancing on the various indexes in the Index Portfolios in January 2004. Previous to that they were rebalanced monthly. Annual rebalancing is closer to the actual rebalancing of client accounts, therefore it was adopted as the new method in January 2005.

4. June 2006: The historical monthly returns of the 15 IFA indexes and the 20 IFA Index Portfolios were reconstructed in June of 2006 to address the following issues:

A. The availability of new and better sources of data for historical returns.

B. The correction of errors in the prior data.

C. Changes to the substitution of U.S. index data for international indexes in years prior to the existence of international data.

The overall impact of these changes to the returns is small. To illustrate, the 79-year average annualized returns for Portfolios 5, 50, and 100 changed as follows:

Average Annualized Return from Jan. 1927 to Dec. 2005			
	Portfolio 5	Portfolio 50	Portfolio 100
Old Return	5.66%	9.65%	12.58%
New Return	5.54%	9.58%	12.62%

5. Backtested performance results assume the reinvestment of dividends, ordinary and capital gains and annual rebalancing. The performance of the strategy reflects, and is net of, the effect of IFA's investment management fee of 0.9% per year, billed monthly. Monthly fee deduction is a requirement of our software used for backtesting. Actual IFA advisory fees are deducted quarterly, in advance. This fee is the highest fee IFA has ever charged. Depending on the size of your assets under management, your investment management fee may be less. Backtested risk and return data is a combination of live (or actual) mutual fund results and simulated index data, and mutual fund fees and expenses have been deducted from both the live (or actual) results and the simulated index data. More information about advisory fees, expenses, no-load mutual fund fees, prospectuses for no-load index mutual funds, brokerage and custodian fees can be found at www.ifa.com/Admin/fees.asp.

Although index mutual funds minimize tax liabilities from short and long term capital gains, any resulting tax liability is not deducted from performance results. Performance results also do not reflect transaction fees and other expenses charged by broker-dealers, which reduce returns.

IFA is not paid any brokerage commissions, sales loads, 12b1 fees, or any form of compensation from any mutual fund company or broker dealer. The only source of compensation from client investments is obtained from asset based advisory fees paid by the client.

More information about advisory fees, expenses, no-load mutual fund fees, prospectuses for no-load index mutual funds, brokerage and custodian fees can be found on www.ifa.com.

6. For all data periods, annualized standard deviation is presented as an approximation by multiplying the monthly standard deviation number by the square root of twelve. Please note that the number computed from annual data may differ materially from this estimate. We have chosen this methodology because Morningstar uses the same method. (See IFA Indexes Time Series Construction in Appendix B.)

7. Not all of IFA clients follow their recommendations and depending on unique and changing client and market situations, IFA may customize the construction and implementation of the Index Portfolios for particular clients, including the use of tax-managed mutual funds, tax-harvesting techniques and rebalancing frequency and precision. In taxable accounts, IFA uses tax-managed index funds to manage client assets. However, the tax-managed index funds are not used in calculating the backtested performance of the Index Portfolios, unless specified in the table or chart. Some clients substitute the mutual funds recommended by IFA with investment options available through their 401k or other accounts, thereby creating a custom asset allocation. The performance of custom asset allocations may differ materially from (and may be lower than) that of the Index Portfolios.

8. Performance results for clients that invest in accordance with the Index Portfolios will vary from the backtested performance provided in this book due to market conditions and other factors, including investments cash flows, mutual fund allocations, frequency and precision of rebalancing, tax-management strategies, cash balances, lower than 0.9% advisory fees, varying custodian fees, and/or the timing of fee deductions. As the result of these and potentially other variances, IFA clients have not and are not expected to have achieved the exact results shown since November 1999, when IFA first placed investments. Actual performance for client accounts may differ materially from (and may be lower than) that of the Index Portfolios. Clients should consult their account statements for information about how their actual performance compares to that of the Index Portfolios.

9. As with any investment strategy, there is potential for profit as well as the possibility of loss. IFA does not guarantee any minimum level of investment performance or the success of any index portfolio or investment strategy. All investments involve risk (the amount of which may vary significantly) and investment recommendations will not always be profitable.

10. Past performance does not guarantee future results.

11. Why go to all this trouble? Backtested performance data analysis is important because a shorter time-period introduces a large statistical sampling error for both risk and average returns. Past performance does not predict future performance, however, analyzing 30 years or more of simulated risk and return data is a more reliable source of information concerning the cost of capital for firms and their shareholders and the resulting expected returns for investors who

trade their cash for shares and bonds of those firms. That is the essence of capitalism.

The result of this data is a probability distribution with an average return and a standard deviation around the average, which best characterizes future random events that are totally unpredictable like the roll of the dice or flip of a coin. Yet, these random events over long time horizons, like 30 years or more, accumulate to new distributions. These distributions are, to varying degrees, similar to a large sample of previous distributions, such as 30 years. Shorter time horizons demand lower risk investments, while longer time horizons allow for regression to the mean. The "mean" refers to the average expected outcome of returns, which is also the most probable outcome. The distribution of historical market data is a leptokurtic distribution, meaning it is not conclusive in any way as to the limits of losses or gains. Dice rolls and coin flips do have limits, but the market does not. There is an unlimited risk on stock market investments that can not be clear in even very long-term historical data. For example, in the stock market crash of 1929, the market declined 89% and many investors had leveraged their capital and lost all of their investments. The stock market is a risky investment and investors can lose all, or nearly all of their money because of the risk of firms going out of business, general macroeconomic and political risks, and challenges to the ideas of capitalism, in general.

However, this analysis is far more useful than the traditional 1, 3, or 5 year returns and risk data used by the great majority of individual and professional investors. Without such longer-term analysis, investors would be merely speculating on the risks and expected returns of their investments with a statistically unacceptable sample, like a gambler in a casino hopelessly trying to beat the casino statistician, who may be referred

to as the dice, card, and roulette wheel actuary. This is in fact what investors do and several studies have confirmed it is the source of their near zero average returns over the last 20 years, after inflation and taxes. As Louis Bachelier stated in the first published paper on the random character of stock market data, "The Theory of Speculation" (1900), "...the mathematical expectation of the speculator is zero." Statistically speaking, investors have a relatively high standard error of the mean (average return) with data of less than 30 years.

Because Index Funds Advisors, Inc. is recommending mutual funds that correlate to the investment criteria of the simulated index data, there is a greater chance that the data is useful to index funds advisors than it is to actively managed mutual fund advisors that do not replicate the index and therefore engage in style drift. Past performance for active managers is an especially poor indicator of future results, due to the relatively small number of years of performance data available for each active manager and the fact that even during that period they are style drifting.

This analysis and investment strategy is consistent with Modern Portfolio Theory, which is the term used to summarize the combined research of Harry Markowitz, William Sharpe and Merton Miller. They were awarded the Nobel Prize for Economics in 1990 for their efforts to describe how financial markets work and how to build efficient portfolios.

ABOUT THE ARTIST

LALA RAGIMOV



Lala Ragimov

I would like to extend a special thanks to artist, Lala Ragimov, who painted the 47 original and beautiful oil paintings that are located throughout the book. Lala, who was born in Moscow, draws her artistic inspiration from the art of the Renaissance and Baroque periods. She graduated from the world-renowned, California Institute of the Arts, located in Valencia, California. Today Lala works as an artist and illustrator for companies and private collectors.