

Actively Managed Funds vs. IFA Indexes

Five Years (July 2001 - June 2006)

There is no longer any doubt that the costs of following an active investment strategy present an insurmountable hurdle. The manager-pickers have the wind in their face, and the longer they attempt to find someone to beat the market, the further behind the market they are destined to fall. The superiority of passive over active has been consistently documented by Standard & Poors in their quarterly "Indices vs. Active Funds Scorecard" (SPIVA). In contrast to most other publicly available sources of mutual fund information, this report includes the performance of terminated funds (i.e., it does not suffer from survivorship bias).

The table below shows that for the five year period ending June 30, 2006, between 69% and 96% of actively managed funds (depending on the fund category) underperformed their corresponding IFA benchmark, across six different categories. So much for the pundits who claim that indexing is only valid for domestic large cap stocks. The table also highlights the style drift problem that plagues the mutual fund industry. The pie charts on page 2 vividly illustrate the underperformance of actively managed funds. Those who still think that they can find a market-beating manager would do well to read [Step 5: Manager Pickers](#).

Standard & Poor's Actively Managed Funds Data

Five Years (July 2001 to June 2006)

Category	Large Blend	Large Value	Small Value	International	International Small	Emerging Markets
IFA Index	IFA U.S. Large Company**	IFA U.S. Large Value	IFA U.S. Small Cap Value	IFA International Value	IFA International Small Company	IFA Emerging Markets Blend***
% of Active Funds Underperforming IFA Index	70.30	94.98	89.81	95.92	68.75	89.61
Survivorship %	63.20	75.50	86.00	68.71	75.00	66.23
Style Consistency %*	26.40	53.30	60.50	67.01	75.00	64.94
Average Active Fund Return %	1.93	4.87	11.84	9.87	15.38	21.23
IFA Index Return %	2.37	8.88	16.65	15.75	20.00	24.69

*Style Consistency % shows the percentage of funds that had the same style classification at the end of the period as at the beginning of the period.

**The IFA Large Company Index is an investable version of the S&P 500 Index.

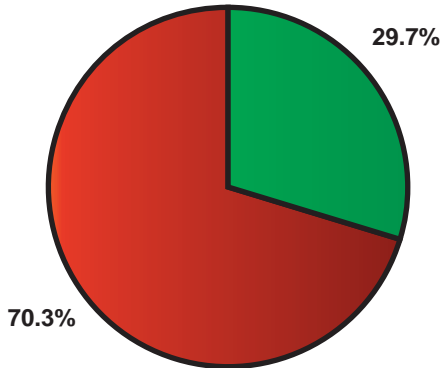
***The IFA Index for Emerging Markets consists of a 30/30/40 blend of IFA's Emerging Markets, Emerging Markets Value, and Emerging Markets Small. This is the blend of emerging markets used in the 20 IFA portfolios.

Actively Managed Funds vs. IFA Indexes

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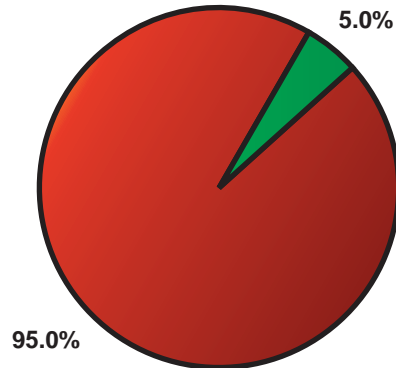
Large Cap Blend Mutual Funds
367 Funds vs.
IFA U.S. Large Company Index

Underperforming Outperforming



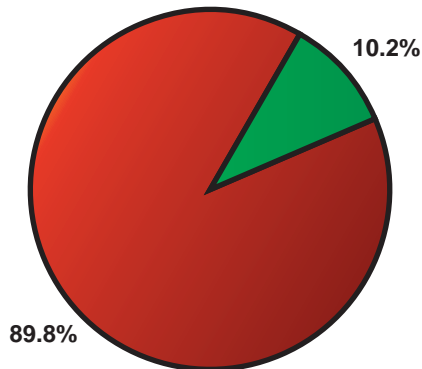
Large Value Funds
319 Funds vs.
IFA U.S. Large Cap Value Index

Underperforming Outperforming



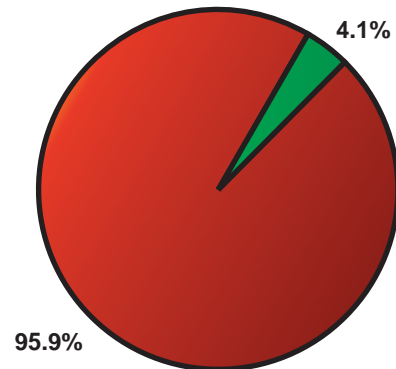
Small Cap Value Funds
157 Funds vs.
IFA U.S. Small Cap Value Index

Underperforming Outperforming



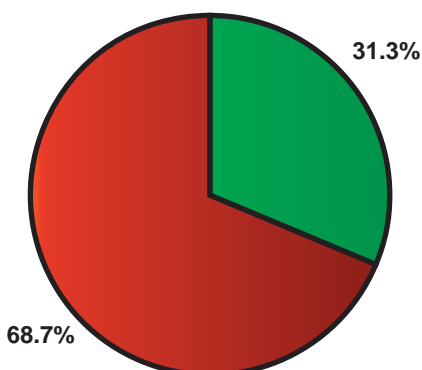
International Funds
294 Funds vs.
IFA International Value Index

Underperforming Outperforming



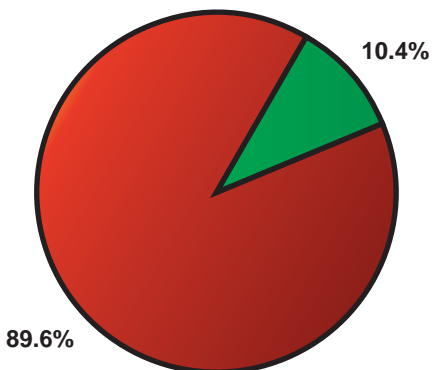
International Small Funds
32 Funds vs.
IFA International Small Company

Underperforming Outperforming



Emerging Markets Funds
77 Funds vs.
IFA Emerging Markets Blended Index

Underperforming Outperforming



Disclosure for Back-tested Performance Information on the Simulated Strategies of IFA Indexes and IFA Index Portfolios (Indexfolios):

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 charts and tables represents back-tested 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 portfolios of index funds or indexes. Back-tested 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 Modern Portfolio Theory and the Fama and French Three Factor Model for Equities and Two Factor Model for Fixed Income. 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 IFA Indexes Time Series Construction can be conducted by going to www.ifa.com/btp and is an integral part of and should be read in conjunction with this explanation of back-tested performance information. (Please note that this document is a printed version of a web-based document which contains embedded links to various other references.) For detailed descriptions and definitions of the underlying criteria and data used to construct back-tested performance, see the Data Sources and IFA Indexes Time Series Construction both located at <http://www.ifa.com/btp>. Simulated index data is based on the performance of indexes as described in the Data Sources page at <http://www.ifa.com/btp>. 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 performance is used after the inception of each mutual fund. 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 5 equities indexes and 2 bond indexes, in Feb. 1955 there are a total of 10 indexes, and there are 15 indexes in March 1998 to 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. It is IFA's advice that 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. Please go to <http://www.ifa.com/btp> to see the analysis of the evolution of these portfolios. Back-tested 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, please go to <http://www.ifa.com/btp> for 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. Back-tested 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. Back-tested performance results have certain inherent limitations. Such results do not represent the impact that material economic and market factors might have on an investment advisor's decision-making process if the advisor were actually managing client money. Back-tested 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:
 - A. 1991-1999: Index Portfolios 10, 30, 50, 70 and 90 (see www.ifa.com/btp) 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 (see the pdf located at <http://www.ifa.com/btp>). Portfolios between each of the above listed portfolios were created by IFA in 1999 by interpolating between the above portfolios. Index 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.
 - B. November 2002: Due to the high similarity 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 Portfolios 95 and 100. (See "Characteristics, Covariances, and Average Returns: 1929-1997," written by Eugene Fama, Kenneth French and Jim Davis and found at <http://www.ifa.com/btp>.)
 - C. 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.
 - D. 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:
 1. The availability of new and better sources of data for historical returns.
 2. The correction of errors in the prior data.
 3. 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:
- | | Portfolio 5 | Portfolio 50 | Portfolio 100 |
|------------|-------------|--------------|---------------|
| Old Return | 5.66% | 9.65% | 12.58% |
| New Return | 5.54% | 9.58% | 12.62% |
- The Big Table (found at <http://www.ifa.com/btp> and the Returns Calculator, also at <http://www.ifa.com/btp> reflect the new data. All new tables and charts updated after June 22, 2006 will be based on the updated data series.

deducted from performance results. Performance results also do not reflect transaction fees (as found at <http://www.ifa.com/btp> and other expenses charged by broker-dealers, which reduce returns. IFA is not paid any brokerage commissions, sales loads, 12b-1 fees, or any form of compensation by 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. For a copy of IFA's ADV Part II, please call 888-643-3133. 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 <http://www.ifa.com> in the gold navigation bar on every page of the ifa.com web site.

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 at <http://www.ifa.com/btp>.)
7. Not all IFA clients follow our recommendations and, depending on unique and changing client and market situations, we 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 back-tested 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 401(k) 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 invested in accordance with the Index Portfolios (found at <http://www.ifa.com/>) will vary from the back-tested performance provided on the site 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, our clients have not and are not expected to have achieved the exact results shown since November 1999, when we placed our first investment. 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?

This type of 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 investment 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. The dice and coin flip 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 investment. 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 risk, 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 17 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 expected return of speculation is zero." Statistically speaking, investors incur a relatively high standard error of the mean (average return) with data of less than 30 years. Because Index Funds Advisors 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.

12. IFA Index and Index Portfolio (Indexfolios) Value Data is based on a starting value of one, as of Jan 1, 1927. You can view the Risk/Returns calculator at <http://www.ifa.com/btp>. Sources and Disclosures: As stated above, dfa.com, and yahoo.com.

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