Index Fund Strategies

ASSET CLASS®

A monthly update of asset class performance, trends, & topics for long-term investors

Asset Class Returns

	2000	2001	2002	Last 10 yrs.	1/23 2003
Bonds					
Short-term	6.7	5.8	3.9	5.3	0.1
5-Y Global	6.7	5.9	10.4	7.6	-0.2
Intermediate	13.5	8.2	15.0	7.9	-0.6
Long-term	19.7	4.3	16.3	9.1	-0.8
U.S. stocks					
Large Market	-9.3	-12.1	-22.2	9.3	0.9
Large Value	10.2	3.9	-14.9	10.8	1.4
Small Micro	-3.6	22.8	-13.3	11.6	0.6
Small Market	2.5	12.7	-19.1	9.0	0.4
Small Value	9.0	22.6	-9.3	12.8	-0.4
Real estate	28.4	13.2	4.2	9.1	-3.4
Int'l stocks					
Large Market	-14.0	-20.8	-14.6	4.0	-1.4
Large Value	-0.2	-15.3	-8.5	6.8	0.0
Small Market	-5.4	-10.5	1.9	3.0	3.3
Small Value	-3.1	-4.6	5.8	3.8	3.5
Emerg. Mkts.	-29.2	-6.8	-9.4	3.5	1.5

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fu
5-Y Global bonds	DFA Five-Year Global Fixe
Intermediate bonds	DFA Intermed. Gov't Bond fun
Long-term bonds	Vanguard Long-term U.S.Treas
U.S. Large Market	DFA US Large Co. (S&P 500
U.S. Large Value	DFA Large Cap Value fun
U.S. Small Micro	DFA US 9-10 fun
U.S. Small Market	DFA US 6-10 fun
U.S. Small Value	DFA US 6-10 Value fun
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Int'l Large Cap fun
Int'l Large Value	DFA Int'l Large Cap Value fun
Int'l Small Market	DFA Int'l Small Company fun
Int'l Small Value	DFA Int'l Small Cap Value fun
Emerging Markets	DFA Emerging Markets fund

"Last 10 yrs." returns are ended 12/31/02 and for U.S. Large Value (3/93), U.S. Small Value (3/93), Int'l Large Value (3/93), Int'l Small Market (10/96), Int'l Small Value (1/95), and Emerging Markets (5/94) include simulated data prior to fund inception (in parentheses).

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Due to the length of the following article, there is no update this month.

Investors *and* advisors should fight the urge to "tweak" portfolios too much

Jeff Troutner, TAM Asset Management, Inc.

The investment business is full of conflicts of interests and incongruities between what is expected by investors and what should actually occur in the management of portfolio assets. These conflicts are too often the result of an advisor placing marketing or business decisions above prudent investment principles. This, in turn, can result in asset allocations based on recent trends and "hot" market sectors and over-activity in the portfolio.

If practiced in its most basic form (a debatable subject itself), our strategies are downright boring and the best we could do in the actual management of the assets after the initial allocations are set is basically nothing. Sure, rebalancing helps. But even that can be overdone, especially in taxable accounts. Tax-loss harvesting, a subject for another newsletter, also has a downside. Instead, our efforts on an ongoing basis are better spent *managing expectations* and keeping clients from making decisions that appear to be productive in the short-run, but are potentially very costly in the long-run.

Warren Buffett stated in a *Business Week* article, "Success in investing doesn't correlate with IQ once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble investing." I couldn't agree more. So let's review some of those urges and their possible pitfalls.

Adding Too Many Asset Classes

The core principles underlying our asset class approach are based on the Fama/French Three-Factor research. This research divides the stock market into large, small, growth, and value stocks. That's it. This simple model is radical to some, most notably John Bogle, the former chairman of The Vanguard Group, who believes the market is only one-dimensional and returns cannot be enhanced by extending diversification beyond a "total market" index fund. (Will the past three years of lousy total market fund returns and Vanguard's recent decision to rework its indexes change his mind? We'll see.)

We also include short-term bonds and emerging markets in client portfolios depending on risk and return objectives. DFA, the institutional fund manager most closely associated with the Fama/French research, also offers asset class

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funds covering REITs and emerging markets small cap and value stocks. To some, “hedge funds” are also an asset class. The question is, should we invest in any of these?

REITS

Real Estate Investment Trusts (REITs) are a sector of the overall stock market. Unlike technology stocks, another sector that was notoriously overweighted by investors in the 90’s, some advisors and investors consider REITs a special case worthy of their own asset class. But utility stocks are also a special case and, despite their low price-to-book ratios, are not included in the Fama/French indexes either since they are not considered “distressed,” they do not have a higher cost-of-capital, and they are highly regulated. Should we treat utilities as a separate asset class as well? Most advisor don’t think so.

So why all the fuss about REITs? Well, as a group they have outperformed the overall market the past five years. (Sound familiar?) They also have significantly higher dividend yields than the average stock and are therefore considered by some as bond substitutes. In other words, REITs are the anti-stock and that sells pretty well today.

Over time, however, REITs have significantly underperformed the asset they track most closely—small value stocks. But they’ve been “hot” recently and for some the temptation to add them to a portfolio is too strong. Let’s look at some numbers:

1978-2002	Return	Annual Volatility
U.S. Small Value	17.4%	17.2%
Wilshire REIT index	13.0%	16.5%

Source: DFA “Returns” program; 1978 is inception of Wilshire data

Do you see a compelling reason to add REITs to your portfolio from the numbers above? I don’t. Granted, over the past five years REITs have outperformed the S&P 500 by almost 30%. *But they underperformed small value stocks over those five years!*

Don’t get me wrong. You can do worse than adding REITs to your portfolio and investors interested more in dividend income and less on total return might find REITs attractive. But you should ask yourself whether it’s worth taking assets away from large or small value stocks to buy a concentrated group of companies investing in office buildings, public storage units, and shopping malls. As Jerry Maguire said in the movie, “Show me the money!”

Emerging markets small and value stocks

We are big believers in applying well-researched and highly scrutinized academic data to build investment strategies. But we are also very cautious in how we apply that research. The Long Term Capital Management debacle a few years back convinced us that this is the right course. We also have a lot of respect for the folks at DFA who create the best tools for us to use in applying the research. But we don’t simply add new funds to a portfolio just because DFA creates one.

Emerging markets (EM) are a special animal. I believe that the hype surrounding EM in the early 90’s was another creation of Wall Street, and firms like DFA introduced funds to meet the demand of their institutional clients. I also believe, however, that the countries included in DFA’s EM funds are riskier than the developed countries and that the companies within these fund portfolios have a higher cost-of-capital. Therefore, over time, investors should expect higher returns with higher risks from EM funds and I think a relatively small allocation to EM for some long-term investors make sense.

Given the much higher risks of EM and the asset class’s pathetic performance up to now, I don’t think adding the additional risks of small cap and value stocks to EM large company stocks is prudent. That’s a “tweaking” I think investors can do without.

Hedge funds

Hedge funds are the latest craze in the money management business. Usually classified as “alternative” investments and given their own asset class slot in the pie, hedge funds are marketed as sophisticated investments for sophisticated clients. In reality, they are simply high fee, non-public variations of actively-managed mutual funds. As such, they have just about as much chance of “positive alpha” (added value from active strategies) as any mutual fund—maybe less after fees and other costs.

Hedge funds are not an asset class since there are no real-world economic factors that drive risk and return, such as cost-of-capital. An investor in a hedge fund is simply putting faith in an individual (or a “black box” fine tuned by an individual) to produce returns similar to what they have in the past. Hedge funds are mostly just a way for a former mutual fund guru who built a decent track record to go off on their own to “earn” millions of dollars in fees. And hundreds of these funds fail every year. Enough said.