Markets Update  Wednesday, June 17, 1998

The U.S. market peaked at just over 9200 on the Dow in May and sits today at 8829, down almost 400 points. In just the past few days, the market has had swings of -207 points and +167 points. Large company stocks continue to outperform smaller companies, and in recent weeks value stocks have given back all of their gains over growth stocks.

The world stock markets have been rocked once again by more bad news from Japan. During the first three months of this year, Japan’s economy has contracted by 1.3%. Japan’s internal woes—falling real estate prices, bad bank lending policies, nervous consumers, and poor political leadership—have been aggravated by the continuing crisis in the smaller Asian economies. Stock returns have also been impacted by a falling yen.

As frustrating as the Japanese performance has been for globally-diversified investors in the U.S., the situation must be ten times worse for the Japanese people. It appears, however, that the political leadership in Japan believes their problems will simply disappear with time. While we are confident that Japan’s economy will recover eventually, the impact it is having on the smaller Japanese companies and its Asian neighbors is a concern. We will be addressing this issue in next month’s Asset Class.

On the bond front, long-term interest rates have fallen steadily since April as inflation expectations remain low and the concern over the Asian crisis is causing a “flight to safety.”

Index Funds “R” Us

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For better or worse, most parents of small children have at least some familiarity with Toys “R” Us, the world’s largest toy store chain. Investors old enough to remember Jimmy Carter in the White House may also recall Toys “R” Us as one of the great investment success stories of the era. Emerging from the bankruptcy of former parent company Interstate Stores in March 1978, the company practically invented the “category killer” retail concept. The strategy was simple: create a stranglehold on a key merchandise category by being the first to offer giant stores, huge selection, and everyday low prices. For a while the concept seemed bulletproof, and Toys “R” Us steam-rollered both neighborhood toy merchants and traditional department stores in city after city on its way to 1,400 locations.

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Don't kick yourself too hard for missing this one; beating the market with a great growth stock may be harder than you think. As an article in the June 1 issue of Forbes points out (“Trouble in Toyland”) what once appeared to be a bulletproof business franchise now faces sharper competition, with warehouse-club outlets offering lower prices and smaller toy stores providing superior service. Forbes sees “no easy exit” to the predicament, and as the outlook has dimmed, so has the stock price: Toys “R” Us shares have lost over a third of their value from their peak five years ago despite a soaring stock market and strong overall toy sales.

As a result of the poor performance in recent years, a long term buy-and-hold strategy in Toys “R” Us stock has wilted compared to the S&P 500. If you had identified this rocket ship as early as January 1982, a buy-and-hold strategy still underperformed the S&P 500 by 286 basis points annually through April 1998. If you had been smart enough to get on board two years earlier (January 1980), TOY beat the S&P 500 (19.08% vs. 17.70%), but still trailed the 20.1 1% annualized return of small cap value stocks (Fama-French simulation). Only by investing in January 1979 did a buy-and-hold strategy beat both the S&P 500 and a small cap value index in a convincing manner - 22.99% for TOY vs. 20.98% for small cap value and 17.73% for the S&P.

But to have done this would have meant identifying a future winner a mere nine months after it emerged from four years in Chapter 11 reorganization and holding a single non-dividend paying issue through the next 18 years.

Makes diversification look pretty appealing to us.

S&P 500 Index Components

We are often asked what percentage of the S&P 500 market value is attributable to the largest 10 or 20 companies. Standard & Poor’s weekly Outlook publishes a useful table ranking the top 150 companies in the S&P 500 Composite index. The data on the right appeared in the April 22, 1998 issue.

In looking over this list, we note that Pfizer has moved up sharply in market value over the last year from 17th-largest to 6th-largest U.S. firm, just behind rival pharmaceutical giant Merck. We frequently hear the argument that the strong performance of large cap stocks in recent years is attributable to indiscriminate buying of the very largest stocks by index funds. If this were the case, it is difficult to explain why two companies in a similar business have performed so differently over the past year. According to Standard & Poor’s Stock Guide, Merck shares have delivered a total return of 54.8% for the twelve months ending April 1998, while Pfizer has clocked a return of 140.0%. A more satisfying explanation for the disparity is that investors have repriced Pfizer stock sharply higher in response to new information: the impressive commercial success of its wildly popular new impotence treatment, Viagra.