The big news so far in the New Millennium (if you believe it’s already started), is the extreme volatility of the technology stocks, as indicated below with the NASDAQ 100 Index. There have also been many trading days already this year when the blue-chip Dow index and NASDAQ have moved in opposite directions.

Should We Fear a Total U.S. Market Collapse?
Or is a gradual “rotation” among asset classes more likely?

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Fortune magazine recently published an article by Shawn Tully titled “Has the Market Gone Mad?” In it, Tully offers four alternatives to the conclusion that the market is insanely overvalued and will soon collapse under its own weight. It’s a very intelligent analysis by the same person who wrote “How the Really Smart Money Invests”— a 1998 article about the brains behind Dimensional Fund Advisors. John Bogle, the former chairman of the Vanguard Group, and Warren Buffett, perhaps the smartest investor of all time, have also argued recently that investors should only expect a 6%-7% annual return on stocks over the next decade or so. These analyses and predictions are sure to cause concern among investors, many of whom will react by pulling out of stocks completely.

It is important to recognize, however, that in almost all cases concerns about today’s valuations focus on the market as defined by the S&P 500 or the Wilshire 5000 Total Market Index (the “S&P 500-lite” as I like to call it). Since these are market-cap weighted indexes, they are dominated by the large U.S. growth stocks that have appreciated so much in price that past five years. But most talk of a “correction” in stocks prices or even a market crash, suggests a significant drop in stocks prices across the board. But why should we expect that? Only one asset class—large growth companies, has dominated the market advance and sits at historically high valuations. As the following charts show, the relative price inflation for small growth, small value, and large value has been much less extreme.

To put the current U.S. market in perspective, consider the foreign stock markets over the past eighteen years. From 1982-1988, the market-cap weighted EAFE index rose an average of 28% per year. During this period, the total return for
large company stocks in Japan was over twice the return of comparable stocks in Continental Europe, almost two and a half times those in the U.K., and over six times better than large companies in the Pacific Rim region. By the end of 1988, Japanese stocks represented approximately 60% of the EAFE index.

Since 1989, Japanese large company stock prices as a group have not appreciated at all. As a result, the EAFE index has risen by only 7.6% per year and the index’s weighting to Japan has fallen to just over 20%. Large company stocks in the U.K., Continental Europe, and the Pacific Rim rose an average of 14% per year over the same period. Needless to say, investors in foreign stocks would have been better off the past eleven years with a more balanced foreign portfolio. For example, a simple mix of 25% in each of these regional asset classes would have produced a 11.4% annual return, or a 3.75% per year diversification premium over the EAFE index.

Just for kicks, let’s consider the share of large growth stocks—or, more specifically, technology stocks, in the Wilshire 5000 index today to the share of Japanese large company stocks in the EAFE index in their heyday. What are the possible implications? Well, high-priced technology stocks now make up 30% of the total U.S. market capitalization. Just five years ago the percentage was around 10%. Now, look at where prices are today compared to where they were five years ago for the various U.S. asset classes using specific index funds. (charts).

Just as the other foreign markets didn’t collapse along with Japan eleven years ago, it’s very probable that rather than steep declines in all U.S. stocks, we could see a significant rotation in performance leadership among the U.S. asset classes. We are already seeing this so far this year. The Vanguard Total Market fund is down 2.6% while the DFA 9-10 fund is up 10.3%. And just like with the foreign markets in 1989, investors will probably be better off with a more balanced mix of large, small, growth, and value stocks than to allow the market-cap weighted indexes like the S&P 500 and Wilshire 5000 to pull them along as the tech/Internet bubble expands.

TAM portfolios are not and never will be market-cap weighted like the major market indexes. Instead, they are split more evenly among large, small, growth and value depending on the risk/return expectations of each client. They also include a foreign component which has benefited greatly in recent months from a resurgence in those forgotten Japanese stocks.

No one knows for sure what the markets will do in the short-run, but balanced, global diversification is still a sound, rational choice for long-term investors.