TAM Asset Management, Inc. REVIEW

Diversified, indexed investment strategies for long-term investors, retirement plans, and trust fiduciaries

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After a nice two-year ride, we are seeing a reversal in market strength from the foreign markets to the U.S. markets. Japan, the Pacific Rim, and the emerging markets are all down so far this year, although all of these markets gained momentum right at the quarter end.

As U.S. stocks rise further and traditional measures of value—dividend yields and P/E ratios—become unattractive, investors will look for alternative markets. Right now, international stocks look like a pretty good candidate.

This newsletter is published by TAM Asset Management, Inc. Editor: Jeffrey C. Troutner

Comments, questions, or suggestions are always welcome. For information on our investment management services, please call 1-800-826-4015.

Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is one of the most useful, objective, and contemporary sources on prudent investment strategy. It is also less than 100 pages long and very easy to read.

Mr. Ellis is managing partner of Greenwich Associates, the leading consulting firm specializing in financial services worldwide. The author of six books and dozens of articles, he has taught courses at both Yale and Harvard. Ellis earned his B.A. at Yale, an M.B.A. (with distinction) at Harvard and the Ph.D. at New York University.

Individual Investors (Part 1)

Investment Policy: How to Win the Loser's Game

By Charles D. Ellis (Part 15 of 15)

Individual investors are different, very profoundly different from institutional investors. And it's not just that individual investors have less money. One difference is decisive: each individual is mortal. Life is short and its duration unknown. Inevitable mortality is the dominant reality for all individual investors—as individuals and as investors.

Other important differences between individuals and institutions are also compelling. Those of us who are earning incomes usually have a finite period of years in which to build our lifetime savings and investments. And those who are no longer earning and saving have finite financial resources upon which they will depend for the indefinite duration of their lives. Another way in which individual investors are different is that their money often takes on great symbolic meaning and can engage their emotions powerfully. Some investors feel their money represents themselves and the worth of their lives (as entrepreneurs often identify their value and their work with their companies). Yet another important differentiation is that individual investors have considerable power to impact others—both financially and emotionally—with gifts and bequests made or not made, or made larger or smaller than anticipated or considered "fair." The emotional power and symbolism of money is often more important than its economic power, and individual investors will be wise to deal carefully with both.

All investors share one formidable and all too easily underestimated adversary: inflation. This adversary is particularly dangerous for individual investors.

For individual investors, inflation is *the* problem—not the attention-getting daily or cyclical changes in securities prices that most investors fret about. The corrosive power of inflation is truly daunting: At 5 percent inflation, the purchasing power of your money is cut in half in less than 15 years—and cut in half again in the *next* 15 years.

At 7 percent, your purchasing power drops to 25 percent of its present level in just 21 years—the elapsed time between "early" retirement at 61 and age 82, an increasingly normal life expectancy. This is clearly serious business, particularly when the individual is retired and has no way to add capital to offset the dreadful erosion of purchasing power caused by inflation.

Here is a table that shows how increasing inflation cuts into purchasing power.

Rate of Inflation	Time to Cut Your Money on Half
2	36
3	24
4	18
5	14
6	12
7	11

Individual investors are also differentiated from institutional investors by the fact that each of us has responsibilities we take very personally: educating our children, providing security for ourselves and for our loved ones, helping pay the costs of health care for

Individual Investors (cont.)

elderly relatives, contributing to the schools and other institutions from which we have benefited or hope our communities will benefit, and so forth. In addition, as individual investors, each of us will want to provide a strong self-defense against catastrophe—including the risk of living longer and needing more health care than anticipated. Finally, most individuals wish to leave something to their children or grandchildren to help enhance their lives. (Our children having better lives is, for most of us, the main meaning of "progress.") Not only are these responsibilities taken very personally, in many cases, the amounts that will be involved are unknown—and may become almost "unlimited." The potential cost of health care in old age is one uncomfortable example.

Most individual investors have a long-term implicit "balance sheet" of assets and responsibilities. However, most investors have not examined their own total financial picture or put it all down on paper. And most have not been explicit about the direct and indirect stake holders—the "we"—in their balance sheet responsibilities.

In planning the "responsibility" side of your investor's balance sheet, you will want to decide who is included in your "we"—and for what purpose. How much responsibility do you plan to take for your children's education? College is costly. Graduate school is increasingly accepted as the norm, and it's costly too. After providing for education, is help with a child's first home important to you? Help in starting a business or a dental practice? How about your parents, brothers, and sisters, or your in-laws? Under what circumstances would they need your financial help? How much might be involved and when? Be sure you know what your total commitments would add up to and when the money would be needed.

Retirement and the accelerating costs of old age should be provided for. Friends in their 80s advise that old age and its costs and threats are profoundly different from what most people mean by "retirement"—and require separate consideration. In retirement, you have less income. In old age, the costs of health care increase rapidly and can be "exploding." A daunting rule of thumb is worth considering: 95 percent of the lifetime cost of medical care is incurred in the last 5 percent of a typical individual's life—and 50 percent in the last 1 percent.

The timing with which an investor's accepted responsibilities are met can be crucial. While gifts during the investor's life to those in the "we" group can make wonderful sense as part of an overall estate plan (the avoidance of estate taxes at high rates and the pleasure of being helpful while still alive and the enjoyment of seeing the consequences can both be splendid), the investor will be wise to reread *King Lear* before making any commitments or gifts to family, friends, or charities[1] that are large in proportion to the investor's wealth.

But what about elderly investors ...? Shouldn't they, the conventional wisdom would have it, invest primarily in bonds to "preserve capital"? As usual, the conventional wisdom may have got it wrong.

Naturally, the investor should have an estate plan and review it regularly, ideally annually—partly to assure it fulfills the investor's chosen responsibilities, partly to assure it will not do unintended harm. While Mae West was speaking correctly for herself when she announced that "too much of a good thing is wonderful!" a large inheritance is not necessarily wonderful for your children.

Saving naturally and necessarily comes before investing because we can only invest what we have previously saved. Buying straw hats in the fall or Christmas cards in January and saving through the many other daily forms of conscientious underspending can make a splendid difference over the years—particularly when matched with a sensible long-term approach to investing.

The first purpose of saving is to accumulate a defensive reserve that can be turned to for help—like a fire extinguisher—if and when trouble comes. And like a fire extinguisher, such a reserve should be clearly used boldly and fully whenever needed. If you use your defensive reserve cautiously or only partially, you will simply require a proportionately larger reserve—and it's costly (in opportunity costs) to have a larger reserve than is really needed. So the reserve is on hand to be *spent*, not to be held back in time of need. After providing for protection against serious contingencies, further savings can be invested for the long term.

With enough time, the consequences of the accumulating power of compound interest can be astounding. Consider: $1 invested in common stocks—and held there—from 1926 to 1990 would have compounded (assuming no taxes, commissions, or management fees) into $500! This is nearly incredible—but not wrong. It may seem more plausible after making certain "adjustments." For example, if the annual cost of brokerage commissions and management fees were 1/2 percent, the final amount would be $350. And if a 28 percent tax were assumed on all income and capital gains, the end amount would be $110. And if adjusted further for inflation (compared with a normally "safe" investment in Treasury bills, which would barely return the original $1 in purchasing power), the end sum from investments in stocks would be $16—sixteen *times* your money—in real purchasing power!

[1] The then-president of Consolidated Cigar was thrilled to see his company transformed into a "growth" stock in the early 1960s by the Surgeon General's first reports on smoking and health. Accepting his new-found position as a man of wealth, he pledged $10 million to his alma mater—only to find that as the share price declined back to "normal," he could not fulfill his pledge. But the university had spent the money on a building and sued for payment. A lot of unnecessary emotional harm was done.

Individual Investors (cont.)

One of the core concepts and basic themes of this book is that funds available for long-term investment will do best for the investor if invested in stocks—and *kept* in stocks through time. But what about elderly investors whose life expectancy is less than the 10 years that approximates "long term"? Shouldn't they, the conventional wisdom would have it, invest primarily in bonds to "preserve capital"? As usual, the conventional wisdom may have got it wrong.

While retired investors may decide for "peace of mind" that they prefer to invest in relatively stable securities with relatively high income, they should know they are letting their emotional interests dominate their economic interests. They may well be right to do so, but not necessarily. For individuals, as for institutions, investing in bonds to generate more current income dooms the individual to Ellis's law: $1 of income costs $1.50 in the total returns that would have been earned through long-term equity investments. This may be a heavy price to pay for the apparent conservatism of shifting assets into higher-yielding "defensive" investments such as bonds and income stocks—and becoming a stationary target for inflation to do its eroding harm.

Moreover, while the elderly investor may not expect to live for long, the investments—after being inherited by beneficiaries—may have a very long-term mission. There may be no reason to limit the time horizon of the investments to the owner's lifetime when the owner's true objectives—providing for children, spouse, or alma mater— have a much longer-term horizon.[2]

To be a truly successful lifetime investor, the first and central challenge is to "know thyself"—understand your personal financial goals and what would truly be successful for you. As 'Adam Smith' (Jerry Goodman) so wisely counseled: "If you don't know who you are, the stock market is an expensive place to find out!" (So are real estate, commodities, and options.)

Investors will be wise to take time to learn as much as possible about themselves—and how they will feel and behave as investors. For example, here's a simple test—with a friendly twist—that, for most investors, provides some useful insight.

Question: If you had your own choice, which would you prefer?

Choice A: Stocks go up by quite a lot—and stay up for many years.

Choice B: Stocks go *down* by quite a lot—and stay *down* for many years.

Without looking ahead, which did you choose? If you selected Choice A, you would be joining 90 percent of the professional investors who've taken this little test. Comforting to know most pros are with you? Shouldn't be. Here's why. Unless you are a *seller* of stocks, you would have chosen *against* your own interests if you chose A.

First, remember that when you buy a common stock, what you really buy is the right to receive the dividends paid on that share of stock.[3] Just as we buy cows for their milk and hens for their eggs, we buy stocks for their current and future dividends. If you ran a dairy, wouldn't you prefer to have cow prices low when you were buying, so you could get more gallons of milk for your investment in cows?

The lower the price of the shares when you buy, the more shares you will get for every $1,000 you invest and the greater the amount of dollars you would receive in dividends on your investment. So if you are a saver and a *buyer* of shares—as many investors are and will continue to be for many years—your real long-term interest is, curiously, to have stock prices go *down* quite a lot and stay there, so you can accumulate more shares at lower prices and thereby receive more dividends with the savings you invest.

So the right long-term choice is the counter-intuitive Choice B— it's best for you to have stock prices go way down and stay down— so you can acquire more rights to receive more dividends in future years with the money you invest now.

This has been much more than a clever explanation of a question with a twist. It can be the key insight that will enable you to enjoy greater success as an investor *and* greater peace of mind during your investing career.

Most investors, being all too human, much prefer stock markets that *have been* rising and feel most enthusiastic about buying more shares when stock prices are already high—causing the future rate of return from their dividends to be axiomatically low. (The dollars of dividends to be received will be the same per share of stock whether you pay a lot or a little for the shares.) Similarly, most investors feel quite negatively about stocks *after* share prices have gone down and are most tempted to sell out at the wrong time—when prices are already low—and the future dividend yield on the price paid would be high.

If you can use the insight illuminated by our simple quiz and incorporate the *rational* answer into your own investment thinking and *behavior*, you will appreciate that your human emotions often move contrary to your rational economic interests. You will school yourself to go against the crowd *and* your own feelings—and will strive to avoid the temptation to jump on the bandwagon to buy when stocks are high or to jump off when stocks are low.

[2] Besides, one of the secrets to a long and happy life is to "keep climbing" and stay, in Disraeli's felicitous phrase, "in league with the future." It keeps us young to invest in stocks.

[3] Yes, you also get the right to vote on the selection of auditors, the election of directors, and so forth. And you get the right to be bought out at a higher price if and when there's a future takeover. But realistically, very few votes of shareholders go against management's recommendation, and unanticipated buyouts occur at very, very few companies—so these shareholder rights are usually not very important compared with dividends. Yes, you also get the right to sell the stock to another investor, hopefully, of course, at a higher price. But what determines the price that next investor will gladly pay? The present value of expected future dividends.

Performance Notes:

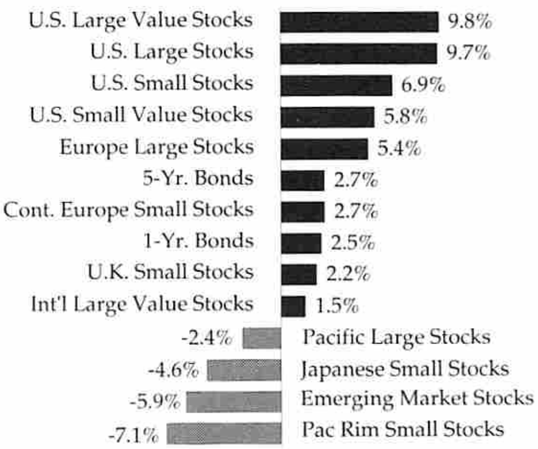
Asset Class Returns: 1-Yr. Bonds = DFA One-Year Fixed Income Portfolio; 5-Yr. Bonds = DFA Five-Year Government Portfolio; U.S. Large Stocks = Vanguard 500 Index Fund; U.S. Large Value Stocks = DFA Large Cap Value Portfolio; U.S. Small Stocks = DFA 9-10 Small Company Portfolio; U.S. Small Value Stocks = DFA Small Cap Value Portfolio; Pacific Large Stocks = Vanguard Pacific Index Fund; Europe Large Stocks = Vanguard Europe Index Fund; International Large Value Stocks = DFA Large Cap International Portfolio; Japanese Small Stocks = DFA Japanese Small Company Portfolio; Cont. Europe Small Stocks = DFA Continental Small Company Portfolio; U. K. Small Stocks = DFA United Kingdom Small Company Portfolio; Pac Rim Small Stocks = DFA Pacific Rim Small Company Portfolio; Emerging Market Stocks = DFA Emerging Markets Portfolio.

TAM Portfolio Returns Net of Fees: These are the actual returns of TAM portfolios in each risk category net of actual TAM management fees, custodial fees, and fund expenses. The "Growth" returns were calculated using a model portfolio from 12/31/92 to 4/30/93 and actual accounts thereafter. The "Aggressive" returns were calculated using a model portfolio from 12/31/92 to 3/31/93 and actual accounts thereafter. In both cases, the maximum TAM fee was deducted, representative custodial costs were deducted, and all mutual fund returns are net of expenses. The "Moderate" returns were calculated using actual account performance since inception. Past performance is no guarantee of future returns. This is especially the case with model portfolios which are not subject to specific economic or market factors.

Benchmarks: Balanced Fund & Capital Appreciation Fund Indexes: Lipper Analytical's indexes representing the 30 largest balanced mutual funds and 30 largest capital appreciation mutual funds in the country.

Asset Class Returns

Year-to-Date Through 3/31/95



TAM Portfolio Returns

Through 3/31/95

Risk (% stocks)		YTD 1995	1994	1993	Since Inception 12/92-3/95
Aggressive	(95%)	+1.9%	+5.3%	+21.1%	+29.9%
Growth	(85%)	+2.8%	+2.6%	+16.6%	+22.8%
Moderate	(65%)	+3.1%	+2.1%	+14.0%	+20.0%
Benchmarks					
Balanced Fund Index		+6.0%	-2.2%	+11.7%	+15.8%
Capital Apprec. Index		+7.0%	-2.5%	+14.8%	+19.8%
S&P 500 Stock Index		+9.8%	+1.3%	+10.1%	+22.4%
Salomon Broad Bond Index		+5.1%	-2.8%	+9.9%	+12.2%
Morgan Stanley EAFE Index		+1.9%	+8.0%	+32.9%	+46.3%

*See "Performance Notes" on back page for explanations.

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