TAM Asset Management, Inc. REVIEW

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

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If all the markets rose at the same time, they would all fall at the same time.

The only asset class outperforming the S&P 500 so far this year, is its close relative—U.S. large value stocks. The S&P 500 was up over 17% through May and U.S. large value stocks are up almost 20%.

According to a Wall Street Journal article, the S&P 500 is beating 90% of stock funds, not the normal 70%, this year.

Foreign markets overall are producing much more modest returns. The Morgan Stanley EAFE Index is up 4.6% year-to-date. As the chart on the back shows, the Pacific markets are experiencing a very difficult year so far.

Most of the return in the bond market is coming from the long maturities—the opposite of last year. One-year bonds are up just over 4% through May, while five-year bonds have gained about 5.5%.

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"Trust Me"

By Jeff Troutner

Lincoln Savings & Loan and Charles Keating. Orange County and Robert Citron. Barings Bank and Nicholas Leeson. And now, the New Era Foundation and John Bennett. Billions of dollars lost to greed—greed on the part of these individuals *and* the investors, public officials, and directors who placed trust in an individual and abnormally-high returns instead of prudence and basic common sense.

It is a sad fact that most investors spend less time trying to understand investment alternatives and monitoring outcomes than they do planning their summer vacation. And most investment professionals, responding to the "sound bite" attention span of most investors, figure on spending maybe one hour convincing a potential client of the merits of their program. Naturally, past performance and the "unique" talents of the advisor become the focus of these one-hour presentations. The implication is "Trust me. I've done well in the past and you can expect just as much in the future."

This is where trust *given* instead of trust *earned* can lead to investment disaster. In all of the cases above, a herd mentality developed. Extraordinary returns were produced (or simply promised) over a short period of time, word spread, and new money blindly followed based on trusted referrals or "professional" recommendations.

Sometimes these financial disasters are so large and "institutional" that the average person cannot relate to them. But they affect all of us—taxpayers, stockholders, senior citizens, and the beneficiaries of charities.

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Excerpts from John R. Emshwiller's article, "Plucking Pigeons: Why the Wealthy Are Often Targets of Fraudulent Deals," in the May 16, 1995 *Wall Street Journal*

There is often an "arrogance that comes with having money or having made money," says Irving Einhorn, a former top official with the Securities and Exchange Commission and now an attorney in Los Angeles. Mr. Einhorn says he has repeatedly seen a certain mind-set among the successful and those who manage their money. "Their feeling is that 'because I make a lot of money, I must be smart.'"

The social and business networking that the wealthy often engage in can make them more susceptible to being defrauded, experts say. "If a business opportunity comes through someone they trust, there is a presumption that due diligence has been done when it really hasn't," says James B. Hunt, national practice leader for Price Waterhouse's investigative services group, which specializes in cases involving white-collar crime.

The wealthy also are susceptible to a roller-coaster psychology: They may be initially skeptical, but once the gang climbs aboard, they don't want to be left behind. "It happens that a friend makes some money, and based on that small success, 30 other friends go in big-time," says Einhorn, the former SEC official. "They just throw caution to the wind."

"Trust Me" (cont.)

On just as large a scale, trust is given daily to brokers, financial planners, banks, and insurance agents based on referrals or even in the name of "tradition." My first years in the investment business were spent trying to convince corporate retirement plan sponsors that the term "trust department" was an oxymoron. "Trust" translated into low returns, feeble management, and lousy service. Few were willing to consider the evidence, especially from a twenty-something broker challenging the integrity of a fifty-something banker. It took the bull market of the mid-80's and the crash of 1987 before intellectual laziness gave way to economics and prudence.

Today, of course, bank trust departments control a much smaller piece of the retirement plan market (they have redirected their attention to selling stock and bond funds to little old ladies with maturing CDs who still fall for that "trust me" line). Our challenge now has shifted to convincing decision-makers of the risk-return-cost benefits of indexing over active strategies. Different challenge, same closed doors (and minds). Why?

Investors follow the crowd. In the 60's and 70's "prudent" meant putting your money in a bank trust department. Today it's considered prudent to hire an active manager with a billion dollars under management *(they must be good)*, with a large research staff *(they must be smart)*, and a recent history of beat-the-market performance *(they must be talented)*.

What investors fail to realize is that *investment advisors* are the worst crowd-followers of all. Roger Lowenstein, in his Wall Street Journal article *Why Gurus Weren't Wise to New Era's Wiles* (see box), writes: "This is the dirty little secret of experts. Outsiders view them with awe, particularly when their field is an abstruse one such as investing. But in truth, experts are courageous or impressionable, independent or conventional, in the same degrees as other two-legged beasts. And all of an expert's brains and training will not count for much if, at the crucial moment, he relies on somebody else's brains instead of his own."

Lowenstein refers to a study by Robert J. Shiller, a contemporary Yale scholar, who polled 1,000 investors—both professional and individuals—after the '87 market crash. Shiller found that the pros had been far more irrational of the two: "While individual investors mostly remained calm, the pros, hired for their supposed expertise, admitted to a 'contagion of fear', with attendant symptoms such as sweaty palms, rapid pulse rates and tightening of the chest. They checked their screens—checked to see what others were doing—an average of 35 times a day."

Lowenstein concludes that this is why 70% of money managers are estimated to be crowd-following momentum players. Quoting Mr. Shiller, he states: "All our lives, we work under the assumption that what other people do must be right...because they must know something."

If passive investing has done anything it has focused investor attention on the realities of the financial markets and the uncertainties of active strategies and fund/manager selection services. It has shown that trust in a manager's judgement over an understanding of market principals and one's personal objectives will most often lead to disappointing results.

Passive investing has shifted power from the pros to the investor himself. And it has redefined the role of advisors like TAM, which is to extract the most dangerous elements of investing—emotion and judgment—from the equation and keep clients well-informed at all times. This combination of a well-informed and rational investor with a non-crowd following, disciplined advisor finally realizes the full potential of a free and efficient securities market.

Trust can betray investors. Far too often the false security of a referral or the comfort of the crowd is substituted for thoughtful review of the facts. Am I suggesting that trust has no place in an investment relationship? Of course not. But you should trust *first* in your own common sense, then in the facts, and finally in the person or organization you believe can deliver on its promises.

Trust should be built on a solid foundation and earned, not simply granted.

The Foundation for New Era Philanthropy

The Foundation for New Era Philanthropy, based in Philadelphia, filed for bankruptcy-court protection in May of this year. Over the course of the past several years, John G. Bennett Jr., the foundation's chairman, helped raise over $500 million in charitable donations from many of the wealthiest people in America. Sadly, many small foundations and endowments, mostly religious, also donated millions.

The lure? A promise of a 100% return in six months. Bennett told potential donors that a group of anonymous philanthropists would match contributions one for one. The victims intended to use this setup to double their own contributions to worthy causes.

The New Era foundation was basically a Ponzi, or pyramid scheme. Victims are promised huge returns and paid, for a while, from the principal and contributions of others. All seems well until the scam artist disappears with most of the money.

The Truth, —, and Nothing But the Truth?

By Jeff Troutner

How desperate have active managers become in their efforts to counter the benefits of indexing? A critical look at David Dreman's article in the April 24, 1995 issue of *Forbes* might provide the answer.

Dreman's objective is to convince investors that large U.S. stocks outperform small U.S. stocks over time. To do this, he starts out by suggesting that the performance of initial public offerings (IPOs) is indicative of small company stock performance overall. This is an absurd comparison. IPOs have a life of their own. The hype and hysteria associated with most of these offerings create short-term extremes of gains and losses that are nowhere near the average for a large universe of small company stocks

Dreman knows this, of course, but he got the reader's attention. So he moves on to a much more relevant comparison of the S&P 500 index (U.S. large stocks) to the Russell 2000 and DFA 9-10 small company indexes. But here Dreman betrays the long-term investor and the tenants of basic research by focusing on one time period—January 1, 1982 to March 31, 1995. Why this period? For one reason, Dreman claims that the Russell 2000 and DFA 9-10 indexes "only go back to 1982." For another, this is a period dominated by U.S. large company stocks. More importantly, and Dreman doesn't mention this, he is a U.S. large stock specialist.

Dreman states: "The institutional belief that small-cap stocks outperform large caps over time has attracted billions of dollars to small-cap stocks. The trouble is, no long-term index exists showing the superior performance of this group. The Russell 2000 is the most widely used small-cap index, and it only goes back to 1982. In that time it returned 12.2% annually, versus 15.2% for the S&P 500 to March." He goes on to say, "Ironically, one of the strongest proofs that small caps don't deliver what their adherents claim comes from Dimensional Fund Advisors, partially owned by the original small-cap theorists themselves. The DFA U.S. 9-10 Fund is an index devised by them to replicate small-cap performance. Since its inception in 1982 the DFA index has been outperformed by the S&P 500 by 38% to the end of February 1995."

The fact is, the Russell Index goes back to 1979 and the data for DFA 9-10 Index starts in 1926. Let's look at a more realistic period somewhere between the extremes of 1926 and Dreman's 1982 period—say, 1975 on—and see whether Dreman's argument holds up.

What we find is that for the total period, 1/75 to 3/95, small company stocks outperform large company stocks by over 5% <u>per year</u> (Table 1). But as TAM clients know, there were periods when one class outperformed the other—the reason why we diversify among both classes. If we divide the total period in two, from 1975 to 1983 and from 1984 to 1995, we see that small company stocks outperformed by 18.5% per year (!) for the first period and under-performed by 4.4% over the last period. If we divide this last period (1984-1995) in two parts, from 1984-1990 and 1991-1995, we see a similar relationship in reverse.

So what does all of this tell you? First, don't believe everything your read in the mass media. Second, statistics can lie. Third, it pays to diversify. And fourth, certain active managers have an ax to grind and will distort statistics to make their case.

Is it realistic to expect the average investor to read a Dreman-like article and recognize its flaws? Probably not. And let's face it, Dreman wasn't suggesting that commodity futures, options, or limited partnerships are the way to go. Owning only U.S. large stocks isn't bad, it's just not the best diversification for long-term investors.

But someone touting a much riskier strategy using Dreman's "logic" could cause serious harm to a lot of investors. The way to avoid this is to use common sense <u>first</u> and take the time to dig deeper into the underlying principals and data. In this case, most investors believe correctly that small company stocks are more risky than large company stocks. This higher risk must translate into higher returns eventually, otherwise only dumb investors would keep buying small company stocks.

There's no denying that 13 years (since 1982) is a long time for small stocks to underperform. But the 9-10 index produced a 13.1% annual return over the period and the odds favor a reverse in the trend. Now is not the time to give up on small stocks.

By the way, how has Dreman's Contrarian Fund performed since it started in mid-1988? It's up 9.7% versus 10.9% for the 9-10 Fund and 12.9% for the S&P 500. It seems to me that the quintessential contrarian is missing a golden opportunity in small company stocks.

Table 1

	Annual return for period				
	1/75-3/95	1/75-12/83	1/84-3/95	1/84-12/90	1/91-3/95
DFA 9-10 Small Cap	20.0%	34.2%	9.8%	2.6%	22.6%
S&P 500 Large Cap	14.9%	15.7%	14.2%	14.7%	13.6%
Small Cap Advantage	5.1%	18.5%	-4.4%	-12.1%	9.0%

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 5/31/95

Asset Class	Return
U.S. Large Value Stocks	19.6%
U.S. Large Stocks	17.4%
U.S. Small Stocks	14.0%
Europe Large Stocks	12.6%
U.S. Small Value Stocks	12.6%
U.K. Small Stocks	8.4%
Cont. Europe Small Stocks	6.4%
Emerging Market Stocks	5.6%
5-Yr. Bonds	5.4%
1-Yr. Bonds	4.3%
Int'l Large Value Stocks	3.9%
Pacific Large Stocks	-1.4%
Pac Rim Small Stocks	-5.4%
Japanese Small Stocks	-11.5%

TAM Portfolio Returns

Through 5/31/95

Risk (% stocks)	YTD 1995	1994	1993	Since Inception 12/92-5/95
Aggressive (95%)	+6.2%	+5.3%	+21.1%	+35.4%
Growth (85%)	+7.1%	+2.6%	+16.6%	+28.0%
Moderate (65%)	+7.0%	+2.1%	+14.0%	+24.5%
Benchmarks				
Balanced Fund Index	+11.4%	-2.2%	+11.7%	+21.7%
Capital Apprec. Index	+11.6%	-2.5%	+14.8%	+25.0%
S&P 500 Stock Index	+17.3%	+1.3%	+10.1%	+30.8%
Salomon Broad Bond Index	+10.7%	-2.8%	+9.9%	+18.2%
Morgan Stanley EAFE Index	+4.6%	+8.0%	+32.9%	+50.1%

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