Index Fund Strategies

ASSETCLASS

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

Index Returns

	1997	1998	1999	Last 7 yrs.	11/28 2000
Bonds					
Short-term	6.0	5.7	4.6	5.3	**+ 6.0**
Intermediate	9.2	10.5	-3.6	6.0	**+ 12.5**
Long-term	14.3	12.0	-7.9	7.4	**+ 10.1**
Global	8.3	8.4	3.7	7.6	**+ 5.6**
U.S. stocks					
Large Market	33.2	28.7	20.8	21.3	**- 8.3**
Large Value	28.1	12.0	4.8	16.3	**+ 1.3**
Small Market	22.8	-7.3	29.8	16.5	**- 1.7**
Small Value	30.7	-7.3	13.1	15.6	**+ 4.5**
Real estate	19.3	-15.4	-2.0	6.7	**+ 19.0**
Int'l stocks					
Large Market	5.5	18.2	28.5	14.3	**- 16.3**
Large Value	-3.1	14.9	16.3	13.9	**- 5.3**
Small Market	-23.7	8.2	21.9	6.6	**- 7.2**
Small Value	-22.7	5.3	19.0	5.8	**- 6.1**
Emerg. Mkts.	-18.9	-9.4	71.7	13.0	**- 31.0**

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Bond Index Long-term
Global bonds	DFA Global Fixed Income fund
U.S. Large Market	Vanguard Index 500 fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Market	DFA US 9-10 fund
U.S. Small Value	DFA US 6-10 Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Int'l Large Cap fund
Int'l Large Value	DFA Int'l Large Cap Value fund
Int'l Small Market	DFA Int'l Small Company fund
Int'l Small Value	DFA Int'l Small Cap Value fund
Emerging Markets	DFA Emerging Markets fund

"Last 6 yrs." returns 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).

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy.

Past performance does not guarantee future returns.

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Markets Update

Wednesday, November 29, 2000

I must concede that the markets have remained volatile. I'll also concede that technology stocks have been hardest hit recently, but that stocks across the board have been affected by the uncertainty of the presidential election. I must concede as well that prospects of a slowing economy, lower than expected Internet sales, and a belated reaction to sky high prices for large growth companies have put a damper on the stock market for now. Those investors accumulating assets for their retirement should welcome lower prices as they allow for accumulation of more shares, but I'll concede—finally—that most investors *feel better* about *rising* stock prices.

Now it's time for someone else to concede so this country can move on to greater things.

The Risk of "Buying Performance"

(Or, Why Not Buy When It's Bad?)

Jeff Troutner, TAM Asset Management

One of the really fun things an investment advisor employing a multi-asset class strategy has to look forward to is the occasional reminder from a client that someone else is "doing it better" (thank God my wife isn't a client). In most cases, the advisor doing it better has done so with a much more concentrated strategy that just happens to be in sync with current market trends. But the degree of concentration or even its relevance can get lost for obvious reasons. There is also the tendency to believe that the hot manager was in the right place at the right time by design—a belief that is usually easily dispelled with a little research.

I engaged in one of these moments with a client recently. He was considering what I would call a very traditional active money manager who has generated an impressive track record over the past five years. The performance was so good in fact that little consideration had been given to the manager's investment strategy or the composition of their portfolios—other than noting that they were "blue-chip." There is a tendency under these circumstances to "buy performance" rather than buy "a strategy." Hiring a separate account active manager is also different than buying a mutual fund because investors tend to put all of their stock money with these kinds of money managers, something they seldom do with a mutual fund.

Therefore, in order to put this decision in a more familiar perspective, I looked for a mutual fund that has been managed very similar to this advisor's accounts for the past ten years or so. I didn't have to look far since a money manager in Marin County runs such a fund. I won't say who the manager is but the fund name includes "Blue-Chip"—which sums

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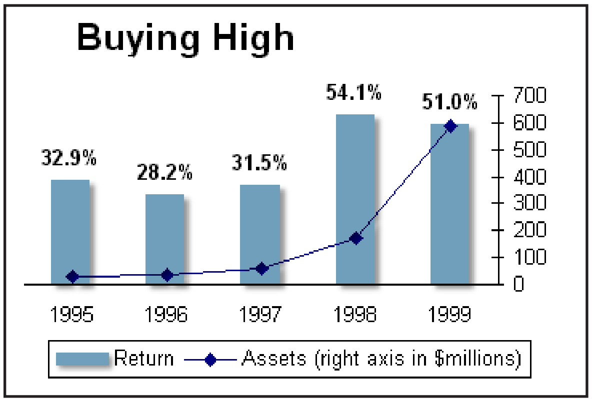
up its investment strategy. To say this manager has been hot the past five years is a gross understatement. For the five years ended December 31, 1999, the annual compound return for the fund was over 39%! Who wouldn't be attracted to a 39% annual return, especially when a much more balanced and diversified portfolio of short-term bonds, small cap, value, and foreign stocks produced about a third of that return over the same period?

Well, even the most optimistic and glassy eyed investor wouldn't predict 39% per year from this fund over the next five years, but even half that return would be great. Is this realistic? Was this period an anomaly? How do other investors react to this kind of performance? *Upon further review, would you be prepared to put all of your money in this one fund?* I believe any investor can pick up a Morningstar Mutual Fund report and answer these questions. Here's what I found.

Buy High, Sell Low?

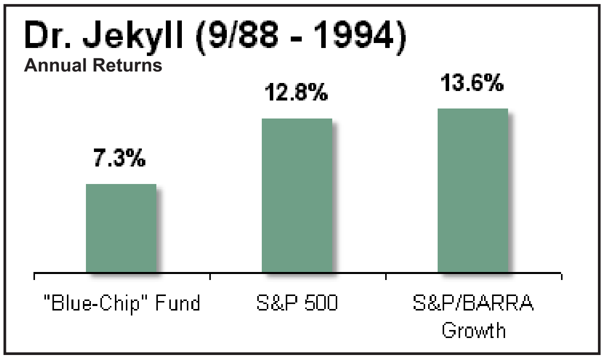
It's a sad fact that despite our best intentions, once we engage in market timing or advisor or fund swapping we tend to buy high and sell low. A look at the cash inflows and outflows of this fund illustrates this point. On December 31, 1994—prior to its big move— this fund had total assets of $24 million. At its peak, in 1992, it had about $44 million in assets (the fund started in August, 1988). Based on this low asset base and the fund's past performance (which we will get to in a moment) it's clear that investors were not prepared at the end of 1994 to predict great things for this fund in the future.

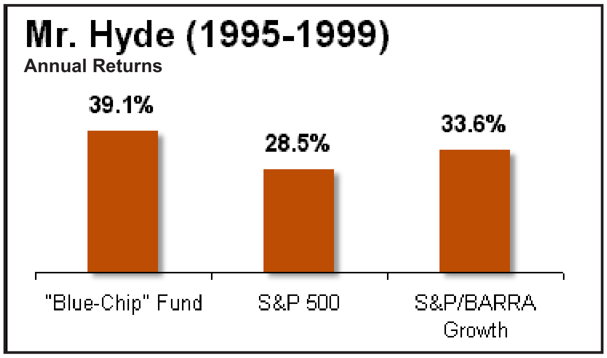


After a 33% return in 1995 and a 28% return the following year, the fund still had assets of only $35 million. Even after another 30%+ year in 1997 assets had only grown to $60 million. So much for buying low. It wasn't until the following year after the fund was up an incredible 54% did assets really start flowing in and even then its assets grew by only $111 million—$33 million of it from capital appreciation. Needless to say, a fund with a 54% return (94th out of over 9,000 funds) attracted some attention and assets shot up to almost $600 million by the end of last year. Those investors who were in for the full year were well rewarded as the fund was up over 50% again in 1999. As these numbers show however, most investors in the fund did not benefit from a full five-year string of outstanding performance. Most got in near the top.

Jekyll and Hyde Performance

From its inception in 1988 through the end of 1994 the fund had an annual return of 7.3% versus 12.8% for the S&P 500 Index and 13.6% for the S&P/BARRA Growth Index This is not the kind of performance that would cause someone to give up on their investment strategy to buy the fund—especially those investors with more balanced and diversified strategies.





The last five years ended 1999 were a different story. The fund gained 39% annually versus 28.5% for the S&P 500 and about 34% for the S&P/BARRA Growth Index. However, if we factor in the last 11 months, the Growth Index has actually outperformed the "Blue-Chip" fund since the end of 1994 with the S&P 500 fund only slightly behind. Since the "Blue-Chip" fund's inception, both of the indexes have outperformed it by a pretty wide margin.

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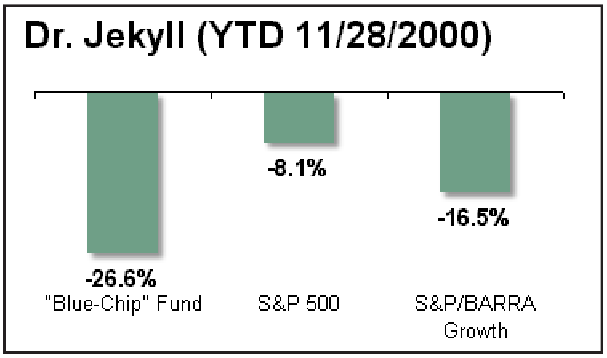
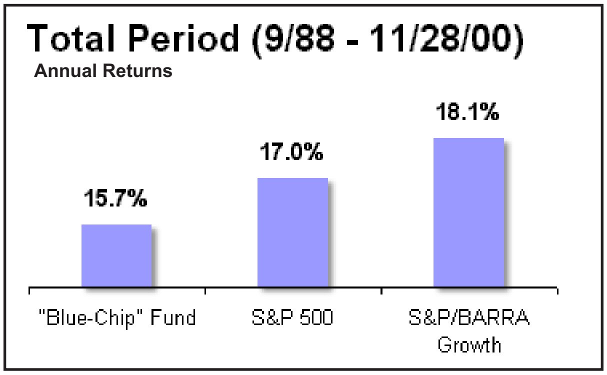
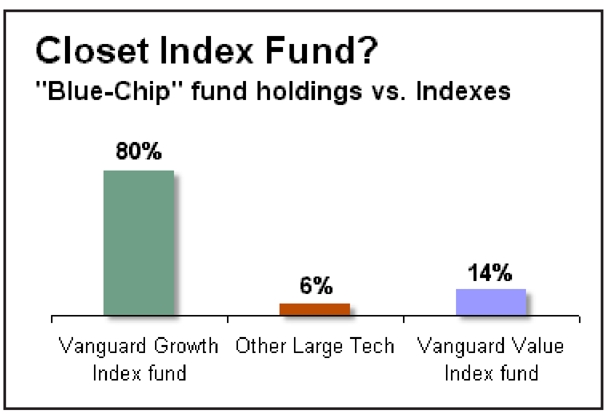




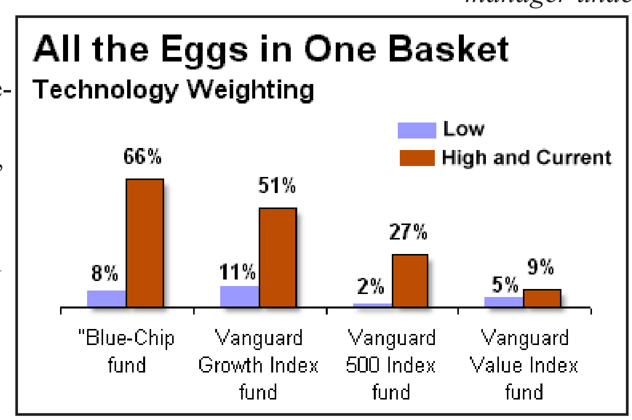
So what would *today's* investor be buying if they invested in the fund? Dr. Jekyll (pre-1995 and post-1999) or Mr. Hyde (1995-1999)?

All the Eggs in One Basket

A look at the current holdings for the "Blue-Chip" fund shows that about 80% of the names are also in the Vanguard Growth Index fund and another 14% are in the Vanguard Value index. Since the five remaining stocks are all tech related, we'll lump them in the Growth category bringing that total to 86%.



From an industry perspective, the "Blue-Chip" fund has gone from a low of 8% technology to a high of over 66% today, much higher than the indexes. (Note: Morningstar states that these ranges are for the past three years—doubtful given other Morningstar data).



Conclusion

Over the past twelve years, the "Blue-Chip" fund has had a period when it significantly underperformed the indexes and a period when it significantly outperformed. Unfortunately, few investors participated fully in its "glory years." In fact it's very probable that since most investors in the fund came in last year, the average "Blue-Chip" fund investor has actually lost money. The fund is also highly concentrated in one style (U.S. large growth companies) and one industry (technology), both of which require current investment at historically high, albeit falling, prices.

Since this fund is so similar in strategy and portfolio composition to the active manager he is considering, the client should ask himself this question: Am I comfortable putting 86% of my money in the Vanguard Growth Index fund and 14% in the Vanguard Value Index fund, ignoring more value stocks, smaller companies, foreign stocks, and global bonds *and* maintaining this balance for the long-term? If the answer is yes, he should do just that and *not* hire the money manager. He should also ask himself how different he thinks he is from the investors in the "Blue-Chip" fund who did not buy the fund when it's style was out of favor and performance was low, but jumped in near what may very well be the top for this cycle. Will he stick around when Dr. Jekyll reappears or will he "buy performance" once again and shift to the next "hot" hand? You should ask yourself the same question.

A final note: Over the past five years, the "Blue-Chip" fund outperformed the active money manager under consideration 39.1% to 30.2% annually. But from 1989-1999, the performance of the two options has been almost identical—and still lower than the S&P/BARRA Growth index .