Index Fund Strategies

ASSET CLASS®

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

Index Returns

	1998	1999	2000	Last 8 yrs.	6/25 2001
Bonds					
Short-term	5.7	4.6	6.7	5.5	**2.8**
S-T Global	8.4	3.7	6.7	7.5	**2.8**
Intermediate	10.5	-3.6	13.5	6.9	**4.3**
Long-term	12.0	-7.9	16.6	8.5	**4.5**
U.S. stocks					
Large Market	28.7	20.8	-9.1	17.0	**- 6.8**
Large Value	12.0	4.8	10.2	15.5	**8.3**
Small Micro	-7.3	29.8	-3.6	13.8	**16.3**
Small Market	-5.4	25.4	2.5	12.6	**7.5**
Small Value	-7.3	13.1	9.0	14.8	**17.5**
Real estate	-15.4	-2.0	28.4	9.2	**8.4**
Int'l stocks					
Large Market	18.2	28.5	-14.0	10.3	**- 13.9**
Large Value	14.9	16.3	-0.2	12.1	**- 6.6**
Small Market	8.2	21.9	-5.4	4.9	**1.0**
Small Value	5.3	19.0	-3.1	4.7	**5.5**
Emerg. Mkts.	-9.4	71.7	-29.2	6.6	**- 7.4**

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
S-T Global bonds	DFA Five-Year Global Fixed
U.S. Large Market	Vanguard Index 500 fund
U.S. Large Value	DFA Large Cap Value fund
U.S. Small Micro	DFA US 9-10 fund
U.S. Small Market	DFA US 6-10 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 8 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).

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Markets Update

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Stocks *Are* for the Long Run

Jeff Troutner, TAM Asset Management

Isn't it funny how the things you want to be predictable about investments (like stock prices) aren't and the things that end up hurting you the most are? One of the most predictable aspects of the investment business is the plethora of positive "new era" articles that are written during extreme stock market rises and pessimistic "doom and gloom" articles written during market declines. In both cases, writers tend to use very selective statistical "evidence" to enhance their arguments. The predictable downside is that investors by the droves fall for these apparently logical arguments and their natural tendency to "market time" kicks in. The results are almost always disastrous financially *and* psychologically for the investor.

Just as Harry Dent (*The Great Boom Ahead*, 1994) and James Glassman and Kevin Hassett (*Dow 36,000*, 1999) gained instant fame with their wild projections of stock market boom, Professor Robert Shiller of Yale University is now gaining wide recognition for his projections of impending stock market doom (*Irrational Exuberance*, 2000). The natural progression is for the investment media and investment advisors to use the information in these books and the authors' conclusions (Buy! Sell!) to write provocative stories that either excite or scare investors.

Investors would be well served to consider the motivations of the authors of these books and articles. First, everyone knows that "shock" sells, whether in the form of radio programs, the six o'clock news, movies, or the written word. And the fact is the stock market is driven as much by emotion as it is by rational thought. So, these authors stand to sell millions of books and earn more millions from speaking engagements. Investment advisors and stockbrokers who build stories of extreme returns—positive or negative—attract clients who happen to feel particularly "bullish" or "bearish" at the same time.

Today, we are fed constant reminders of the 1929 stock market peak and subsequent crash as support for Shiller's pessimistic projections. The fact that the crash of 1987 is all but forgotten is evidence of reverse "new era" thinking as anything else. In other words, we are led to believe that a 1929-type scenario has developed—an "old era" argument if you will—and are asked to disregard the fundamental changes that have occurred in the financial markets, economic theory, and government policy since then—changes that can lead to markets recovering quickly as they did post-1987.

These doom and gloom articles (often presented as simply giving investors the "whole story") also refuse to acknowledge that the excesses that developed in the market over the past six years or so were limited almost exclusively to large company growth stocks. That doesn't mean, of course, that a sell-off in technol-

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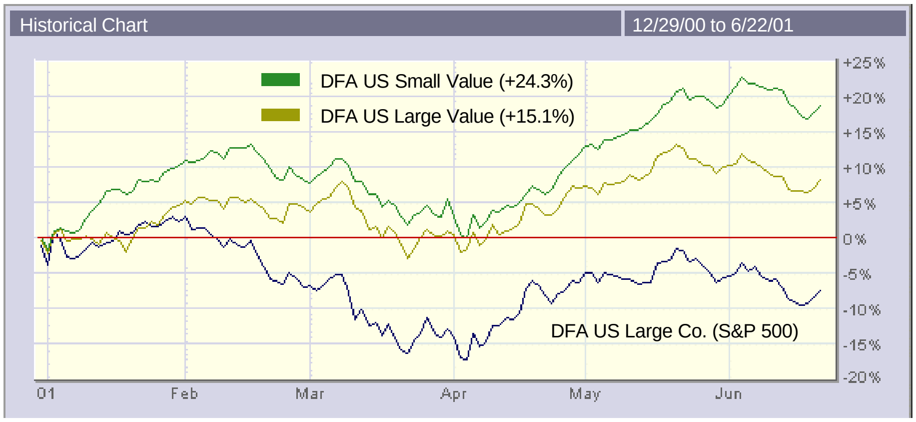
ogy, telecom, biotech, and financial service stocks isn't going to affect all stocks to some degree. But it's not unreasonable to expect that the other "forgotten" segments of the market, such as value stocks and small company stocks, can do relatively well as large growth stocks float back to earth. After all, not everyone turns into a pessimist. Some see opportunity. Others simply stay the course and continue to fund their diversified portfolio as always. This is apparently what is happening so far this year, as shown by the chart below.



( ) = Performance advantage over DFA US Large Co. as of 6-22-01

As TAM clients are well aware of by now, the performance of the S&P 500 is dominated by the very largest growth stocks such as Cisco, Microsoft, Pfizer, GE, and AOL Time Warner and is hardly affected at all by the returns of small company and value stocks. In questioning whether stocks are good long-term investments one article not only limited its discussion to the returns of large company stocks from their peak in 1929, but also embellished its bearish tone by excluding dividends from the equation. This struck me as odd since dividends were a major component of stock returns back then and eliminating them from an analysis of that kind would be like excluding interest payments on bonds.

In truth, the average dividend yield from 1929 to 1960 (the writer's breakeven point for the hypothetical 1929 peak investor) was 5.2%. An investor who bought at the peak in 1929 broke even with dividends by 1936, not 1960 as the writer claimed. The investor was set back again in the 1940's, but by 1960 was up almost 500% after inflation on their original investment. In contrast, the after inflation total return on Treasury Bills for the period was -21% and for 20-year Treasuries, 37%.

Of course, well-informed investors know that stocks can go through lengthy periods of underperformance. That's the nature of risk. If they didn't, returns on average would be lower reflecting the lower uncertainty of returns. But we prepare for these periods by:

Including fixed income securities in the balance

Since the alternative, market timing, has been thoroughly discredited by virtually every reputable investment expert, the best way to protect a portfolio from stock market declines is to hedge the portfolio with short-term bonds. This isn't without risk itself, of course, since inflation is a constant concern.

Diversifying broadly among a number of asset classes

No investor is restricted to purchasing large company growth stocks or an index funds dominated by such stocks. We have the tools to develop a more even balance of large, small, growth, value, U.S., and foreign stocks or whatever balance meets an individual's specific needs.

Continuing to purchase stocks as their prices decline

The mythical poor soul in the doom and gloom articles apparently froze with fear after making that one investment at the peak. (This was probably due to all the doom and gloom articles he was reading). Actually, I'm sure it was difficult, if not impossible, for many Americans to invest during a period like the 30's when businesses were failing at an alarming rate and money was extremely tight. Investing in anything is difficult under those conditions. But a 30's-type depression, while always possible, is highly unlikely in the America of today.

A wise *long-term* investor will ignore "current valuations" and overly optimistic or pessimistic articles and opinions as they strive to reach their investment goals. To do otherwise can lead to the "market timing" trap, which will more often than not eliminate any gains made from choosing a well-structured passive asset class strategy over any active strategy.

Short-term investors, on the other hand, should be acutely aware of asset class valuations and reasonable outlooks for the markets. These investors should question whether *any* exposure to stocks makes sense. But market timing for these investors can be much more destructive since they often do not have time to allow their investments to recover if they make the wrong timing move.