Index Fund Strategies

ASSET CLASS®

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

Index Returns

	1999	2000	2001	Last 9 yrs.	1/25 2002
Bonds					
Short-term	4.6	6.7	5.8	5.5	0.1
S-T Global	3.7	6.7	5.9	7.3	0.0
Intermediate	-3.6	13.5	8.2	7.1	0.2
Long-term	-7.9	16.6	8.2	8.1	1.0
U.S. stocks					
Large Market	20.8	-9.3	-12.1	13.3	- 1.2
Large Value	4.8	10.2	3.8	14.1	0.3
Small Micro	29.8	-3.6	22.8	14.8	0.1
Small Market	25.4	2.5	12.7	12.6	- 1.4
Small Value	13.1	9.0	22.7	15.6	0.2
Real estate	-2.0	28.4	13.2	9.6	- 0.6
Int'l stocks					
Large Market	28.5	-14.0	-20.8	6.3	- 4.3
Large Value	16.3	-0.2	-15.3	8.6	- 1.8
Small Market	21.9	-5.4	-10.5	3.1	- 1.2
Small Value	19.0	-3.1	-4.6	3.6	- 0.8
Emerg. Mkts.	71.7	-29.2	-6.8	5.1	5.2

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
S-T Global bonds	DFA Five-Year Global Fixed
Intermediate bonds	DFA Intermed. Gov't Bond fund
Long-term bonds	Vanguard Long-term Bond Index
U.S. Large Market	DFA US Large Co. (S&P 500)
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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There is still a lot of uncertainty and fear in the financial markets holding stock prices down. The collapse of the Argentina economy, the bankruptcy of both Enron and Kmart, and the continuing terrorist threat have contributed to a general malaise and lack of optimism.

Long-term investors should continue to avoid the temptation of market timing and and enjoy the few pockets of improving performance (value, small company, and emerging markets) until better economic news brings optimism back to the markets. Once this happens (and it will), let's hope that more realistic expectations are the norm and the excesses of the dot-com era are avoided.

Interest rates remain very low with the shortest maturity fixed income securities barely yielding 1% per annum. Even 30-year Treasury Bonds remain below 6%.

Predicting Stock Market Returns, Shifting Allocations, and Other New "New Era" Thinking

The Blob That Wouldn't Die...

Jeff Troutner, TAM Asset Management, Inc.

So, you thought you were done with all that "new era" thinking, right? Unfortunately not. Many investors and far too many professional investment advisors have found a new way to trumpet the latest new era thinking in these times of extreme market behavior.

Just as concentration in a new Nifty Fifty was reborn in the late 90's—to the detriment of so many otherwise intelligent investors—now market timing has been resurrected as the saving grace for investors still concerned about high stock prices, slowing economic activity, terrorist threats, and the Enron collapse. I covered this issue in the last *Asset Class* (way back in August), but investors' emotions just won't let it to go away.

At least one thing is consistent. Those of us who preached diversification and a buy-and-hold philosophy, and suggested ignoring the sirens' cry to buy the soaring Cisco's and Yahoo!'s are still preaching diversification and buy-and-hold when the emotional mood has now shifted to Chicken Little cries of the sky is falling. Oh, yea. And some people still look at us like we have three heads.

The catalyst for extreme optimism and portfolio concentration *then* was a plethora of books and articles preaching the long-term benefits of stock investing in general and growth stock investing specifically. The catalyst today for extreme pessimism, lower stock allocations, and a new buy-and-sell philosophy are a series of articles by very notable investment experts

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such as John Bogle (formerly of the Vanguard Group), Warren Buffett (Berkshire Hathaway), and my own favorites, Eugene Fame Sr. and Ken French (noted academics). All have concluded that the "expected return" of the stock market today is about 6%. It's not clear over what time period that number applies, but in the grand scheme of things that does not seem to be very important. It's also not clear what these experts believe investors *should do* about this lower expected return. But none, to my knowledge, has called for investors to sell their stocks, except where an investor's time horizon is relatively short.

So there's one camp, of which I am a member and I believe the gentlemen above belong, that believes that these projections should be used to *reduce expectations* on *one part* of your investment portfolio and that part is represented by large growth stocks, an S&P 500 index fund, or a "Total Market" index fund. (Since the latter two are market cap weighted, they tend to be proxies for the first.) Note that I said reduce *expectations*, not reduce *allocations*. To reduce (or increase) allocations based on projections of future stock market returns used to be called market timing and up until this new "new era" market timing was a dirty word (OK, phrase).

The other camp, which includes many who would have been called die hard buy-and-hold zealots a couple of years ago, now believe that expected return calculations for the stock market (usually fairly simple dividend discount models and earnings-to-price ratios) should be used to determine an investor's asset allocations. In other words, if the expected return calculation shows a 6% future stock market return investors should presumably sell stocks and if the expected return calculation yields some higher number (we're not quite sure what that is), investors should buy stocks.

Investors who subscribe to this strategy should realize several very important things: 1) these expected return numbers are very fluid and they change with rising and falling stock prices, dividends, corporate earnings, interest rates and growth rates; 2) there evidently is no absolute number at which buying and selling works best; and 3) a decision has to made as to how much a stock allocation should be raised or lowered. For those who believe as we do that certain asset classes have different risk/return characteristics, the strategy is further complicated by the decision of *which* asset classes to buy, hold, or sell and by *how much* and *when*. The goal, as with all "active" strategies, is to generate a higher return over time than by simply holding your allocation through all the inevitable ups and downs of the stock market.

It can't be overemphasized that these expected return projections are just that—projections. Other very notable academics and financial economists have projected much higher returns and some have projected much lower returns. Concentrating on absolute numbers is almost always a sure path to disappointment. We believe a better solution for establishing long-term allocations is to understand the unique risk/return characteristics of asset classes base on long-term historical data and solid academic research, how the asset classes are correlated, the volatility of asset class returns, and their downside risk. The resulting asset mix should be consistent with your investment time horizon and be an all-weather portfolio.

Only individuals who have over-concentrated their investments in one asset class or whose investment time horizon is short should concern themselves with the low expected return calculations produced by these simple models. And, I would argue, if you have over-concentrated your investments in one asset class by matching its long-term risk/return characteristics with your objectives and you continue to contribute to the asset class regularly, changing your asset allocation based on short-term valuations is counterproductive. Over time you will add money when valuations are extremely favorable as well. This is the situation investors in Total Stock Market index funds and most 401(k) investors face today. Keep investing regularly and, if you need to, *lower your expectations or spending habits* for a while. Better that than jumping in and out of stocks.

Admittedly, the lure of avoiding a market decline or many years of low returns—even for a small portion of your portfolio—is very powerful. But those who tell you they can do it based on very logical, intelligent-sounding models are cut from the same mold as those who told you the road to investment riches was paved by "new economy" stocks. This is the same old medicine in a different bottle. Drink it at your own risk.

Don't be Fooled By...

...Market timing schemes under a different name such as "tactical asset allocation" or "valuation-based asset allocation." Their goals are the same: to get you in or out of an asset class at the "right" time.

...Those who say their motivation is not to "beat the market, but to reduce risk" or other soft-peddling terms. They're denying that investors know that stock markets go up and down and are simply selling you on avoiding the downs.