Index Fund Strategies

ASSET CLASS

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

Index Returns

	YTD 5/27	Change From 4/24
Bonds		
Short-term	+2.1%	+0.7%
Intermediate	+0.6%	+1.4%
Long-term	-0.9%	+1.8%
Global	+2.3%	+0.7%
U.S. stocks		
Large Market	+15.5%	+11.7%
Large Value	+11.5%	+10.7%
Small Market	+4.9%	+10.9%
Small Value	+7.7%	+9.7%
Real estate	+0.1%	+3.4%
Int'l stocks		
Large Market	+7.5%	+10.0%
Large Value	+6.0%	+9.8%
Small Market	+1.7%	+7.0%
Small Value	+1.6%	+6.4%
Emerging Mkts.	+6.8%	+2.0%

Short-term bonds = DFA One-Year Fixed Income fund; Intermediate bonds = DFA Intermediate Government Bond fund; Long-term bonds = Vanguard Bond Index Long-term (except first two months of 1994 = 20-yr. U.S. Treasuries); 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 6-10 Small Company fund; U.S. Small Value = DFA Small Cap Value fund; Real Estate = DFA Real Estate Securities fund; Int'l Large Market = DFA International Large Cap fund; Int'l Large Value = DFA International Large Cap Value fund; Int'l Small Market = DFA International Small Company fund; Int'l Small Value = DFA International Small Cap Value fund(except 1994 = DFA International Small Company fund); and Emerging Markets = DFA Emerging Markets fund. *Index returns are included for some of the international funds that have not been in existence for three years.

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Markets Update

Monday, May 27, 1997

Major Markets	Close 5/27	Point change from 4/25	% change from 4/25	% change from 12/31
DJIA	7383.41	+644.54	+9.6%	+13.9%
S&P 500	849.71	+84.34	+11.0%	+14.4%
NASDAQ	1409.21	+199.92	+16.5%	+7.6%
Nikkei 225 (Japan)	19889.89	+1277.03	+6.9%	+3.4%

All figures are without dividends reinvested.

All of the major markets moved significantly higher over the past month, led by the NASDAQ Composite (+16.5%). The surge in the NASDAQ index has been driven for the most part by the large technology stocks such as Microsoft and Intel.

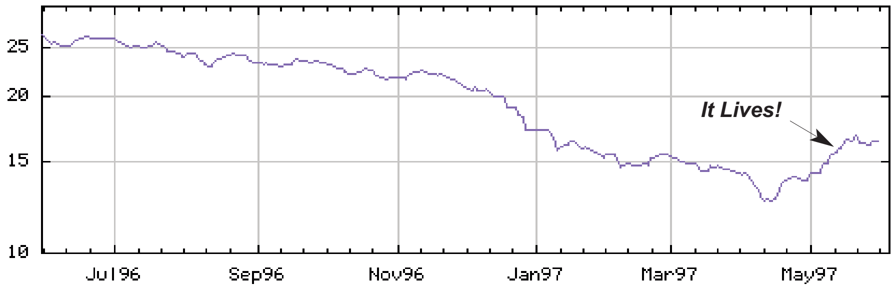
The largest U.S. multinational firms continue to dominate the indexes with their rise in market value. General Electric became the first stock to top $200 billion in market capitalization—10 times the size of the entire airline industry. Coca-Cola has a market value of $170 billion. The '90's version of the "Nifty Fifty" is not only alive and well, it appears to be out of control.

A narrowly-focused market such as this can be driven to extremes very quickly as money managers and investors strive to be in the "right" stocks, moving them to even higher valuations relative to earnings, book value, and dividends. Fundamentals are ignored in favor of short-term performance.

Value stocks continue to be a mixed bag. U.S. large value stocks lag the S&P 500 by 4% so far this year while small value stocks are ahead of the DFA 6-10 index by 2.8%.

International stocks got a boost from a long-awaited rally in Japanese stocks which in turn was enhanced by a drop in the dollar versus the yen.

DFA Japanese Small Company Stock Fund



“Have I got a cool head or am I just stupid?”

This quote, from a mutual fund manager in today’s (5/27) *Wall Street Journal*, pretty much sums up how I’ve been feeling lately. I think it also sums up the feelings of most professional money managers as expressed by the title of the first article in the Money & Investing section: “Leading Stocks Become a Must for Managers.” Think about that. There’s a lesson here.

The article wasn’t titled “Leading Stocks Become a Must for *Investors*.” Why? Because the article is not about being a successful *investor,* it’s about being a successful *money manager* and the two don’t necessarily go hand-in-hand. Money managers aren’t just concerned with the risks and potential rewards to their *clients* of the strategies they employ. They must also be concerned with the *business* risk and reward of their strategies (ain’t America great?). Right now, too many managers are concerned about not being in the hot (leading) stocks of the moment. And right now, the hot stocks are those of a relatively few very large U.S. multinational firms.

Why would managers worry about such things? For two reasons. First, too many investors are focused on short-term performance and, therefore, their selection of mutual funds, money managers, or investment strategies can be short-term—not conducive to a stable client base. Second, short-term trends can turn out to be longer-term trends. Now, the first reason doesn’t really concern me. TAM clients are long-term investors and all investors who index for the long-term benefit immensely from the short-term attitude of all other investors (they make the market more “efficient”). But, a short-term trend *extended too far* can break the discipline of even the coolest heads and make investors and money managers look stupid. As Forrest Gump said, “Stupid is as stupid does,” which can mean throwing in the towel on a good strategy just as rationality reenters the markets.

A couple of years ago, Dimensional Fund Advisors sponsored a meeting for advisors like TAM to talk about the benefits to *investors* of value stocks over growth stocks. Naturally, the talk was focused on long-term returns and the reasons for the value advantage. But Rex Sinquefield, the president of DFA and one of the most highly respected minds in the investment business, could not help but point out the business risk to *advisors* of moving from a growth-only or growth/value index mix to an all-value strategy. The implication was clear: if we run into a period when the S&P 500 significantly outperforms large value stocks, will your clients stay with the strategy?

No one is more qualified to ask that question than Rex Sinquefield. DFA launched its 9-10 Small Company Fund in 1982 after years of research into the return advantage of small company stocks. From 1926-1981, small stocks grew by 11.8% per year compared to 9.1% for the S&P 500. From 1975-1981, the period after the infamous bear market of 1973-1974 and before the 9-10 fund launch, small stocks outperformed an incredible 34.3% vs. 14.0% for the S&P 500. Rex and DFA were clearly onto something. (But they also had to feel a certain anxiety after such a wide and unsustainable recent advantage for small stocks.)

For the next *nine* years, small stocks *under*performed the S&P 500 8.8% to 16.2% per year. *Talk about business risk*. Yet DFA prospered because institutional investors with long-term investment horizons saw the diversification benefits of adding small stocks to their portfolios. It paid off from 1991-1996 as small stocks have outperformed 23.3% to 17.6%—not quite enough to offset the margin of the earlier years, but clearly on the right track.

Which brings us to another related article in the Journal (I guess these guys had too much to think about over the holiday weekend): “Small Stocks Leave Some Unnerved.” The gist of the article is that despite the relative undervaluation of small company stocks, many fund managers are too gun-shy to own them. Of course, given the fact that the average fund manager is 29 years old, is it surprising that they lack the conviction of the Sinquefields of the world and tend to be followers rather than leaders?

I went away from the DFA meeting convinced that value stocks offered the best long-term risk/return benefits and that I could communicate those benefits in an effective way to investors. So far, that’s been the case. Only time will tell whether cool heads are also smart ones.

—Jeff Troutner, TAM Asset Management, Inc.