Index Fund Strategies

ASSET CLASS®

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

Asset Class Returns

	1999	2000	2001	Last 9 yrs.	9/17 2002
Bonds					
Short-term	4.6	6.7	5.8	5.5	2.9
S-T Global	3.7	6.7	5.9	7.3	7.9
Intermediate	-3.6	13.5	8.2	7.1	12.5
Long-term	-7.9	16.6	8.2	8.1	11.7
U.S. stocks					
Large Market	20.8	-9.3	-12.1	13.3	- 23.2
Large Value	4.8	10.2	3.8	14.1	- 13.7
Small Micro	29.8	-3.6	22.8	14.8	- 15.0
Small Market	25.4	2.5	12.7	12.6	- 20.0
Small Value	13.1	9.0	22.7	15.6	- 10.4
Real estate	-2.0	28.4	13.2	9.6	5.7
Int'l stocks					
Large Market	28.5	-14.0	-20.8	6.3	- 15.6
Large Value	16.3	-0.2	-15.3	8.6	-8.4
Small Market	21.9	-5.4	-10.5	3.1	2.6
Small Value	19.0	-3.1	-4.6	3.6	6.1
Emerg. Mkts.	71.7	-29.2	-6.8	5.1	- 8.6

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 9 yrs." returns are ended 12/31/01 and 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 **September 18, 2002**

The broad market averages are relatively unchanged since the last newsletter in July, but as investors ran out of things to sell they looked to the remaining asset classes. As a result, U.S. and international large value and international small and small value took the brunt of the sell-off the past two months.

If the markets stay pretty much in the funk they are currently this will be a rare three-year decline for the S&P 500. The last one occurred from 1939-1941 when the index declined a total of about 20.6%. Through August it's down over 35% for this stretch, not quite as bad as the two years 1973-1974.

Now that you are sufficiently depressed, ask yourself whether the cup is half empty or half full. You are broadly diversified. Capitalism and American entrepreneurism haven't died. And the terrorists are on the run. Be optimistic.

Ten Stupid* Things People Do to Mess Up Their Investment Portfolios

Jeff Troutner, TAM Asset Management, Inc.

I'm not sure what it is about Americans and the workings of our financial markets that causes these frequent boom and bust cycles, but I suspect that they are a result of the following:

A. The very short-term memory of most investors,

B. The tendency (in light of A) to project good times and bad times too far into the future, and

C. Powerful fear and greed emotions, stoked by the constant onslaught of the Wall Street marketing machine.

Short-term memory leads investors to look at recent stock, bond, or mutual fund performance and ignore long-term results. They then believe that these very good or very bad returns will last forever. When things are going well, as they did up until March 2000, investors get greedy and concentrate their portfolios in hot stock, sectors, and industries. When stocks are not doing particularly well, they tend to engage in some or all of the following bad behaviors out of fear.

Of course, this behavior does not apply to TAM clients (right?), but it never hurts to be reminded. At the very least, you might share this newsletter with a friend, colleague, or relative and potentially save them a lot of frustration and money.

So, in light of these unfortunate realities, I've compiled the following list.

* The title is derived from, and I should give credit to, Dr. Laura's "Ten Stupid Things Couples Do to Mess Up Their Relationships." If you feel offended in any way, please replace "stupid" with irrational, boneheaded, not particularly bright, confused, silly, or other appropriate adjective.

continued on back...

1. **They stop making regular contributions to their investment portfolios.**

What is it about the urge to pay consistently higher prices for stocks during the "good" times while avoiding stocks like the plague when they're on sale?!? Let's see, "I want to keep my average cost high because..."? I know that I don't get any particular thrill out of paying higher gasoline prices every time I pull up to the pump, so why do so many investors feel good about paying higher prices for stocks?

The only rational exception to this is when you are nearing retirement or some other point when you begin making regular *withdrawals* from your portfolio. In this case, you should have been *selling* stocks when prices were rising, not buying. Even investors with lump sum contributions from the sale of another asset or a restructuring of a portfolio from a failed strategy should make regular investments back into stocks during market declines.

2. **They shift from stocks to bonds.**

This is a common alternative to #1, but just as irrational. In this case, investors are moving from an asset class with increasing expected returns (due to falling prices) to one with decreasing expected returns (rising prices, lower yields). Engaging in market timing ain't too smart to begin with. Doing it only at the *wrong* times, is particularly bone-headed.

I should touch on this concept of "expected" return briefly. Expected return is a financial concept that is the opposite of cost of capital. For example, if a bank makes a loan at 10% interest, the bank's expected return, or return on capital, is 10% and the borrower's cost of capital is 10%. According to high level academics, like Eugene Fama Sr. at the University of Chicago, investors price stocks in a similar fashion.

Rational investors pay higher prices for stocks that they believe are less risky—those with more consistent earnings, better management, etc. It follows, then, that these investors should expect a lower return on their capital as a result. Lower risk, lower return, right? Remember, return on capital is on the other side of the equal sign from cost of capital. Companies with higher stock prices ("growth" stocks) can sell less of their shares to attract the same amount of capital as companies with low stock prices ("value" stocks).

Lower cost of capital = Lower return on capital

I believe that there are many more investors during optimistic times who are willing to pay higher and higher prices for stocks because they perceive greater certainty (less risk) in earnings growth and prosperity of these companies *while at the same time expecting higher future returns!!*

Do you see the disconnect? It's perfectly rational to pay higher prices for stocks as the perception of risk decreases (just like banks charge lower rates on loans during good economic times), but it is irrational to expect higher returns as the risk decreases. Higher future returns in excess of the perceived risk comes from *surprises*—unanticipated earnings growth or successful product introductions, for example.

3. **They extend bond maturities and/or settle for lower quality to gain higher yields.**

Talk about adding insult to injury. Investors rush out of falling stocks to buy bonds at their lowest yields in 40 years. At a 40-year low, what is more likely to happen, interest rates fall much further or rise? What happens when interest rates rise? Bond prices fall. Jonathan Clements of *The Wall Street Journal* just discussed this in an article titled "Widows and Orphans Beware: T-Bonds Aren't Quite as Safe as You Think" (9/18/02).

Some investor are compounding their risk by buying high-yield (once known as junk) bonds in place of Treasuries or high quality corporates. How's this for an oxymoron: SAFECO High-Yield fund *down* 22.8% year-to-date (through August). Nuff said.

4. **They buy fixed annuities.**

Fixed annuities aren't priced daily like bonds so their prices don't rise and fall. That's the nicest thing I can say about them. Most offer "teaser" rates that are higher than current short-term rates, but then disappear after a year. That wouldn't be so bad except that most insurance companies lock you into the annuity for up to ten years with "surrender charges" that can be 7% or more of your account balance. Also, since these are tax-deferred insurance products, once you're in them you can't get out before age 59 1/2 without paying a 10% penalty tax in most cases. Quality? Risk? Remember Executive Life?

There are low-cost annuities without surrender charges. But, as you would expect, they tend to pay closer to market rates of interest. So why tie up the money?

To be continued next Asset Class...