



TAM ASSET MANAGEMENT, INC.

# ASSET CLASS<sup>SM</sup>

An update of performance, trends, research, & topics for long-term investors

## Asset Class Returns

|                     | 2001  | 2002  | 2003 | Last 10 yrs. | 7/31 2004 |
|---------------------|-------|-------|------|--------------|-----------|
| <b>Bonds</b>        |       |       |      |              |           |
| Short-term          | 5.8   | 3.9   | 1.6  | 5.0          | 0.3       |
| Five-Year           | 5.9   | 10.4  | 3.0  | 6.8          | 0.3       |
| Intermediate        | 8.2   | 15.0  | 2.5  | 6.9          | 0.7       |
| Long-term           | 4.3   | 16.7  | 2.7  | 7.7          | 1.3       |
| <b>U.S. stocks</b>  |       |       |      |              |           |
| Large Market        | -12.1 | -22.2 | 28.5 | 10.9         | -0.1      |
| Large Value         | 3.9   | -14.9 | 34.4 | 12.1         | 2.3       |
| Small Micro         | 22.8  | -13.3 | 60.7 | 14.8         | -1.4      |
| Small Market        | 12.7  | -19.1 | 51.5 | 12.2         | -0.6      |
| Small Value         | 22.6  | -9.3  | 59.4 | 15.6         | 5.4       |
| Real estate         | 13.2  | 4.2   | 35.6 | 10.8         | 6.3       |
| <b>Int'l stocks</b> |       |       |      |              |           |
| Large Market        | -20.8 | -14.6 | 36.7 | 4.9          | 0.8       |
| Large Value         | -15.3 | -8.5  | 49.4 | 7.0          | 5.3       |
| Small Market        | -10.5 | 1.9   | 58.8 | 4.8          | 9.4       |
| Small Value         | -4.6  | 5.8   | 66.5 | 6.1          | 9.9       |
| Emerg. Mkts.        | -6.8  | -9.4  | 60.2 | 2.3          | 0.7       |

### Descriptions of Indexes

|                    |                                 |
|--------------------|---------------------------------|
| Short-term bonds   | DFA One-Year Fixed Income fund  |
| Five-Year bonds    | DFA Five-Year Global Fixed      |
| Intermediate bonds | DFA Intermed. Gov't Bond fund   |
| Long-term bonds    | Vanguard Long-term U.S.Treas.   |
| U.S. Large Market  | DFA US Large Co. fund           |
| U.S. Large Value   | DFA Large Cap Value fund        |
| U.S. Small Micro   | DFA US Micro Cap fund           |
| U.S. Small Market  | DFA US Small Cap fund           |
| U.S. Small Value   | DFA US Small Value fund         |
| Real Estate        | DFA Real Estate Securities fund |
| Int'l Large Market | DFA Large Cap Int'l fund        |
| Int'l Large Value  | DFA Int'l 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 10 yrs." returns are ended 12/31/02 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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### Why Don't You Compare My Portfolio to the S&P500?

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This is a question new clients sometimes ask and it tends to release all kinds of bad memories from my days on The Dark Side<sup>1</sup>. More often than not, the question indicates a very important and fundamental misunderstanding of what an "asset class" portfolio really is and suggests that the investor still believes his or her portfolio is in a horse race against some market index or that TAM is in a race with another advisor.

I have no problems with horse races per se, but when an investor has just entered my long-distance thoroughbred in a race with a bunch of front-running geldings that tend to falter in the backstretch, I want to make sure the rules are well understood before the gun goes off.

#### Active Portfolios: Piecemeal selection based on "talent"

Before I discuss appropriate benchmarks for an asset class portfolio, let me share with you the experience many investors go through as they develop an actively-managed portfolio. To do this, I'll switch metaphors since an advisor friend, Jack Calhoun of Capital Directions in Atlanta, describes the experience so well this way:

*Imagine walking into a car dealership and, instead of being shown the latest cars, you were shown the latest carburetors. You were told that the new carburetors were great performers, and asked to make a buying decision on that item alone. Then you were asked to repeat the buying process for all the major parts of the car, each evaluated strictly on its own merits without regard for how it worked within the overall vehicle. At the end of the process you were left with a pile of components and no concept of how those pieces worked together to get you where you needed to go. It sounds absurd, but that is exactly how most investors go about building an investment portfolio – usually aided and abetted by a broker or advisor. Typically, investments – whether they be stocks, funds or money managers – are sold to the investor based on their individual merits.*

What Jack is describing is the process of screening funds, managers, or individual stocks based on recent past performance. The performance of each component is compared to either an index (sometimes an appropriate one) or a "peer group." What the investor is left with is a stellar portfolio of Four & Five Star Funds, Top-20% advisors, or A-Rated Stocks. *The sun shines bright in the old Kentucky home...And they're off!* Ah, the smell of new-mown bluegrass.

Back to Jack Calhoun's metaphor, what the investor now has is a shiny new high-performance racing machine. But in no time parts begin falling off—funds, managers, or stocks begin underperforming their benchmarks. How do investors react? Usually by dumping and replacing the losers<sup>2</sup> and/or adding money to the surviving winners. Think about this: Investors only change the components of active strategies *after* they have underperformed indexed benchmarks. They repeat this process about every three years (or earlier if the manager/fund/stock had a *really* bad year). Do you know any investor who sold a high-performing mutual fund or fired a market-beating manager to rebalance into the "losers"?

In the end, or more optimistically at the beginning of "The Enlightenment," these investors are pattering around in broken down Pintos. All that the performance tracking and compar-

*continued on back...*

ing to indexes did was create an ongoing cycle of buying high and selling low. Investors hang on or add to their winning funds, managers, or stocks because they think they may be holding the next Peter Lynch, Warren Buffett, or Bill Gates. In an environment of incubator funds<sup>3</sup>, regression to the mean<sup>4</sup>, and a record that shows 75%-80% of active fund managers underperforming a simple market index, is this rational? I don't think so.

### Passive Portfolios: Developing a cohesive structure

All investors should have goals for their portfolios. Developing realistic ones is the starting point of *rational investing*, not the screening of active funds, managers, or individual stocks. Goals should be determined based on a thorough understanding of the financial markets, the relationship between risk and return, and realistic projections of future earnings growth rates and dividends for stocks and interest rates on bonds. Once goals are set, it's only natural that an investor would want to track the progress of the portfolio toward their goal.

Goals determine portfolio structure. Portfolio structure, in turn, determines the growth rate of the portfolio. Thinking back to Jack Calhoun's good perspective: in asset class investing the investor decides what kind of performance she needs from a portfolio to get from point A to point B. No portfolio is perfect and there *will* be many bumps in the road over the investor's time horizon. But when you start out with parts that have demonstrated a very high failure rate and very inconsistent and unpredictable performance (active funds and strategies), the odds of not reaching your destination are significantly increased. Rational investors seek to build portfolios with the most *reliable* and *stable* parts so that they reduce the chance of breakdowns on the road to their goal. The most reliable parts for a long-term portfolio are broadly diversified index funds and/or well-engineered, passively-managed asset class funds.

The choice of index and asset class funds is important and can add significantly to the return of the portfolio, particularly in this age of lower projected asset class returns. *Portfolio engineering is every bit as important on the fund level as it is on the portfolio level.* But let's assume you or your advisor has selected the best asset class funds. What you are left with is, in essence, a portfolio of *benchmarks*. Therefore, comparing the portfolio to one benchmark or even a combination of benchmarks is not very productive. Here's an example:

Let's say that you adopt the most basic passive strategy and simply "buy the market." Assuming an all-stock portfolio, you would buy just one fund, say, the Vanguard Total Stock Market fund. The proper benchmark for this portfolio would be the Wilshire 5000 total market index. But what does comparing this portfolio to the index really tell us? Not much. *We expect* to receive the Wilshire 5000 return minus Vanguard's fund expenses assuming we chose the best total market index fund in the first place (usually the one with the lowest expenses).

Now extend this thinking to a multi-asset class portfolio that an investor builds to take advantage of other risk dimensions. Each component represents a specific segment of the total market: large growth, large value, small growth, and small value. These segments might be further divided among U.S. and foreign stocks. What we end up with is a *portfolio of indexes* minus fund expenses. Again, comparing this portfolio to a relevant mix of indexes doesn't tell us much. Furthermore, comparing the

portfolio to one index, such as the S&P 500, is even less useful. *If the S&P 500 (the expected return of large growth stocks) is our goal, why not just buy the S&P 500 in the first place?*

Some investors/advisors also have the tendency to compare an asset class portfolio to a mix of indexes that do not correspond to the funds in the portfolio. For example, the U.S. large value index component of the benchmark mix might be engineered to represent larger and "growthier" stocks than the U.S. large value asset class *fund* in the portfolio. If the goal is larger and growthier stocks, buy the correct index fund in the first place.

So what are appropriate benchmarks for an asset class portfolio? This takes us back to goals. If the goal is "inflation plus 3%," the proper benchmark is the Consumer Price Index (CPI) and the portfolio should be structured using today's estimates of the CPI and the various asset class returns. This process can be fairly complex and should consider other variables such as taxes, fund expenses, and advisor fees. But let's look at a simple example. Assume inflation is running at 3% per year, short-term interest rates are 3.5%, and the expected returns for U.S. large growth, large value, small growth and small value stocks are 6%, 7%, 8%, and 10% respectively. Let's also assume total fund and advisory fees are 1.2%. Clearly this investor will not meet her goals by investing all her assets in short-term bonds. Some combination of bonds and the various asset classes will have to be used to construct a portfolio with an expected *net* return of 6% (inflation plus 3%). As always, portfolio risk and the investor's tolerance for risk should be considered in the process.

The same process would take place if the investor's goal is an absolute number like "8% per year." In this case, the benchmark is a straight 8%, not the S&P 500, or the Wilshire 5000, or "the Morningstar average stock fund return", etc.

To see how a comparison to an inappropriate index can hurt asset class investors, consider how you would have felt with a multi-asset class portfolio at the end of 1999. Assuming you started the portfolio five years earlier, you would have been reminded that while your portfolio grew at a very respectable 16% per year, the S&P 500 and NASDAQ indexes grew by 28% and 40% respectively! If your "bogey" was the S&P 500, you may have been tempted to shift most, if not all, of your assets to U.S. large growth stocks. Since the end of 1999, the asset class portfolio has grown by over 30% while the S&P 500 and NASDAQ have *fallen* 17% and 49%; moving the asset class portfolio ahead of both for the full period.

Rational investing starts with realistic goals. A structured portfolio of well-engineered asset class funds is the best vehicle for attaining those goals. Periodic rebalancing to target allocations and reviewing the progress, using *goal-oriented* benchmarks, will keep your eye on the ball while making for a confident and stable investing experience.

<sup>1</sup> The Dark Side is the world of stock picking and market timing.

<sup>2</sup> Actually, investors tend to hang on to losing *stocks* way too long.

<sup>3</sup> Some fund companies have a nasty habit of starting several new funds with similar styles and launching the "winner" to the public with rave reviews.

<sup>4</sup> Regression to the mean is the tendency of high performing funds or money managers to become average, or worse, over time.

<sup>5</sup> This is not uncommon when "Monte Carlo" simulations are used or a portfolio (such as a trust) has a fixed distribution requirement.