TAM ASSET MANAGEMENT, INC.

ASSET CLASS℠

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

September 2004

Asset Class Returns

	2001	2002	2003	Last 10 yrs.	8/31 2004
Bonds					
Short-term	5.8	3.9	1.6	5.0	0.8
Five-Year	5.9	10.4	3.0	6.8	2.3
Intermediate	8.2	15.0	2.5	6.9	3.3
Long-term	4.3	16.7	2.7	7.7	4.7
U.S. stocks					
Large Market	-12.1	-22.2	28.5	10.9	0.3
Large Value	3.9	-14.9	34.4	12.1	2.3
Small Micro	22.8	-13.3	60.7	14.8	-2.9
Small Market	12.7	-19.1	51.5	12.2	-2.0
Small Value	22.6	-9.3	59.4	15.6	3.8
Real estate	13.2	4.2	35.6	10.8	14.7
Int'l stocks					
Large Market	-20.8	-14.6	36.7	4.9	1.4
Large Value	-15.3	-8.5	49.4	7.0	6.7
Small Market	-10.5	1.9	58.8	4.8	10.4
Small Value	-4.6	5.8	66.5	6.1	11.2
Emerg. Mkts.	-6.8	-9.4	60.2	2.3	3.5

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 12/31/03 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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Plotting Your Course (Part 1)
The Art & Science of Our Investment Relationships

Jeff Troutner, TAM Asset Management, Inc.

I mentioned in the last *Asset Class* article that most investment experiences could be compared to a person walking into a car dealership and instead of being directed to the best car to fit their needs or desires is sold a bunch of high-performance parts one at a time. The analogy was used in the context of "benchmarking" and portfolio construction, but it describes the whole relationship process to which the vast majority of investors are exposed. As a logical follow-up then, this article and the next two will outline two very different approaches to managing investment relationships, one of which I will refer to as "transactional" and the other "consultative."

The Two Worlds of Investment Advice

Transactional advisors[1] tend to ask a few questions of investors in order to frame the recommendations of their investment products du jour. The portfolios that result from this approach are often simply a collection of packaged "products" thrown together with no apparent plan or objective save one: the maximization of fees to a salesperson or revenues to their firm. Ongoing "advice" tends to be centered on periodically replacing underperforming products with new ones and/or adding a hot new product to the mix (hedge funds anyone?). In various twisted ways this process is marketed as value-added by transactional advisors.

Consultative advisors, on the other hand, blend the *art* of relationship management with the *science* of portfolio engineering. These advisors spend much more time listening to their clients in order to uncover their financial goals and objectives. The portfolios resulting from this approach are purposefully engineered to deliver an agreed upon risk/return objective with minimal costs and taxes. Subsequent advice is centered on maintaining the agreed upon investment policy, reinforcing key investment principles during difficult market cycles, and attending to other needs and concerns as they arise. Both the advisory relationship and the investment portfolio resulting from a consultative approach tend to be more predictable and much more stable over time.

Today, transactional advisors dominate the investment business. Why? I think the answer is that most people view the financial markets and the investing process from a Wall Street and financial media-manipulated prism of emotion, randomness, mystery, and financial complexity that they can never hope to understand, let alone try to control. This perspective creates irrational performance expectations, misconceptions of risk, insensitivity to investment costs and taxes, and a dependency based on personality, "brand name," or blind trust. The result is often an investor who is a very malleable target for investment salespeople, not an informed or enlightened one with rational expectations and well-defined goals.

These malleable targets are made softer by a deliberate effort on the part of many transactional advisors (stockbrokers and insurance agents especially) to develop a personal relationship with their clients. This is being driven home today by the Morgan Stanley commercials of the "trusted advisor" hanging out on the beach or in the maternity ward

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waiting to help the happy couple "reposition" their portfolio to meet their new life challenges. I have a general theory that the closer your advisor gets to you personally, the less secure he or she is with the advice given. Clearly there are exceptions, but when the relationship is based on transactions that generate commissions one should always maintain an attitude of healthy skepticism.

The Investment Relationship Process

I believe there are three major stages to a successful investment advisory relationship that involve varying degrees of art and science:

1. **Discovery (mostly art)**
2. **Portfolio Engineering (mostly science)**
3. **Management and Counseling (mostly art)**

These stages are handled very differently by transactional and consultative advisors and it's the beginning stage that sets the tone for everything that follows.

The Discovery Stage: It's All About Perspective

I believe the essential difference between the transactional advisor and the consultative advisor in this stage is the perspective of the advisor. The transactional advisor views the process from the perspective of what is best for him first and the client second. This is why "sales" skills are so important. Maximizing their "production" from each customer relationship without losing the relationship is the goal. The reality is more often high relationship turnover and poor client satisfaction.

The consultative advisor views the process from the *client's* eyes and therefore must try to understand the experiences, biases, fears, needs, and knowledge of the client as much as possible. This is critical to building the best portfolio for the client, of course, but more importantly it creates the *confidence and security in an investment process* that is essential in surviving market cycles and the allure of Wall Street marketing.

The goal of the consultative advisor is to develop long-term relationships built on rational expectations, the substance of fact-based financial economics, and the discipline and knowledge to avoid common investor mistakes. High, up-front commissions, back-end loads, or flat task-oriented fees are antithetical to the goals of the consultative advisor and his/her client. Reasonable, recurring asset-based fees encourage long-term interaction of the two parties toward a similar goal and lead to a more stable and *mutually-beneficial* relationship.

The difference between transactional and consultative advisors was reinforced for me by articles at Morningstar.com[2]. They are decidedly anti-indexing with titles like *How to Market Against Index Funds* and *How to Build Your Practice as an Active Portfolio Manager* and play fast and loose with the facts in a recklessly irresponsible and deceitful manner. Yet Morningstar states that the author was *"trained as a research scientist, [and] has specialized for the past 23 years in practice building, investment psychology, behavioral finance, and the development of low-risk, high-reward investment methods."* He also happens to be co-author of a book titled, *Ultimate Selling Power: How to Create and Enjoy a Multi-Million Dollar Sales Career.*

So there you have it. You know exactly where the author, transactional advisors, and Morningstar are coming from. And it ain't from your side of the desk.

Our Approach as Consultative Advisors

The discovery process can vary significantly among clients and part of our challenge is to understand what each client is looking to get out of the process. We have many clients who come to us with fairly extensive knowledge and appreciation for asset class investing from the school-of-hard knocks and a personal journey for "the truth." Many come to us after having read William Bernstein's *The Intelligent Asset Allocator*, for example. These clients have well-defined needs and expectations and move fairly quickly to the second stage of portfolio engineering.

Other investors are referred to us by current clients, attorneys, accountants, and other professionals, and only know that they are not "happy" (some are downright livid) with their current investments and/or advisor relationships. These relationships are usually very challenging from the start since a certain amount of "deprogramming" from the transactional environment is necessary. And, of course, we welcome these challenges.

In most cases, we learn a great deal about the investor by analyzing their current portfolio. This can indicate their level of investment knowledge, their attraction to sizzle rather than substance, their sensitivity to costs and taxes, and the level of their engagement in the investment process. Far too often we find portfolios in direct conflict with the expectations of the investor. For example, we'll find investors who seek maximum diversification being sold 40 different mutual funds that have extensive overlap of stock holdings and which are collectively clustered within one asset class category (almost always "large growth stocks"). We find others seeking predictability and stability who were switching among "hot" active funds (with wide annual variance from market performance) every couple of years.

These relationships often involve more extensive initial meetings where we learn the details of prior investment experiences, what they want their investments to achieve, and how much they want to be involved in the investment process. We also listen to their views on the importance of money, security, and taking care of their family or other beneficiaries. Ultimately our goal is to discover what *financial independence* means to them.

We never underestimate a client's needs and expectations in the first stage of our relationship process because we know that a firm foundation with effective follow-up (the third stage) will have a significant influence on whether goals are met. This influence is hard to measure quantitatively, but we and our clients know it exists and that it is meaningful. In the next issue of *Asset Class*, I will outline the more easily quantifiable value-added steps we take in the second stage of portfolio engineering.

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[1]Most stockbrokers and insurance agents are not registered investment advisors. In fact, The Financial Planning Association (FPA) asked the Securities and Exchange Commission in June to give up or substantially alter a four-year-old proposal that would regulate when brokers could provide investment advisory services and fee-based brokerage accounts without registering as investment advisers.

[2]http://advisor.morningstar.com/advisor/doc/article/0,8832,3771,00.html