TAM ASSET MANAGEMENT, INC.

ASSET CLASS℠

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

December 2004

Asset Class Returns

	2001	2002	2003	Last 10 yrs.	11/30 2004
Bonds					
Short-term	5.8	3.9	1.6	5.0	0.7
Five-Year	5.9	10.4	3.0	6.8	2.2
Intermediate	8.2	15.0	2.5	6.9	3.2
Long-term	4.3	16.7	2.7	7.7	4.8
U.S. stocks					
Large Market	-12.1	-22.2	28.5	10.9	7.1
Large Value	3.9	-14.9	34.4	12.1	13.7
Small Micro	22.8	-13.3	60.7	14.8	13.2
Small Market	12.7	-19.1	51.5	12.2	13.9
Small Value	22.6	-9.3	59.4	15.6	21.0
Real estate	13.2	4.2	35.6	10.8	25.8
Int'l stocks					
Large Market	-20.8	-14.6	36.7	4.9	13.7
Large Value	-15.3	-8.5	49.4	7.0	22.7
Small Market	-10.5	1.9	58.8	4.8	25.0
Small Value	-4.6	5.8	66.5	6.1	28.2
Emerg. Mkts.	-6.8	-9.4	60.2	2.3	22.1

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 3)
The Art & Science of Our Investment Relationships

Jeff Troutner, TAM Asset Management, Inc.

As the prior two *Asset Class* articles have outlined, there are three stages to our investment advisory relationships: Discovery, Portfolio Engineering, and Management & Counseling. The final stage, which I will outline in this article, is as dependent on the first two stages as Portfolio Engineering is on the Discovery stage. If rational expectations and a suitable portfolio have not been established before the final stage, our clients are vulnerable to the seductive fear and greed produced by stock market highs and lows. These emotions make market timing, "fear products" such as commodity or hedge funds, and "hot" active managers or mutual funds appear as more attractive and rational choices. Investors who give in to these emotions risk a very costly detour on their road to financial independence.

Management

The first part of the Management & Counseling stage is task-oriented and includes:

- **Cash Flow Management**—Buy and sell mutual fund shares as contributions are made to the portfolio or assets are withdrawn. In taxable accounts, transactions are recorded by tax lot.
- **Portfolio Rebalancing**—The "buy low, sell high" discipline of maintaining the asset class risk balance of the portfolio.
- **Tax Management**—Minimize tax consequences on both the fund and portfolio levels for taxable accounts.
- **Maximizing Portfolio Holdings**—Change portfolio holdings as new or better asset class alternatives become available or investor objectives change.
- **Portfolio Monitoring & Reporting**—Process daily transactions from custodians in order to monitor and manage cash flows, review current vs. target allocations, and report portfolio progress.

All of these steps can add value to a portfolio's bottom line. For example, we generally keep cash balances to 1% or less of the total portfolio and encourage clients to "plunge in" to the market with new contributions rather than "wade in" or wait for some defined drop in the market before committing the new cash.[1] Since stocks tend to go up more than they go down over time and money fund yields are currently very low, we believe this approach will result in higher portfolio returns. We also find that a discipline of immediate investment avoids the emotional ups and downs that very often accompany and usually alter a "wade in" plan.

A disciplined approach to portfolio rebalancing achieves two goals: it keeps a portfolio in line with stated risk objectives and it forces investors to take profits from "hot" asset classes to invest in "cold" asset classes. For taxable accounts, this is best achieved by adding money to the asset class laggards rather than selling the winners and creating a tax consequence.[2]

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Certain strategies for taxable accounts can enhance after-tax returns. We place greater emphasis today on tax-management at the fund level since fund companies like DFA have introduced new funds in recent years that utilize sophisticated methods for reducing taxable distributions. Tax-management on the portfolio level (buying and selling "similar" funds to realize gains or losses) can also add value, but I have found that potential benefits may often be reduced or even eliminated by less-than-optimal fund choices, depending on the holding period.

As indexing has become more popular with investors, fund companies have been tripping over themselves to introduce new funds representing almost every conceivable slice of the stock market pie. For TAM, the most significant new funds were the DFA "value" funds introduced in the mid-90's. In recent years, asset class and industry-based exchange-traded funds (ETFs) have been all the rage. A couple of years ago, Vanguard switched the indexes tracked by most of their funds. And, finally, fund companies have introduced more exotic versions that track everything from hedge funds to gold bullion. Add in a consistently lively academic debate about investor behavior, efficient markets, active vs. passive investing, etc., and you get a sense of what we review/debate on an ongoing basis.

TAM receives daily electronic downloads of portfolio transactions from several custodians. This information is then posted to specialized portfolio management software that can generate reports of cash flows, dividends, buy and sell transactions, and target vs. current allocations, among other things. On a quarterly basis, we report holdings and portfolio progress to clients and are able to generate tax reports on request and at year-end.

Counseling

In my view, ongoing counseling to investors who have adopted a long-term, buy-and-hold, asset class strategy is *the* critical function of an advisor. This is where we either add the greatest value in the relationship or we fail in meeting our goals. This counseling can be overt (such as the *Asset Class* newsletter, phone calls, meetings, and emails) or covert (such as, "I better not give this market timing stuff too much thought or Jeff will really let me have it!"). Either way, the goal is to keep the client's focus on rational expectations and well-defined goals. The process also keeps the advisor's focus on the same expectations and goals. In fact, the Investment Policy Statement that TAM provides to every new client (and existing clients whose objectives have changed) is directed at what I as the advisor must adhere to as a prudent fiduciary and the client *should* focus on as a prudent investor.

Putting a specific value on the benefit of prudent counseling is almost impossible and it can vary dramatically among different investors and advisors. One thing I'm sure of, however, is that the number is large for most investors—often much more than the savings from lower mutual fund or advisory fees (assuming a reasonable starting point). One way to look at this is from the negative, or "what if," perspective. This is the view I get every time I meet with a new client these days.

Virtually every portfolio I review has the same set of late-90's vintage growth stocks and mutual funds. I can see the seductiveness of high (past) returns and the emotional nature of irrational investing in all of these portfolios—whether they were self-managed or advisor-managed—and the negative value-added. Most portfolios are 30%, 40%, or even 50% below their 1999-end values. I am also talking with more and more investors who discovered indexing late in the bull market, but limited their investments to S&P 500 or Wilshire 5000 index funds, and still have portfolios underwater (the S&P 500 is down 16.5% since March 2000). It's not just a case of lack of diversification either. In almost every case, it's a lack of discipline that moved the investor to overly concentrate their portfolios or change their investment strategy at the wrong time.

What tends to amaze me more is when I see portfolios of other "index" *advisors* that had shifted toward large growth stocks or tech stocks as the bull market was on its last breath. Maybe these advisors had visions of stardom and the flow of assets that usually results. Or maybe their clients threatened to leave if they didn't jump on the bandwagon. Either way, they failed to provide the discipline their clients were paying for.

Counseling might also involve other aspects of a client's financial picture, from ongoing advice on non-TAM assets such as 401(k) and 403(b) plans, educational funds, generational transfer and financial guidance to children and other potential heirs, charitable giving options, existing variable annuities and life insurance products, and many other issues. Some clients also place significant value in knowing that a trusted advisory relationship and a solid, prudent strategy will continue after their death, insuring that their spouse and/or children will avoid dealing with the typical "repositioning" of the assets common at brokerage firms and other transaction-based "advisors."

The Whole Enchilada

The goals of the Discovery stage of our advisory relationship are to establish rational investment expectations and determine our client's risk and return objectives. The goal of the Portfolio Engineering stage is to develop low-cost, efficiently diversified portfolios that are expected to meet those expectations and objectives over a client's investment time horizon. The goals of the final stage, Management & Counseling, are to maximize portfolio returns, report progress, and maintain the discipline and focus necessary from both the client and TAM to see the strategy through to its objectives. To be successful, an asset class strategy requires that investors engage in a more intellectual, rather than an emotional, process and understand issues such as risk, return, costs, diversification, and discipline better than the average investor.

[1] See the TAM Position Paper, "The Delicate Question, Which?"

[2] It was not uncommon for investors to do just the opposite during the heady days of the 90's market mania. Many investors not only failed to trim their stock holdings as prices rose, they actually borrowed money to buy more stocks and, in many case, loaded up on the very priciest of stocks—the technology and telecommunications companies.