Investors are becoming increasingly aware of the fact that the S&P 500 and Total Stock Market indexes are dominated by large growth companies (many received virtual PhDs on this topic courtesy of the bursting stock market “bubble”). Because these indexes have fallen 10.6% and 8.7% respectively over the last 5 ½ years, many investors are questioning whether this is the kind of “balance” they wish to maintain for their portfolios. Regardless of what they think individually, the index weightings represent what investors in total prefer—which is to own shares of very large, well-known companies with consistent earnings growth over smaller, lesser-known companies with less consistent earnings growth.

Dimensional Fund Advisors (DFA) recently asked a group of Bay Area investment advisors to measure their clients’ exposure to asset class risk. The purpose was to identify our tilts away from the market’s bias toward large growth stocks. The chart below plots these exposures. The Total Stock Market is at the intersection of the lines. The S&P 500 (large growth), Micro Cap (small growth), Small Value, and Large Value indexes represent the outer limits of individual asset class risk/return for TAM portfolios. The different tilts for the advisor clients are shown by the blue diamonds, with TAM clients shown by the green box. As you can see, TAM clients have the greatest tilt to small and value of the group and are the farthest away from the average investor in U.S. stocks.

So the average TAM client is not like the average investor. What does this imply? My answer, which would be sure to stir controversy among indexing “purists” if they read this newsletter, is that my clients are smarter. That’s right, they’re smarter. If you doubt that, think about a couple of simple facts. First, something like 75% of all securities portfolios are actively-managed, not indexed. This is in...
spite of the fact that 70%-80% of professional money managers fail to beat an indexed strategy over time. It’s really not hard to be smarter than the average investor.

But I’ll cut the average investor some slack. When it comes down to it, the “only” thing really separating active and passive (index) investors is about 2% in annual costs. Let’s assume in the aggregate that there’s no difference in cost. What we’re left with is the market portfolio. Lots of people will own Microsoft, some will own little unknown stocks, and some will own index funds. Thus, the total stock market represents the risk preference of the average stock investor.

Where does this preference for big growth companies come from? Well, we’ve already established that most investor use active strategies despite their well-documented failures on the whole. So, would it be safe to say that most investors are listening to and following the “advice” of the financial media, Wall Street talking heads, stock brokers, and advisors selling to investors fear and greed rather than reading William Bernstein’s *The Intelligent Asset Allocator*? I think so (as much as some people laugh at Jim Cramer and his *Mad Money* show, there’s no doubt in my mind that many people call their brokers the next day).

Big companies are big advertisers. They have dominant market positions in their industries, well-known products, big-name CEOs, and really cool technology. Who wouldn’t want them in great abundance? Answer:

✔ Investors who have a better understanding of their investment objectives and risk tolerance than the average investor.

✔ Investors who recognize the diversification benefits of a more balanced asset class portfolio.

✔ Investors who wish to hedge risks in other areas.

✔ Investors who are more patient and less emotional than the average investor.

✔ Investors who have studied the history of asset class returns and aren’t afraid of small company and value stocks in broadly diversified portfolios.

✔ Investors who wish to increase their portfolio’s expected return over the market’s.

✔ Investors with investment time horizon longer than that perceived by the average investor.

✔ Investors who place greater emphasis on sound strategy and less on short-term returns.

In other words, the typical TAM client.

Indexing purists would say that TAM clients are making a bigger “bet” on small company and value stocks than the average investor. In the sense that they expect higher return for higher risk taken, maybe it is a bet. But is it a foolish one? Is the extra risk not worth it? Well, let’s see.

Those who argue most strongly against a greater-than-market weight to value always point to the Great Depression as an example of value stocks gone bad. Yes, small value stock prices fell 85% from 1929-1932. But the total stock market fell 70%! Personally, I would have been selling apples on the corner no matter what my asset class weightings were. But after the next 13 years (through 1945), I might have owned every apple orchard in Washington State if I had stuck with a more small cap and value weighting. Over those years, the total market grew by 14.2% per year while small value stocks grew by 28.6% per year.

And think about this: From April 2000 to February 2003, the average technology mutual fund fell almost 80% in value and large growth stocks dropped 51%! What’s more likely to happen in the next 30 years, another Great Depression or another “bubble” in large growth company stocks?

We also hear a lot lately about the 1966-1981 period when six-month Treasury Bills outperformed stocks (7.6% vs. 6.5%). Large value stocks returned 11.0% per year over that period and small value 14.2%. Big “bet” there.

How about 1973-1974? The total stock market was down a total of 40.4%. Large value was down 20.4% and small value was down 45.7%. Where’s the beef? For the next 12 years prior to the start of the current “bull market,” the total stock market returned 16.1% while small value did 33.3% per year.

Finally, from 1995-1999 the total stock market gained 27.7% per year while small value “only” returned 14.8%. From 2000 to 9/2005, however, the total stock market has fallen 1% per year compared to a rise in small value stocks of 19.2% per year.

So I ask you, if tilting away from total market weights is a “bet” against the collective risk preference (wisdom?) of all investors, is this a bet you’re willing to take? Does your better understanding of financial markets risk and your personal objectives make you more or less comfortable with not being average?

The answer’s an easy one for me.

1 The Micro Cap index is the CRSP 9-10 index; Small Value is the Fama/French Small Value index; and Large Value is the Fama/French Large Value index.

2 Source: Morningstar Principia Pro.