TAM ASSET MANAGEMENT, INC.
ASSET CLASS℠
An update of performance, trends, research, & topics for long-term investors

Asset Class Returns

March 31, 2006 (YTD)

	2003	2004	2005	Last 10 yrs.	YTD 2006
Bonds					
Short-term	1.6	0.9	2.3	4.3	1.0
Five-Year	3.0	2.9	1.7	6.1	0.1
Intermediate	2.5	4.3	1.6	6.2	-3.8
Long-term	2.7	7.1	6.6	7.1	-3.4
U.S. stocks					
Large Market	28.5	10.7	4.9	8.9	4.2
Large Value	34.4	18.2	10.2	11.9	6.2
Small Micro	60.7	18.4	5.7	13.6	14.4
Small Market	51.5	17.9	6.1	11.8	13.9
Small Value	59.4	25.4	7.8	15.9	15.0
Real estate	35.6	32.1	13.2	15.1	15.4
Int'l stocks					
Large Market	36.7	18.8	13.5	6.2	9.0
Large Value	49.4	28.8	15.3	9.2	12.3
Small Market	58.8	30.9	22.0	N.A	11.1
Small Value	66.5	34.8	23.2	10.2	12.7
Emerg. Mkts.	60.2	29.9	29.9	8.5	10.7

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 12/31/05.

TAM Asset Management, Inc. is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of any mutual fund and read the prospectus carefully before investing.

Past performance is no guarantee of future results.

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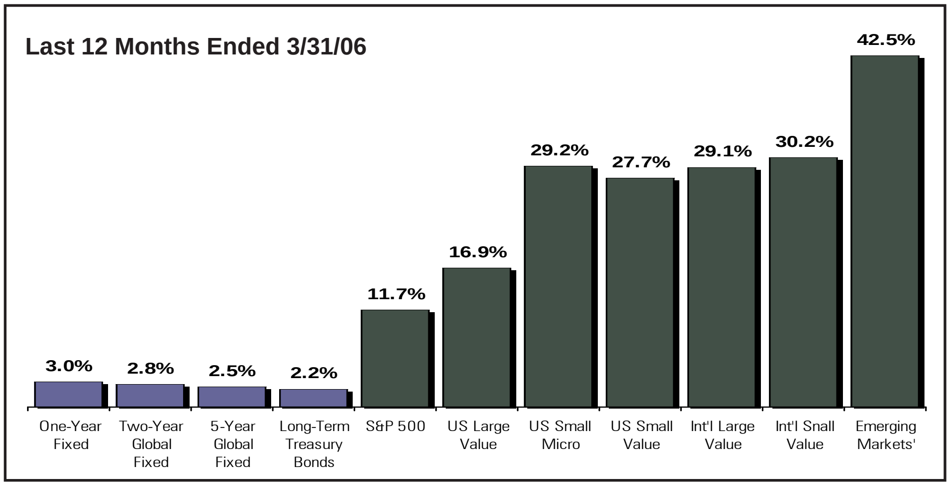
The Squeaky Wheel

Jeff Troutner, TAM Asset Management, Inc.

In a diversified asset class portfolio there's always a squeaky wheel. At the moment it happens to be the least risky asset class, short-term fixed income, which is the one we include in portfolios primarily to act as the grease to smooth our ride in the equity markets. As interest rates have risen recently, bonds with longer maturities have seen their prices fall, temporarily offsetting the increase in yields.



A common reaction to an "underperforming" asset class is first to question the need for the asset class in the portfolio and second to question whether the best vehicle is being used in that space. Given that the allocation to short-term bonds carried a lot of balanced portfolios through the rough years following the market peak in 2000, I'm pretty confident TAM clients understand the long-term value of the short-term bonds in mitigating portfolio volatility and downside risk. The *reasonable* reaction to one asset class underperforming the others is to *rebalance*—buy more of the laggard, in other words.

The second reaction—questioning the vehicle we use to represent the asset class—is not as easily dismissed. It is, after all, a process we go through on a regular basis and it's not readily transparent to our clients. Invariably, though, I'll get calls from some clients who put more value in Morningstar Mutual Fund ratings than I do and I'll go through the process of explaining the flaws in their methodology, the pitfalls of relying on their conclusions for long-range strategy decisions, and the step-by-step details of our process of selecting asset class funds. In an attempt to head off some of these calls, let's review the selection of the DFA Five-Year Global Fixed Income fund as our core bond holding. The same kind of thinking applies to other bond funds we may use for different situations (i.e. tax-free income).

Morningstar awards the DFA Five-Year Global Fixed Income fund a ★★★ rating—which is average—despite the fact that the fund is ranked *third* among short-term bond funds over the past 10 years.[1] Far from average, this fund has outperformed 96% of its "peers"! And it has outperformed the Vanguard Short-Term Bond Index fund by almost 1% per year over the period. So where is Morningstar going wrong? Morningstar places

continued on back...

the DFA fund in its "World Bond" category. This has the effect of putting the total emphasis on the *nationality* of the bond issuers instead of on the average quality of the bonds in the fund, the length of their maturities, and investment style of the fund manager. The World Bond category also includes funds that take on currency risk and invest in emerging market debt (redefining the saying, "One man's junk is another man's gold"!). So, once again, I say: *Ignore Morningstar and Prosper!* Now let's look at things in a more logical way.

Question: What determines bond returns?
Answer: Risk

The most obvious way to increase the yield on fixed-income investments (at least in the short-run) is to take on more risk. This means lowering the quality of the bonds in the portfolio and incurring greater "default" risk and/or lengthening bond maturities and incurring greater interest rate risk (bond prices fall as interest rates rise). We believe that investors are not sufficiently rewarded for either of these risks over time and are better off looking to the equity side of the portfolio to increase risk and expected returns. This can be achieved by tilting more towards stocks in general and small cap and value stocks specifically.

There are people in the investment industry who will tell you that they can reduce bond default and interest rate risks through *better management*. Here are some of their "better" techniques:

- Guessing the future direction of interest rates
- Guessing the future economic cycles of all the developed and emerging nations
- Guessing the future yield spread between investment grade and junk bonds
- Guessing the future capital flow in and out of the emerging markets
- Guessing the future direction of foreign currencies vs. the US dollar

How have they done? Common sense would tell you "not very well" given what we know about crystal balls and economic forecasts. But just for kicks let's use Morningstar for the one thing it's somewhat useful for: keeping track of past fund performance.[2] Over the past ten years of steadily falling interest rates, the Lehman Brothers Long-Term Gov't/Credit Index outperformed 95% of "high yield" bond funds and 95% of *all* U.S. taxable bond funds.[3] So if experienced, smart, and motivated bond managers can't beat the index by any or all of the above techniques, why on earth would anyone *not* use a more passive, low risk, and low-cost approach to their bond investments? This leads us to the query:

Question: What passive bond strategy works best?
Answer: One that keeps maturities short and adjusts for yield curve variations.

Let's start with bond maturities. I mentioned earlier that investors can increase their yields by taking more risk, but a glaring exception to this rule is that riskier long-term bonds have not really provided a higher return over time. The total return of long-term U.S. Treasury Bonds has barely exceeded the return of 5-Year U.S Treasury Notes since 1926 (5.5% vs. 5.3%). This additional 0.2% has come with almost twice as much annual volatility in returns and significantly greater downside risk during periods of rising interest rates. When interest rates start rising again this 0.2% will erode very quickly.

Dimensional Fund Advisors (DFA) has recognized that yield curves[4] change over time and that the risk/return equation can be altered in favor of the investor through periodic non-predictive shifts in short-term bond maturities. It does not make sense, for example, to own five year bonds if the yield on three years bonds is essentially the same. This is what happens when the yield curve flattens (like today). Regardless of what causes a flattening of the curve, the point is that we can get similar return at lower risk and the DFA Five-Year Global fund takes advantage of this. The fund can even look globally among the developed countries for these yield curve "gifts" to enhance returns even more.

This is not an advantage you have with "laddered" bond portfolios or indexed bond portfolios because the amount of money you (or an advisor) has in various maturities is fixed (or, in the case of indexed portfolios, shifts slightly with the change in the overall bond market). This leads to the final question:

Question: What about costs?
Answer: Keep them low, but see the forest through the trees.

A*ll else being equal*, the lower the investment costs associated with your fixed-income investment, the higher your yield. We believe low-cost bond funds like DFA's and Vanguard's are worth their modest expense ratios based on their buying power alone. You save money in the bond business by purchasing very large blocks of bonds at once, not by purchasing many small blocks over the course of a year through some broker on an "institutional" desk. Mutual funds managed by Vanguard, DFA, and others have a clear advantage *because they are buying large quantities for one account—the fund*. DFA's Five-Year Global fund adds further value with its variable-maturity (yield curve) strategy and currency-hedged global reach.

Some advisors using "institutional" desks of major brokerage firms to purchase individual bonds will claim that they also buy bonds cheaply. I don't buy it and I see no proof of such claims. They *might* get a break on commissions or spreads over retail investors, but they are not getting the breaks on *price* that the big boys are. Investing time and resources for no value-added on the low-risk side of the investment equation also detracts from all of the more important aspects of the client/advisor relationship.

For more information on our approach to fixed income investment, please see the "Fixed Income Strategies" position paper at www.tamasset.com/Site/Library.html.

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[1] Morningstar Principia Pro screen of "Short-Term" bond funds with 10-year track records ended 3/31/06. "Distinct portfolios only" (eliminates multiple fund share classes).

[2] Except that Morningstar excludes funds that have closed or merged—a frustrating "survivorship bias" that we just have to live with.

[3] Morningstar Principia Pro screen of "High Yield" and "Taxable" bond funds with 10-year track records ended 3/31/06. "Distinct portfolios only" (eliminates multiple fund share classes).

[4] A normal yield curve is one in which short-term debt instruments have a lower yield than long-term debt instruments of the same credit quality. This gives the yield curve an upward slope and is the most common yield curve shape.