TAM Asset Management, Inc.

Asset Class℠

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

Asset Class Returns

October 31, 2006 (YTD)

	2003	2004	2005	Last 10 yrs.	YTD 2006
Bonds					
One-year	1.6	0.9	2.3	4.3	3.9
Five-Year	3.0	2.9	1.7	6.1	3.2
Intermediate	2.5	4.3	1.6	6.2	3.3
Long-term	2.7	7.1	6.6	7.1	2.6
U.S. stocks					
Large Market	28.5	10.7	4.9	8.9	11.9
Large Value	34.4	18.2	10.2	11.9	15.6
Small Micro	60.7	18.4	5.7	13.6	11.8
Small Market	51.5	17.9	6.1	11.8	13.0
Small Value	59.4	25.4	7.8	15.9	16.4
Real estate	35.6	32.1	13.2	15.1	31.9
Int'l stocks					
Large Market	36.7	18.8	13.5	6.2	18.2
Large Value	49.4	28.8	15.3	9.2	25.0
Small Market	58.8	30.9	22.0	N.A	15.3
Small Value	66.5	34.8	23.2	10.2	18.1
Emerg. Mkts.	60.2	29.9	29.9	8.5	16.7

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 Evolution Continues (Part 2)

Jeff Troutner, TAM Asset Management, Inc.

The consistent failures of most active managers to outperform unmanaged indexes—regardless of market cycle, asset class, or country—has resulted in a fairly rapid evolution of a new way of managing serious assets. The huge body of academic research on markets, risk, and return that naturally grew from the need to explain these failures has resulted in the evolution of indexing as a rational alternative to active management. Indexing has further evolved into a more sophisticated strategy we call *asset class investing*.

New tools for maximizing the returns of an asset class strategy continue to be created and improved on by innovative firms like Dimensional Fund Advisors (DFA). These tools help advisors implement strategies for their clients based on sound financial science, real world experience, and structure—all necessary ingredients for combating investing's worst enemy: emotion.

Markets Work

What academic research has shown is that markets work. And markets work because of competition: Companies compete *for* capital and investors compete with each other (by buying and selling stocks) to find the most attractive returns *on* their capital. This competition forces prices to fair levels, which represent the consensus view of risk and potential return for each security.

Investors using active strategies are armed with *some* information, yet they attempt to outthink all other investors as a group (the "market") who are armed with *all* of the information. As a result, 70%-80% of active fund managers fail to beat the market over time. On the other hand, advisors who embrace asset class investment strategies treat markets as allies, not adversaries. As DFA states it, "Rather than trying to take advantage of ways markets are mistaken, we take advantage of the ways markets are right—the ways they compensate investors."

Active Management	Indexing	Asset Class Investing
* Attempts to beat market * Inconsistent asset class exposure * Generates high fees, costs, and taxes	* Commercial index defines asset class * Reducing "tracking error" is primary goal, increasing trading costs and taxes.	* Private indexes based on academic research designed to fully capture asset class return * Reduces trading costs and taxes

Evolution →

Free market economies thrive over time through competition and innovation. By wringing out all the risks and uncertainty of active management, indexing leaves investors with only the *compensated* risk and return of the overall economy as reflected in stock prices. The first index funds were created to profit from the total

continued on back...

economic growth of the developed nations through indexes such as the S&P 500, Wilshire 5000, and EAFE (non-U.S.). Because these indexes are weighted by company size, however, they are and always will be dominated by the stock performance of the very largest corporations.

Markets are Three-Dimensional

As financial economics has evolved, research has shown that stock markets are actually *three-dimensional*, resulting in higher risks and expected returns for small company and value stocks. This led DFA to devise better strategies and indexes for capturing the higher expected returns in those segments of the market in which stocks were illiquid and costly to trade. Their first fund, the "U.S. 9-10" small company fund (now called U.S. Micro Cap) was based on a proprietary index developed with the help of University of Chicago academics and the Center for Research in Securities Prices (CRSP) database.

DFA's success with their Micro Cap fund (the subject of a Harvard case study) demonstrates the value of not being slaves to commercial indexes. Fund managers who base their strategies on these traditional indexes must buy the exact securities in the exact percentages as the index. For example, to properly track the Russell 2000 small cap index, a fund manager must rank all U.S. publicly traded stocks by size (share price times number of shares outstanding) and then select the largest 3000. The Russell 2000 index is made up of the 2000 smallest stocks of that universe. Every year, the index fund must adjust for companies that float in or out of that list *and* adjust constantly for asset flows in and out of the fund. This generates turnover that results in higher costs to the fund shareholders (transactions costs and higher prices) than is necessary to capture the return premium we expect from the higher risk of small company stocks. Furthermore, limiting the "buy" list to the largest 3000 stocks ignores almost 6,000 *smaller* U.S. stocks.

DFA improved on the traditional indexing philosophy through a process called "patient trading" and by constructing their own (private) proprietary indexes. They found that in small cap and value stock portfolios, which usually own thousands of different stocks, it was not necessary to track an index perfectly. In fact, value is added by negotiating lower prices for buys and higher prices for sells with other institutional investors, especially index fund managers who are *forced* to track a public index. Private indexes also allow DFA to "dig deeper" into the small cap and value stock universe and capture more of the return premium these asset classes generate over time. DFA has shown that a more refined investment process, skillfully executed, adds value that flows directly to fund shareholder's bottom line.

The Core Evolution

As I mentioned in the previous *Asset Class*, advisors like TAM have used DFA's various asset class funds to build client portfolios targeted to very specific mixes of large, small, growth, and value stocks based on each client's risk and return objectives. For clients seeking higher returns, we allocate more of the portfolio to stocks in general and to small and value stocks specifically.

DFA's work with financial advisors over the past fifteen years or so[1] has exposed them to more "whole portfolio" issues, such as portfolio rebalancing and tax management. This experience has lead to the realization that this "component" asset class methodology could be improved upon by a "core" strategy that over- or under-weights small cap and value stocks *within* one fund rather than *across* several. This reduces expenses and taxes within the funds due to lower turnover and reduces transactions costs and taxes within a client *portfolio* due to less rebalancing among component funds.

Here's an example. Let's say we have a U.S.-only stock allocation of 30% S&P 500 (large growth), 30% large value, 20% small growth, and 20% small value. In the extreme, if a small growth company grows to the point where it needs to be sold in the small growth fund and purchased by one of the large cap funds, DFA executes two transactions.

In a core fund, which owns all of the stocks of the two funds, the stock's allocation would be reduced to keep the asset class balance intact, resulting in one transaction. In mutual funds owning thousands of stocks, this cost savings can be very significant.

In another example, let's say because of good performance we experience an increase in the small value allocation from 20% to 24%. In the component strategy, we would sell 4% of the small value allocation and increase the allocation of an asset class that is below its target. This creates potential tax consequences in a taxable account and transactions costs in either taxable or tax-deferred. Using core funds, most of the rebalancing is handled at the *fund level* by DFA as they work to keep the large/small/growth/value weights within their established targets. Using tax-management strategies within the funds, DFA can add even more value.

Greater detail on the workings and potential value-added of the DFA core strategies is beyond the scope of this article. Suffice it to say that TAM has the responsibility to implement asset class strategies that are best structured to meet our clients' goals. Risk, expected return, costs, taxes, and other issues are always considered.

While we view better structured alternatives to traditional index funds as a positive evolution in asset class investing, we will use them in client portfolios only where we believe they will add value. DFA is just one firm creating these alternatives, but they are clearly the leaders in confirming once again that not all "index" funds are created equal.

[1] Prior to the early 90's, DFA only managed portfolios for large institutional clients such as foundations, endowments, and corporate and public retirement systems and then only for a segment of the total portfolio, such as small cap stocks.