



Index Fund Strategies

ASSET CLASS

A monthly update of asset class performance, trends, & topics for long-term investors

Index Returns

	YTD 10/31	% Change From 9/30
Bonds		
Short-term	+5.1%	+0.7%
Intermediate	+7.9%	+1.8%
Long-term	+11.2%	+2.9%
Global	+7.1%	+0.4%
U.S. stocks		
Large Market	+25.2%	-3.3%
Large Value	+25.1%	-5.1%
Small Market	+26.1%	-4.4%
Small Value	+31.8%	-3.5%
Real estate	+14.6%	-2.8%
Int'l stocks		
Large Market	+4.4%	-8.2%
Large Value	+1.6%	-5.2%
Small Market	-11.5%	-4.4%
Small Value	-10.8%	-3.9%
Emerging Mkts.	-13.8%	-14.9%

Short-term bonds = DFA One-Year Fixed Income fund; Intermediate bonds = DFA Intermediate Government Bond fund; Long-term bonds = Vanguard Bond Index Long-term; Global bonds = DFA Global Fixed Income fund; U.S. Large Market = Vanguard Index 500 fund; U.S. Large Value = DFA Large Cap Value fund; U.S. Small Market = DFA 6-10 Small Company fund; U.S. Small Value = DFA Small Cap Value fund; Real Estate = DFA Real Estate Securities fund; Int'l Large Market = DFA International Large Cap fund; Int'l Large Value = DFA International Large Cap Value fund; Int'l Small Market = DFA International Small Company fund; Int'l Small Value = DFA International Small Cap Value fund; and Emerging Markets = DFA Emerging Markets fund.

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy. **Past performance does not guarantee future returns.**

*This newsletter is published by
TAM Asset Management, Inc.
175 N. Redwood Dr., Suite 155
San Rafael, CA 94903
phone: 415-499-8862
fax: 415-499-8864
email: trout@tamasset.com
Web Site: www.tamasset.com*

Editor: Jeffrey C. Troutner

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What do you get when you combine a severe currency crisis in Southeast Asia with a dramatic drop in Hong Kong stock prices and high price-earnings ratios for U.S. stocks? A 554 point drop in the Dow one day and a 337 point rise the next. These kinds of moves can be distressing to investors, but they should not be unexpected after such a sustained rise in stock prices. When considering the relevance of these moves keep in mind that the drop on October 27 was only one-third as bad in percentage terms as the crash of 1987 and that U.S. large company stocks are still up over 28% for the year. U.S. small value stocks are up almost 35%.

In volatile periods like this it is also not uncommon to see many of the world's markets moving together. Global diversification works well in the intermediate-to-long term, but in the short run all bets are off.

Long-term investors will be rewarded for their patience during times like these. If good buying opportunities develop, the wise investor will gradually invest accumulated cash reserves, not pull back in fear.

Emerging Markets: The Final Frontier for Active Managers

By offering intellectually-sound arguments *and* producing superior long-term results in the U.S. markets, "indexers" have won the biggest battle of the global investment war.

The battle's still raging on the international side, however, as active proponents hang on to the belief that good stock picking and market timing work overseas. This is silly, of course, when you consider that crystal balls made in Taiwan are no better than those made in the good old U.S., but when you're fighting for your financial survival (or your reputation), who cares about logic or common sense? Basically, their arguments hinge on the fact that active managers as a group have outperformed international indexes over the past few years.

Before you fall for the "international markets are inefficient" argument, think about the challenges fund managers face in evaluating companies in, say, Malaysia. Are they obtaining full disclosure of facts? Are they factoring in significant accounting differences? What about insider trading? Currency fluctuations? Earnings projections? Interest rate forecasts? Economic cycles? Stock trading restrictions? Fragile governments? Etc., etc. Is it possible that a fund manager in Chicago who travels a couple of times a year to Southeast Asia can choose this Malaysia stock over that Malaysia stock with any consistent degree of success?

Most fund managers know this can't be done. So what do they do instead? They "market time." That's right. They use the most discredited strategy in the universe to shift assets from one country to another in an attempt to buy low and sell high. If they're right, they're heroes and they "prove" that international markets are inefficient and exploitable.

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To demonstrate the fallacy of this argument let's look at the most "inefficient" of international asset classes: emerging markets. Can these inefficiencies be exploited by talented, high-priced fund managers? Looking at the Templeton Developing Markets fund the answer is, apparently, yes.

So far this year (11/4), the Templeton fund is up 3.5% versus -8.2% for the DFA Emerging Markets index fund and -11.6% for the Vanguard Emerging Markets index fund. Since 1/1/95, the Templeton fund has gained an annualized 8.9% versus 1.6% for the DFA fund and 1.0% for the Vanguard fund.

There you have it. Proof that active management works in the emerging markets. End of story.

Or is it?

Let's say it's the end of 1990 and you have just been told by your favorite advisor that emerging markets is the next hot investment opportunity. You look at your Morningstar report and see that the only two emerging markets mutual funds were down 14.4% and 5.3%. You decide to wait. Next year (1991) you watch the funds and find that the original two were up 24.2% and 23.4% respectively, while a new fund from Fidelity struggled to a not-too-hot 6.8% return. (This strikes you as odd, being the international-markets-are-inefficient type you are, but what the heck. Maybe the biggest and richest fund company in America—the home of Peter Lynch, no less—can't always attract the best and brightest fund managers.) Since an S&P 500 index fund was up 30.2% anyway, you decide to wait again.

Good thing, since the three funds were only up 3.8%, 1.2%, and 5.9% respectively in 1992 and the S&P 500 index fund was up 7.4%. You decide to wait once again.

Oops. Your advisor told you emerging markets were hot! In 1993, the funds soared 63.4%, 69.0%, and a whopping 81.8%

respectively (maybe I was too quick to judge that hot shot from Fidelity). The S&P 500 index fund was up a mere 9.9%.

O.K., you decide now is the time to move. You look at the Morningstar data again and notice that Templeton opened an emerging markets fund in 1992. Unfortunately, it lost 9.8% that year when all the others were up and it lagged the Fidelity fund in 1993 (+74.5% to +81.8%). So you consult your crystal ball and decide to place your bet on that highly-paid Ivy League talent at Fidelity and plunge into the brave new world of emerging markets mutual funds.

Ouch. Down 17.9% in 1994. Down 3.2% in 1995. Up 10% in 1996 (thank God). Down 37.7% so far in 1997!! Darn (or stronger expletive of your choice). *So much for exploiting inefficiencies!* That yo-yo from Fidelity lost over 45% of your money in just over three years!

Of course your advisor tells you that *he* never really liked that guy at Fidelity. You know, ever since Peter Lynch retired the place has gone downhill. *His* choice was always Templeton (up 16% over the same period), but you wanted that higher performance Fidelity had generated in 1992 and 1993, remember?

So there you have it. The international markets really are inefficient. You just have to have the right crystal ball.

Needless to say (I hope), we believe a small percentage in emerging markets stocks makes sense for long-term investors. We just think the asset class—like all asset classes—should be indexed. We're confident that these economies as a whole will grow at high rates over the next few decades and this growth will be reflected in stock prices. But we're not confident that we or anyone else can predict the often severe short-term fluctuations in the individual stock markets of these countries.

—Jeff Troutner

