



Index Fund Strategies

# ASSET CLASS

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

## Index Returns

	% Return			5/15
	1995	1996	1997	1998
<b>Bonds</b>				
Short-term	8.0	5.8	6.0	2.1
Intermediate	19.1	2.4	9.2	2.3
Long-term	30.1	-1.3	14.3	1.8
Global	16.0	10.8	8.3	3.1*
<b>U.S. stocks</b>				
Large Market	37.5	22.9	33.2	14.9
Large Value	38.4	20.2	28.1	18.6*
Small Market	28.7	18.2	24.6	8.4
Small Value	29.3	22.3	30.7	11.5*
Real estate	12.1	33.8	19.3	-3.2
<b>Int'l stocks</b>				
Large Market	13.1	6.4	5.5	14.2
Large Value	11.5	7.8	-3.1	19.1*
Small Market	0.5	2.6	-23.7	18.1
Small Value	1.2	1.0	-22.7	17.4*
Emerg. Mkts.	2.2	11.4	-18.9	2.6*

\*TAM asset classes

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 = Vanguard Index Small Cap; U.S. Small Value = DFA US 6-10 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.**

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## Markets Update Tuesday, May 19, 1998

The DFA U.S. large and small value index funds continue to outperform their "market" counterparts this year by 3.7% and 3.1% respectively. What most investors aren't aware of, however, is the extreme difference in valuations between these indexes today. In view of a Dow at 9,100, maybe it's time they were.

	<u>P/E<sup>1</sup></u> <u>Ratio</u>	<u>P/B<sup>2</sup></u> <u>Ratio</u>	<u>P/C<sup>3</sup></u> <u>Ratio</u>	<u>Div.<sup>4</sup></u> <u>Yield</u>
DFA U.S. Large Cap Value Fund	19.2	2.1	7.9	2.71%
Vanguard Index 500	30.0	7.1	20.0	1.28%
DFA U.S. 6-10 Value	23.0	2.0	9.4	2.32%
Vanguard Index Small Cap	26.8	4.4	13.4	1.01%

It's interesting that while investors *today* pay a substantially lower average price for the stocks in the DFA funds compared to the Vanguard index funds, the *past performance* of the funds over this last bull run (1/95 to 5/15/98) has been very close.

	<u>Total Return</u>
DFA U.S. Large Cap Value Fund	134.2%
Vanguard Index 500	143.6%
DFA U.S. 6-10 Value	119.0%
Vanguard Index Small Cap	97.0%
50/50 DFA Large & Small Value	126.6%
50/50 Vanguard Large & Small	120.3%

<sup>1</sup>Price/Earnings per share, <sup>2</sup>Price/Book Value per share, <sup>3</sup>Price/Cash Flow per share, <sup>4</sup>Dividend/Price per share

## The Truth Investors Don't Want to Hear On Index Funds...

Jeff Troutner, TAM Asset Management, Inc.

Jonathan Clements, a writer for *The Wall Street Journal*, wrote an article recently that started out, "The numbers don't lie. But investors, it seems, don't want to hear the truth."

He was speaking, of course, about indexing and he went on to list about half a dozen reasons why *most* investors continue to buy actively-managed funds, listen to the advice of stockbrokers, and subscribe to investment newsletters.

For the most part, *index fund* investors believe the numbers and understand that they have put the investment odds in their favor by rejecting active strategies. But some have more faith than others. For those tempted by "The Dark Side" (as DFA's chairman refers to active management), here's a review of some of Clement's observations, as well as some of my own.

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### **People Justify the Value of Something Based on Its Popularity**

For some, this is the bottom line. Forget about *why* it's popular. If everyone else is doing it, it must be good. I made a presentation to a hospital investment committee once and near the end of the meeting the only response their high-priced consultant could make to my case for indexing was, "But, if indexing makes so much sense, why isn't *everyone* doing it?"

### **We Think We Can Pick Winners**

The hospital committee believed that the consultant could pick the winners and was willing to pay her a substantial fee to do so. What they didn't know (because the consultant didn't tell them) is that the odds of picking a winner are about 1 in 4 (last year it was 1 in 10) and the winners change every year! Furthermore, consultants never come armed with a track record showing their *past* performance at picking the winners, they simply show their *current* picks.

### **We Want to Believe There Is Order in the Markets**

One thing I try to stress with investors is that by owning common stocks they are investing in the *future economic growth of the U.S. and foreign countries*. If you believe capitalism and free markets work, it shouldn't take a lot of faith to believe that share prices in these countries will be higher ten years from now.

In the meantime chaos reigns! Day-to-day stock prices are random. Stock markets move in opposite directions at different times (e.g., the U.S. and Japan the past three years). There is no order in the short-term. Yet too many investors believe that an active manager's performance over the last year has a lot to do with what his performance will be over the *next* year.

We are comfortable with patterns and trends. Therefore, we are comfortable with gurus who seem to be able to make sense of them.

### **Despite Common Sense, We Believe Some People Can Predict the Future**

Of course, we don't look at it this way. We think *our* broker or money manager is just smarter than

the other guy. He sees things differently from everyone else or he works harder. He has a special "touch" or maybe he's just lucky. We don't care. We just know he's made some good decisions in the past and we have no reason to think he'll blow it in the future.

In an unregulated environment where a limited number of people could act on inside information, or someone investing more time digging up the facts could act sooner than everyone else, or transaction cost were non-existent, this attitude could pay off. But that's not the environment we're in.

And that is why "regression to the mean"—that wonderful phenomenon that humbles advisors, consultants, and investors alike—is a real problem. Consultants and brokers live by the mantra, "The king is dead. Long live the king."

### **People Have Very Limited Knowledge of Investments**

As one writer noted in a recent book on indexing, most people know more about amoebas from their high school biology course than they do about investing. We don't teach this stuff in school. Even most *accountants* I run into have no idea of the benefits of indexing or the consistent failures of active management. They, like most people, are *sold* investment ideas. And he who has the most interesting idea usually wins (and we all know how boring indexing is).

### **We Want to Be Told What to Do**

I know my *best* clients will be those who take the time to study some of the research and read some of the books I have read *before* deciding on an indexed strategy. Many, however, take what I tell them as fact and simply accept it.

Most advisors would be happy with the latter group. I'm not because I know that without *real knowledge* investors are susceptible to the next great idea.

Investors need to review both sides of the active/indexing argument because advisors with more popular strategies who think they can predict future market moves or pick winners by identifying trends, prefer to tell less knowledgeable clients what to do.