

Index Fund Strategies

ASSET CLASS[®]

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

Index Returns

	% Return			8/4
	1995	1996	1997	1998
Bonds				
Short-term	8.0	5.8	6.0	3.3
Intermediate	19.1	2.4	9.2	4.7
Long-term	30.1	-1.3	14.3	6.2
Global	16.0	10.8	8.3	4.8*
U.S. stocks				
Large Market	37.5	22.9	33.2	11.4
Large Value	38.4	20.2	28.1	6.7*
Small Market	28.7	18.2	24.6	-7.6
Small Value	29.3	22.3	30.7	-5.3*
Real estate	12.1	33.8	19.3	-13.8
Int'l stocks				
Large Market	13.1	6.4	5.5	13.4
Large Value	11.5	7.8	-3.1	17.5*
Small Market	0.5	2.6	-23.7	10.2
Small Value	1.2	1.0	-22.7	8.6*
Emerg. Mkts.	2.2	11.4	-18.9	-11.8*

*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 Wednesday, August 5, 1998

The DJIA dropped 300 points yesterday to close at 8487, a decline of 850 (9.1%) from its peak of July 17. But as a recent article in the *Wall Street Journal* points out, the *average* U.S. stock has fared much worse. As of July 28, the *average* stock on the New York Stock Exchange was *down* 24.3% from its 52-week high—the biggest decline since 1990, the last official bear market. On the NASDAQ exchange, the average stock has declined even more, off 35%.

In light of these numbers, how can the S&P 500 still be up 11.4% for the year? The answer lies in the fact that just 78 stocks in the average accounted for all of the return. In fact just five stocks—Microsoft, Lucent Technologies, GE, Wal-Mart, and Pfizer—provided one-quarter of the index's return. Since the S&P 500 and most indexes are market cap weighted, these larger stocks have a greater impact on return.

A common fallacy, particularly as it relates to index funds, is that mutual fund buying is responsible for this lopsided market in favor of large stocks (this was one of the explanations given in the above article). However, as the table below shows, fund ownership of large company stocks isn't as high as you might expect. Of course, a look at the Lipper Growth & Income Fund Average—up 4.6% versus 11.4% for the S&P 500—would suggest the same.

Stock	Market Cap (\$ bil)	% Shares Held By Funds
General Electric	\$272	9
Microsoft	\$209	6
Coca-Cola	\$194	4
Exxon	\$173	6
Merck	\$140	10
Pfizer	\$136	13
Wal-Mart	\$123	12
Intel	\$117	9
IBM	\$114	13
Proctor & Gamble	\$113	8
Bristol-Myers Squibb	\$107	16
AT&T	\$99	13

The silver lining in this cloud for TAM clients is that once the bloom comes off of the large growth stocks, the beneficiaries (over time) should be low-priced large and small company value stocks.

On the non-U.S. side, changes are occurring in the Japanese political leadership that offers some hope in moving that country out of their prolonged recession. This will eventually lead to a recovery in the Asian economies. Since a recovery in the stock markets is likely to precede an economic recovery, attempting to time moves in or out of the markets carries a lot of risk.

What Should We Do About Asia?

Jeff Troutner, TAM Asset Management, Inc.

An investment strategy based on sound principles is of no value without the discipline to follow it when things get tough. This is certainly true of a strategy based on the “cost-of-capital” risk and return principles such as ours. The observations and assumptions underlying the philosophy are *long-term* in nature and, by default, will appear weak at certain times in the market cycles.

Right now, two major components of our strategy—diversification among small company stocks and international stocks, particularly Asian—are affecting returns to the point where strong discipline is required to realize the expected benefits.

Asia

The question is not so much whether these markets *will* recover and produce relative returns in line with historical averages, but *when*. After almost ten years of a Japanese bear market, this question is very relevant and understandable.

This leads us to the most fundamental issue facing long-term investors: Can the start and duration of these periods be predicted ahead of time, at least close enough to make a difference in performance?

My answer is unequivocally “No”. The serious downturns cannot be predicted with any more accuracy or consistency than the inordinately high upswings. I keep coming back to the fact that most U.S. money managers missed the huge surge in Japanese stock prices in the eighties, but it’s a fact.

So if we have no idea when or how long debacles like the Asian crisis will occur, should we just ignore them completely? To long-term investors, I would say yes. Rebalance your portfolio occasionally, but fight the urge to make major allocation changes.

For investors with a lower risk tolerance or shorter investment time horizon, I would suggest that the degree of the problems in Asia might warrant a fresh look at your portfolio allocation to international small stocks and emerging markets stocks. The reasons I say this are: (1) there is an increased risk of bankruptcies among smaller companies in that region, and (2) the recovery period for these economies *could* be fairly long.

Before you decide to eliminate these asset classes, however, consider these points. First, the Asian stock markets have already taken big hits in their stock prices. The Hong Kong, Malaysia, and Singapore “WEBS” (World Equity Benchmark Shares traded on the AMEX)

have fallen 62%, 75%, and 62% respectively from their 52 week highs. In view of the fact that the DFA International Small Company, International Small Value, and Emerging Markets funds are down 16%, 15%, and 37% over the same period, it’s difficult to see the point in moving out now.

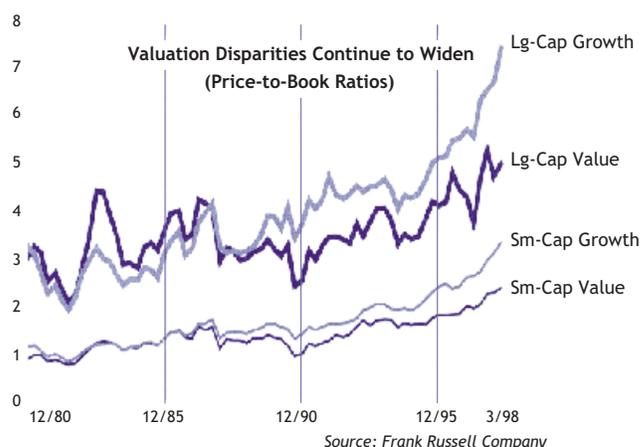
Second, more conservative investors and those with shorter time horizons have less exposure to these markets in the first place. TAM “Conservative” portfolios (50% stocks) do not own the international small or emerging markets portfolios. The TAM “Moderate” portfolios (65% stocks) have about 7% of total assets invested in all of the Asian markets including Japan.

So, while the Asian financial crisis has affected TAM returns, most investors, I believe, would be better off maintaining an allocation to the region and being there when things start moving ahead once again.

Small Company Stocks

Personally, the very narrow market in the U.S. has me more concerned. Are we to believe that the most basic of investment principles—higher risk leads to higher returns—has been forever suspended? Aren’t smaller companies inherently more risky as a group than GE, Coke, Microsoft, and Wal-Mart?

The chart below shows the widening disparity between the valuations for large growth stocks and small value stocks. A move back to a more “normal” spread should favor small stocks in general and small value stocks specifically.



In any case, I believe patience will be rewarded for investors owning small company and Asian stocks. Asset class diversification is as sound a strategy today as it was three and a half years ago.