



Index Fund Strategies

# ASSET CLASS

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

## Index Returns

	% Return			9/25
	1995	1996	1997	1998
<b>Bonds</b>				
Short-term	8.0	5.8	6.0	4.2
Intermediate	19.1	2.4	9.2	10.0
Long-term	30.1	-1.3	14.3	10.8
Global	16.0	10.8	8.3	6.8
<b>U.S. stocks</b>				
Large Market	37.5	22.9	33.2	8.8
Large Value	38.4	20.2	28.1	-0.1
Small Market	28.7	18.2	24.6	-17.3
Small Value	29.3	22.3	30.7	-16.1
Real estate	12.1	33.8	19.3	-12.4
<b>Int'l stocks</b>				
Large Market	13.1	6.4	5.5	0.2
Large Value	11.5	7.8	-3.1	-0.5
Small Market	0.5	2.6	-23.7	-1.9
Small Value	1.2	1.0	-22.7	-3.2
Emerg. Mkts.	2.2	11.4	-18.9	-29.9

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 = 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 Friday, September 25, 1998

Stock markets around the world continue to struggle with the economic shocks from Japan, the smaller Asian markets, and now Russia. After hitting their lows in August, the U.S. markets have bounced back a bit, but are still plagued by high volatility.

Investors who believe that short-term “extremes” in the markets are corrected over time have to be frustrated with three prominent trends that still appear to have strong momentum: (1) the performance of U.S. large stocks versus small stocks; (2) the ongoing bear market in Japan; and (3) the valuations on Internet-related stocks. Since these trends develop gradually over time and take most investors by surprise, there is no way to profitably exploit them on a consistent basis. This is why we diversify broadly and do not engage in market timing. (While the Internet trend does not affect us directly, it does signal an excessive optimism that is not particularly “healthy” for the market.)

There are really only two ways to react to trends like these. You can either invest in all of the asset classes with biases in favor of the long-term averages (the TAM approach, where we recommend a 60/40 bias to small companies and a 100% bias to large and small “value” stocks) or you can make bigger bets based on recent trends. The problem with the second strategy is that if you jump on a trend early—which is the only way to really profit given the fact that you also need to bail out at the right time—you have very little information to go on. In other words, if the trend is so certain based on current information, the move’s probably already over.

On the other hand, as advisors we can learn from these trends and adjust the way we approach client asset allocation recommendations. The last five years have taught me that some investors have an “emotional” time horizon that is much different and just as important as their true investment time horizon. I will discuss this concept and its implications in next month’s *Asset Class*.

## Avoiding an Irrational Response To “Irrational” Markets

Jeff Troutner, TAM Asset Management, Inc.

Since the beginning of 1995, large growth companies have provided higher returns to shareholders than small companies by a wide margin. This is not the experience of the previous twenty-one years, nor is it consistent with “cost of capital” principles that state that investors should expect lower returns from lower risk securities.

There is a tendency to suggest that investors have acted irrationally by bidding large growth stocks to their current levels, while ignoring the better fundamentals of small company stocks. I suggest instead that the only investors acting irrationally are those who will or have already shifted money out of small company stocks and into large company stocks *expecting these recent return relationships to continue long-term*. On the other hand, investors who have shifted to large company stocks *seeking more security and less risk*—and, thus, lower returns than small company stocks over time—have made a rational move.

Before we discuss how large company stocks could have produced such “irrational” returns recently, let's put small company returns in perspective. As Table 1 shows, small company stocks since the beginning of 1995 and through the recent “correction” have returned 12.6% annually. This is pretty close to the 13.0% per year for the previous

inflation, and global economic prosperity (with notable exceptions, like Japan). As the earnings streams of the large multinational became more “certain” in investors minds, they were willing to pay higher and higher prices for these stocks. In other words, the perceived risk of owning these stocks has fallen over time.

Table 1 Asset Class	Annual Return	
	1995 - 8/98	1973-1994
U.S. Large Companies (S&P 500)	24.4%	10.7%
U.S. Small Companies (6-10 Index)	12.6%	13.0%
U.S. Large “Value” Companies (DFA)	19.9%	14.8%
U.S. Small Value Companies (6-10 Value Index)	14.8%	17.7%

Some people would argue that investors have come to expect 20% + returns on large growth stocks. I don't think that's the case. I believe *most* investors have felt more comfortable and secure owning the very largest companies and their stable brand names. This lower perceived risk meant they were willing to pay more for these shares.

twenty-one years. Small value stocks returned 14.8% over the recent period and 17.7% over the previous one. *Investors have been well rewarded—in line with historical averages—for the risk of owning small company stocks the past four years.* So what should we make of the fact that over this period large, established companies provided investors with twice the return of small company stocks with less investment risk? Should we expect this trend to continue?

### Where We Stand Today

At the end of 1994, the S&P 500 was priced at a 17.6 times earnings (P/E) and 3.2 times book value (P/B). By the end of June of this year, these numbers were 30.1 and 7.1 respectively. On August 31, after a major decline, the multiples stood at 26.4 and 6.3. In contrast, the average small company P/E and P/B were 19.7 and 2.4 at the end of 1994 and are 19.9 and 2.7 today—relatively unchanged. Yet earnings growth rates for small company stocks have almost doubled.

Let's start with the second question first. The answer is no. We should not expect large growth companies to generate higher returns on capital than small company stocks, let alone twice the return. Otherwise we would be saying that by taking less risk we should expect higher returns. What a deal! The flip side is that we could take *more* risk by owning smaller, riskier companies with the wonderful prospect of earning less return on our money!

### Looking Back

Four years ago, the S&P 500 was coming off a miserable year. The total return for the index in 1994 was 1.2%. Interest rates were rising on inflation fears, financial derivatives and bad money management caused the bankruptcies of Orange County and the 232 year-old Barings Bank, the dollar was falling to post-World War II lows against the German mark and Japanese yen, and the Mexican economy collapsed. Michael Metz of Oppenheimer summed it up when he said that there was “a perception of rising instability, not only in international emerging markets, but also in currencies and even in the U.S. market”\* as 1995 began. Large company stock prices reflected this pessimism.

What happened since then is that investors were pleasantly surprised by stronger than expected earnings in large company stocks during a period of falling interest rates, low

Table 2 Asset Class	4-Yr. Earnings		
	P/E	P/B	Growth
U.S. Large Companies			
1994	17.6	3.2	4.4
June 1998	30.1	7.1	20.4
August 1998	26.4	6.3	17.6*
U.S. Small Companies			
1994	19.7	2.4	9.6
June 1998	23.4	3.5	17.4
August 1998	19.9	2.7	17.7*

\* 3-Yr. Earnings Growth Rate, Source: Morningstar

We can't predict how long large company stocks will outperform small company stocks. But we do know this: Investors must realize that a decision to buy or sell large or small company stocks *today* is done at *today's prices*, not the prices of four years ago and they should avoid making irrational asset allocation moves by focusing on today's prices and *sound risk/return principles*, not recent *returns*.

\* It Was a Very Good Year: Extraordinary Moments in Stocks Market History, By Martin S. Fridson, p. 217