

Index Returns

	1996	1997	1998	Last 6 yrs.	3/17 1999
Bonds					
Short-term	5.8	6.0	5.7	5.4	+ 0.9
Intermediate	2.4	9.2	10.5	7.7	- 1.4
Long-term	-1.3	14.3	12.0	8.9	- 2.3
Global	10.8	8.3	8.4	8.3	+ 1.6
U.S. stocks					
Large Market	22.9	33.2	28.7	21.4	+ 5.7
Large Value	20.2	28.1	12.0	18.3	+ 3.7
Small Market	18.2	24.6	-5.5	12.4	- 7.0
Small Value	22.3	30.7	-7.3	16.0	- 6.6
Real estate	33.8	19.3	-15.4	8.2	- 3.8
Int'l stocks					
Large Market	6.4	5.5	18.2	12.1	+ 2.2
Large Value	7.8	-3.1	14.9	13.5	+ 1.8
Small Market	2.6	-23.7	8.2	4.2	+ 0.7
Small Value	1.0	-22.7	5.3	3.7	+ 1.7
Emerg. Mkts.	11.4	-18.9	-9.4	5.4	+ 4.0

Descriptions of Indexes

Short-term bonds	DFA One-Year Fixed Income fund
Intermediate bonds	DFA Intermed. Gov't 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 US 6-10 fund
U.S. Small Value	DFA US 6-10 Value fund
Real Estate	DFA Real Estate Securities fund
Int'l Large Market	DFA Int'l Large Cap fund
Int'l Large Value	DFA Int'l Large Cap 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 6 yrs." returns for U.S. Large Value (3/93), U.S. Small Value (3/93), Int'l Large Value (3/93), Int'l Small Market (10/96), Int'l Small Value (1/95), and Emerging Markets (5/94) include simulated data prior to fund inception (in parentheses).

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 Thursday, March 18, 1999

As the Dow Jones Industrial Average closes in on the 10,000 mark, investors are being deluged with opposing views on the short-term direction of the market. The *Wall Street Journal* published an article yesterday (3/17) by two authors of a new book who are suggesting that the market should be at 36,000—today! By their calculations, stocks should be trading at 100 times earnings, not the historically high 27, 35, or 41 times earnings of the Dow, S&P 500, and S&P/BARRA Growth indexes respectively today. Their assumptions depend on interest rates, earnings growth rates, consumer spending, oil prices, etc., etc., staying at current levels, of course. And we know that always happens. The only *real* certainty is that they will sell a lot of books. Too bad we can't buy stock in that!

Clearly, painfully (for those of us who believe in the potential of small company and value stocks), most of the action continues to be in large growth stocks, and the cream of this crop are the technology companies. Investors should decide—rationally, not emotionally—whether participating in this feeding frenzy is wise at these price levels. Long-term there is little question that it is, but long-term we also feel confident that the extra risk of small company and value stocks will generate even higher returns.

The Asset Allocation Debate Rages On

Jeff Troutner, TAM Asset Management, Inc.

Visit just about any investment bulletin board on the Internet or pick up any financial magazine and you will find the expert of the day questioning the "small cap" and "value" premiums (the extra returns small company stocks and stocks trading at low prices relative to their book values have produced over the long-term). The implication is that since large U.S. growth companies have outperformed every other asset class on the planet over the past four years, there is no reason to expose yourself to greater risks in search of higher returns elsewhere.

Of course, these debates are nothing new. There was an article in *Business Week* in August 1982 that suggested that the *equity* premium did not exist. That was after 17 years when risk-free Treasury Bills had a higher return than the S&P 500! Seventeen years!!

There was another period of nine years, 1975-1983, when U.S. small company stocks outperformed large company stocks (the S&P 500) by over 18% per year and value stocks beat growth stocks by almost 7% per year. Over the past four years, large stocks have turned the tables by 14% and 6% respectively.

The latest return premium touted by the experts is the "technology" premium. This has been "proved" by the performance of the NASDAQ 100 index over the last four years (see chart). Of course, no expert will

Table 1: Where Was the Equity Premium?

17 Years 1964-1981	6-Month Treasury Bills	S&P 500
Annual Return	7.2%	6.9%
Annual Volatility	3.3%	17.2%

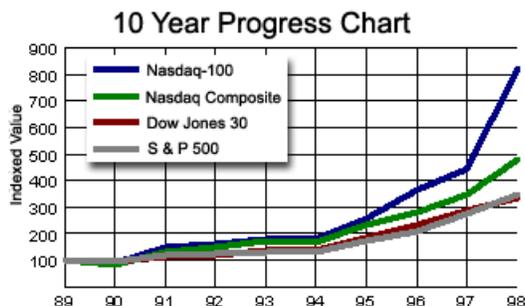
Table 2: Small Cos. & Value Stocks Have Their Streaks

9 Years 1975-1983	S&P 500	U.S. Large Value	U.S. 9-10 Small Co.
Annual Return	15.7%	22.3%	34.2%
Annual Volatility	15.5%	16.9%	19.2%

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suggest that times have changed based strictly on recent performance. Give them a chance (and a hefty signing bonus) and they'll write a book about why large U.S. multinationals with strong brand names will dominate world commerce from here on out, or why the future growth in sales and earnings of technology companies will far outpace the growth of the general economy (both books come in 1972 and 1999 versions, by the way).



Among all of the "expert" analyses one study stands out as serious financial economics that considers both return and risk when claiming a "premium" for one asset class over another: the Fama/French Three Factor Model. The core assumption of the Model, as we have pointed out in many of our newsletters, is the common sense fact that in a free and active market extra return can only come from taking extra risk. Investors who choose to ignore this principal and assume that large, established U.S. growth companies are a "free lunch" to higher returns, could be in for a big surprise.

Instead, investors should look at the last four years as a fact of life in the financial markets: asset classes—despite their long-term risk/return characteristics—can run counter to our expectations for many years. You can use this knowledge in two ways:

1. Build a portfolio that includes *all* of the asset classes, or
2. Build a portfolio that optimizes long-term risk/return by eliminating stocks with high prices relative to their book values (growth stocks).

TAM has generally recommended the second option to our clients. At the same time, we have asked clients to take the time to review the underlying principals of this approach and become familiar with the long-term return data for the asset classes. As a result, we have placed greater emphasis on small company, value, and international stocks to build long-term portfolios. Newer clients, understandably more sensitive to recent events, have chosen to build portfolios that include less of these asset classes and more of a tilt toward large U.S. growth companies. The trade-off, which they are willing to accept, is a lower overall expected *long-term* return and the risk that recent asset classes trends reverse in the *short-term*.

This is a major decision facing investors today. Do you maintain an allocation much less concentrated in large U.S. growth

stocks in order to capture the expected return premiums from small companies and value stocks, or do you reallocate assets to the current "hot" asset class? What if the "hot" asset class stays hot for *another* four years?

I believe the answer lies in how *uncomfortable* you have felt with your portfolio the past couple of years. I would suggest that an investor moving too heavily to large growth stocks has a high probability of feeling uncomfortable the *next* four years. But what about an investor who makes the following changes?

Old Allocation	New Allocation
From: 100% value	To: 50/50 growth/value
From: 40/60 large/small	To: 60/40 large/small
From: 60/40 U.S./foreign	To: 70/30 U.S./foreign

The table below shows the past (expected) returns for these portfolios for different time periods. Period 1 ends in 1994 and shows the numbers as we saw them four years ago, Period 2 represents only the last four years, and Period 3 shows the total period through last year. The old allocation has a slightly higher annual volatility. Both allocations are 100% stocks.

Long-term Return Premium vs. Better "Benchmark" Tracking

Period	Old Allocation	New Allocation	Difference	S&P 500
1: 1973-1994	17.9%	15.1%	2.8%	10.8%
2: 1995-1998	13.5%	17.7%	-4.2%	30.3%
3: 1973-1998	17.2%	15.5%	1.7%	13.5%

The historically extreme performance of the S&P 500 over the past four years caused the new allocation to narrow the gap with the old allocation for the total period, yet the return premium for the old allocation remains high. However, this 1.7% (or whatever it turns out to be in the future) may be worth giving up to avoid falling too far behind a highly publicized benchmark like the S&P 500.

Unfortunately, too many investors are being drawn to that 30.3% return of the S&P 500 and severely overweighting their portfolio toward the one asset class. If the fundamental principals of risk and return and cost-of-capital ever reassert themselves, the cost to these investors could be huge, and will most likely be compounded by another reactionary move the other way.

It is hard to argue against a continuing bull market in large U.S. growth and technology stocks in the face of our current optimism and the momentum of these stocks. It's like standing in front of a freight train. The train may roll on for a long time, it may slow down, or it could crash and take many years to rebuild itself. Our clients don't pay us to speculate about the future, so we won't. But we will provide the tools to help build diversified portfolios to meet specific objectives. If your objectives and expectations have changed, you should consider changing your asset allocation. Otherwise, we suggest you sit back and enjoy the ride at the speed you've chosen.