



Index Fund Strategies

ASSET CLASS

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

Index Returns

	1996	1997	1998	Last 6 yrs.	7/7 1999
Bonds					
Short-term	5.8	6.0	5.7	5.4	+ 2.2
Intermediate	2.4	9.2	10.5	7.7	- 3.8
Long-term	-1.3	14.3	12.0	8.9	- 6.7
Global	10.8	8.3	8.4	8.3	+ 2.2
U.S. stocks					
Large Market	22.9	33.2	28.7	21.4	+ 14.1
Large Value	20.2	28.1	12.0	18.3	+ 16.6
Small Market	18.2	24.6	-5.5	12.4	+ 10.7
Small Value	22.3	30.7	-7.3	16.0	+ 12.3
Real estate	33.8	19.3	-15.4	8.2	+ 5.7
Int'l stocks					
Large Market	6.4	5.5	18.2	12.1	+ 7.4
Large Value	7.8	-3.1	14.9	13.5	+ 8.7
Small Market	2.6	-23.7	8.2	4.2	+ 18.3
Small Value	1.0	-22.7	5.3	3.7	+ 20.2
Emerg. Mkts.	11.4	-18.9	-9.4	5.4	+ 44.5

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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Value stocks continue to lead the way this year, but over the past couple of weeks growth stocks have narrowed the return gap. Small company stocks have also found new life, particularly in the overseas markets.

The best performing asset class, by far, has been the emerging markets. Last year you couldn't give these stocks away. After selling out at the bottom, I have to wonder how many investors are buying them now.

Diversified investors are being rewarded this year for their patience. As more focus is placed on *real* earnings, price multiples, and dividend yields, asset classes besides large U.S. growth stocks should continue to benefit.

The Grand Infatuation

William J. Bernstein, *Efficient Frontier*

Troll the latest reincarnation of the office water-cooler—investor internet chat rooms and discussion boards—and you'll find abundant evidence of romantic disaster in the making. No, I'm not suggesting that these forums are hotbeds of amorous intrigue, but rather are incubators of heartbreak of the financial sort.

Without putting too fine a point on it, fund investors have an alarming tendency to fall in love with their fund managers. There is an ever-growing body of data which suggests that superior fund manager performance simply does not persist. And, having paid the price myself, I speak from sad experience. Increasingly I find myself in the role of a maiden aunt observing the romantic follies of my nephews and nieces, knowing full well the heartache they will soon find.

First some data. I'll say it loud, and I'll say it clear. Human beings cannot pick stocks. Period. Yes, over any given time period some funds will perform better than others. But on the average, superior performance does not persist. There are now dozens of academic studies that all pretty much show the same thing. Namely, that if you take the top tier of money managers over a given period, they may or may not best their peers by a dozen or two basis points going forward, but they still underperform the market by 100-200 basis points.

Remember that these managers had as a group outperformed their peers by several hundred basis points looking back, but only a tiny sliver of that superior performance translates forward. It's as if Babe Ruth were to hit only 7 home runs the season after he hit 60.

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These studies do show one area of strong persistence, however—the worst performing managers—whose inferior performance shows a remarkable tendency to continue.

Probably the best study of mutual fund performance persistency was done by Micropal. Their worldwide fund database extends back three decades, and provides a panoramic view of fund returns. Starting with 1970, they looked at the top 30 domestic diversified funds for a given 5 years and followed their performance out to June 1998.

Here are the results:

1970-1974		
	Return 1970-74	Return 1975-98
Top 30 Funds 1970-74	0.78%	16.05%
All Funds	-6.12%	16.38%
S&P 500	-2.35%	17.04%

1975-1979		
	Return 1975-79	Return 1980-98
Top 30 Funds 1975-79	35.70%	15.78%
All Funds	20.44%	15.28%
S&P 500	14.76%	17.67%

1980-1984		
	Return 1980-84	Return 1985-98
Top 30 Funds 1980-84	22.51%	16.01%
All Funds	14.83%	15.59%
S&P 500	14.76%	18.76%

1985-1989		
	Return 1985-89	Return 1990-98
Top 30 Funds 1985-89	22.08%	16.24%
All Funds	16.40%	15.28%
S&P 500	20.41%	17.81%

1990-94		
	Return 1990-94	Return 1995-98
Top 30 Funds 1990-94	18.94%	21.28%
All Funds	9.39%	24.60%
S&P 500	8.69%	32.18%

In each example the top funds for the first period underperformed the S&P 500 in the subsequent period, and in 2 of the above 5 examples actually underperformed their peers as well.

Does this look like the performance of highly skilled money managers? No. We are looking at the proverbial bunch of chimpanzees throwing darts at the stock page. Their “success” or “failure” is a purely random affair. The most successful chimps (who are all very well dressed, it seems) wind up being interviewed in Money, The New York Times, and by Uncle Lou. Their assets under management balloon, and their shareholders' admiration is vindicated by all of the media attention.

However, time passes, and the laws of chance eventually catch up with these folks. Hundreds of thousands of investors find that the handsome prince managing their funds turned out to be just another hairy simian. In fact, with the particularly perverse logic of fund flows, very few investors actually obtain the spectacular early returns of the “top” funds. These early high returns inevitably attract large numbers of later investors, who wind up with merely average performance, if they are lucky.

Just about every fund investor I come across thinks that they're the exception to this rule. Sure, everybody else's funds eventually go kerplunk, but my managers have a unique long-term investment outlook and discipline that will endure and flourish. Very well then, I suggest a simple exercise. Trek down to your basement, get out your old fund statements, and take a look at which funds you were invested in 10 years ago. I can guarantee you that the list will be for the most part an embarrassment. (Mine is so bad that I'm too ashamed to mention most of the names in print.) You say you weren't investing in funds 10 years ago? Oh. Then wait a few years, and join the crowd.

Note: In his online version of this article, Bill continues with an analysis of Robert Sanborn's management of the once-hot Oakmark Fund. Needless to say, it's worth reading—as are all of Bill's articles at his web site (www.efficientfrontier.com). The URL for the article is www.efficientfrontier.com/ef/799/apeman.htm

—Jeff Troutner