Index Fund Strategies

AssetClass

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

Index Returns

	1996	1997	1998	Last 6 yrs.	11/15 1999
Bonds					
Short-term	5.8	6.0	5.7	5.4	**+ 4.1**
Intermediate	2.4	9.2	10.5	7.7	**- 2.0**
Long-term	-1.3	14.3	12.0	8.9	**- 4.7**
Global	10.8	8.3	8.4	8.3	**+ 3.6**
U.S. stocks					
Large Market	22.9	33.2	28.7	21.4	**+ 14.4**
Large Value	20.2	28.1	12.0	18.3	**+ 6.6**
Small Market	18.2	24.6	-5.5	12.4	**+ 13.5**
Small Value	22.3	30.7	-7.3	16.0	**+ 7.0**
Real estate	33.8	19.3	-15.4	8.2	**- 3.9**
Int'l stocks					
Large Market	6.4	5.5	18.2	12.1	**+ 16.5**
Large Value	7.8	-3.1	14.9	13.5	**+ 11.1**
Small Market	2.6	-23.7	8.2	4.2	**+ 17.9**
Small Value	1.0	-22.7	5.3	3.7	**+ 17.7**
Emerg. Mkts.	11.4	-18.9	-9.4	5.4	**+ 48.0**

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).

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Markets Update

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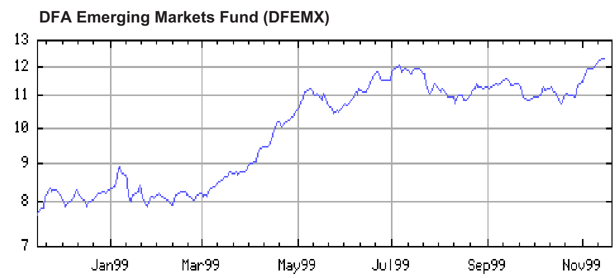

Since our last newsletter in September, US growth stocks have widen their lead over value stocks—both large and small—and are poised to end another year in double digits. Interest rates have fallen a bit, fueling a small rise in bond prices. Long-term bond returns remain negative for the year, however.

Foreign stocks continue to do well, led by the emerging markets. But their lead over US stocks has dwindled as well.

"Total Stock Market" Index Funds, Part 2

Looking for large and small value exposure? Better keep looking.

Jeff Troutner, TAM Asset Management, Inc.

The last issue of *Asset Class* discussed a new trend in investing toward index funds targeted to "total stock market" indexes. The most common of these is the Vanguard Total Stock Market fund, which is based on the Wilshire 5000 index. My goal in the article was to point out how heavily these funds are invested in the largest, most expensive growth stocks trading in the U.S. This is due to the fact that the indexes are market cap weighted. And the largest companies in the U.S., for the most part, are trading at historically high multiples of their earnings, dividends, and book values.

My beef with these funds is not this overweighting to large growth stocks *per se*, but rather the fact that many of the experts touting these funds fail to mention—let alone quantify—this overweighting. Investors, as a result, believe they are getting much greater small cap and value exposure than they really are. The fact is, 100 companies, or about 3% of the total, represent almost 60% of the total market value of the index. There were long periods in stock market history when a more even balance of large growth, large value, small growth, and small value provided significantly better returns.

The following table shows the breakdown for the total market based on size and book-to-market deciles. We use the CRSP[1] index data, rather than the Wilshire 5000 due to availability, and define size, growth, and value according to the guidelines used by Eugene Fama and Ken French in their "Three Factor" research. For size, stocks are ranked by their market capitalizations and the universe is divided equally—deciles 1-5 are large companies and deciles 6-10 are small companies. A second screen ranks stocks based on their book-to-market (BTM) ratios. Those with a BTM's in the top 30% and

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size in the top 50% are considered large growth stocks. Those with BTM's in the bottom 30% and size in the bottom 50% are considered small value stocks. Companies with BTMs in the middle four deciles are consider "core" stocks.

CRSP Universe (Total Market) Style Map

Book-to-Market Deciles

Size Deciles	1 2 3	4 5 6 7	8 9 10
1 2 3 4 5	Large Growth 68.0%	Large Core 20.0%	Large Value 5.5%
6 7 8 9 10	Small Growth 2.0%	Small Core 2.5%	Small Value 2.0%

All Small = 6.5% **All Value = 7.5%**

Many market experts believe large US growth stocks are priced to generate significantly lower returns in the future. In an interview with Fortune magazine[2], Warren Buffett, stated that his most probable annual return projection for the stock market over the next 17 years is 6%. Note that he is referring to the cap-weighted *total stock market*. But investor aren't limited to investing in only a cap-weighted market index. They have at least two other options.

The first is to put together a portfolio of individual stocks that the market has priced to yield more than 6%. This is what Buffett has always done with unparalleled success. Rather than do it yourself, you could buy shares in Berkshire Hathaway, Buffett's holding company. But despite his incredible track record, even Buffett might have a hard time repeating his success this time around. He controls much more money, has huge positions in several very well-known stocks, and is twenty years closer to the big stock market in the sky.

The other way to potentially do better than the market is to ignore market cap weightings and build a portfolio more deliberately weighted to value and small cap stocks. This doesn't require a market timing mind set. These asset classes have outperformed large growth stocks over most time periods. Investors would do well to maintain a more balanced portfolio *all the time*.

I know it's difficult to believe that last statement after the last four years, but are you willing to believe that only a handful of 25-100 companies are capable of growing their earnings at above average rates from now on? Or that large technology and Internet companies are the only ones with a future? I personally don't think so. There are over 7,000 publicly-traded companies. *Most* are priced much more reasonably relative to their current earnings than those 100 companies fueling the total market indexes.

[1] The Center for Research in Security Prices, University of Chicago
[2] Web version: www.pathfinder.com/fortune/1999/11/22/buf.html

The New Breed of Index Funds: Internet E-Commerce & Services

It's a sign. But of what? A market top or "New Era"?

It had to happen. The Indexing craze meets the Internet craze. Result: Internet Index Funds. These aren't your mother's index funds, however.

At last count, there were 11 new Internet-related indexes! Many already have mutual funds attempting to track them.

Index	# of Companies
Dow Jones Internet Composite	40
CBOE Internet Index	13
GSTI Internet Index	16
Goldman Sachs E-Commerce Index	39
Interactive Week Internet Index	50
The Street.com Internet Index	20
ISDEX Internet Index	50
AMEX Internet Commerce	14
Wired Index	40
SG Cowen Internet Index	43
H&Q Internet Index	60

The latest Internet index fund to be launched is the Integrity Global Asset Management (IGAM) Internet Index Fund. The fund tracks the new Dow Jones Composite Internet Index, a market-cap weighted index divided among Internet "Commerce" companies and Internet "Service" companies.

The most common feature of all the Internet index funds are their extremely high expenses. These are rationalized, I'm sure, by the extremely high returns these funds *expect* to generate from this sector. For example, the IGAM fund has a total expense ratio of 1.8%. This is before the customary "management fee waiver" for the first year, in this case .40%. It also has a 1.5% fee for shares sold within 90 days of purchase.

Wall Street always finds a way to exploit a trend. The question is, how much do you want to pay to go along?