

Index Fund Strategies

ASSET CLASS[®]

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

Index Returns

	YTD 3/25	Last 3 yrs.* 1994-1996
Bonds		
Short-term	1.1%	5.4%
Intermediate	-0.3%	5.1%
Long-term	-1.6%	6.5%
Global	1.1%	7.1%
U.S. stocks		
Large Market	6.9%	19.7%
Large Value	4.5%	16.7%
Small Market	-1.8%	15.9%
Small Value	1.2%	17.0%
Real estate	3.5%	11.2%
Int'l stocks		
Large Market	-3.1%	8.6%
Large Value	-3.6%	9.4%
Small Market	-3.5%	4.9%
Small Value	-3.4%	4.7%
Emerging Mkts.	8.7%	2.1%

Short-term bonds = DFA One-Year Fixed Income fund; Intermediate bonds = DFA Intermediate Government Bond fund; Long-term bonds = Vanguard Bond Index Long-term (except first two months of 1994 = 20-yr. U.S. Treasuries); 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 6-10 Small Company fund; U.S. Small Value = DFA Small Cap 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 (except 1994 = DFA International Small Company fund); and Emerging Markets = DFA Emerging Markets fund. *Index returns are included for some of the international funds that have not been in existence for three years.

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy. **Past performance does not guarantee future returns.**

This newsletter is published by
TAM Asset Management, Inc.
 10 H Street, Suite 100
 San Rafael, CA 94901
 phone: 415-456-2905
 fax: 415-456-8345
 email: trout@tamasset.com
 Web Site: www.tamasset.com

Editor: Jeffrey C. Troutner

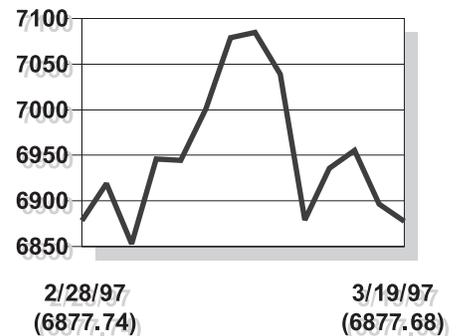
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Markets Update

Tuesday, March 25, 1997

DJIA	6876.17	-29.08	S&P 500	789.07	-1.82
NASDAQ	1248.06	+5.42	Nikkei 225	18439.61	+395.79

What do you see in the chart on the right? A technical analyst would probably call this a classic "head & shoulders" pattern (which means that the market will either go up or down in the near future). A frustrated stock trader might describe it as Alan Greenspan's brain waves during the past few months. Depending on my mood, I see either extreme indecision on the part of short-term investors or Spring skiing in the Sierras.



Actually, the chart shows a 232 point move in the Dow over fourteen days, driven in part by the conflicting statements by the Federal Reserve chairman. In December, Greenspan warned of "irrational exuberance" in the U.S. stock market. The market dropped 55 points that day and then proceeded to close over 7,000 for the first time on February 13. On February 26, Greenspan again urged "caution...with regard to the sharp rise in equity prices during the past two years." The market dropped another 55 points. He then backed off his cautious stance by proclaiming on March 4 that if corporate profit margins continue to rise, stocks are "probably fairly priced." The market moved up 93 points that day and closed at a record high of 7085.16 on March 11. Two days later the Dow dropped 160 points.

The negative reactions to Greenspan's statements were due to the fact that investors came to expect the Fed to raise the discount rate in order to slow down the economy and keep inflation in check. So how do you explain this headline in yesterday's *Wall Street Journal* (March 25): "Stocks and bonds rallied [by 100.46 points] amid expectations that the Fed will raise interest rates by a quarter of a percentage point today.?"

Note: *Asset Class* has replaced the *TAM Review* and will be published on a monthly basis. As always, all questions, comments, or suggestions on the content of the newsletter are welcome.

Lies, Damn Lies, & Statistics

International Indexing vs. Active Management

The news on indexing has been so good lately that I guess the *Wall Street Journal* decided they needed to give active managers a little morale boost. They found it in the performance of foreign (non-U.S.) mutual funds last year.

In a March 6 article, "Stock Pickers Beat Indexes in Other Lands," the *Journal* points out that the average foreign fund returned 12% last year compared to only 6.4% for the Morgan Stanley EAFE index. In fact, they say, the average foreign fund beat the index in six out of the last eight years. I checked these facts against my Morningstar database and found that the *Journal* is absolutely correct. So what's my beef? Well, there are several things actually (surprise!).

First, the article failed to note that the EAFE index beat foreign funds in two out of the last three years. And the reason given for why foreign funds did particularly well last year was because most managers had underweighted Japan. But the writer failed to tell us that just two years ago managers had also underweighted Japan and the result was: Japan 21.4%, Managers -1.9%. The implication is that managers were "smart" to avoid Japan last year. Does that mean they were "dumb" in 1994? Or should we simply assume that sometimes market timing works (lucky) and sometimes it doesn't (unlucky)?

Let's face it, Japan has stunk up the place over the last eight years and managers who avoided Japan have done pretty well. But as evidenced by their misread in 1994 and their performance in the mid-80's, I think we can safely conclude that active managers *have never really figured out when to buy or sell Japan*. For the period 1984-1988, the index outperformed foreign funds every year with an average margin of victory of 13.2% per year!

Japan's economic machine hasn't died. But it is going through a difficult transition not unlike the restructuring American corporations went through early in this decade to become more productive and globally-competitive. The big

question is, will active managers recognize value in Japan and not repeat their mistakes of the early eighties when Japanese stocks gained an average of 34.5% compared to 19.9% for the average foreign fund.

Before we accept the *Journal's* implication that active foreign fund managers are an investor's best friend let's remember what they cost us the last time around. For the seven years 1982-1988, the EAFE index produced an extra \$194,517 on a \$100,000 investment than the average foreign fund. For the last eight years, the foreign fund managers have managed to eke out an advantage of only \$49,717 over the index on a \$100,000 investment.

I have other problems with the article, of course. Like the fact that they failed to mention that 15 out of the top 25 foreign funds last year were actually single-region funds—Latin America funds with an average return of 26%. In 1995, Latin America funds captured 19 out of the *bottom* 25 slots with an average return of -21%. These kinds of funds should not be included in a comparison of diversified funds.

Finally, I have a hard time with an article that quotes a money manager with a one-year track record. "It's the victory of man over the indexing machine," crows Mark Yockey, the manager of Artisan International Fund. "You got rewarded and you still get rewarded in international investing for using your head, not just putting your hat on." Pretty cute quote, but we'll keep an eye on Mr. Yockey to see if he turns out to be a one-hit wonder. We have reason to be skeptical since he somehow missed the Latin America rally where he had only 5% of his tiny fund last year.

Keep these things in mind: First, the EAFE index has outperformed the average foreign fund over the *total* fifteen years. Second, trends reverse. The last eight years have been bad for Japan and good for active foreign fund managers. And finally, one year is not a trend, despite what the *Wall Street Journal* and Mr. Yockey would have you believe.

Margin of Victory: International Funds

