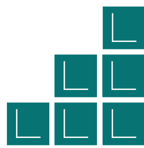

Index Fund Strategies

ASSET CLASS

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

Index Returns

	1996	1997	1998	Last 6 yrs.	12/21 1999
Bonds					
Short-term	5.8	6.0	5.7	5.4	**+ 4.4**
Intermediate	2.4	9.2	10.5	7.7	**- 3.5**
Long-term	-1.3	14.3	12.0	8.9	**- 7.9**
Global	10.8	8.3	8.4	8.3	**+ 3.6**
U.S. stocks					
Large Market	22.9	33.2	28.7	21.4	**+ 17.8**
Large Value	20.2	28.1	12.0	18.3	**+ 0.2**
Small Market	18.2	24.6	-5.5	12.4	**+ 18.3**
Small Value	22.3	30.7	-7.3	16.0	**+ 7.5**
Real estate	33.8	19.3	-15.4	8.2	**- 4.8**
Int'l stocks					
Large Market	6.4	5.5	18.2	12.1	**+ 22.0**
Large Value	7.8	-3.1	14.9	13.5	**+ 12.9**
Small Market	2.6	-23.7	8.2	4.2	**+ 18.4**
Small Value	1.0	-22.7	5.3	3.7	**+ 16.8**
Emerg. Mkts.	11.4	-18.9	-9.4	5.4	**+ 62.0**

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 — Wednesday, December 22, 1999

Technology stocks are riding a wave of optimism that might be unparalleled in the history of the stock market. In a move that appears to be based more on "The Greater Fool Theory" than the "Efficient Market Theory", anything related to the Internet is exploding in price. Technology stocks have even surpassed emerging markets as the big winner this year. You remember emerging markets. That's the asset class everyone wanted out of last year. The DFA Emerging Markets Fund is up over 60%. The NASDAQ 100, the tech heavy index of large, non-financial companies, is up over 90% so far this year.

An indication of how quickly investor attitudes can change is the end of the rally in value stocks about mid-year. It could be argued that the extreme gains we're seeing in an elite group of big name companies and one specific sector (technology) is being driven as much by fund managers trying not to "miss the boat" as by inexperienced investors with no grasp of market history and fundamental accounting. Oh yea, it *could* also mean that amazon.com will earn a billion dollars next year.

The Greater the Degree of Pessimism or Optimism, the Dumber Smart People Become

Jeff Troutner, TAM Asset Management, Inc.

> *Anyone bold enough to try predicting what will happen to stocks in the next decade ought first to look back at what smart people in 1989 were expecting for the '90s.*
>
> *Japan's market still was seen as a miracle -- although it was a bubble about to burst. The U.S. was standing on the doorstep of its greatest bull market of the century, but the operative word among U.S. investors was angst.*
>
> *"In 1989, many people were extremely nervous -- nervous about the economy and nervous about the markets," recalls stock-market bull Abby Joseph Cohen, now of Goldman Sachs, then of Drexel Burnham Lambert.*
>
> **The Wall Street Journal, December 13, 1999**

Optimism was at a peak in Japan in 1989 and stock prices reflected it. Investors perceived little risk in continuing to own and purchase more shares of Japanese companies. Why else would they borrow money against their homes, retirement assets, and other stock holdings to continue buying more stock at such high prices? (Sound familiar?)

In the US, feelings were quite different. Still gun shy from the market crash two years earlier and compounded by a "they've got it figured out and we don't" attitude, investors were not pushing US stock prices much higher. In fact, the smart money seemed to have it right for awhile. For four of the next five years, the market averaged a paltry 3.8% return. But just as the overoptimism in Japan led to very disappointing returns for the next ten years, the overpessimism in the US eventually resulted in the biggest bull market in history.

continued on back...

continued from front...

Efficient market proponents and anyone who believes in a direct relationship between risk and return view the last ten years as perfectly normal. Overoptimism equals low perceived risk, which, in turn, equals low return. Overpessimism equals high perceived risk, which should result in higher returns over time.

So what does this perspective say about today's market? In the *Wall Street Journal* article (Goodbye, Golden Decade. Now What Will the '00s Bring?), the writer states:

> *As the decade draws to a close, technology-oriented individual investors, many of them trading online and cruising the Internet for ideas, have begun to play a role in the market that rivals that of the pros. The hot-trading individuals send Internet-related initial public stock-offerings soaring. Although some pros worry that Internet-related stocks are forming a giant bubble, and while most ordinary, nontech stocks have been declining in value, the major indexes are continuing to rise, due in large part to a few hot tech stocks.*
>
> *Of 12 stocks recommended at the end of 1989 by four experts quoted in the Wall Street Journal, three were gold companies -- a defensive investment if there ever was one. Most of the 12 have trailed the market during the decade; the gold stocks actually have lost value. Among today's most actively traded stocks, a surprising number weren't even publicly listed in 1989: Cisco Systems, Yahoo!, America Online, Qualcomm, MCI WorldCom.*

Our overoptimism has even changed the way we evaluate stock investments:

> *The shift in the basic ways that investors view the market may have been as important as the magnitude of the gains. Fundamental research is out of fashion; simply chasing whatever is hot, which is delicately referred to as "momentum investing" and was considered a goofy idea a decade ago, is in.*

And expectations?

> *Expectations are through the roof. "People are borrowing money on their houses to invest in stocks, and in 1989 you didn't see any of that," Mr. Herrmann* [chief investment officer at Waddell & Reed] *says. "People trying to adopt a rational view these days are viewed as Cassandras."*
>
> *People "are almost ready to throw in the towel now and say they are going up forever,"* [Robert Harrington, Paine Webber] *says. "We thought that Microsoft's 10-year move was dynamic, and some of these Internet stocks are doing it in 10 weeks. If you can honestly say you predicted that, then I tip my hat to you."*

A confusing concept for investors and investment professionals alike is whether markets price stocks "fairly". In fact, a recent *Forbes*[1] magazine article listed as the first of eight time-tested rules of investing, "Don't Trust the Market to Value a Stock." Now, I don't expect a lot out of *Forbes* (it's still incredibly hard for them to publish a pro-index story), but it's safe to assume they meant to add "fairly" or "properly" at the end of that statement. In any case, the question we should all ask is, if the "market" doesn't know how to value a stock (properly), who does? The smart people like the editors at *Forbes*? I'm sure they had it right back in 1989, aren't you?

I think the problem stems from this whole concept of "value." Investors (the market) aren't pricing today's stocks based on underlying fundamentals (earning, book values, etc.) any more than they did in 1989, 1987, 1972, or whenever. They price stocks based on ***expectations!*** That's why price-to-earnings ratios constantly change. The trick is to figure out how to profit from these changes.

Investors basically have three choices. One is to try to measure the *degree* of optimism or pessimism in the market <u>and</u> make a determination of *when* stock prices will change to reflect changes in investor attitudes. This requires Warren Buffett-like confidence since you will face overwhelming opinion against you *and you have to be extremely patient*. Let's say you went against the tide and bought all the stocks you could at the end of 1989. The next year you were down 3%. You hung in there. The next year you were rewarded as the market climbed 30%. Now the chorus of naysayers is louder than ever, but you didn't listen and bought more stock. For the next three years you averaged about 6% per year. Did you hang in there?

Another option is to exploit the overoptimism/overpessimism cycles by investing in index funds that buy stocks with lower prices relative to their earnings and book values. What history and academic theory has shown is that stocks with high prices (overoptimism?) as a group underperform the lower priced stocks (overpessimism?) over time.

The third option is to own a diversified portfolio of all of these stocks in a mix that is compatible with your risk tolerance and hold on through thick and thin. For most investors, this is the most sensible choice. But as the *Wall Street Journal* pointed out, this doesn't appear to be the most *popular* choice today.

[1] 8 Investing Rules, December 27, 1999

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