

January/February 1996

Volume 4 Number 1

The Real "Bull" Market...

The biggest trend in 401(k) plans today is for employers to offer mutual fund "supermarkets" to their employees. Employees choose one or more funds from literally thousands offered by firms like Charles Schwab. As expected, many employees switch every year to the funds with the highest performance last year. Some choose funds with a Morningstar rating of "Five Stars".

As a result, the new year is greeted by fund managers touting their one-year performance and star ratings via ads in the Wall Street Journal, Investor's Daily, and Money magazine. In other words, the real bull starts flowing.

The bigger fund companies like Fidelity never see the money leave their firm. With hundreds of different funds, at least a few are ranked in the top-10% in their categories.

The loser in this market of bull, of course, is the investor. They end up, more often than not, placing their money with a manager who just happened to make a few good calls last year or whose style just went out of favor.

Can you fault the fund companies for playing the performance game?

I don't think so.

Can you blame the employers for turning their employees loose with their retirement money to choose from 2,000 different mutual funds?

I think so.

This newsletter is published by TAM Asset Management, Inc.
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Comments, questions, or suggestions are always welcome. For more information on our investment management services, please call 1-800-826-4015.

A Fresh Look at International Diversification

By Jeff Troutner

At the end of January, TAM implemented asset allocation changes that bring our portfolios more in line with the Fama/French research on asset class returns. As you recall, Eugene Fama and Kenneth French, of the University of Chicago, have shown that investors are rewarded over the long-term for increasing their exposure to stocks generally and small company and value stocks specifically.

Additional research by Rex Sinquefeld at Dimensional Fund Advisors has shown that international diversification using the more widely-accepted indexes like the Morgan Stanley EAFE index does not improve portfolio returns as one might expect. There are only two ways in which international diversification can help: (1) through higher expected returns, or (2) by being sufficiently uncorrelated with U.S. stocks to reduce portfolio volatility. International large value stocks exhibit these characteristics and, arguably, render irrelevant the benefits of international small stocks.

Table 1 shows the asset class returns through last year. As you can see, the return advantage of the value classes is significant. Note, however, that while international small stocks have outperformed EAFE by almost 5% per year, they have only matched the return of international large value stocks and with significantly greater volatility.

Now let's look at simple portfolios of these asset classes. Table 2 shows that a portfolio which includes an EAFE component (Column 2) reduces the return of a U.S.-only portfolio while also reducing volatility. Shifting the EAFE allocation to the international large value class bumps the return up by 2% per

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Table 1: Asset Class Returns 1973-1995

	1	2	3	4	5	6	7
	US Large	US Large Value	US Small	US Small Value	Int'l Large (EAFE)	Int'l Large Value	Int'l Small
Annual Return	11.8%	15.8%	14.4%	18.2%	12.6%	17.6%	17.5%
Annual Risk	17.3%	18.1%	26.6%	22.5%	23.0%	24.7%	30.2%

A Fresh Look...(cont.)

year with only a slight increase in volatility (Column 3). Splitting the international allocation among large value stocks and small company stocks does not improve the portfolio by any significant measure (Column 4).

There are other benefits to these allocation changes. Value stocks tend to perform better in down markets as shown in Table 3. They are also more attractive on a price-to-earnings, price-to-book, and dividend yield basis (Table 4). Shifting to value-only classes does decrease diversification, but it still remains much higher than anything achieved by most active managers and mutual funds.

The combination of a shift to an all-value portfolio and the elimination of riskier international small stocks should improve returns over time without an increase in portfolio volatility. We have maintained a small allocation to a diversified basket of stocks of emerging markets as a way to participate in the fastest growing economies of the world.

Why change now? The value asset class funds were not available when we began managing client accounts in 1993. Clearly, looking at Table 1, international small stocks offered a diversification benefit when combined with the less risky stocks represented by the EAFE Index. We have followed the Fama/French research for the past couple of years and reviewed other opinions concerning the value of international small stocks in portfolios. With the introduction of the international large value fund in 1994, it became increasingly apparent that we could

Table 2: Sample Portfolio Returns 1973-1995

	1	2	3	4	5
US Large Value	50%	30%	30%	30%	30%
US Small Value	50%	30%	30%	30%	30%
Int'l Large (EAFE)	-	40%	-	-	-
Int'l Large Value	-	-	40%	20%	-
Int'l Small	-	-	-	20%	40%
Annual Return	17.1%	15.8%	17.8%	18.0%	18.1%
Annual Risk	19.7%	18.0%	18.5%	18.5%	19.1%

Table 3: Performance in Down Markets

	US Large	US Large Value	US Small	US Small Value	Int'l Large (EAFE)	Int'l Large Value
1973	-14.7%	-2.8%	-39.0%	-26.0%	-14.2%	No Data
1974	-26.5%	-22.4%	-28.6%	-18.1%	-22.1%	No Data
1977	-7.2%	0.7%	26.8%	21.8%	19.4%	33.2%
1981	-4.9%	11.2%	-2.7%	10.5%	-1.0%	13.5%
1984	6.3%	14.1%	-6.7%	5.1%	7.9%	7.6%
1987	5.2%	2.3%	-9.3%	-6.3%	24.9%	31.2%
1990	-3.2%	-13.9%	-21.6%	-20.8%	-23.2%	-15.6%
1992	7.7%	21.2%	23.3%	29.9%	-11.8%	-3.1%
1994	1.3%	-4.5%	3.1%	1.2%	8.0%	8.8%

Table 4: Fundamentals

	US Large	US Large Value	US Small	US Small Value	Int'l Large (EAFE)*	Int'l Large Value
Price/Earn.	16.1	11.0	15.4	13.1	29.5	26.9
Price/Book	2.1	1.2	1.5	1.1	2.4	1.5
Div. Yld.	2.5%	2.9%	.7%	1.3%	2.8%	1.8%
# of Stocks	500	185	2592	1340	942	697

* estimate

realize similar risk/return benefits *for the portfolio* with a less risky asset class. We continue to monitor the international small value fund introduced by DFA at the beginning of last year, but we feel the verdict is still out on the benefit of this asset class.

We have always said that indexing is not the "simple" concept many (mostly competitors) make it out to be. And as much respect as we have for the Vanguard Group and their stand on indexing, asset class funds based on "accepted" indexes like the S&P 500 are simplistic answers to an asset class strategy. We will keep abreast of the research, analyze the funds, and make changes if and when we feel they are appropriate.



Our Web Site: (Part II)

Our URL (address) on the Web has changed already. You can now find us at <http://www.tamasset.com>. Our e-mail address is trout@tamasset.com. I strongly recommend that you use the latest version of Netscape as your "browser" software and place a "bookmark" at this URL. I am running the version 2.0 beta 5 copy on the Mac with no problems.

I also recommend that you sign up with a local Internet provider for direct access, instead of going through American Online or others. The cost is usually \$15-\$25 per month with virtually unlimited access (no connect charges). A 28.8 modem is also essential.

In case you're wondering, we have developed this Web site as an electronic complement to our printed materials. It is easier, in most cases, to update pages on the Web. We also hope at some point to include audio and video files with our Web pages, enabling us to do mini-seminars on important topics.

Unlike many people, we do not expect to generate new business from the Web, nor do we believe in creating a lot of "links" to other Web sites. Nevertheless, **please feel free to refer others to our Web site.** If nothing else, it offers people the opportunity to learn about the benefits of indexing on their own terms and at their own pace.

We welcome any comments you have on the content of our Web pages via phone, fax, or e-mail. If you have any questions or encounter any problems, please let us know.

Things you will find at our Web site:

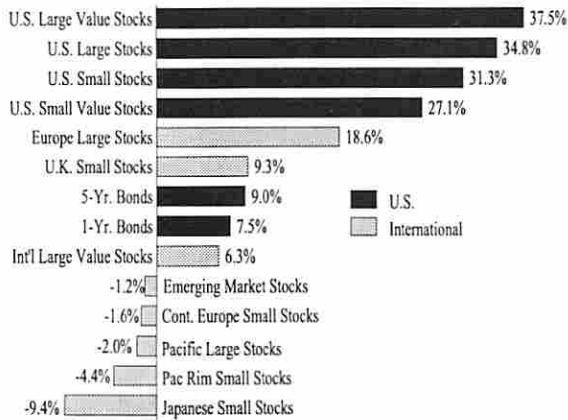
- Online version of *TAM Review*
- Weekly index fund performance
- Comparisons of simple index portfolio models to TAM's
- Profiles on almost all index funds available
- Asset class returns 1973-1995
- Model portfolio returns 1973-1995
- Good quotes from the "experts"
- List of recent articles on index-related topics
- Books on basic investment principles and asset class investing
- A review of indexing principles
- A booklet on the TAM strategy
- More to come...

Performance Notes:

Asset Class Returns: 1-Yr. Bonds = DFA One-Year Fixed Income Portfolio; 5-Yr. Bonds = DFA Five-Year Government Portfolio; U.S. Large Stocks = Vanguard 500 Index Fund; U.S. Large Value Stocks = DFA Large Cap Value Portfolio; U.S. Small Stocks = DFA 9-10 Small Company Portfolio; U.S. Small Value Stocks = DFA Small Cap Value Portfolio; Pacific Large Stocks = Vanguard Pacific Index Fund; Europe Large Stocks = Vanguard Europe Index Fund; International Large Value Stocks = DFA Large Cap International Portfolio; Japanese Small Stocks = DFA Japanese Small Company Portfolio; Cont. Europe Small Stocks = DFA Continental Small Company Portfolio; U. K. Small Stocks = DFA United Kingdom Small Company Portfolio; Pac Rim Small Stocks = DFA Pacific Rim Small Company Portfolio; Emerging Market Stocks = DFA Emerging Markets Portfolio.

TAM Portfolio Returns Net of Fees: These are the actual returns of TAM portfolios in each risk category net of actual TAM management fees, custodial fees, and fund expenses. The "Growth" returns were calculated using a model portfolio from 12/31/92 to 4/30/93 and actual accounts thereafter. The "Aggressive" returns were calculated using a model portfolio from 12/31/92 to 3/31/93 and actual accounts thereafter. In both cases, the maximum TAM fee was deducted, representative custodial costs were deducted, and all mutual fund returns are net of expenses. The "Moderate" returns were calculated using actual account performance since inception. Past performance is no guarantee of future returns. This is especially the case with model portfolios which are not subject to specific economic or market factors.

Benchmarks: Morningstar Mutual Fund Averages; Combinations of Morningstar averages corresponding to TAM Model Portfolios. MStar 65 = 35% Gov't Bond Fund Ave., 32% Growth & Income Stock Fund Ave., 33% Foreign Stock Fund Ave.; MStar 85 = 15% Gov't Bond Fund Ave., 44% Growth & Income Stock Fund Ave., 41% Foreign Stock Fund Ave.; MStar 100 = 45% Growth & Income Stock Fund Ave., 55% Foreign Stock Fund Ave.

Asset Class Returns**Year-to-Date Through 12/31/95****TAM Portfolio Returns****Through 12/31/95**

Risk (% stocks)	Since Inception			
	1995	1994	1993	12/92-12/95
Aggressive (95%)	+15.1%	+5.3%	+21.1%	+46.8%
Growth (85%)	+15.9%	+2.6%	+16.6%	+38.5%
Moderate (65%)	+14.6%	+2.1%	+14.0%	+33.5%

Benchmarks

Gov't Bond Fund Ave.	+17.0%	-4.2%	+10.8%	+24.2%
Growth & Income Fund Ave.	+31.5%	-1.1%	+10.9%	+44.2%
Foreign Stock Fund Ave.	+6.3%	-2.3%	+37.9%	+43.2%
MStar 65 Index	+18.1%	-2.5%	+19.0%	+37.0%
MStar 85 Index	+18.5%	-1.7%	+21.0%	+40.9%
MStar 100 Index	+17.1%	-1.6%	+25.0%	+44.0%

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January/February 1996 Newsletter:
Now, The Real "Bull" Market Begins