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The March 25th issue of The Wall Street Journal pointed out that the Price/Book Value ratio (P/B) for the market stands at 4.3—an all-time record. In contrast, the median P/B ratio since 1905 is 1.5.

The P/B ratio can be used as a measure of optimism among investors. In view of the huge ongoing flow of money into stock mutual funds today, one could argue that there is a lot of optimism in this market. One thing is certain, though, the ratio will not remain this high forever.

Essentially, two things can happen to bring the ratio down. Book values could rise or prices could fall. If book values fail to rise, pessimism can creep (or leap) into the market and prices will fall.

Investors can lower the P/B ratio of their portfolios on their own rather than wait for the "market" to do it for them. This is exactly what we did in February when we went to all-value portfolios. The P/B ratios for the DFA funds and some alternatives are:

<i>Vanguard Index Growth</i>	<i>6.4</i>
<i>Vanguard Index 500</i>	<i>4.5</i>
<i>Average stock fund</i>	<i>4.4</i>
<i>Vanguard Index Small Cap</i>	<i>3.9</i>
<i>Vanguard Index Value</i>	<i>2.5</i>
<i>DFA U.S. Large Value</i>	<i>1.1</i>
<i>DFA U.S. Small Value</i>	<i>1.4</i>

Low P/B stocks will also fall in a general market decline, but since their prices are not over-inflated to start with the pain should be less.

Cushioning a decline was not our only motive, of course. Over the past 23 years large value stocks have returned 15.8% per year versus 11.8% for the S&P 500.

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Maintain Your Perspective

By Jeff Troutner

What happens if the market drops 30%? Will it come back? How long will it take? Should I just bail out and buy CD's?

We must be near a market top because I hear these questions about every day. They are legitimate questions and my quick answers are: buy more, yes, I don't know, and maybe. But serious investors deserve a better response and in order to do this, they need a historical perspective along with a review of their objectives—most importantly investment time horizon. Then, any decision on a different course of action can be made objectively, not emotionally.

To develop a historical perspective on the stock market I will use examples of four investors: one makes a lump sum investment at the beginning of 1973, another invests everything at the beginning of 1975, and the last two build portfolios by contributing the same amount every year.

In presentations and informational materials, I use a time period starting in 1973 because it begins with the worst market collapse in over 60 years. This generates long-term annual returns which are more realistic. And, let's face it, investors are more inclined to move greater percentages of their assets to stocks near market tops than market bottoms. Anyone who suggests otherwise, particularly by showing numbers starting in 1975, is not experienced in dealing with individual investors or investment committees.

First, assume that an investor, Ms. Ros O. Loot, invests a lump sum of \$100,000 in stocks on January 1, 1973 and stays fully invested in the market through the end of last year. The timing of the investment *seems* pretty good since the market was up almost 20% the year before and 14% the year before that. As you can see in Chart 1, however, Ms. Loot did not see the happy side of her \$100,000 again until four years later. Even after six years, she had only earned a paltry .90% annual yield! Of course, all's well that ends well and, true to her name, Ros stuck with the market and earned an annual return of 11.8% per year through last year. Her faith in free markets, capitalism and the American way (or her stubbornness) paid off as long-term bonds and CDs did not perform nearly as well.

Now, let's look at the case of Mr. Lucky Slob who didn't have \$100,000 in 1973 but wins the lottery a couple of years later and decides against

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everyone's advice (the market fell a total of 40% the previous two years!) to dump it all into stocks on January 1, 1975. Lucky realizes an annual return of 15.6% through 1995. Now, the fact is, there is only one human being alive today with the confidence, guts, foresight—whatever you want to call it—to make a move like that and his name is Warren Buffett.

Table 1

Year	S&P 500 Return	Ros. O Loot's \$100,000 at year-end	Lucky Slob's \$100,000 at year-end
1971	14.3%		
1972	19.0%		
1973	-14.7%	\$85,300	
1974	-26.5%	\$62,696	
1975	37.2%	\$86,018	\$137,200
1976	23.8%	\$106,491	\$169,854
†			
1995	37.4%	\$1,300,653 (11.8%/yr.)	\$2,805,629 (15.6%/yr.)

Here's a much more likely scenario. Let's say a different investor, Mr. Val C. Later, put his \$100,000 in stocks at the beginning of 1973, stayed in through 1974, then bailed out and swore off stocks for two years. He then went back in and stayed fully invested until the Crash of '87, ran for the exit again, shook that one off in two years and got back in for the duration. Sound reasonable?

It's not as crazy as you think. Look at Table 2. In 1969 and 1970, the market dropped 8.5% and then rose a mere 4%. During the same time, CDs yielded 7.8% per year. So Mr. Later is feeling pretty smug about his CD investments while his swinging friends (this *is* the seventies) are wasting their time in stocks. But then, in 1971 stocks rise 14.3% while CD yields fall to 5%,

and in 1972 stocks add another 19% while CD rates fall even further. Now who's feeling smug.

Mr. Later starts to feel the peer pressure and buys stocks. The market tanks in 1973. He decides to stay in to recoup his losses. It drops another 26% in 1974! Now he's thinking *total collapse of the free world as we know it* and sells everything and buys gold (that's another story). Mr. Later then watches the market rise 70% over the next two years!

Ouch. Better get back in.

Market falls 7% in 1977.

#\$!%#!. Stay calm.

Democracy and capitalism

haven't collapsed. The market starts acting better and things are pretty good for *nine* years.

Until 1987—the market drops 23% in one day! *I'm outta here. I will never buy stocks again!!* The market's up 17% in 1988 and another 32% in 1989. Mr. Later remarries (that's another story), he's smiling all the time (that's another story), and he's thinking, *hey, why not give it another shot?* The market drops 3% in 1990 but he's still feeling pretty good and stays with it through the end of last year.

O.K., how much did Mr. Later lose by vacillating back and forth for 23 years. Table 3 shows his return compared to Ms. Loot's and Certificates of Deposit (CDs). Ms. Loot's loot grew to twice the amount of Mr. Later's, she's still on her first marriage, and she didn't drive herself nuts worrying about where the market was *going*. The moral of the story is if you can't stand the

Table 2

Year	S&P 500 Return
1969	-8.5%
1970	4.0%
1971	14.3%
1972	19.0%
Mr. Later buys stocks	
1973	-14.7%
1974	-26.5%
Mr. Later bails out	
1975	37.2%
1976	23.8%
Mr. Later buys stocks	
1977	-7.2%
†	
1987	5.2%
Market crashes 23% in 1 day	
Mr. Later bails out for good	
1988	16.8%
1989	31.5%
Mr. Later buys again	
1990	-3.2%
†	
1995	37.4%

heat stay out of the kitchen. Buy CDs and sleep better. Or, at least split your assets among stocks and short-term bonds with a higher percentage in stocks if your time horizon is sufficiently long.

Table 3: Growth of \$100,000**1973-1995**

Ros O. Loot	\$1,300,653
CDs	\$599,779
Val C. Later*	\$659,954

*Invested in CDs when not in stocks

Now let's look at a more common "accumulating" investor, such as someone saving retirement assets in a 401(k) plan. Investor A (I'm out of cute names) invests \$10,000 per year starting in 1973 and Investor B invests the same amount starting in

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1975. At the end of last year, despite the terrible markets of 1973 and 1974, Investor A has \$1,704,716 while Investor B has \$1,420,352. The extra \$20,000 invested during a terrible market decline turned into almost \$300,000 after 23 years.

Table 4: Growth of \$10,000/yr.

Investor A (1973-1995)	\$1,704,716
Investor B (1975-1995)	\$1,420,352
CDs	\$630,389

Starting with \$10,000 and contributing \$10,000 at the end of each year.

Clearly, it pays to start investing as early as possible and on a regular basis without worrying about the inevitable ups and downs of the stock market. A CD investor would have accumulated \$630,389 (or \$326,126 after inflation) over the same period.

So, how should these examples guide you in relation to your own objectives? If you are an accumulating investor with a time horizon of ten years or more, I suggest you keep most of your investment portfolio in stocks and greet market declines as welcome buying opportunities, not as reasons to seek "safe" investments.

If you have stopped accumulating and need to tap into this reserve, the amount of the withdrawal every year should determine the percentage you invest in stocks versus short-term bonds. If your withdrawal is 10% or less, I would keep 85%-100% in stocks. If the amount is 10%-15%, consider keeping no more than 50%-

65% in stocks. And if the withdrawal is 20% or more, I suggest you invest most of the assets in high-quality short-term bonds or money market securities.

Regardless of your age, if you plan to pass these assets on to your children, grandchildren or charitable causes rather than use them yourself,

you should consider maximizing growth by staying fully invested in stocks (the beneficiary's time horizon is now important).

In all cases, the stock portion should be indexed and diversified among different asset classes, both domestic and international.

Recommended Investment Strategies**Type of Investor****Asset Allocation**

- | | |
|---|-----------------|
| 1. Accumulating investor with long time horizon (at least 10 years) | 85%-100% Stocks |
| 2. Same as above, but can't tolerate high annual volatility | 65%-85% Stocks |
| 3. Stopped accumulating; 10% withdrawals per year | 85%-100% Stocks |
| 4. Stopped accumulating; 10%-15% withdrawals per year | 50%-65% Stocks |
| 5. Stopped accumulating; 20% or more withdrawals per year | 0%-50% Stocks |
| 6. Passing assets on to children, grandchildren, etc. | 85%-100% Stocks |

The amount of time that you can keep the assets invested should determine the mix between stocks and short-term bonds.

Your tolerance for short-term volatility, however, should always override the influence of time horizon. If not, you will be vulnerable to emotional moves in and out of stocks at the wrong times in the market cycles.

Understanding how markets work and reviewing market returns for periods in line with your investment time horizon will help increase your tolerance for short-term volatility, make you less susceptible to bad advice, and allow you to reap higher rewards or avoid unnecessary losses.

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 Value Stocks = DFA Large Cap Value Portfolio; U.S. Small Value Stocks = DFA Small Cap Value Portfolio; International Large Value Stocks = DFA Large Cap International 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 for the four months 1/31/93 to 4/30/93 and actual accounts thereafter. The "Aggressive" returns were calculated using a model portfolio for the three months 1/31/93 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		TAM Portfolio Returns					
Year-to-Date Through 2/29/96		Through 2/29/96					
Emerging Market Stocks	8.4%						
U.S. Large Value Stocks	4.3%						
U.S. Small Value Stocks	1.8%						
Int'l Large Value Stocks	1.5%						
5-Yr. Bonds	0.9%						
1-Yr. Bonds	0.8%						
		Risk (% stocks)	YTD				Total Return
			1996	1995	1994	1993	1/93-2/96
		Aggressive (100%)	2.6%	15.1%	5.3%	21.1%	50.5%
		Growth (85%)	2.2%	15.9%	2.6%	16.6%	41.6%
		Moderate (65%)	1.9%	14.6%	2.1%	14.0%	35.9%
		Benchmarks					
		MStar 100 Index	3.5%	17.1%	-1.6%	25.0%	49.0%
		MStar 85 Index	2.8%	18.5%	-1.7%	21.0%	45.0%
		MStar 65 Index	1.5%	18.1%	-2.5%	19.0%	39.0%
		Gov't Bond Fund Ave.	-1.6%	17.0%	-4.2%	10.8%	22.3%
		Growth & Income Fund Ave.	4.1%	31.5%	-1.1%	10.9%	50.0%
		Foreign Stock Fund Ave.	3.3%	6.3%	-2.3%	37.9%	47.9%

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