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*We are starting to see more written about "non-conventional" indexing like the value-indexed strategy employed by TAM (see the attached article from The Wall Street Journal).*

*Unfortunately, the financial writers continue to miss the main reason for indexing, conventional or otherwise. It is not because of some blind faith in "efficient" markets, but rather a real-world observation that active managers and investors have an extremely difficult time exploiting any inefficiencies that may exist. Identifying, hiring, and sticking with one of the few lucky or talented managers that ultimately do beat the market is even more difficult.*

*I know I sound like a broken record sometimes, but you would think that responsible financial people would quit getting bogged down with academic issues and just look at the experiences of most money managers and investors and concede that indexing puts the odds of success squarely in the investor's favor.*

*Does the fact that high book-to-market stocks (value) outperform the overall market over time prove that the market is inefficient? Is this phenomenon due to a risk factor or irrational investor behavior?*

*Who cares except the academics? The important question is: Do you want to try to exploit this opportunity with ten stocks or one thousand. With Joe Schmo guru or a low-cost index fund?*

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## "A Type of Dementia I Can't Even Classify"

By Jeff Troutner

Those words were spoken recently by Charlie Munger, Vice Chairman of Berkshire Hathaway, to describe indexing and Modern Portfolio Theory. Munger is the right-hand man of the greatest investor of all time, Warren Buffett, and Berkshire is the holding company for Buffett's investments.

Perhaps a person less secure in his belief in the benefits of indexing might collapse in self doubt at such blunt comments from such a respected expert. But I know how Warren Buffett became one of the richest man in the country and I know why Munger made those comments. I also believe very strongly in Buffett's investment approach. Before I go into that, however, I urge you to take a moment to read the words of Mr. Buffett himself on the first page of the prospectus for the recently-issued "Baby Berkshires" (the Berkshire Class B common stock, priced at 1/30th of the \$33,000 *per share* Class A stock):

Warren Buffett, as Berkshire's Chairman, and Charles Munger, as Berkshire's Vice Chairman, want you to know the following (and urge you to ignore anyone telling you that these statements are "boilerplate" or unimportant):

1. Mr. Buffett and Mr. Munger believe the Berkshire's Class A Common Stock is not undervalued at the market price stated above. *Neither Mr. Buffett nor Mr. Munger would currently buy Berkshire shares at that price, nor would they recommend that their families or friends do so.*

3. In recent years the market price of Berkshire shares has increased at a rate exceeding the growth in per-share intrinsic value. *Market overperformance of that kind cannot persist indefinitely. Inevitably, there will also occur periods of underperformance, perhaps substantial in degree.*

Munger believes indexers are insane, Buffett doesn't think you should buy Berkshire stock, and I believe Buffett's investment strategy is pretty sound if applied effectively. Have we all been driven mad by this runaway bull market??

No, of course not. The only one not thinking rationally is Munger. He wants us to believe that mere mortals can use Buffett's strategies to beat the market, ignoring all of the factors—emotion, time, lack of knowledge, etc.—that work against us. He knows that Buffett has been influenced primarily by the investment strategies of Benjamin Graham and yet he will not acknowledge that the 75% of professional money managers who fail to beat the market are also followers of Graham's principles to some degree or other. Munger is not just

*Continued on next page...*



*A Type of Dementia...(cont.)*

talking to professional money managers. His words are being heard by individual investors who, if they believe him, think they can achieve Buffett-like success without, as he referred to it, the “twaddle” of indexing.

I have met virtually every kind of investor over my sixteen years of investment experience and I believe no one except Buffett and a few of his cohorts has the essential discipline, focus, and self-confidence to succeed with a highly concentrated, buy-when-no-one-else-will-and-hold-on-forever approach.

If you have any doubts, consider the origin of Buffett’s investment strategy. According to Buffett himself, he is 85% Benjamin Graham (value) and 15% Philip Fisher (growth).

**Graham**

Graham described three approaches in his writings: the cross-section approach, the anticipation approach, and the margin of safety approach<sup>1</sup>.

The cross-section approach would be similar to most indexed investing today. Graham conceded over forty years ago that there was no certainty Wall Street could outperform a market index and, shortly before his death in 1976, he acknowledged times had changed and the “efficient market” proponents were on the right track.

Graham divided the anticipation approach into the short-term selectivity approach and the growth stock approach. The short-term selectivity approach is the most prevalent one

on Wall Street today because of its emphasis on change and transactions. But Graham felt this strategy’s dependence on forecasts of a company’s economic prospects in the short-term rendered it superficial and useless. Graham believed the greatest challenge with the growth stock approach was to determine to what degree the current share price reflected the company’s growth prospects. Growth stocks are usually high priced in relation to their *current* earnings and therefore bear greater downside risk (see box on “P/E ratios” on page 3).

Graham determined that the last approach—the margin of safety approach—would produce above market returns if applied properly. He developed techniques for determining a company’s “intrinsic value” or “that value which is determined by fact.” Graham did not feel that investors needed to determine an exact intrinsic value. An approximate value that is considerably below the company’s market price would provide a “margin of safety.” In any case, quantitative factors—earnings, dividends, assets, and liabilities—were most important to Graham’s way of thinking. He felt qualitative factors, such as management capabilities and the “nature of the business” were elusive concepts that were hard to measure and could ultimately lead to risky strategies if relied upon to any significant degree. Also, in implementing his margin of safety strategy Graham believed that diversification was very important.

**Fisher**

In contrast to Graham, Philip Fisher believed that greater emphasis should be placed on measuring a

company’s earnings *potential* and the *quality* of its management. He also liked companies that invested significant resources to research and development, an indication of the sustainability of its earnings potential. Fisher also analyzed a company’s sales organization, its profit margin, and its accounting controls. Finally, Fisher investigated a company’s management by interviewing former employees, competitors, customers, and vendors. His goal was to develop an accurate picture of the strengths and weaknesses of each company. Because this “scuttlebutt” approach was so time consuming, Fisher restricted his portfolios to as few as ten stocks with three or four companies representing over 75% of his portfolio.

**Buffett**

In his early years Buffett followed a strict Graham-based value approach. He was buying “cheap” stocks but found that many were so priced because of significant problems that would take years to resolve. As a result, he decided to move away from Graham’s *methodology* while still embracing his “margin of safety” philosophy. He did this by placing greater importance on qualitative factors in the equation to determine a company’s intrinsic value. This change was influenced by Charlie Munger who, in turn, was greatly influenced by Philip Fisher.

It is important to note that Graham’s methods are relatively low-risk to start with and are further tamed by diversification among many stocks. Buffett has never diversified beyond twenty stocks and at the end of 1987

<sup>1</sup>Robert G. Hagstrom, Jr., The Warren Buffett Way, Investment Strategies of the World’s Greatest Investor (John Wiley & Sons, Inc., 1994)



*A Type of Dementia...(cont.)*

he had all \$2 billion of Berkshire's investment portfolio in only three stocks. Fisher's methods were considerably riskier because of the higher prices and multiples paid for stocks, his reliance on intangible, qualitative factors, and his belief in very low diversification.

This is where Munger, by his comments about indexing, starts to lose touch with the real world. You see, Graham's goal was to create a methodology *anyone* could apply. But it was so risk-averse that it was difficult to find many stocks meeting his criteria during the middle to later stages of the current bull market. Buffett, with Munger's influence, began to buy stocks based on *future* growth prospects which, in turn, were influenced by the quality of the company's management. Buffett was able to reduce the risk of Fisher's methodology by pouring over annual reports (Graham's influence) and correctly judging management quality and dedication to enhancing shareholder value (Fisher's influence).

We know that most professional money managers fail using variations of Buffett's and Munger's technique. Indexing offers a very attractive alternative to all of us non-Buffetts and to all of the investors who know the frustration of trying to find the next Buffett *in advance*.

A value-indexed approach incorporates Graham's margin of safety concept across a broad spectrum of U.S. and foreign stocks. It allows us to profit from value stocks without subjecting portfolios to all the risks and expense of active management. Since the Fama/French value indexes are relative (lowest 30%

price-to-book stocks in each asset class) rather than absolute (e.g., only stocks with a P/B less than 1.5) investors participate in all phases of the market cycle without the downside risk of growth stocks.

Munger would do all investors a favor by admitting that he and Buffett possess a rare combination of qualities that allow them to apply a difficult strategy over just a few stocks and succeed where most fail. For serious investors low diversification and a long-term bet on some manager's dubious stock picking expertise is a recipe for failure. Far from "twaddle", indexing offers a prudent and very sane alternative.

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**It's Obviously Not Genetic**

According to Charlie Munger anyone can beat the market. But what if you were the son of Philip Fisher, investment legend, and grew up to be in the same business. Would you have a stock-picking advantage over us common folk?

I guess not. Even though Ken Fisher, Philip's son, predicted last year in *Forbes* magazine that the market would be up 20% to 40% *and* touted five small company stocks—all of which did very well in 1995—he failed to capitalize on his predictions. Ken's Enterprise Small Company Fund was up only 9.2% for the year vs. 34.5% for the DFA 9-10 Small Company Fund.

How would we classify *that* dementia?

**“Low P/E ratios, rather than indicating bad corporate performance, are often associated with excessive investor pessimism. High P/E ratios, rather than indicating superb corporate performance, are often associated with excessive investor optimism”**

Sumner Levine, *Financial Analysts Handbook I, Methods, Theory, and Portfolio Management*.

Let's assume that a growth stock is selling for \$60 and has earnings of \$2.00 per share. The Price/Earnings ratio of 30 indicates that investors are optimistic about the company's future growth prospects. Suddenly the outlook changes and projected earnings per share drop 25% to \$1.50. At 30 times earnings the price falls to \$45—a loss of 33%. But investors have lost confidence in the company's ability to grow as fast and are no longer willing to pay 30 times earnings for the stock. If the multiple drops to 25, the price will fall further to \$37.50 (25 x \$1.50)—a loss of 60%!

The opposite can occur with “value” stocks, whether measured by P/E or P/B (price-to-book) ratios. If a stock is selling for \$30 and has earnings of \$3.00 per share the P/E ratio is 10—indicating pessimism about the company's growth prospects. If earnings move to \$3.50 per share (a 17% growth rate), the stock will move to \$35 for a gain of 17%. But investors are now more optimistic about the company and the P/E multiple expands to 15. In this case, the stock moves to \$52.50 for a gain of 75%!

**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; Int'l Large Value Stocks = DFA Large Cap International Portfolio; Int'l Small Value Stocks = DFA International Small Cap Value 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****Year-to-Date Through 5/31/96**

U.S. Small Value Stocks	14.0%
Emerging Market Stocks	12.6%
U.S. Large Value Stocks	11.9%
Int'l Small Value Stocks	10.4%
Int'l Large Value Stocks	5.4%
1-Yr. Bonds	2.1%
5-Yr. Bonds	1.8%

**TAM Portfolio Returns****Through 5/31/96**

		YTD				Total Return
		1996	1995	1994	1993	1/93-5/96
<b>Risk (% stocks)</b>						
Aggressive	(100%)	9.8%	15.1%	5.3%	21.1%	61.1%
Growth	(85%)	8.6%	15.9%	2.6%	16.6%	50.4%
Moderate	(65%)	6.5%	14.6%	2.1%	14.0%	42.1%
<b>Benchmarks</b>						
MStar 100 Index		8.9%	17.1%	-1.6%	25.0%	57.1%
MStar 85 Index		7.1%	18.5%	-1.7%	21.0%	51.2%
MStar 65 Index		4.5%	18.1%	-2.5%	19.0%	43.4%
Gov't Bond Fund Ave.		-3.3%	17.0%	-4.2%	10.8%	20.1%
Growth & Income Fund Ave.		9.2%	31.5%	-1.1%	10.9%	58.0%
Foreign Stock Fund Ave.		8.7%	6.3%	-2.3%	37.9%	55.6%

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