TAM Asset Management, Inc. REVIEW

Diversified, indexed investment strategies for long-term investors, retirement plans, and trust fiduciaries

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Considering the Downside

By Jeff Troutner

The drop in stock prices we experienced in July prompted a few phone calls to our office. This isn't surprising given the nearly straight up ride we've been on since the end of 1994. In fact, we haven't seen a major stock market decline in almost six years!

Bad memories of the Crash of 1987 and the Mini-Crash of 1990 are still fresh in people's minds and most investors know that good times don't last forever. The normal reaction to periods like the last eighteen months is to pull out of stocks and wait for things to cool off. The risk in that strategy, as I've mentioned many times before, is (1) the market could go much higher before a major decline, and (2) getting back in can be tricky.

TAM accounts are insulated in various degrees from the full brunt of a market decline. Investments in short-term bonds, international stocks, and value stocks are all intended to serve this purpose. This diversified strategy makes market timing unnecessary and counterproductive. On the other hand, an investor with the majority of his or her assets in U.S. growth stocks might consider market timing well worth the risk and cost.

Focusing just on the value component of our portfolio, it might be helpful to look back over the past 30 years to see how value stocks performed in up *and* down markets. Table 1 on the next page shows 17 different cycles of various lengths since 1964 and the performance of large value stocks versus a market index. Overall, large value stocks outperformed in 14 of 17 cycles. These stocks did particularly well in down cycles. The same relationship also holds for small value stocks (not shown).

Will Stocks Do As Well The Next 15 Years?

There has been a lot of talk among investment "experts" recently that we may be near the end of a long-term bull market and, as a result, the next ten or fifteen years will produce much lower stock market returns. These experts cite the significantly higher average returns of stocks over the current cycle and suggest that they will eventually "revert to the mean."

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"Investors in index funds are generally more sophisticated than the average fund investor. So they might be more willing to ride out volatility or see market downturns as a buying opportunity."

Vanguard spokesman John Woerth

This statement from the September issue of *Investment Advisor* magazine was no surprise to me, but two months as a guest contributor to a Prodigy Online investment bulletin board drove home the point.

What I found in the lively "debates" I engaged in with advisors around the country—most of whom use actively-managed funds for client portfolios—is that investors are hearing a limited and distorted view of what works in the financial markets. Most of these paid professionals have spent no time learning the benefits of indexing or the dangers of relying on the past performance data of active managers and mutual funds.

As a result, investors in index funds are better informed, more confident, and less prone to emotional decisions than the majority of stockbrokers, financial planners, and investment advisors "serving" the investing public.

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Editor: Jeffrey C. Troutner

Comments, questions, or suggestions are always welcome. For more information on our investment management services, please call 1-800-826-4015.

TABLE 1: Market Cycles Since 1964

Cycle	Value	Market	Value Advantage	# Months
⇑ Jan. 1964 - Jan. 1966	56.8%	32.2%	24.6%	25
⇓ Feb. 1966 - Sept. 1966	(12.9%)	(15.4%)	2.5%	8
⇑ Oct. 1966 - Nov. 1968	70.2%	55.6%	14.6%	8
⇓ Dec. 1968 - June 1970	(29.2%)	(31.1%)	1.9%	26
⇑ July 1970 - Dec. 1972	63.3%	78.2%	(14.9%)	30
⇓ Jan. 1973 - Dec. 1974	(24.5%)	(40.3%)	15.8%	24
⇑ Jan. 1975 - June 1975	49.8%	42.9%	6.9%	6
⇓ July 1975 - Sept. 1975	(8.2%)	(11.9%)	3.7%	3
⇑ Oct. 1975 - Dec. 1976	60.2%	35.1%	25.1%	15
⇓ Jan. 1977 - Feb. 1978	(4.1%)	(12.5%)	8.4%	14
⇑ Mar. 1978 - Nov. 1980	64.7%	95.9%	(31.2%)	33
⇓ Dec. 1980 - July 1982	4.9%	(17.6%)	22.5%	20
⇑ Aug. 1982 - Aug. 1987	291.0%	263.8%	27.2%	61
⇓ Sept. 1987 - Nov. 1987	(25.4%)	(29.2%)	3.8%	3
⇑ Dec. 1987 - Dec. 1989	67.7%	64.4%	3.3%	25
⇓ Jan. 1990 - Oct. 1990	(20.2%)	(13.4%)	(6.8%)	10
⇑ Nov. 1990 - June 1996	183.7%	166.9%	16.8%	68

A "Down Market" is defined as consecutive monthly periods with a 10% or greater decline in the market. "Market" is the CRSP 1-5 Index (the largest half of U.S. stocks) and "Value" is the Fama/French Large Value Index. ( ) = negative

Considering the Downside (cont.)

But there is another equally strong school of thought that says that the U.S. is in a long-term growth period, fueled by advances in technology and enhanced by our dominate economic position in the world. If this is true, we will be happy to reap the rewards for many years. But let's assume that the first analysis is right. What might we expect from a value-based portfolio under less generous market conditions?

The table on the right shows rolling 10-year periods since July 1963 for value stocks and the market. The ten-year period right before this series (7/62 - 6/72) produced a 10.5% annual return and from mid-1940 until then, double-digit ten-year returns were the norm (these aren't shown to save space).

TABLE 2: Rolling 10-Year Periods

Period Starting	Market	Large Value	Value Advantage
7/63	7.3%	10.4%	3.1%
7/64	3.5%	7.0%	3.5%
7/65	4.5%	9.2%	4.7%
7/66	5.3%	10.8%	5.5%
7/67	4.3%	10.5%	6.2%
7/68	3.1%	9.3%	6.2%
7/69	4.6%	10.2%	5.6%
7/70	9.5%	14.6%	5.1%
7/71	7.7%	13.2%	5.5%
7/72	5.0%	12.6%	7.6%
7/73	10.7%	17.0%	6.3%
7/74	11.9%	18.1%	6.2%
7/75	13.2%	18.7%	5.5%
7/76	15.2%	17.7%	2.5%
7/77	17.2%	19.2%	2.0%
7/78	16.3%	18.7%	2.4%
7/79	16.8%	19.3%	2.5%
7/80	16.2%	18.4%	2.2%
7/81	14.7%	16.7%	2.0%
7/82	17.9%	19.7%	1.6%
7/83	13.9%	17.0%	3.1%
7/84	14.8%	16.1%	1.3%
7/85	14.3%	15.1%	0.8%
7/86	13.6%	14.8%	1.2%

Besides noting the absolute returns of value stocks over these periods, notice the changing spread between value stocks and the market. During the early periods when the market was producing single-digit returns, value stocks outperformed by as much as 7.6% per year. As this current bull market has marched on the spread has narrowed considerably.

This narrowing of the spread between value stocks and the market indexes can be interpreted in a couple of ways. First, one could assume that value investing has become more popular and investor demand for these stocks have driven prices up closer to those of growth stocks. This is not likely as I will explain in a moment. Instead, it could be argued that growth stocks have become more and more desirable as the bull market continues and investors are willing to pay higher prices relative to earnings, dividends, and asset values. In other words, investors (and money managers) have increasingly come to believe that the good times will continue to roll, and they look to fast growing, big name companies for higher returns. Remember, a rising tide lifts all boats—growth and value alike. But at the end of a bull market, when optimism is running particularly high, the growth stock boat takes off like a hydroplane.

Why will the demand for value stocks never reach the point

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Considering the Downside (cont.)

where the advantage disappears? I'll probably devote a whole newsletter to this topic some day, but for now let me quote Robert Haugen from his recent book "The New Finance, The Case *Against* Efficient Markets."

Haugen asks the question: "*Why do money managers as a group consistently underperform?*" He points out that proponents of Modern Portfolio Theory, like Eugene Fama and Kenneth French, believe the reason is that markets are efficient. But if markets are efficient, it should be just as hard to find overvalued stocks (as most managers do) as it is to find undervalued stocks. Haugen and others from the "behavioral" school of economics believe that most managers fail because overvalued stocks (growth stocks) are:

> "...good-looking stocks. Stocks with good records of success. Stocks with good press. Stocks doing well. Stocks their clients will feel comfortable about having in their portfolios. Stocks that the market has overreacted to. Stocks that have risen in price too far. Stocks that will subsequently produce poor returns, *driving the performance of money managers as a group below the market averages.*
>
> Why should they *not* want to invest in under-valued stocks? ...Unless undervalued stocks are the ones with poor trailing records and bad press. Stocks their clients will feel uncomfortable about having in their portfolios. The ones with prices that have been driven down too far. *The ones that will produce above average returns in the future* (emphasis added).
>
> 'Remove them from the portfolio so we won't have to explain to our clients why they're there.'
>
> The reason managers underperform is *not* because they are facing an *efficient* market.
>
> Managers underperform because they have an agency problem with their clients and, as a result, *they may be the* ***victims*** *of market inefficiency!*"

Haugen goes on to say:

> "Fiduciaries are like sheep, and the portfolios managed by the flock all look pretty much the same: some cash, a little real-estate, a smattering of foreign stocks and bonds, a healthy chunk of domestic bonds, and a considerable commitment to domestic stocks. Most make a great effort (heartily endorsed by the professional consulting industry) to ensure that their stock investments are representative of the entire market—some growth stocks, some value stocks and some small stocks."

This approach by institutional investors, combined with similar recommendations from brokers to their retail clients, pretty much ensures that the value advantage will remain forever, which, by the way, is probably also true of indexing in general.

So, I wouldn't be surprised to see the spreads in Table 2 start to increase once again as the bloom of growth stocks starts to fade and the value advantage marches on.

Jeff Troutner is President of TAM Asset Management, Inc.

First Trust/Datalynx Charges Reduced

Beginning last quarter, the annual custodial charge to First Trust/ Datalynx was reduced from $150 annually to $50 per account. The flat $15 mutual fund trading fee remains the same. This fee applies to initial purchases and on funds bought or sold due to contributions or withdrawals from accounts. As we have always done, TAM covers the costs of rebalancing portfolios since we are able to group these into block purchases and sales.

TAM clients derive significant cost saving from the Datalynx relationship when compared to Charles Schwab and other custodians. For example, one large advisor with a style similar to ours just "negotiated" a .25% account charge for their clients with Trust Company of America. On the average TAM account, this would amount to $625 per year and would increase as the account value grows. On TAM's largest account, the fee would be over $12,000 per year!

At Schwab, the *minimum* trading fee I am aware of is $20 and increases as a percentage of the amount bought or sold. In addition, Schwab charges every account for every transaction in the event of an overall account rebalancing. The advisor I referred to above moved from Schwab to lower their clients' custodial costs.

You may be wondering why any advisor would use a mutual fund custodian like Charles Schwab. Good question.

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 months1/31/93 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 6/30/96

Asset Class	Return
Emerging Market Stocks	13.1%
U.S. Small Value Stocks	12.0%
Int'l Small Value Stocks	9.0%
U.S. Large Value Stocks	8.3%
Int'l Large Value Stocks	6.3%
5-Yr. Bonds	2.6%
1-Yr. Bonds	2.5%

TAM Portfolio Returns

Through 6/30/96

Risk (% stocks)		YTD 1996	1995	1994	1993	Total Return 1/93-6/96
Aggressive	(100%)	8.6%	15.1%	5.3%	21.1%	59.4%
Growth	(85%)	7.3%	15.9%	2.6%	16.6%	48.8%
Moderate	(65%)	5.7%	14.6%	2.1%	14.0%	41.0%
Benchmarks						
MStar 100 Index		9.3%	17.1%	-1.6%	25.0%	57.5%
MStar 85 Index		7.4%	18.5%	-1.7%	21.0%	51.8%
MStar 65 Index		5.1%	18.1%	-2.5%	19.0%	44.2%
Gov't Bond Fund Ave.		-2.3%	17.0%	-4.2%	10.8%	21.5%
Growth & Income Fund Ave.		8.9%	31.5%	-1.1%	10.9%	57.6%
Foreign Stock Fund Ave.		9.5%	6.3%	-2.3%	37.9%	56.7%

TAM Asset Management, Inc.
10 H Street, Suite 100
San Rafael, CA 94901

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