

**July/August 95**

Volume 3 Number 7

*The phenomenal rise in the U.S. stock market this year reminded me of a question Charles Ellis asked in his book Investment Policy:*

*If you had a choice, which would you prefer?*

*A. Stocks go up by quite a lot—and stay up for many years, or*

*B. Stocks go down by quite a lot—and stay down for many years.*

*What's your answer?*

*Most people (and money managers, I'm afraid) would choose answer A.*

*So why can't I get excited by the sharp rise in U.S. stock prices this year? The reason is simple. TAM clients, for the most part, are in the accumulation phase of their investment programs. The lower the price they pay for the mutual funds in their portfolios, the more shares they receive for every \$1,000 invested and the greater the dollar amount of the dividends they will receive over time.*

*So, for any investor saving for retirement, the answer should be B. The irony is that most investors only buy when stocks have already gone up. They sell or sit frozen in indecision after major declines.*

This newsletter is published by TAM Asset Management, Inc.  
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.

## You Mean There Aren't Mexican Stocks in the S&P 500?

By Jeff Troutner

To all of you smaller investors who believe a degree in finance, a CPA designation, or a job running \$65 million in foundation assets suggests "investment sophistication", think again. Even the most sophisticated financial people fall for the lure of *past* stock picking success while ignoring obvious warning flags. Here's the kind of sophistication I come across every day:

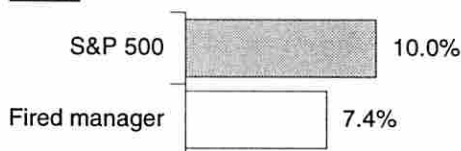
Last year, the vice president of finance for a medical foundation asked his high-priced local consultant to find a new "core" equity manager to replace one that didn't work out (the fired manager only returned 7.4% in 1993 when the S&P 500 was up 10.0%). The consultant uses a sophisticated style-analysis computer program to group stock manager into seven categories and defines core managers as:

Managers which do not exhibit any style bias from the market; rather, core managers emphasize security selection as a means of adding value to the portfolio's return. Consequently, core portfolios have characteristics very similar to those of the market, and thus should have a volatility close to that of the market as well.

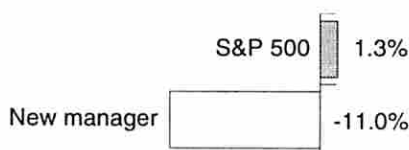
Sounds pretty good. Let's punch a few keys on our computer, select five years of past performance, and voilà—a "superior" manager emerges. It's not surprising with the above description that our v.p. of finance referred

to his new manager as an "index" manager. Anyway, the foundation hires the manager and, to the surprise of everyone, produces a return of -11.0% last year vs. +1.3% for the S&P 500. The v.p.'s response to this disturbing performance of his "core" manager? "Over the previous five years, this manager beat the market. He had a couple of really good years in there. We have no plans to change managers at this time."

### 1993



### 1994



*Continued on next page...*

*You Mean There Aren't Mexican...* (cont.)

That's a curious reaction, especially after their last manager failed to beat the market by "only" 2.6% and produced a positive return. Was the new manager selected based on adherence to a style or for his past performance? Was the manager true to the style? Should the foundation expect this manager to "get back on track" over the next few years?

Well, we're not a high priced consultant with a sophisticated computer database of 6,500 portfolios and 1,052 managers, but we did get hold of one page of the consul-

tant's 80-page quarterly report. Here's what we found: The manager only owns 40 stocks, the average market cap (size) of the stocks is one-half the average of the S&P 500, and of the six worst performing stock positions last year three were *Mexican* stocks (down 45%, 33.4%, and 14.6%).

Okay, all of you "unsophisticated" investors out there, does that sound like a core *market*-like manager or someone betting the farm trying to have another of those really good years?

This is the big secret of active managers. They usually throw in

one or two "high flyers"—small, high-risk growth companies—which, if they pan out, make the manager look like a genius. But this manager went even further and bought several Mexican stocks at their peak prices.

The foundation could recognize "style analysis" for the index-wannabee it's not, fire their high-priced manager consultant, drop active management altogether and just index their portfolio. The downside? Our v.p. of finance could never brag to his fellow colleagues and peers that his "core" manager beat the market by 20%.

## Past Performance *Is* Important In Selecting Index Funds

By Jeff Troutner

The previous article points out the danger in relying on past performance to select active managers or funds. But with index funds, past performance is very important.

Once an asset class is defined, an index fund should capture the full benefits of the asset class within the context of broad diversification. If the index fund does not fully represent the asset class, if diversification is not broad enough, if fees and expenses are too high, or if the fund management is negligent in mirroring the index with its securities purchases and sales, the investors objectives will not be met.

A good advisor will screen all available index funds for the combination that offers the best risk/return benefits for a portfolio. Before we get into the selection process for specific index funds, let's look first

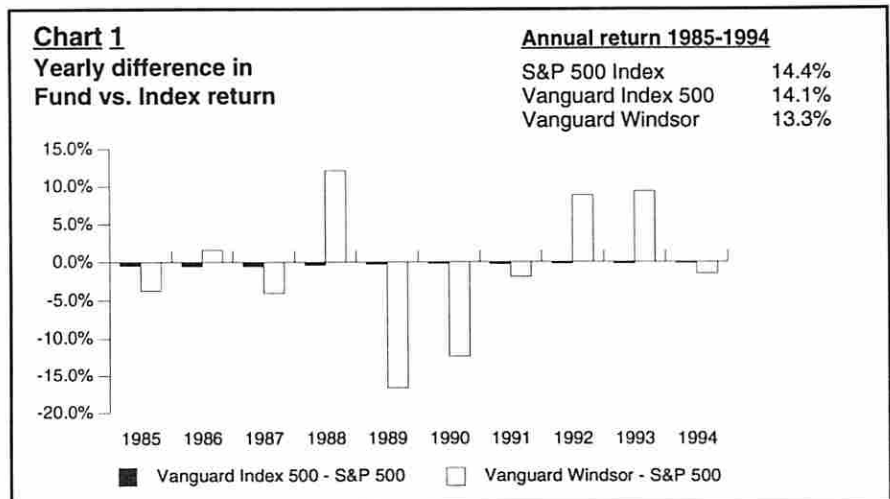
at the predictability of index fund performance versus active funds.

The Vanguard Windsor fund is one of the largest and most popular mutual funds of all times. Morningstar gives it a four-star rating and it's manager, John Neff, is consider one of the top money managers of all time. Chart 1 shows Windsor's yearly returns vs. the Vanguard Index 500 fund (the

U.S. large stock fund we use in client accounts) and the S&P 500 Index for the past 10 years.

As you can see, the Vanguard Index 500 fund has deviated very little from the overall market every year while Windsor has deviated as much as 16.7% in one year. In some years the deviation for Windsor has been on the upside

*Continued on next page...*



*Past Performance... (cont.)*

and in others it's been on the downside. Over the total ten-year period, the S&P 500 has returned 14.38% per year compared to 14.05% for Vanguard Index 500 and 13.28% for Vanguard Windsor.

Even if Windsor had beaten the Vanguard Index 500 fund over the period, is the yearly unpredictability worth the *promise* of higher returns? We don't think so. We would rather have the predictability of the asset class returns and enhance portfolio returns through diversification among other asset classes, notably small stocks and value stocks.

We use an S&P 500 fund to represent our "market" component for a couple of reasons. The S&P 500 is very familiar to most people, the total market capitalization of the stocks in the index represents the majority of the total market, it is fairly easy to construct and manage a 500 stock portfolio (in contrast to a Wilshire 5000 fund), and there are enough funds based on the S&P 500 to force fees to minimal levels.

Beyond U.S. large stocks, index fund selection can get tricky. Look at the differences in performance this year among index funds where we have the choice not just between fund managers, but between underlying indexes (the chart on the right).

We have chosen the DFA funds in each case because of the greater concentration in the stocks defined by an asset class and for the higher returns this strategy produces. For example, in the case of U.S. large

*value* stocks Vanguard has limited its universe to the S&P 500 and purchases about 300 of the highest book-to-market stocks. Since the S&P 500 is already biased in favor of *growth* stocks, this fund does not provide the value concentration we seek. DFA, on the other hand divides the total stock market in half by size and then selects the stocks in each group with the highest book-to-market ratios.

For their 9-10 Small Company fund, DFA again screens *all* publicly-traded stocks in the U.S. and selects the smallest 20%.

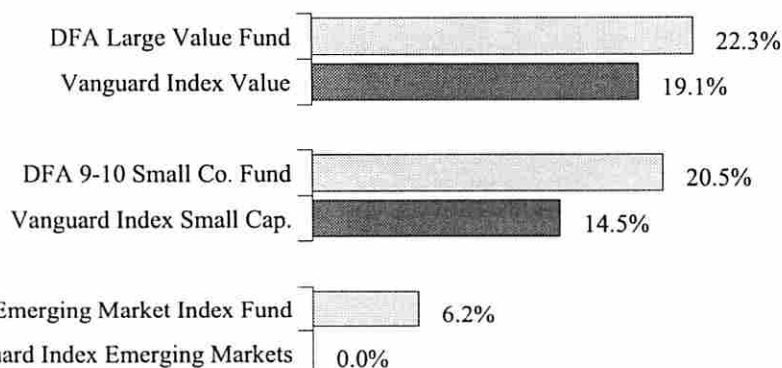
Vanguard's fund, on the other hand, is based on the Russell 2000 index. This index consists of the 2,000 smallest stocks in the Russell 3000 index. The Russell 3000 index comprises the 3,000 *largest* stocks traded in the U.S.. Since there are over 5,000 publicly-traded stocks, the Russell 2000 index ignores over 2,000 of the smallest of these stocks.

With the emerging markets funds, the difference is between equal allocation among countries (DFA) and market-weighted allocations (Vanguard). Here we are dealing more with a risk issue and the ultimate long-term return difference between the funds is impossible to estimate. For example, since Mexico is given a greater weighting in the Vanguard fund, that fund could outperform DFA's over the next ten years if Mexico outperforms the average emerging market. This isn't a bet we're willing to take with such unproven markets.

In any given year, there can and will be a reversal of the performance advantage for the index funds. During strong markets for growth stocks, Vanguard's Value fund should outperform DFA's. Over the long-term, however, the greater concentration on the value and size factors should result in a significant advantage for the DFA funds and TAM clients.

### Define the Asset Class, Create a Better Index, and Hold Down Expenses—DFA's Indexing Advantage

#### Fund Performance Year-To-Date Through June, 1995



*This performance advantage holds from inception for these funds.*

**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:** Balanced Fund & Capital Appreciation Fund Indexes: Lipper Analytical's indexes representing the 30 largest balanced mutual funds and 30 largest capital appreciation mutual funds in the country.

**Asset Class Returns****Year-to-Date Through 7/31/95**

U.S. Small Stocks	28.3%
U.S. Large Value Stocks	27.6%
U.S. Large Stocks	24.1%
U.S. Small Value Stocks	23.3%
Europe Large Stocks	19.9%
U.K. Small Stocks	12.8%
Cont. Europe Small Stocks	10.5%
Emerging Market Stocks	10.4%
Int'l Large Value Stocks	8.7%
5-Yr. Bonds	6.4%
1-Yr. Bonds	5.4%
Pac Rim Small Stocks	1.1%
Pacific Large Stocks	1.1%
Japanese Small Stocks	-9.3%

**TAM Portfolio Returns****Through 7/31/95**

<u>Risk (% stocks)</u>	<u>YTD</u> <u>1995</u>	<u>1994</u>	<u>1993</u>	<u>Since Inception</u> <u>12/92-7/95</u>
Aggressive (95%)	+13.3%	+5.3%	+21.1%	+44.4%
Growth (85%)	+13.1%	+2.6%	+16.6%	+35.1%
Moderate (65%)	+11.6%	+2.1%	+14.0%	+29.9%
<b><u>Benchmarks</u></b>				
Balanced Fund Index	+15.8%	-2.2%	+11.7%	+26.5%
Capital Apprec. Index	+23.9%	-2.5%	+14.8%	+38.8%
S&P 500 Stock Index	+24.3%	+1.3%	+10.1%	+38.6%
Salomon Broad Bond Index	+11.3%	-2.8%	+9.9%	+18.8%
Morgan Stanley EAFE Index	+9.3%	+8.0%	+32.9%	+56.8%

**TAM Asset Management, Inc.**

10 H Street, Suite 100

San Rafael, CA 94901

1-800-826-4015

**July/August 1995 Newsletter:**

*You Mean There Aren't Mexican Stocks  
in the S&P 500?*