Index Fund Strategies

AssetClass®

A monthly update of asset class performance, trends, & topics for long-term investors

Index Returns

	YTD 4/24	Change From 3/25
Bonds		
Short-term	+1.4%	+0.3%
Intermediate	-0.8%	-0.5%
Long-term	-2.7%	-1.1%
Global	+1.6%	+0.5%
U.S. stocks		
Large Market	+3.8%	-3.1%
Large Value	+0.8%	-3.7%
Small Market	-6.0%	-4.2%
Small Value	-2.0%	-3.2%
Real estate	-3.3%	-6.8%
Int'l stocks		
Large Market	-2.5%	+0.6%
Large Value	-3.8%	-.02%
Small Market	-5.3%	-1.8%
Small Value	-4.8%	-1.4%
Emerging Mkts.	+4.8%	-3.9%

Short-term bonds = DFA One-Year Fixed Income fund; Intermediate bonds = DFA Intermediate Government Bond fund; Long-term bonds = Vanguard Bond Index Long-term (except first two months of 1994 = 20-yr. U.S. Treasuries); Global bonds = DFA Global Fixed Income fund; U.S. Large Market = Vanguard Index 500 fund; U.S. Large Value = DFA Large Cap Value fund; U.S. Small Market = DFA 6-10 Small Company fund; U.S. Small Value = DFA Small Cap Value fund; Real Estate = DFA Real Estate Securities fund; Int'l Large Market = DFA International Large Cap fund; Int'l Large Value = DFA International Large Cap Value fund; Int'l Small Market = DFA International Small Company fund; Int'l Small Value = DFA International Small Cap Value fund(except 1994 = DFA International Small Company fund); and Emerging Markets = DFA Emerging Markets fund. *Index returns are included for some of the international funds that have not been in existence for three years.

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy. **Past performance does not guarantee future returns.**

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Markets Update

Friday, April 25, 1997

DJIA	6738.87	-53.38	**S&P 500**	765.37	-5.81
NASDAQ	1209.29	-18.81	**Nikkei 225**	18612.86	-85.21

The DJIA is down 137 points to 6739 since our last newsletter (3/25), having recovered somewhat from a fall below 6400. Volatility remains high as attention has drifted from the comments of the Fed chairman to concerns over earnings.

This period has been marked by spectacular one-day gains and losses in some high profile stocks. On Friday, IBM's stock jumped over 11 points to 153 5/8 on strong first quarter earnings. On the same day, Delta Airlines stock dropped 5 points to 93 1/8 *despite* a surprisingly strong earnings report.

U.S. small stocks continue to feel the brunt of this correction. The average small company fund, according to Lipper Analytical, is down 12.6% for the year. The DFA funds have held up much better, however, with the Small Cap Value fund down only 2.0%.

The Japan stock market is up only slightly from a month ago and volatility there also remains high. The *Wall Street Journal* reports today that "the other shoe has dropped" with the government shut down of Nissan Life. The banking and savings-and-loan sectors have already been badly shaken over the past few years and many analyst view the shift to the insurance industry as the beginning of the end of the financial crises in Japan. If this is the case, stock prices should already reflect much of the bad news.

Interest rates have risen slightly since last month from about 7.0% to 7.13% on the long-term U.S. Treasuries.

Value Stocks

The short-term story for value stocks remains a mixed bag. In the U.S. large category all the attention is still focused on a select group of very large multinational corporations and earnings momentum is the name of the game. As a result, large value stocks are lagging by 3% so far this year. It's a different story with small cap stocks, however, as value stocks are outperforming by 4%. On the international side, both large and small value stocks are slightly behind for the year.

—Jeff Troutner

Monitoring Your Portfolio: Stability Is The Key

The competition among fund managers to produce the highest short-term performance has increased the instability of fund holdings and strategies. As a result, monitoring the asset mix of an active account can be very challenging and is usually done only *after* a drop in performance. With an indexed portfolio, monitoring the asset allocation is much more straightforward—what you see is what you get. Below are several key areas mutual fund investors should review to insure that their overall objectives are being met.

Fund Holdings & Expenses

Active funds can experience high turnover over the course of a year, particularly during volatile markets. Things to look for include changes in the number of holdings, their average size (market cap), industry weightings, and key fundamentals such as price/earnings, price/book, and dividend ratios. If significant changes have occurred, it might be time to change funds. Too often investors discover that their "value" fund has become a "momentum" fund only after a drop in performance. This is not a problem with index funds which must follow strict guidelines for portfolio construction.

A significant change in recent years has been the increase in fund expenses caused by, among other things, the creation of "fund supermarkets" such as Charles Schwab. The birth of 12b-1 and NTF (no transaction fee) funds has given fund companies a new way to hide costs from consumers. As you would expect expenses have risen, not fallen, in such an environment. In contrast, the biggest change we've seen in index funds over the past few years has been a *drop* in expenses.

Relative Fund Performance

Active fund performance can vary widely from their "category" averages. For example, under the Morningstar "Large Blend" category, which includes the Vanguard 500 Index fund, you can find funds deviating from the market by over 20% (2000 basis points) in one year. The fund shown in the table below missed its mark by over 1000 basis points *per year* over the past ten years. Compare this to the 24 basis points average for the Vanguard fund. Investors paid for this volatility in the end since the fund grew by only 8.8% per year versus 15.0% for Vanguard.

Index fund deviation is usually limited to the internal expenses of the fund. Even the most vulnerable funds (in terms of redemption potential) have sophisticated tools to insure proper tracking in all market environments. While these "tracking errors" should be monitored, the risk of abnormal deviations is minimal.

Asset Allocation

Active fund investors are faced with a difficult job of maintaining a stable asset allocation. This is because most active funds have wide latitude when it comes to the cash/bond/stock mix. The most recent example of this is the recent shakeup at Fidelity Magellan. The former manager raised cash and bond levels right in time to witness a surge in stock prices. It is safe to say that most investors took the performance hit before moving out of the fund, rather than identifying the style change early and switching to another fund in that category.

Index funds have very static asset allocations, so this review only needs to be done on the *portfolio* level. Most indexed portfolios are set up with long-term asset allocations that change only as market levels change. And then, most are rebalanced periodically to objectives. Since asset allocation is the most critical feature of the portfolio, even indexed investors should review this periodically.

—Jeff Troutner

Deviation From S&P 500 and Portfolio Characteristics (bold is negative deviation)

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	Average
SunAmerica "Blue Chip" Fund	**12.8**	12.7	**18.9**	**22.1**	**0.5**	0.8	9.3	**6.1**	**6.5**	**12.3**	10.2
Vanguard 500 Index	**0.6**	**0.4**	**0.3**	**0.2**	**0.3**	**0.2**	**0.2**	**0.1**	**0.1**	**0.1**	**0.3**

	Price/Earnings	Price/Book	5-Yr. Earnings Growth %	Median Mkt. Cap
SunAmerica "Blue Chip" Fund	25.5	5.0	22.0	$11.1 billion
Vanguard 500 Index	23.5	5.4	18.2	$28.1 billion