



Index Fund Strategies

ASSET CLASS[®]

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

Index Returns

| | 1998 | 1999 | 2000 | Last 8 yrs. | 5/25 2001 |
|---------------------|-------|------|-------|-------------|-----------|
| Bonds | | | | | |
| Short-term | 5.7 | 4.6 | 6.7 | 5.5 | 2.3 |
| S-T Global | 8.4 | 3.7 | 6.7 | 7.5 | 2.4 |
| Intermediate | 10.5 | -3.6 | 13.5 | 6.9 | 1.5 |
| Long-term | 12.0 | -7.9 | 16.6 | 8.5 | 0.7 |
| U.S. stocks | | | | | |
| Large Market | 28.7 | 20.8 | -9.1 | 17.0 | -2.9 |
| Large Value | 12.0 | 4.8 | 10.2 | 15.5 | 11.0 |
| Small Micro | -7.3 | 29.8 | -3.6 | 13.8 | 19.6 |
| Small Market | -5.4 | 25.4 | 2.5 | 12.6 | 11.8 |
| Small Value | -7.3 | 13.1 | 9.0 | 14.8 | 20.1 |
| Real estate | -15.4 | -2.0 | 28.4 | 9.2 | 4.6 |
| Int'l stocks | | | | | |
| Large Market | 18.2 | 28.5 | -14.0 | 10.3 | -8.8 |
| Large Value | 14.9 | 16.3 | -0.2 | 12.1 | -3.6 |
| Small Market | 8.2 | 21.9 | -5.4 | 4.9 | 3.8 |
| Small Value | 5.3 | 19.0 | -3.1 | 4.7 | 7.5 |
| Emerg. Mkts. | -9.4 | 71.7 | -29.2 | 6.6 | -4.0 |

Descriptions of Indexes

| | |
|--------------------|---------------------------------|
| Short-term bonds | DFA One-Year Fixed Income fund |
| Intermediate bonds | DFA Intermed. Gov't Bond fund |
| Long-term bonds | Vanguard Bond Index Long-term |
| S-T Global bonds | DFA Five-Year Global Fixed |
| U.S. Large Market | Vanguard Index 500 fund |
| U.S. Large Value | DFA Large Cap Value fund |
| U.S. Small Micro | DFA US 9-10 fund |
| U.S. Small Market | DFA US 6-10 fund |
| U.S. Small Value | DFA US 6-10 Value fund |
| Real Estate | DFA Real Estate Securities fund |
| Int'l Large Market | DFA Int'l Large Cap fund |
| Int'l Large Value | DFA Int'l Large Cap Value fund |
| Int'l Small Market | DFA Int'l Small Company fund |
| Int'l Small Value | DFA Int'l Small Cap Value fund |
| Emerging Markets | DFA Emerging Markets fund |

"Last 8 yrs." returns for U.S. Large Value (3/93), U.S. Small Value (3/93), Int'l Large Value (3/93), Int'l Small Market (10/96), Int'l Small Value (1/95), and Emerging Markets (5/94) include simulated data prior to fund inception (in parentheses).

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, May 25, 2001

As the Wall Street pundits debate whether a "bear" market has ended, value stocks and small company stock continue to make up for lost ground, as noted in the table on the left. Even the left-for-dead foreign small company stocks have found new life. Let's hope it continues.

If nothing else, "asset class investing" reminds us constantly of the value of diversification. I'll be the first to admit that it would be nice to ride the large growth stocks up for a period of time, sell them and buy small value and ride that train for awhile. But it can't be done. Consider all of the highly successful and brilliant investment gurus who folded their tents the past few years. If they can't exploit such dramatic up and down markets, who can?

Thinking in terms of "bull" and "bear" markets is a waste of time. In fact, the only thing positive I can say about Merrill Lynch is that their "We're Bullish on America" motto captures the essence of asset class investing pretty well. Too bad such a wise, long-term oriented philosophy is so consistently tarnished by their brokers and "analysts."

Markets Don't Have to Be Right to Be Efficient

Gene F. Fama Jr., Vice President, Dimensional Fund Advisors

The recent internet-stock experience and the vogue for "behavioral finance" have people really questioning the Efficient Markets Hypothesis (EMH). This is nothing new. The EMH has been contested since its debut thirty years ago. Usually, critics say it's a fanciful idea that looks good on paper but in the end is irrelevant because it doesn't explain some quirky (and usually recent) behavior of prices.



The very fact that the hypothesis still comes under assault is stronger testimony to its deep relevance. People don't argue about irrelevant ideas and the EMH still dominates the research agenda. It has stood through endless testing and debate with almost no modification because simply repeating its core ideas dispatches most objections. These core ideas are useful to consider while investing, and are all too often misunderstood.

In a nutshell, the EMH purports that markets are full of people trying to maximize profit by predicting the future values of securities based on freely available information. Many intelligent participants compete to trade at a profit. The price they strike in trading a stock is the consensus of their opinions about the stock's value. This is based on all their information about the stock, everything they know that has happened in the past and everything they predict will happen in the future. The end result is that the price of the stock is usually a good estimate of its intrinsic value.

Critics often challenge the notion that investors on the whole are informed enough to price stocks correctly by consensus. Most investors can't possibly know that much about any given stock. But market efficiency doesn't require that most investors

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have information. It only requires that “many intelligent participants” have information. In fact, no single investor has that much information. Even the smartest, most savvy guy has only a tiny fraction of all the information out there. Information isn’t a big secret squirreled away somewhere; it is widely distributed in little pieces. The market functions as a mechanism that gathers the information, evaluates it, and builds it into prices.

This is what it means to say prices are a consensus view of a stock’s value. At some level every investor includes (or doesn’t include) a security in his or her portfolio until the stock’s value to the investor is about equal to its market price. Since the price is the same for everyone, so is the value. Now granted, if everybody investing is wrong, prices might conceivably be poor estimates of value. For this to happen on any scale, the ignorant investors would have to be overly optimistic or overly pessimistic as a group. Otherwise, the optimists will cancel out the pessimists and the price struck will be rational. Since stocks are more likely to trade when the person selling is pessimistic and the person buying is optimistic, prices on average are more likely to represent rational consensus.

Admittedly, sometimes it can be hard to view prices as rational. We see stocks with no assets other than a website and with little or no profit suddenly become bigger than General Motors only to melt down a year later. How can such prices be good estimates of value? They seem so illogical, possibly the consensus view of ignorant day traders and kids with e-accounts chasing fads.

Let’s suppose for the sake of argument that investors behave like lemmings and that the market systematically misprices stocks. Such a market would surely be child’s play for a smart investor with real analytical skills. The reason such successes are hard to identify is that there’s more than just one or two smart investors out there. There are thousands of savvy analysts looking for over- or under-valued securities. The opportunities to generate excess profit are diminished when these investors trade away disparities between a stock’s price and its intrinsic value.

The EMH does not claim markets are always perfectly rational or that the information reflected in prices is always correct. The consensus view

of investors can temporarily result in prices well above or well below a stock’s intrinsic value. The only condition efficient markets require is that a disproportionate number of market participants does not consistently profit over other participants.

After taking risk into account, do more managers than you’d see by chance outperform with persistence? Virtually every economist who studied this question answers with a resounding “no.” Mike Jensen in the Sixties and Mark Carhart in the Nineties both conduct exhaustive studies of professional investors. They each conclude that in general a manager’s fee, and not his skill, plays the biggest role in performance. Since mutual funds report performance after deducting fees, the bigger the fee, the worse the performance. Aside from that, expert investors with nearly unlimited resources working around the clock can’t seem to outpredict the market.

This means investors are better off avoiding active managers—especially pricey active managers. History shows that in the long run a thoughtfully designed, diversified strategy of “passive” funds typically beats all but a few active managers. It’s not easy to structure and maintain such a strategy. It requires some initial research and discipline to stay the course. But it’s much easier than predicting which active managers will randomly beat this approach.

Tidbits

Why the Nasdaq has fallen from its high of 5,000? This picture is worth a thousand words.

Real (inflation-corrected) S&P Composite Stock Price Index and Real S&P Composite Earnings.

Source: *Irrational Exuberance*, by Robert J. Shiller, Princeton University Press, 2000



Source for both charts: *Forbes* ASAP 5/28/01

Considering stock advice from a broker? Better think again.

