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.	8/21 2001
Bonds					
Short-term	5.7	4.6	6.7	5.5	**3.6**
S-T Global	8.4	3.7	6.7	7.5	**3.8**
Intermediate	10.5	-3.6	13.5	6.9	**6.3**
Long-term	12.0	-7.9	16.6	8.5	**7.2**
U.S. stocks					
Large Market	28.7	20.8	-9.1	17.0	**- 11.8**
Large Value	12.0	4.8	10.2	15.5	**5.3**
Small Micro	-7.3	29.8	-3.6	13.8	**16.5**
Small Market	-5.4	25.4	2.5	12.6	**7.8**
Small Value	-7.3	13.1	9.0	14.8	**20.6**
Real estate	-15.4	-2.0	28.4	9.2	**14.9**
Int'l stocks					
Large Market	18.2	28.5	-14.0	10.3	**- 15.9**
Large Value	14.9	16.3	-0.2	12.1	**- 6.4**
Small Market	8.2	21.9	-5.4	4.9	**0.4**
Small Value	5.3	19.0	-3.1	4.7	**6.4**
Emerg. Mkts.	-9.4	71.7	-29.2	6.6	**- 10.2**

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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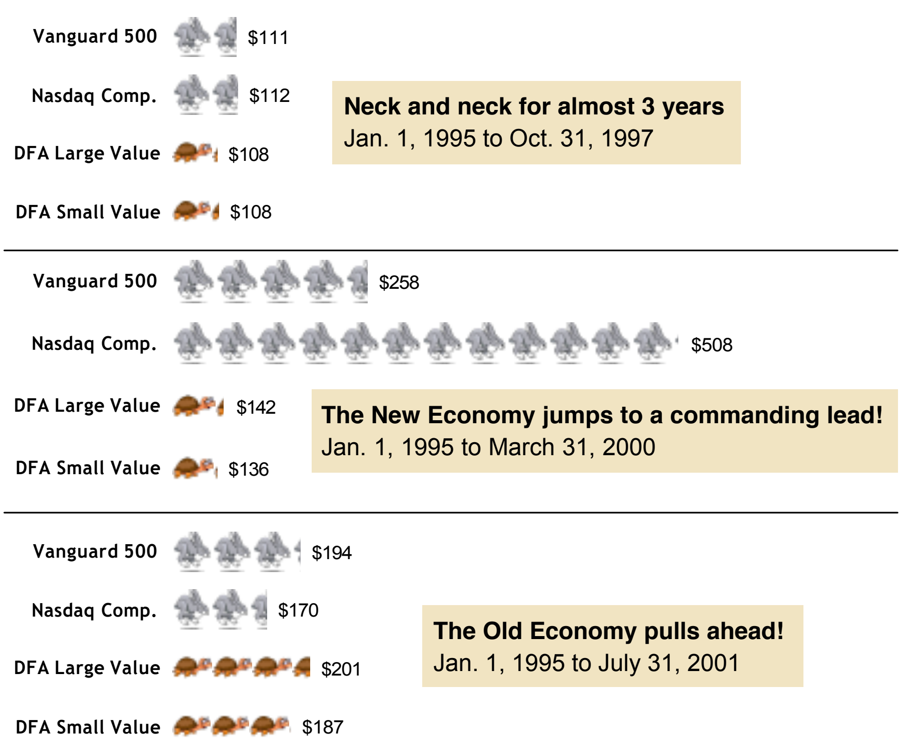
Markets Update — Wednesday, August 22, 2001

The Tortoise & The Hare

A recent article in *The Wall Street Journal* pointed out that the cumulative profits since the fall of 1995 for the Nasdaq-listed companies have been completely erased in the last year.* Not surprisingly, the returns for the "Old Economy" stocks have now caught up and even exceeded those of the "New Economy"since 1995.



* Nasdaq Companies" Losses Erase Five Years of Earnings, *WSJ*, August 16, 2001
Numbers represent growth of $100. Charts use varying scales.

These numbers prompted me to revisit an article from *The Wall Street Journal* of June 11, 1996 in which Jonathan Clements, in his *Getting Going* column, quoted me on value stock indexing. I said:

> *"What I've done is move from a conventional index strategy to a value index strategy. The numbers are really compelling long term, and I think the strategy is really compelling right now, given where the market is. In big down markets, value has always done better."*

In a recent email to Mr. Clements, I reminded him that a 50/50 blend of DFA Large and Small Value has outperformed his favorite "Total Market" index by over 2% annually since then. So far, so good.

Should Asset Allocations Change With Changing Market Levels?

Jeff Troutner, TAM Asset Management

A prominent investment advisor I know has recently taken the position that U.S. large company growth stocks are so highly priced today (even after the fall) that investors should seriously consider eliminating them from their portfolios. Many investors would take this as a market timing decision—and I think they're right. After all, if there is a *time* to get out of an asset class there must be a *time* to get in. And what triggers these moves? Subjective judgment? An objective "black box" analysis? Tea leaves?

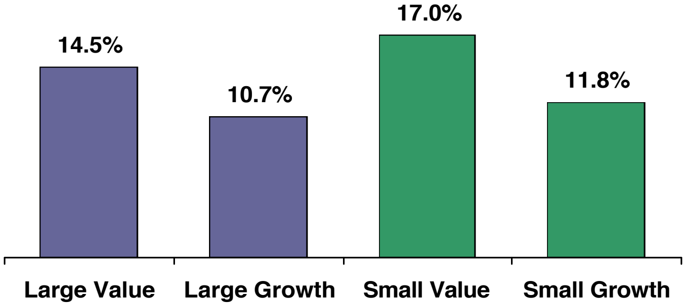
The advisor's response to criticisms of his decision is that his strategy is really only aimed at "sophisticated" investors. The implication, of course, is that only an *unsophisticated* investor could ignore the basic math of prices, earnings, and interest rates today and hang on to large growth stocks at these levels.

So what are the excuses of all those sophisticated mutual fund mangers and hedge fund operators who were fired or folded shop as growth stocks rose to those lofty price multiples? Many of them had recognized that growth stocks were priced at historically extreme prices several years ago. But their *timing* was off! They weren't invested heavily enough in growth stocks to begin with, they didn't move enough to growth stocks in mid-stream, and they almost certainly didn't short them after they began to fall. Simpletons, I guess.

Don't get me wrong. I've never been a big fan of growth stocks. Historically, their returns have been lower than value stocks without a significant difference in return volatility (see the chart below). But I'm much less a fan of market timing. There are few rules in investing that I believe are iron clad. One of them is that market timing **does not work**.

Fama/French Indexes

July 1963 - July 2001



In lieu of a crystal ball, investors are much better off adopting an asset allocation that fits their long-term risk and return objectives and sticking with it. And since the long-term relationships between the asset classes is pretty well-defined thanks to the Fama/French research, I believe it is a mistake to have different allocations for investors with similar objectives just because their starting times are different. Worse yet is to adjust allocations anytime you believe "expected returns" for an asset class have changed due to recent market movements.

To build an "all-weather" portfolio, investors should keep these 5 basic investment "truths" in mind:

1. **There is a direct relationship between risk & return.**
2. **Stock portfolio returns are explained almost completely by their weighting toward style (value vs. growth) and size (small vs. large). Actively managed stock portfolio returns are further influenced by the stock-picking and market timing decisions of managers and this influence is, overall, negative.**
3. **Value beats growth and small beats large *over time*—due to higher risks associated with value and small company stocks.**
4. **Making asset allocation changes based on changing market levels (market timing) is a foolish endeavor.**
5. **As 1995-1999 clearly shows, asset classes run in unpredictable cycles that will call into question Rules 1-4. Therefore, discipline is key.**

Remember, *everyone* who ever tells you that an asset class is "overpriced" or "has an expected return out-of-line with its risk" or any other market timing line has a very rational and seemingly prudent reason for his view. But he almost always is focusing on *price* levels or price multiples. But timing is everything with these calls. Just ask that very sophisticated investor Alan Greenspan. His "irrational exuberance" remarks in 1996 were just a tad early.

Other things can change as well. Interest rates, corporate earnings, consumer sentiment, market crashes, wars, and other unforeseen events can change the "valuation" analysis very quickly. Once you get out, you either stay out forever or pick a time to get back in. I'll pass on that game.